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DC Policy, Investment and Governance Team
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By Email

Dear Sirs

Simmons & Simmons' response to the DWP consultation paper: 'Enabling Productive Finance'

Simmons & Simmons welcomes the opportunity to respond to the DWP's important consultation paper, 'Enabling Investment in Productive Finance' (the "Consultation") which sets out proposed changes to the charge cap for Defined Contribution ("DC") pension schemes.

We support the Government's efforts to remove structural barriers that prevent DC pension scheme trustees from investing in such assets where they feel it is in their members' interests, and therefore consistent with the trustees' fiduciary duties, to do so.

We have long argued for the development of a suitable investment regime for the UK to widen access to long-term and productive capital vehicles, such as the recently introduced Long-Term Asset Fund (LTAF). We see DC pension schemes as having a significant role in the success of such a regime and therefore consider it important that appropriate changes are made to the charge cap to allow DC pension scheme trustees to invest in a broader range of assets in order to deliver better results to their members.

Since the 1980s, we have been active as legal adviser to numerous fund managers and have established a reputation at the forefront in this area globally. We also have a strong UK pensions trustee practice – and advise many trustees on the legal aspects of pension fund investment (including compliance with the charge cap). In addition to many UK pension funds (to whom the Consultation is of particular interest), in terms of Assets under Management, we act for 40 of the top 50 largest European hedge funds, 16 of the top 20 largest US hedge funds and 15 of the top 20 Global Institutional Managers. Accordingly, we take an active interest in seeking to ensure that the UK's regulatory and legal regime creates the correct conditions for a thriving domestic industry.

We have been actively represented on both the Steering Committee and Technical Expert Group of the Bank of England / HMT / FCA Productive Finance Working Group and, in the past year, have submitted detailed responses to HMT's consultation on the tax treatment of asset holding

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companies, its Call for Input on the future of the UK's fund industry and the FCA's consultation CP21/12 on LTAFs.

In addition, we maintain a longstanding involvement through trade associations, such as the Investment Association, the BVCA and AIMA. We have contributed and lend our support to the response of AIMA and the Alternative Credit Council to this Consultation, and consequently our answers broadly reinforce the arguments made in that response.

We summarise below the keys points which we request the DWP take into consideration when determining its final rules. Our answers to the questions in the Consultation are set out in the Annex.

KEY POINTS

We support the proposal to remove performance-based fees from the charge cap and believe this will enable DC scheme trustees to deliver better retirement outcomes for their members, and in this regard we note that:

1. long-term, less liquid assets can offer higher, less volatile long-term returns for investors and we support the Government's efforts to remove structural barriers that prevent DC pension scheme trustees from investing in such assets where they feel it is in their members' interests, and therefore consistent with their fiduciary duties, to do so.

2. it is important to look at the issue of performance fees in terms of end result for the investor:

    - while alternative investment fee structures are often higher than those for more traditional assets, they often offer better real returns (net of fees) than equities and other more "traditional" investments

    - unlike a single flat management fee which is paid regardless of the fund's returns, having a performance-based fee element means that success fees are only payable when a real return is delivered, which helps to align the interests of investors and asset managers.

3. we support the DWP's objectives of increasing the flexibility for DC schemes to invest whilst maintaining suitable member protection.

In particular, our responses explain why we believe that:

1. the exemption for performance fees should apply broadly and not be limited to specific assets or investment strategies

2. DWP guidance should be principles-based and build on existing practices

3. transparency and disclosure requirements should be meaningful and proportionate

4. any legislative changes to implement the exemption should be introduced as a standalone provision to avoid the risk of inadvertent consequences on existing structures.

We consider that the trustees of DC schemes are well placed to consider the appropriateness (or otherwise) of a particular performance fee structure for the particular demographics and asset base of their membership. The fiduciary duties that DC scheme trustees owe their members to invest (on independent advice) in a manner designed to produce real (net of fees) returns for their members are a strong source of member protection. We consider that those fiduciary duties are better suited to offer a solid basis for member protection in the context of a particular scheme than more rigid regulation.

As mentioned above, we support the direction of travel set out in the Consultation and see a reformed charge cap regime as an important step in widening access to less liquid assets –

important not only for the investors in DC pension schemes and other investment funds but also for the wider UK economy.

We would be happy to discuss any aspect of our response with you should you consider that would be helpful.

Yours faithfully

Simmons & Simmons LLP

ANNEX

Question	Simmons & Simmons response
1a. Would adding performance-based fees to the list of charges which are outside the scope of the charge cap increase your capacity and appetite, as a DC scheme, to invest in assets like private equity and venture capital? Are you already investing in assets like private equity and venture capital, and if so would this change increase how much you invest? If you do not currently invest in such assets would this change make it more likely for you to, and do you have an idea of to what % of AUM that might be?	Our DC pension trustee clients are more likely to invest in productive assets if performance fees are taken out of the charge cap.
1b. Would adding performance-based fees from the list of charges which are outside of the scope of the charge cap incentivise private equity and venture capital managers to change their fee structures?	The charge cap effectively acts as a barrier that prevents DC schemes from investing in assets such as private equity and venture capital. Exempting performance-based fees from the charge cap will remove this barrier and should be an incentive for asset managers to revisit the UK DC market. We expect that this will consequently lead to dialogue between DC schemes and alternative asset managers regarding fee structures that work for and align the interests of both DC schemes and asset managers.
1c. If you do not believe that the proposal outlined in this consultation is the right solution to the barrier posed by the regulatory charge cap, what might be a more effective solution?	We support the Government's proposal (subject to our response to question 5b regarding implementation). We are not aware of a more effective solution to meet the Government's aim of both enabling an investor to invest in a broader range of assets while maintaining the investor protection that the charge cap provides.
2. How can we ensure members of occupational DC pension schemes invested in default funds are sufficiently protected from high charges, whilst adding the performance related element of performance fees to the list of charges outside the scope of the charge cap? **2a. Do you have any suggestions for how we can ensure that the regulations ensure members are only required to pay fees when genuine realised outperformance is achieved?**	We support the proposal for DWP guidance that will support DC scheme trustees to assess if fee structures offer value for money. We agree that trustees should always be cost conscious and consider the best interests of the members, but recommend that the focus of such guidance be on the overall benefit that a member receives – i.e. actual net returns, rather than just cost. Provided they are reasonable and proportionate to the returns that investors receive, higher charges levied under some investment management strategies should not be a cause for concern per se. The ultimate protection ensuring that DC schemes do not pay performance fees where there is no real outperformance is that the trustees have a fiduciary

	duty to make informed decisions on fund investments, and must obtain advice on investment options from investment professionals before making an investment decision. We do not consider that the regulations themselves need address this further. We consider that those fiduciary duties are better suited to offer a solid basis for member protection in the context of a particular scheme than more rigid regulation. An assessment of outperformance depends on a combination of factors, many mentioned in the Consultation. We consider that any DWP guidance as to what constitutes 'well designed performance fee structures' should address these factors in a principles-based manner and that it should be left to the market, in dialogue with DC scheme trustees, to design specific performance fee structures. Being overly prescriptive would be unhelpful to the encouragement of innovation in the area and may well lead to unintended consequences. We note that regulatory and supervisory material relating to fee structures in the asset management sector already exists[1], and that DWP guidance could build on this to support trustees in evaluating fee structures across different assets and investment strategies. Finally, we note the concern expressed in the Consultation that introducing an exemption for performance fees from the charge cap may lead to a greater number of funds in other asset classes introducing performance fees when they would not otherwise have done so. If other asset classes were to lower their fixed charges (payable irrespective of investment performance) in exchange for the introduction of a performance fee element that is only paid where higher real (net of fees) growth is delivered, then that would be to members' benefit.
3. Which of these conditions should the Government apply to the types of performance-based fees that are excluded from the list of charges subject to the charge cap? Are there other conditions we should consider? If supported by guidance on acceptable structures would this give confidence to more schemes?	Introducing conditions for performance fee structures to be exempted from the charge cap is unlikely to work well given the broad range of assets and investment strategies that exist in the market. We would encourage that a principles-based approach (through guidance, rather than regulation) be taken. When assessing the appropriateness of an investment fee structure, an investor will typically consider several factors - for example, the type of fund used, the expected return strategy, and the applicability of hurdle rates. As a result, a wide variety of fee structures and levels already exists across the alternative investment management sector. Attempting to specify what fee structures should look

[1] See, for example, FCA rules at COLL 6.7 Payments - FCA Handbook, ESMA guidance at https://www.esma.europa.eu/document/guidelines-performance-fees-in-ucits-and-certain-types-aifs and IOSCO Good Practice Final Report at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD543.pdf

	like in regulations or guidance will likely impair the ability to achieve fair and balanced fee structures. Adopting a principles-based approach, on the other hand, will help investors consider the most appropriate factors when assessing whether fees are reasonable and proportionate to the expected returns, without requiring them to adhere to pre-determined structures. This approach has the additional advantage of future proofing the guidance to accommodate the expected innovation on fee structures following the introduction of the exemption for performance fees from the charge cap. We would suggest that these principles are set out in revised DWP guidance, rather than included in the regulations. This would support trustee decision making without adding further complexity to the regulations. The DWP could consider, however, adding a requirement for the trustees to have regard to the update DWP guidance in this space. As noted in the response to question 2, the ultimate protection ensuring that DC schemes do not pay performance fees where there is no real outperformance is that the trustees have a fiduciary duty to make informed decisions on fund investments, and must obtain advice on investment options from investment professionals before making an investment decision. We do not consider that the regulations themselves need address this further. We consider that those fiduciary duties are better suited to offer a solid basis for member protection in the context of a particular scheme than more rigid regulation.
4. Do you agree with our proposal to require disclosure of performance fees if they are outside the scope of the charge cap? If so, we propose this is done in a similar way to transaction costs – do you agree? Could you provide details of any new financial costs that could arise from a requirement to disclose performance fees? Please outline any one-off and ongoing costs.	We support the Government's position that performance-based fees exempted from the charge cap should be disclosed to members in the Chair's Statement. However, the disclosure obligations which give effect to this requirement should be proportionate and reflect the broader value of the investment (and the 'net of fees' return it delivers) rather than simply focusing on cost. This approach would align with broader efforts to provide meaningful and material disclosure to DC pension fund beneficiaries.
5a. If we add performance fees to the list of charges which are not subject to the charge cap, do you agree that we should remove the performance fee smoothing mechanism and the pro-rating easement from the Charges and Governance Regulations 2015?	We support the removal of the smoothing mechanism and pro-rating easement to the extent it does not disadvantage existing investment structures and fee arrangements as noted below.

5b. Is there a need for transitional protection arrangements to be brought in for schemes that have decided to make use of the performance fee smoothing mechanism, and if so what do these transitional arrangements look like?	There is a risk that creating a "safe harbour" for performance fees will (inadvertently) prohibit other structures which are already compliant with the current charge cap. This could actually run counter to the Government's policy intent of encouraging investment in productive finance. Whilst this risk will apply to any existing funds in which DC pension schemes are invested and which use the performance fee smoothing mechanism, we note that there would be a risk to any long-term asset funds that may be launched prior to any changes to the charge cap being made. Given this risk, if the Government proceeds to exempt performance fees from the charge cap, as we hope it will, we suggest that either transitional measures or grandfathering provisions are introduced to ensure that existing investment structures and fee arrangements are not unduly impacted. It is likely that asset managers and their investors would need to review the final legislation and guidance before being able to fully assess whether this is the case. We would encourage DWP to be amenable to further dialogue with industry on this matter prior to finalising changes to the regulations.