

10th November, 2022

DC Policy Team
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Submitted by e-mail to pensions.investment@dwp.gov.uk

For the attention of: DWP's DC Pensions Team,

CFA UK response to the DWP regarding the open consultation on 'Broadening the investment opportunities of defined contribution pension schemes'

The CFA Society of the UK (CFA UK)¹ is pleased to continue to its dialogue² with the DWP on this topic and follow up on our letter to the consultation on 'Facilitating investment in Illiquid assets'. Our detailed responses to this consultation questions are enclosed in Appendix II.

In line with our Society's purpose, our responses to the consultation questions aim to highlight relevant issues to help the investment community to serve its stakeholders well and to build a more sustainable future.

Should you have any questions or points of clarification regarding this letter or our responses to the questions, do not hesitate to contact us.

Yours sincerely,



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With thanks to contributions from:

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and the oversight of the [CFA UK Professionalism Steering Committee](#)

¹ CFA UK's mission is to help build a better investor profession for the ultimate benefit of society. We refer you to Appendix 1 for a brief overview of both CFA UK and our umbrella organisation, CFA Institute.

² For CFA UK's response to the DWP's previous consultation on illiquid assets, please see:
<https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/cfa-uk-response-to-the-dwp-regarding-the-open-consultation-on-facilitating-investment-in-illiquid-as.pdf>

APPENDIX I: About CFA UK and CFA Institute

CFA UK is a professional body representing close to 12,000 members across the UK's investment community and a proud member of CFA Institute's worldwide network of member societies. Many of our members work with pension funds, either managing investment portfolios, advising on investments, or as in-house employees responsible for pension investment oversight.

- The purpose of CFA UK is to educate, connect and inspire the investment community to build a sustainable future: we aim to meet the investment community's needs for skills and knowledge; bring the investment community together; help people build rewarding careers within an inclusive and diverse investment community and help the investment community serve its stakeholders well.
- Founded in 1955, CFA UK is one of the largest member societies of CFA Institute and provides continuing education, advocacy, information and career support on behalf of its members.
- Most CFA UK members have earned the Chartered Financial Analyst® (CFA®) designation or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.
- For more information, visit www.cfauk.org or follow us on Twitter @cfauk and on LinkedIn.com/company/cfa-uk/.

CFA Institute is the global association for investment professionals that sets the standard for professional excellence and credentials.

- The organisation is a champion of ethical behavior in investment markets and a respected source of knowledge in the global financial community. Our aim is to create an environment where investors' interests come first, markets function at their best, and economies grow.
- It awards the Chartered Financial Analyst® (CFA) and Certificate in Investment Performance Measurement® (CIPM) designations worldwide, publishes research, conducts professional development programs, and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry.
- CFA Institute has members in 162 markets, of which more than 170,000 hold the Chartered Financial Analyst® (CFA) designation. CFA Institute has nine offices worldwide and there are 158 local member societies.
- For more information, visit www.cfainstitute.org or follow us on Twitter at @CFAINstitute and on Facebook.com/CFAINstitute.

APPENDIX II: Responses to questions

Question 1: Do you have any comments on the draft regulations in relation to the disclose and explain provisions? Please include in your answer any comments on whether you consider they meet the stated policy intent.

We understand and support the proposal for schemes to explain their approach to illiquid assets. The proposal provides:

- a rationale for why a scheme does, or does not, allocate to these assets,
- stakeholders the opportunity to consider the degree to which one scheme or another might have a more diversified or sophisticated investment approach, and
- an evidenced explanation of why a scheme's investment management cost basis might be higher compared to a scheme making lower cost investments.

We believe this could materially improve the ability of stakeholders to evaluate a scheme's Value for Money. However, it will remain to be seen if this reform itself drives a material change in decision making amongst either advisors/consultants and employers in selecting a DC provider, or members when they consider switching and consolidating their DC pots.

Question 2: Are there other elements not covered in these regulations that you would expect to see?

Schemes who do invest in illiquid assets should explain how they perceive and manage illiquidity risk, in its various forms, in their scheme. We suspect many scheme advisors will be as keen to understand the operational risk mitigants as much as the diversification associated with the scheme's approach to investing in illiquid assets.

This would be a helpful disclosure but is perhaps not best suited to a 'Chairs' statement'; we believe the SIP, or an appendix to the SIP, would likely be the natural home for such a technical narrative.

Question 3a: Do you have any comments on the proposed regulatory asset allocation disclosure requirements included in the draft statutory guidance?

Question 3b: Are there any areas where further clarity might be required?

We note that the definition of bonds in paragraph (b) is not exhaustive – for example, (i) non-UK sovereign bonds are not captured and (ii) securitised bonds would not typically be regarded as corporate bonds. Moreover, we note the definition of bonds under paragraph (b) and the definition of private debt under paragraph (g) do not appear to be consistent: for example, a US Treasury Bond would not fit the definition of a bond under paragraph (b) and hence would be a private debt instrument by the definition of paragraph (g). We assume this is not the intent of the drafting.

We would suggest instead more careful and nuanced definitions of bonds and loans (private debt/credit), making first the distinction that a bond tends to be standardised, divisible and widely distributed and often listed on some form of exchange – typically with non-zero secondary market liquidity, meanwhile private debt deals tend to be privately negotiated, distributed amongst only a few investors (who are generally party to the deal negotiation), are not listed and have little or no secondary market liquidity.

We would also note that the definition of a ‘recognised exchange’ is such that the disclosures would likely capture a much wider set of company shares as ‘private equity’ than would typically be understood to fall within the category.

We would also suggest making it clear that the definition of real estate and infrastructure excludes listed shares; it is not uncommon to see asset allocation breakdowns which include a slice labelled ‘property’ which refers to a holding of listed REITs, for example. To the extent it is deemed preferable to present an asset allocation which appears to be more diversified or to have more illiquid/private market investments, providers may wish to highlight their allocation to REITs, listed infrastructure stocks or, indeed, listed private equity trusts and VCTs as falling within the rubric of alternative/illiquid/private market asset classes. This could be achieved simply by adding to paragraphs (e) and (f) the words “and does not fall within the description in paragraph (c)”. Alternatively, the guidance could provide for disclosure of ‘listed alternatives’ or a limited set of sub-categories under listed alternatives.

Social Housing is an increasingly popular asset class for pension funds seeking to increase their exposure to social factors in their investments. Such investments can be via equity but more often come in the form of either public bonds or loans. We would suggest that the guidance makes clear how such equity, bond and loan exposure should be allocated. Because of the nature of the underlying assets, we would regard ‘E- Infrastructure’ (rather than ‘F- Property’ or ‘D- Private Equity’) as the right home for equity investments and ‘G- private credit’ and ‘B- bonds’ as the right homes for (un)secured housing association loans and bonds, respectively.

More generally, we urge the drafting to avoid making naïve assumptions that pension schemes only invest in certain types of investments in certain geographies; schemes have broad investment powers and many or most aim to be globally diversified. Therefore, a definition of ‘bonds’ or ‘listed equities’ which implicitly assumes a geography a jurisdiction will be specious.

We would expect the ‘Other’ category to be used extremely sparingly if at all; we are keen that it would not be used by schemes who are unable or unwilling to provide transparency to their stakeholders around their asset allocations. We suggest that the DWP monitors the level of AuM disclosed in this category to ensure the list of explicitly defined asset classes remains fit for purpose and to encourage schemes that do have a high allocation to the ‘Other’ category to provide appropriate additional information.

We believe that stakeholders may also find it helpful for schemes to disclose their net foreign exchange exposures pertaining to each asset class – or more simply perhaps, their target hedging ratio for each asset class; we think the DWP should explore the feasibility of this.

Finally, it should be unambiguous in the legislation whether the intention is for schemes to report their long-term strategic, current target or live allocation at the relevant date.

Question 4: Do you agree with the information presented in the impact assessment?

We have no strong opinions on this.

Question 5: Do you have any comments on the impact of our ‘disclose and explain’ proposals on protected groups and how any negative effects may be mitigated?

We do not see any reason for the proposals to have any distinct impact on protected groups.

Question 6: Do you have any comments on the draft regulations in relation to the performance fee measures? Please include in your answer any comments on whether you consider they meet the stated policy intent.

CFA UK does not have a view one way or another as to whether performance fees offer value for money or whether DC schemes should pay performance fees; rather we recognise that they can introduce ‘fairness issues’ as a result of investors entering or exiting an open fund at different times but yet are a commercial norm for most segments of the private markets. Given that even the largest institutional investors pay performance fees, most DC schemes of much smaller scale will have little option but to consider them if they are to access these asset classes. Further, we believe that if more DC schemes access these asset classes, there will be a net benefit in terms of member outcomes. With all that said we welcome, for the most part, the new draft regulations both in their form and purpose. However, we encourage the DWP to carefully consider how it sets out the requirement for schemes to disclose their payment of performance fees³.

We believe that transparency around costs and charges to be critical, not only to engender confidence amongst members, demonstrate value for money to employers and advisors but also to ensure the spirit of the regulatory reforms, and the sanctity of the charge cap, is respected and maintained. We share other stakeholders’ wariness that there is a hypothetical risk that these reforms could lead to abuse in the form of performance fees being levied on vanilla asset classes and/or for meagre performance. Nonetheless, schemes and asset managers must be allowed to protect their commercial interests – including maintaining commercial confidentiality around specific fee level arrangements.

The requirement for schemes to disclose the total amount of performance fees paid in a period in the Chair’s Statement, while unlikely to betray a scheme’s commercial arrangements, does not in our view provide stakeholders a meaningful understanding of the Value for Money achieved in the payment of the performance fees – on its own it is a rather abstract number. We believe that the crucial extra context to understanding if, and to what degree, performance fee arrangements have been appropriately negotiated and deployed are:

- (i) the hurdle rate on each mandate where a performance fee is paid, and
- (ii) the description of what assets that performance fee relates to.

³ For CFA UK’s previous response to the DWP on the question of performance fees and their treatment under the current charge cap for DC Pensions, please see this response (April 2021): <https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/charge-cap-ii-cfa-uk-final.pdf>

In disclosing the hurdle rates on each mandate, and briefly describing that mandate, readers of the Chair's Statement can discern whether, say, the scheme is paying for mediocre performance, or paying performance fees on a strategy where other many other investors have negotiated a simple flat fee arrangement (i.e. where it is not the norm and not necessary). Put another way: if a scheme paid £250k in performance fees on a £5bn asset base, it's entirely ambiguous as to whether there was value-add in their allocation to performance fee incurring mandates; meanwhile if a scheme is paying performance fees to a credit manager over a hurdle rate of SONIA, then it's clear they are not delivering value for money. As such, we strongly suggest the DWP consider making this disclosure a regulatory requirement rather than an element of the guidance, which may be ignored.

We agree with the guidance around the apportionment of fees and J-curve risks to different members; there is no perfectly equitable solution to this problem, and it is appropriate that the regulations and guidance are not overly prescriptive given schemes will face very different circumstances in regards to this problem depending on their fund structure (lifestyle versus target date), member enrolment and transfer activity and membership age profile. We would also remark that while it may feel uncomfortable to apportion fees to members who did not entirely benefit from the performance, the nature of DC is, rightly or wrongly, one where chance and circumstance are major determinants of the benefits which accrue to one cohort versus another - the recent performance of pre-retirement funds being a case in point.

As a final remark on this complex topic, we note that 'carried interests' often form part of the performance remuneration for a private equity fund manager and should be also disclosed outside of the cap; they are not so much a fee but rather a participating interest in the underlying investee companies.

Question 7: Are there other elements not covered in these regulations that you would expect to see?

We believe the amendments to these regulations and guidance provide an opportunity to tidy up and clarify certain aspects of existing regulations and guidance as well as future proofing these amendments.

We agree with the drafting of what would constitute a permissible performance fee arrangement. However, we think it would be worth clearing up any ambiguity on whether and when preferred interest arrangements could be considered viable formulations of a performance fee arrangement.

We also note that the proposed regulations are silent on the topic of 'look through' for performance fees, which was raised in previous consultations regarding the charge cap. If 'look through' is not to apply, as we believe is now proposed, then it would be helpful to state this as fact. Whilst performance fees are not to be included in the charge cap, they still do need to be disclosed. In this context it would be proper to ensure that performance fees relating to say private equity fund-of-funds structures are included in such disclosures. Therefore, we believe that some form of 'look through' provision in terms of the performance fee disclosures will be necessary.

Furthermore, we would urge the DWP to consider using this review and amendment of the charge cap regulations and guidance to provide greater clarity and reduce ambiguity over the definition and classification of other types of costs and charges associated with investing in illiquid assets:

- the treatment of deal costs and broken deal costs should, in our view be properly captured as transaction costs, although the existing guidance is couched in the language of trading public market securities.
- there is some current ambiguity over the treatment of, for example, foreign exchange hedging costs: in a real asset portfolio, FX hedging could be used to a) lock in the price of a foreign denominated asset in the domestic currency before the deal is funded, b) hedge the cashflows on a specific asset or c) hedge the overall portfolio. We would infer that certainly a), and possibly b) fall within the scope of a cost incurred as part of making an investment i.e. a transaction cost not to be captured within the charge cap, while c) potentially may fall outside of that scope and so justifiably be caught within the charge cap. To all intents and purposes, however, these mechanisms each serve ultimately the same function and create the same economic exposures for investors, albeit by varying magnitudes.

Question 8a: Do you have any comments on the performance fee sections of the draft statutory guidance?

We agree with the performance fee sections of the guidance but, as stated above in our answer to question 6, we believe that the disclosure of both i) which assets accrued performance fees and ii) the applicable hurdle rates deserves a more prominent and/or more definitive statutory standing.

Question 8b: Are there any other areas where further clarity might be required?

We have no further comments.

Question 9: Do you have any comments on the impact of our proposals, in relation to the exemption of performance-based fees on protected groups and how any negative effects may be mitigated?

We do not see any reason for the proposals to have any distinct impact on protected groups.