CLIFFORD CHANCE

UK: PENSIONS UPDATE – JUNE 2019

1. COURT OF APPEAL DISMISSES APPEALS AGAINST THE FINDINGS OF THE UPPER TRIBUNAL IN ITV/BOX CLEVER CASE

Last week the Court of Appeal handed down its judgment in the ITV/Box Clever case[1], finding that the Upper Tribunal was entitled to conclude that the Regulator did have jurisdiction and that it was reasonable for the Regulator to issue Financial Support Directions (FSDs) to five ITV companies.

Many of the facts of the case are unusual and will have limited wider application (in particular the context that many of the relevant events took place before the Pensions Act 2004 was in force). However, the judgment illustrates how broad the Regulator's powers are and how widely they can be used.

Further details of the original decision of the Upper Tribunal were set out in the June 2018 edition of our UK: Pensions Update.

2. NEW REGULATIONS ON TRUSTEE STEWARDSHIP ISSUED

The EU's revised Shareholder Rights Directive ("**SRD II**") aims to promote the effective stewardship and long-term investment decision-making of institutional investors (including trustees of occupational pension schemes). The Directive was passed in June 2017 and gave member states two years to transpose it into domestic law.

As we reported in the September 2018 edition of the UK: Pensions Update, several changes have been made to existing legislation governing trustees' investment duties and disclosure obligations designed to better reflect environmental, social and governance (ESG) and stewardship considerations and which are due to come into force on 1 October 2019.

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Stewardship is the activity of investors engaging with the managers of the underlying investments in order to promote the investments' long-term success

On 6 June, new regulations[2] were introduced implementing the outstanding requirements of SRD II and imposing additional requirements on trustees relating to disclosure of engagement policy and engagement policy implementation, arrangements with asset managers and disclosure of investment strategy. Broadly, the new regulations require trustees to:

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[1] Granada UK Rental & Retail Ltd and others v The Pensions Regulator and another [2019] EWCA Civ 1032.

[2] The Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2019, SI 2019/982.

- by 1 October 2020, revise their SIP to reflect their policy in relation to the following (or explain why they haven't done so):
  - how managers are incentivised to align their investment strategies with trustee investment policies and how such policies result in asset managers making decisions based about medium to long-term financial performance;
  - how the evaluation of the asset manager's performance and remuneration correlate with the trustees' investment policy, as well as how they monitor 'portfolio turnover costs' i.e. the costs incurred of buying, selling, lending or borrowing investments including how they define and monitor targeted portfolio turnover (defined as the frequency within which the assets are expected to be bought or sold) or turnover range (defined as the minimum and maximum frequency within which the assets are expected to be bought or sold);
  - how they monitor the investee company on capital structure, manage actual and potential conflicts of interest in relation to their engagement and how they monitor and engage with another stakeholder about relevant matters.
- report annually on their stewardship activities (including, for example, information on the voting behaviour by, or on behalf of, trustees) – this information must be made publicly available free of charge on a website by 1 October 2021.

From 1 October 2020, the SIP must be made publicly available free of charge on a website.

Whilst the new regulations have somewhat taken practitioners by surprise given the lack of consultation, given they closely mirror the wording of the pertinent articles of SRD II it seems there was little scope for interpretation by the government when transposing the requirements into domestic law. It remains to be seen whether imposing additional formulaic requirements as to the content of the SIP will in practice result in increased trustee engagement with investments.

3. DWP ISSUES GMP CONVERSION/ EQUALISATION GUIDANCE

On 18 April 2019 the DWP issued its long-anticipated guidance (available here) on GMP conversion that had been delayed pending the outcome of the Lloyds Bank case[3]. The guidance sets out a ten-stage process that reflects the conversion conditions in section 24B of the Pension Schemes Act 1993 and the procedural requirements contained in section 24E of that Act. In addition, it contains a detailed explanation of method D2, as it was referred to in Lloyds Bank.

Previously the DWP had indicated that its guidance would follow amendments to conversion legislation that would be made to clarify aspects of the requirements; given these have not been forthcoming, it is unsurprising that there are areas of uncertainty the guidance does not satisfactorily address:

- ***Structure of new benefits*****:** historically concerns have been raised with the DWP as to whether indexation and revaluation requirements applicable to standard scheme benefits would apply where a GMP has been converted to a flat benefit. The current guidance confirms only (to the extent confirmation was needed) that, post-conversion, the GMP rules will not apply, without saying whether other indexation/ revaluation rules will or will not apply. The guidance does state that where benefits will be materially different in shape and form, trustees may wish to consider giving the member options (and in doing so should consider the incentives code of practice). We assume the DWP's concern is the potential for complaints if an increasing pension is converted into a non-increasing benefit without member consent, but it seems likely to be unpalatable in many circumstances to give members options on this, unless swept up with a wider PIE (albeit if the latter, it may be difficult for trustees and employers to communicate the different elements to members).
- ***Employer consent***: where the participating employers have changed over the years, the guidance notes that legal advice should be taken as to how (or whether) the consent requirement applies.

[3] Lloyds Banking Group Pensions Trustees Ltd v Lloyds Bank plc [2018] EWHC 2839 (Ch)

- ***Cost of conversion and equalisation***: The guidance notes that trustees may wish to take advice in relation to members for whom the estimated cost of calculating and implementing equalisation is the same or greater than the projected additional benefits.
- ***Tax implications***: whilst there are good arguments that GMP conversion/equalisation should not trigger either annual allowance or lifetime allowance charges, or the loss of protection against the lifetime allowance charge, the legislation is far from clear in regard to these points. Rather unhelpfully, the DWP's guidance does not include any clear statement which would remove the doubts in this area. The guidance only refers to the tax issues, rather than providing any comfort in relation to them, and states that HMRC is looking at these and will provide updates in its newsletters in due course. On point, in its June newsletter HMRC has stated that its GMP Equalisation Working Group is making good progress in considering approaches to avoid potential unintended tax consequences, albeit it does not expect to update guidance before the autumn. The newsletter confirms that "*HMRC is committed to finding a pragmatic and proportionate outcome to all of the pension tax issues*".

Legislative reforms on GMP conversion (and potentially further updates to the DWP guidance) are anticipated. Some schemes have begun the process of GMP conversion and equalisation and there is therefore the risk of new legislation coming into force during the process of conversion, which then necessitates a change in approach (and the attendant additional costs). However, that risk seems low given that at present not even draft legislation has been published, and no specific target date for publication has been set either.

4. EMIR REFIT REGULATION ADOPTED

As we reported in the March 2019 edition of the UK: Pensions Update, the exemption available to certain pension schemes from the obligation to clear over-the-counter (OTC) derivatives under the European Market Infrastructure Regulation (EMIR) expired on 17 August 2018 (having already been extended twice), and the Council of the EU had published a press release announcing that preliminary agreement had been reached on the proposal for a regulation amending EMIR (the 'Refit Regulation').

On 17 June 2019, the Refit Regulation came into force. Article 89(1) of the Refit Regulation revives the exemption until 18 June 2021 and includes a bridging exemption on the same terms to cover the gap between 17 August 2018 and 16 June 2019. There is also a mechanism to enable the Commission to extend the exemption twice, by an additional year.

The Refit Regulation requires the European Securities and Markets Authority (ESMA) to submit a report to the Commission every 12 months (the first report was to be submitted by the 18 June) until the final extension of the exemption on its progress around finding a viable solution facilitating the clearing of OTC derivatives by certain pension scheme counterparties.

5. CMA INVESTMENT ORDER IMPLEMENTED

As we reported in the March 2019 edition of the UK: Pensions Update, the Competition and Markets Authority (CMA) consulted on a range of reforms to the investment consultancy and fiduciary management sector after finding competition problems, particularly in the pensions arena. The consultation closed on 13 March 2019.

On 10 June 2019, the CMA gave notice of the making of the Investment Consultancy and Fiduciary Management Market Investigation Order 2019. Changes to the final order include, *inter alia*:

- the requirement for trustees to use "best endeavours" to obtain three bids for the provision of fiduciary management services has been amended to a "reasonable endeavours" obligation (the Explanatory Note to the Order has also been amended to provide further clarification on what this means in this context);
- large schemes with in-house investment advice or fiduciary management functions have been excluded from the scope of the Order;
- the definition of "Marketing Material" has been amended so as not to pick up material which constitutes advice; and
- definition of "Pension Scheme Trustees" has been amended to include a UK element.

The parts of the Order relating to fiduciary management information provision and CMA monitoring and compliance will come into effect immediately. The parts relating to mandatory tendering, fiduciary management fee and advice separation, investment consultancy objective setting, and minimum performance information will enter into force in six months. The CMA has a duty to keep the Order under review.

The Pensions Regulator is expected to issue guidance on the Order within six months.

6. GOVERNMENT RESPONDS TO CONSULTATION ON COLLECTIVE DEFINED CONTRIBUTION SCHEMES

On 18 March 2019, the DWP published its response to the consultation on how collective defined contribution (CDC) schemes might work in the UK, and the legislative and regulatory regime that would be needed to support it.

At present, the government is not proposing to facilitate CDC schemes more widely and instead will focus its efforts towards realising the single-employer CDC scheme model contemplated by Royal Mail, albeit it has flagged the intention that the legislation will be constructed so that it can move to open up the CDC market quickly to other models (e.g. to master trust schemes) once the Royal Mail CDC scheme is in place.

CDC schemes allow contributions to be pooled and invested to give members a target benefit level (which is not contractually guaranteed) whilst sharing longevity risk. Income will be based on the value of member contributions to the fund and will be subject to fluctuations in value depending on the fund's performance

The consultation response provides a detailed description of the type of CDC framework the government intends to put in place and to a significant extent, it will reflect the existing money purchase legislation and the existing master trust authorisation regime, subject to some amendments to reflect the unique features of a CDC scheme. Points of detail (e.g. around advice requirements on transfers between CDC and DC schemes) remain outstanding, and the consultation response notes the practical challenge for schemes around satisfactorily communicating the variable nature of the pension income in a CDC scheme to ensure that members understand that amounts could go down as well as up.

Both primary and secondary legislation is necessary to enable the Royal Mail CDC scheme to become reality and as such it is not anticipated that CDC schemes will be available more widely, anytime soon. It remains to be seen how much appetite there is for CDC schemes in practice.

7. EQUITABLE LIFE TRANSFER

In early in 2018, Equitable Life announced that it had entered into an agreement to transfer its business to Utmost Life and Pensions (formerly Reliance Life) by the end of 2019, and that with-profit policies would be converted to unit linked funds, and any guarantees would be removed.

The conversion of with-profits to unit linked funds is designed to compensate members for the loss of their guarantees. It is expected that policy holders will get an uplift of around 60% to 70% of current policy value, although some individuals may benefit from a higher uplift if their guarantees are deemed to be more valuable.

Trustees and individual policy holders will receive a fund selection pack and a voting pack, containing the available unit linked fund choices and illustrations for each with-profit member. The illustrations will look at the projected fund value had the member stayed in the with-profit fund vs the projected fund value of an alternative unit linked, fund with allowance for the uplift. Trustees will need to decide whether they select the fund mapping or whether they manage the process such that their members make the selection.

Trustees/ individual policy holders will need to vote on the proposed uplift for their respective members/ themselves and conversion of with-profits to unit linked funds.

It is expected that votes will need to be cast by 1 November 2019. If eligible policyholders vote in favour of the proposal and Equitable Life receives approval from the High Court, it is expected that the proposals will be implemented towards the end of 2019.

In the meantime, trustees should alert any members considering taking a transfer of their funds or retirement prior to the transfer to Utmost Life and Pensions, that they could forgo a significant uplift.

8. FCA CONSULTATION ON INDEPENDENT GOVERNANCE COMMITTEES (IGCS)

On 15 April 2019 the FCA published a consultation paper (available here) proposing to introduce new duties for IGCs and governance advisory arrangements (GAAs, the proportionate alternatives to IGCs) including:

- new duty to report on their firm's policies on environmental, social and governance (ESG) issues, consumer concerns and stewardship, for the products that IGCs oversee;
- a new duty to oversee the value for money of their firm's investment pathway solutions for pension drawdown; and
- a new duty to make the most three recent IGC annual reports publicly and prominently available.

The FCA also proposes to introduce guidance for providers of pension products and investment-based life insurance products, setting out how these firms should consider factors such as ESG risks and opportunities that can have an impact on financial returns, and non-financial consumer concerns, when making investment decisions on behalf of consumers.

The deadline for comments on the consultation is 15 July 2019. The FCA plans to finalise any rule changes in Q4 of 2019.

9. KEYMED V HILLMAN[4]

In this case the company brought a claim against two former directors who also acted as trustees for the company's pension schemes in which they were members, claiming that they had acted in breach of their duties to the company, both as directors and as trustees, by making changes to the company's pension schemes which were said to not be in the company's interests.

The High Court held that while an employer's interests may be a relevant consideration for trustees (e.g. when considering whether to return a surplus to the employer), trustees do not owe a fiduciary duty to employers. In short, a trustee owes a fiduciary duty to the beneficiaries of the scheme and "*can only serve one master*".

The judge's comments risk causing confusion in an area of the law where occasionally we find trustees uncertain as to what, if any, regard they could or should have to the interests of the scheme employer. The judge rightly confirmed the position that trustees are entitled to have regard to the employer's interests, "*even if the protecting of these interests is a matter of indifference to the beneficiaries of the scheme*", (albeit the judge noted that if the employer's interests conflict with those of the beneficiaries, the employer's interests are subordinate) and so it is likely that the rather specific factual context within which the judge appeared to be using the term "duty" will not be taken to have a wider application than is likely to have been intended.

10. BIC V BURGESS[5]

In a judgement handed down in May, the Court of Appeal has held that the back-dated effect of a trust deed and rules executed in 1993 could not be relied upon in principle so as to validate steps which had in fact been taken in 1991/2 to introduce pension increases. The judge held that it was clear that the back-dating of the 1993 trust deed and rules to 1990 was for reasons wholly unconnected with the pension increases and to enable it to validate the 1991/2 introduction of the pension increases would have "*involved the re-writing of history to an impermissible extent*".

The case highlights for both trustees and sponsoring employers the importance of following the proper formalities prescribed in the trust deed and rules when amending an occupational pension scheme. It also highlights the narrower point that a power to amend scheme provisions retrospectively will not necessarily validate previous exercises of powers which, for whatever reason, have failed to achieve their objective.

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[4] KeyMed (Medical and Industrial Equipment) Ltd v Hillman and another [2019] EWHC 485 (Ch)

[5] BIC UK Ltd v Burgess & others [2019] EWCA 806

11. ON THE HORIZON

Brexit

The UK did not leave the EU at 11:00pm on 29 March 2019. An extension has been agreed until 31 October 2019 at the latest. Trustees will need to continue to assess the potential impact of the UK's exit from the EU on scheme investments and take the appropriate steps to mitigate any potential risks.

Guidance on ESG and climate change

We understand that further guidance in respect of environmental social and governance (ESG) and climate change risk is to be included in updates to the defined contribution investment guidance and the defined benefit investment guidance due this summer.

Defined benefit funding code and legislation

The Pensions Regulator is expected to consult in the summer on various options for a revised defined benefit funding framework under a new code and has been working on the design of clearer funding standards (e.g. in respect of the prudence of technical provisions and the appropriateness of recovery plans), as announced in the government's White Paper on defined benefit pensions dated March 2018.

In parallel, the government is expected to make certain legislative changes to clarify the existing defined benefit funding regime.

BT appeal granted

Permission has been granted for BT to appeal to the Supreme Court the decision of the Court of Appeal handed down on 4 December 2018 as to whether the rules of the BT pension scheme allow a switch from RPI to CPI for pension increases.

Government considering changes to AA and LTA for public service pension schemes

The government is considering additional flexibility on pension tax relief in public service pension arrangements in response to claims that reduced annual and lifetime allowances have resulted in senior and experienced public sector staff retiring, reducing workloads, stopping covering vacancies and abandoning leadership positions.

Pension Superfunds

On 7 December 2018 the DWP issued its consultation on defined benefit pension scheme consolidation vehicles (the so-called "superfunds") and is currently developing an authorisation framework to safeguard the benefits of members moving into superfunds. Receiving superfunds will need the Pensions Regulator's authorisation to operate. The DWP consultation closed on 1 February 2019 and the response is expected later this year.

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