CLIFFORD CHANCE

GOVERNMENT CONSULTS ON PROPOSALS FOR STRONGER PENSIONS REGULATOR WHICH COULD HAVE SIGNIFICANT IMPACT ON BUSINESS ACTIVITY

The Government has published a consultation on proposals to create a "stronger" Pensions Regulator that can intervene earlier and more quickly when defined benefit (DB) pension schemes are at risk.

The consultation proposes major reforms, which, if implemented, could have a significant impact on business activity (for example corporate, finance and restructuring transactions) where DB schemes are involved. These include introducing new requirements to notify the Regulator early of certain proposed transactions; imposing fines of up to £1 million and new criminal penalties to punish serious wrongdoing; and expanding the scope of the Regulator's existing so-called anti-avoidance or 'moral hazard' powers.

The consultation ("*Protecting Defined Benefit Pension Schemes – A Stronger Pensions Regulator*")[i] follows a number of recent high-profile corporate collapses which have made DB schemes and their regulation high on the political agenda. It is the first step in taking forward some of the proposals outlined in the pensions White Paper[ii] published in March. (For more details on the White Paper, please see the March edition of our UK: Pensions Update briefing).

In this briefing, we take a detailed look at the proposals outlined in the consultation and the potential implications in practice.

KEY ISSUES AT A GLANCE

- Material extension of the range of events which must be notified to the Regulator e.g. the sale of a material proportion of the business or assets of a significant scheme employer; granting of security; certain board appointments/changes; the deferral, amendment or waiver of a banking covenant and the taking of pre-appointment insolvency advice (although some or all of these events will be notifiable only where a certain risk threshold is exceeded e.g. where the pension scheme is underfunded).
- Bringing forward timing for notification so certain events must be notified to the Regulator when Heads of Terms are agreed (though scheme trustees are expected to be involved earlier) and extending the notification obligations to apply to parties other than just the scheme employers or trustees (e.g. the parent company of a scheme's sponsoring employer).
- New requirement to issue a 'declaration of intent' to the scheme trustees and Regulator in advance of certain transactions (the sale of a controlling interest in a scheme employer; sale of the business/assets of a scheme employer; or granting of security in priority to scheme debt (again depending on a certain risk threshold being exceeded)). To be issued before sale and purchase contract is signed, though the consultation is unclear as to precise timing on this or expected level of engagement with the Regulator regarding declarations of intent.

- Notification requirements are being proposed as an alternative to making Regulator clearance mandatory on the basis mandatory clearance could inhibit business activity, but reforms could have a similar effect in practice. While the proposals would not give the Regulator a "veto" in relation to the relevant transaction, they would mean that the trustees and Regulator would need to be informed of certain corporate and finance/restructuring transactions at an extremely early stage (before the nature of the deal, its viability and its possible impact on the pension scheme are necessarily known) and the content requirements of the proposed declaration of intent are seemingly very similar to the main substance of a clearance application.
- New civil penalty of up to £1 million to punish serious breaches of pension scheme responsibilities (including failure to comply with the notifiable events/declaration of intent requirements above) and new criminal sanctions for the most serious cases of wrongdoing.
- Strengthening the Regulator's existing Contribution Notice (CN) and Financial Support Direction (FSD) powers and increasing scope so FSDs can be issued to individuals and CNs can be issued to anyone connected/associated with recipient of an FSD (which significantly expands the potential range of targets). Potential increase of two-year lookback period for FSDs as well as a number of other proposed changes to both CN and FSD regimes.

TIMING

- Introducing new civil and criminal sanctions, most of the changes proposed to the scope of the Regulator's CN and FSD powers and the new declaration of intent requirements would require primary legislation and are therefore unlikely to be implemented before the 2019-2020 parliamentary session (i.e. by Spring 2020).
- However, some changes to the notifiable events regime and some changes in relation to the CN/FSD regime could, in principle, be implemented earlier where primary legislation is not necessary e.g. extension of the range of notifiable events and for the lookback period for FSDs.
- Consultation closes 21 August. Much of the detail is still to be decided and it is expected the consultation will generate a lot of responses from the pensions industry and beyond.
- Reforms unlikely to be rushed through.

THE PROPOSALS

The proposals outlined in the consultation focus on three key areas: (i) improving the Regulator and scheme trustees' oversight of corporate transactions; (ii) new sanctions to deter wrongdoing; and (iii) extending the Regulator's existing 'moral hazard' powers i.e. its powers to issue CNs and FSDs.

(1) CORPORATE TRANSACTION OVERSIGHT

The consultation proposes several changes designed to increase the Regulator's and trustees' oversight of corporate transactions and business activity where a DB scheme is involved:

- *Revising the notifiable events regime*

  Under current legislation, certain events must be notified to the Regulator (by the scheme employer or the trustees, depending on whether the event is employer-related or scheme-related) as soon as reasonably practicable following an event occurring or sometimes of a decision being made to take a particular action. The regime is designed to give the Regulator early warning that a scheme is at risk.

  Existing events which are notifiable by employers include where the employer decides to take action which will/is intended to result in an employer debt due to the scheme not being paid; the employer deciding to or actually ceasing to carry on business in the UK; or a director/partner of the employer being convicted of an offence involving dishonesty. Employers are also required to notify of certain other events where the pension scheme is underfunded: namely, the breach of a banking covenant (except where the bank agrees not to enforce it); or a company deciding to or actually relinquishing control of a subsidiary that is an employer in the scheme.

The consultation proposes:

1. to add a number of new employer-related notifiable events to the regime:

New notifiable events
• The sale of a material proportion of the business/assets of a scheme employer which has responsibility for funding at least 20% of the scheme's liabilities (proposed on the basis that such transactions can indicate a change in covenant support for the pension scheme).
• The granting of security on a debt to give it priority over the scheme (some security would be carved-out e.g. security granted for specific chattels financing e.g. hire purchase financing for company vehicles).
• A significant restructuring of the employer's board of directors and certain senior management appointments. To include: (i) the appointment of a chief restructuring officer/transformation officer or equivalent to the board or to a senior management role; (ii) appointments made by external parties e.g. if a lender/key financial stakeholder appoints someone to a board or into an oversight/monitoring role to protect its own interests; (iii) changes to at least two out of three of the chairman, chief executive officer and chief financial officer (or equivalents) within a six-month period.
• A sponsoring employer taking independent pre-appointment insolvency/restructuring advice (such as an independent business review).
• Extension of the current breach of banking covenant event to include covenant deferral, amendment or waiver.

   Some or all of these events would only be notifiable where a certain risk threshold is exceeded e.g. where the pension scheme is underfunded on a particular basis (currently, the PPF basis). Some current notifiable events operate in this way (whilst others are always notifiable).

   (The payment of dividends was also mentioned in the consultation paper, but it seems there is no intention at this stage to add this as a notifiable event– instead the issue of dividend payments is to be explored by the Department for BEIS as part of its insolvency and corporate governance consultation.)

2. to bring forward the timing for notification so that company and business/asset sales as well as the granting of security in priority to scheme debt would be notifiable when a Heads of Terms agreement is first put in place (albeit the DWP notes in the consultation paper that it expects trustees to be involved earlier in negotiations); and
3. to extend the notification requirement so that it applies more widely to e.g. directors of a sponsoring employer's parent company who are planning a transaction.

- *Requiring a declaration of intent*

  A new requirement to issue a "declaration of intent". This regime is intended to work alongside the notifiable events regime, with DB scheme employers having to issue a declaration prior to a: (i) sale of a controlling interest in a scheme employer; (ii) sale of the business/assets of a scheme employer; or (iii) granting of security in priority to scheme debt.

  The declaration would be addressed to the scheme trustees and shared with the Regulator. It would explain the nature of the planned transaction, confirm that the trustees have been consulted on the terms of the transaction (and whether or not the trustees agree to the planned transaction) and explain any detriment to the scheme and how this is to be mitigated. Like the equivalent notifiable events, the requirement to issue a declaration of intent is expected to depend on risk criteria (e.g. scheme funding).

  The declaration is to be required at a later point than a notifiable event notification, where there is greater certainty as to the transaction – this will be after completion of transaction due diligence and finalisation of transaction financing, but before the contract is signed. However, it is unclear how much in advance of signing the contract a declaration would have to be issued (e.g. whether it is intended to be sufficiently in advance to give the Regulator the opportunity to review and comment on the transaction and contract).

It is also unclear from the consultation what engagement there is expected to be with the Regulator in the period between informing the Regulator of the notifiable event and issuing the declaration of intent. (The consultation refers to the Regulator taking action (under its new or existing powers) where it has concerns in relation to a declaration of intent.) The reforms could therefore have significant implications for transaction certainty and timing.

- *Reviewing voluntary clearance guidance*

  The Regulator will review its clearance guidance to clarify/expand its expectations as to what employers and trustees should do when considering whether to apply and explain the circumstances in which FSD clearance might be given.

- *Engaging with other regulators*

  The Regulator is currently reviewing its working protocols and information sharing with existing regulators. This is an ongoing process and a programme of engagement is planned over the summer.

Significance in practice

- The reforms to the notifiable events regime are described as an alternative to making Regulator clearance mandatory – something no longer being pursued due to concerns it would unduly interfere with legitimate business activity.
- However, the reforms (coupled with the new requirement for a declaration of intent), if implemented, could still have a significant impact on business activity – with the trustees and Regulator needing to be informed of certain corporate transactions and security arrangements at an extremely early stage before the nature of the deal and its possible impact on the pension scheme are necessarily known. (While the consultation paper notes that the Regulator maintains strict confidentiality as regards market sensitive information it receives, this represents a significant departure from the current position as regards who would typically be privy to the very early stages of a transaction). Together with the new requirement for a declaration of intent, it is difficult to see how the reforms would be significantly less burdensome than a mandatory clearance regime.
- The required content of the proposed declaration of intent is also very similar to the substance of what needs to be covered in the core sections of a clearance application under the existing voluntary clearance regime. Therefore, while clearance is not to become mandatory, a mandatory declaration of intent regime is not too far off this: the requirement to notify (and possibly engage with) the Regulator as well as the trustees has all the hallmarks of a mandatory clearance regime, but without providing the same comfort as formal clearance.
- The new notification requirements which would apply on certain board/senior management changes and on the granting of security are likely to be burdensome in practice in the context of corporate reshufflings, investor/shareholder board appointments and financing restructuring transactions, particularly if there are no more general carve-outs (other than the specific chattels financing carve-out referenced in the consultation) or materiality thresholds are not introduced.
- Whilst a breach of banking covenant is already a notifiable event (except where the bank agrees not to enforce it), extending the regime to include a covenant deferral, amendment, or waiver could defeat the whole purpose of those processes, which generally take place as a confidential matter between the borrower and its lenders to avert financial difficulties arising in the first place. While it may be desirable from the Regulator's perspective to receive early notification of such matters (even though at such stage the potential impact on the pension scheme may not be known), in a restructuring there are always a number of different stakeholder perspectives to take into account. Giving the Regulator a potential influence at such an early stage in a restructuring would be a significant shift in policy and could be perceived as creating a special category of unsecured creditor, by prioritising the pension scheme beneficiaries over other unsecured creditors. Such involvement may, at best, slow down genuine transactions, and at worst, could derail or make restructurings even less certain and more challenging than they already are. The funding position of the pension scheme may become crucial here as the current banking covenant breach is only notifiable where the pension scheme is underfunded on a PPF basis and this may be extended to these new events.
- Under the current proposals, failure to comply with the notifiable events framework and declaration of intent requirements could result in fines of up to £1 million (see further below).

(2) NEW SANCTIONS

The consultation is considering how best to punish 'reckless' behaviour towards pension schemes. The Regulator already has powers under existing legislation to issue civil fines (up to £5,000 for individuals and £50,000 for corporates) for non-compliance with a wide range of duties (including failure to comply with the existing notifiable events regime) and the ability to commence criminal proceedings in certain circumstances (including for obstructing the Regulator's investigations and for providing the Regulator with false or misleading information).

However, these powers are limited in scope and the consultation is proposing some new sanctions, so there would be the following range of potential penalties (depending on the seriousness of the breach):

- **Existing civil penalties (as described above) for low-level non-compliance**.
- **A new civil penalty for more serious offences.** This would enable the Regulator to issue a fine of up to **£1 million** in certain circumstances. The consultation paper suggests this could be used where there is wilful/reckless behaviour; failure to comply with a CN; failure to comply with the notifiable events framework; the deliberate provision of false information to the Regulator/trustees; non-compliance with elements of the new DB funding Code (which is to be consulted on); or non-compliance with the declaration of intent requirements. However, the exact thresholds such behaviour would need to meet to be caught is unclear – the consultation refers to this penalty being used to deter behaviours which are more serious in nature and which have resulted in actual harm to the pension scheme or have the potential to do so if left unchallenged. Given the consequences, more clarity on this would be welcomed.
- **New criminal sanctions.** These would be used to punish wilful or grossly reckless behaviour in relation to a DB pension scheme, non-compliance with a CN, or failure to comply with the notifiable events regime. These sanctions would be applied by the courts and could include a further tier of unlimited fines and/or custodial sentences. The consultation paper refers to these being used in the "most serious cases of wrongdoing".

Connected/associated explained

In certain circumstances, the Regulator can impose responsibility for DB pension liabilities beyond the scheme employers to their "associates" and "connected persons". These terms are broadly defined and include (among others) group companies, individuals such as directors, and anyone entitled to exercise, or control the exercise of, one third or more of the voting rights in group companies.

The consultation proposes that potential targets of the new sanctions should include sponsoring employers and those connected/associated with such employers, which would include **individual directors**. In some circumstances, trustees would also fall within scope (e.g. for failure to comply with the notifiable events regime, non-compliance with elements of the new DB funding Code and failure to provide a Chair's statement), which could result in more reluctance in taking up trustee positions.

(3) EXTENDING THE REGULATOR'S EXISTING MORAL HAZARD POWERS

The Regulator already has powers to issue CNs and FSDs in certain circumstances.

- FSDs can be used to extend pension liabilities to targets (generally only to corporates – not individuals) who are connected/associated with an employer of the DB scheme if certain conditions in relation to the scheme employers are met and where it is "reasonable" to do so. An FSD requires the recipient to put in place financial support for the scheme, though it does not impose a specific enforceable obligation and instead the recipient has to propose this, with separate enforcement action being taken if the proposal is not appropriate. This means the FSD regime is inherently more flexible than the CN regime (see below), but it can take a long time before support is obtained.
- Alternatively (or if a person fails to comply with an FSD), the Regulator can issue a CN requiring a specific sum to be paid to the scheme, but only in respect of certain "events" (and again, where it is reasonable to do so). The scope of who could face a CN is wider – a CN, unlike an FSD, can be used to attach personal liability to directors.

Both powers have been exercised only rarely to date. However, this may be set to change. The consultation proposes to strengthen both powers.

CN Proposals	
Current feature	**Proposal**
• The Regulator may only issue a CN if it considers that it is reasonable to impose liability on the recipient to pay the amount specified in the CN. • In considering whether it is reasonable, the Regulator must have regard to the extent to which, in all the circumstances of the case, it was reasonable for the person to act / fail to act in the way they did. • The Regulator must also have regard to any other matters it considers relevant, including a (non-exhaustive) list of factors specified in legislation (which includes e.g. the degree of the person's involvement in the act/failure to act, their relationship with the employer, their connection/involvement with the scheme, the value of any benefits received from the employer, etc).	• Amend the 'reasonableness' test so there is a stronger focus on the loss or risk caused to a scheme by the act when assessing the amount to be demanded under a CN (as opposed to consideration of issues such as the relationship of the recipient with the employer or the benefits received by the recipient from the employer). An analysis that a potential recipient has not received material benefits from the employer often provides significant comfort at present that the potential recipient will not be targeted by the Regulator, but is less likely to do so in future. Scope for the employer's justification for the act is also to be considered as a determining factor.
• The sum specified in the CN is currently calculated by reference to the employer debt due to the scheme at the time of the act/failure to act.	• Provide a specific mechanism to reflect the delay in payment in the CN sum. E.g. if an act had caused quantifiable harm to a scheme on a particular date, this would be the starting amount which would then be adjusted in line with a specific mechanism to the date the CN is issued. • Change the date on which the cap on the level of a CN is calculated (so that this is calculated at a date closer to the final determination, rather than calculating the cap at the date of the act).
• For a CN, either the 'material detriment' test or the 'main purpose' test must be met. (If either of these tests is met, there are then a number of other tests, including the reasonableness test mentioned above, which must also be satisfied before a CN can actually be issued.) • Broadly, the main purpose test is concerned with an act/failure to act where the main purpose (or one of the main purposes) was to prevent the recovery of all/part of an employer debt; to prevent the debt becoming due; or to compromise, settle or reduce that debt. • The material detriment test is concerned with an act or failure which has a materially detrimental effect on the likelihood of accrued scheme benefits being received.	• Create an additional limb to the 'material detriment' test, assessed by reference to the weakening of the employer, rather than the prospect of scheme benefits being paid many years into the future.
• Currently, only those connected/associated with an **employer** in the scheme fall within scope of a CN.	• Give the Regulator power to impose a CN on any person connected/associated with the recipient of an FSD. This would significantly expand the potential range of targets for a CN.

FSD Proposals	
Current feature	**Proposal**
• Currently, an FSD requires the recipient to put in place financial support for the scheme, though it does not impose a specific enforceable obligation and instead the recipient has to propose a form of financial support for consideration by the Regulator.	• Create a single-stage process, under which the issuance of an FSD would create a specific and enforceable obligation on the target to either require a cash payment or impose a form of statutory guarantee in relation to the sponsoring employers' liabilities to the scheme.
• Currently, an FSD may be issued where, at the relevant time, the scheme employer is either a service company or insufficiently resourced. The insufficiently resourced test is determined by reference to the value of its resources compared to the amount of its debt due to the scheme, as estimated by the Regulator.	• Review the 'insufficiently resourced' requirements and potentially amend/replace them to make the criteria for imposing an FSD clearer.
• Currently, it is generally only corporates who are connected/associated with an employer of the scheme who are potential targets of an FSD (not individuals).	• Allow FSDs to be issued to anyone associated/connected with a scheme employer so that this mirrors the scope of CNs (i.e. includes individuals).
• The Regulator may only impose an FSD if it considers that it is reasonable to impose the requirements of the FSD on the recipient. • In considering whether it is reasonable, the Regulator must have regard to any matters it considers relevant, including a (non-exhaustive) list of factors specified in legislation (which includes e.g. the target's relationship with the employer, their connection/involvement with the scheme, the value of any benefits received, etc).	• Amend the 'reasonableness' test to make clear that the actions of a target in creating/increasing risk are a relevant (but not necessary) factor so that this mirrors the scope of CNs.
• Currently, the Regulator may only issue an FSD if it is satisfied that the employer was either a service company or insufficiently resourced and the target was within scope at the "relevant time". This imposes a maximum two-year lookback period during which the Regulator must issue a warning notice in relation to the FSD.	• Consider whether the two-year 'lookback' period should be increased and what protections would need to be put in place for businesses brought within scope by a longer lookback period.
• Currently, an FSD can only require a person to put in place (and maintain) financial support for a scheme before the scheme enters the Pension Protection Fund (PPF).	• Give the Regulator power to issue a FSD after a scheme has entered the PPF and enable the PPF to enforce it.

CONCLUDING COMMENTS

At this stage, the proposals are just that and the Government is asking for views before any reforms are implemented. The specifics of exactly how some of the new proposals would work will also need to be fleshed out. However, the increased scope of the regimes and enhanced enforcement powers could prove very onerous for groups with a DB scheme and present a real interference to certain transactions (in some cases, disproportionately so). It may be that there will be increased focus on ensuring a scheme is fully funded on whatever basis (currently the PPF basis) obviates the need to issue a declaration of intent or notify certain events. The very material extensions to the scope of the Regulator's CN and FSD powers will also raise concerns for groups.

It is expected that the consultation will generate a lot of responses across the pensions industry and beyond, so timing wise, it seems unlikely that the new reforms will be rushed through.

Introducing new civil and criminal sanctions and most of the changes proposed to widen the scope of the Regulator's CN and FSD powers would require primary legislation and, given the comments made in the White Paper, are therefore unlikely to be implemented before the 2019-2020 parliamentary session (i.e. by Spring 2020).

Introducing the new declaration of intent requirement would also require primary legislation. However, some changes to the notifiable events regime and some changes in relation to the CN/FSD regime could, in principle, be implemented earlier where primary legislation is not necessary e.g. extension of the range of notifiable events and for the lookback period for FSDs. (Extending the notification obligation to other parties would require primary legislation, as may bringing forward the timing for notification.)

The consultation paper also notes that there will be progress on some of the other key areas for reform identified in March's White Paper. In particular, the Government will be consulting on the design of a new statutory framework and authorisation regime for DB consolidation vehicles later this year and the Regulator intends to consult on a revised DB funding Code of Practice next year. These consultations will be keenly awaited by interested parties.

CLIFFORD CHANCE

CONTACTS

Hywel Robinson
Partner

T +44 20 7006 8387
E Hywel.robinson@cliffordchance.com

Clare Hoxey
Partner

T +44 20 7006 8899
E clare.hoxey@cliffordchance.com

Sarah McAleer
Partner

T +44 20 7006 8808
E sarah.mcaleer@cliffordchance.com

Adrian Cohen
Partner

T +44 20 7006 1627
E Adrian.cohen@cliffordchance.com

Iain White
Partner

T +44 20 7006 2825
E iain.white@cliffordchance.com

Charles Cochrane
Partner

T +44 20 7006 2196
E charles.cochrane@cliffordchance.com

Philip Hertz
Partner

T +44 20 7006 1666
E Philip.hertz@cliffordchance.com

[i] https://www.gov.uk/government/consultations/protecting-defined-benefit-pension-schemes-a-stronger-pensions-regulator
[ii] "*Protecting Defined Benefit Pension Schemes*": https://www.gov.uk/government/publications/protecting-defined-benefit-pension-schemes