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INVESTMENT – WALKING IN A REGULATORY WONDERLAND

1 INTRODUCTION

With the prospect of seasonal cheer less than 10 days away, the pensions industry is expecting several sets of regulations to come into force when all is quiet on 30 December 2005. Here we consider some of the key points for pension schemes presented by just one set of them, the Occupational Pension Schemes (Investment) Regulations 2005 (Investment Regulations).

2 KEY CHANGES

- Trustees' investment powers must be exercised "in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole" (the "prudent person principle").
- Scheme assets must be invested predominantly on regulated markets and, to the extent that they are not, investment must be kept to a "prudent level".
- There are new constraints on the ability to invest in derivatives.
- There will be restrictions on trustees borrowing and giving guarantees.
- Statements of investment principles will need to be reviewed on a triennial basis.
- There is a general exemption for schemes with fewer than 100 members (but these schemes will continue to be caught, where appropriate, by the investment provisions of the Pensions Act 1995).

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3 THE REGULATORY ORIGINS

Like other regulations coming into effect on 30 December, the Investment Regulations have their roots in the EU Pensions Directive. Much of the terminology used is therefore a straight transposition from the European legislation. Some commentators raised concerns that this could lead to the regulations being interpreted too conservatively. The Government therefore gave an indication of how it thinks the regulations will work in a paper dated October 2005.

A copy of the Investment Regulations can be found at:

http://www.opsi.gov.uk/si/si2005/20053378.htm

A copy of the Government's October 2005 paper[1] can be found at:

http://www.dwp.gov.uk/publications/dwp/2005/occ_pen_invest/con-doc-response.pdf

4 THE "PRUDENT PERSON PRINCIPLE"

The prudent person principle (or investment mantra) has given rise to some disquiet because it appears to impose a duty on trustees to ensure that a pension scheme portfolio is "both liquid and profitable". In its response paper, the Government makes it clear that the prudent person principle is not intended "to place a higher duty of care upon trustees than that which already exists" under trust law. The purpose is to ensure that trustees focus on the correct matters when making investment decisions "rather than judging them against the outcomes of [their] overall investment strategy".

[1] The paper responds to comments received on the original draft investment regulations published on 21 March 2005

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Scheme assets must also be invested:

- in the *best* interests of members and beneficiaries or, where there is a potential conflict of interest, in the *sole* interest of members and beneficiaries;
- "in a manner appropriate to the nature and duration of the expected future retirement benefits payable under the scheme" in so far as they are held to cover a scheme's "technical provisions" (namely, the amount required on an actuarial calculation under the new scheme funding regime "to make provision for the scheme's liabilities");
- so as to be "properly diversified…to avoid excessive reliance on any particular asset, issuer or group of undertakings and…to avoid accumulations of risk in the portfolio as a whole";
- to ensure that investments "in assets issued by the same issuer or by issuers belonging to the same group [do] not expose the scheme to excessive risk concentration".

The last two requirements are similar to the diversification requirement in the Pensions Act 1995, but are a bit more detailed.

5 INVESTING PREDOMINANTLY ON REGULATED MARKETS

When the Investment Regulations were first published in draft, confusion surrounded the meaning of the word "predominantly" and the degree to which this might curtail direct investment in the likes of property, private equity and hedge funds. Also, what level of investments could be safely held outside regulated markets without jeopardising the *prudent level* test?

Wishing to allow trustees to have access to "the widest range of investment opportunities" the Government has stopped short of defining "predominantly" and "prudent levels" for fear of setting an arbitrary limit

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on the proportion of a scheme's assets which must be invested on regulated markets.

The reference to "regulated markets" was considered ambiguous given that the definition originally used in the draft regulations had been superseded by an EC Directive[2]. The Investment Regulations have therefore been amended to take account of recent EC legislation so that the definition of "regulated markets" is now broader in scope. It is also worth noting here that qualifying insurance policies count for this purpose, as do investments held within a collective investment scheme which are themselves invested on a regulated market.

6 USE OF DERIVATIVES

Scheme assets can only be invested in derivatives for the purpose of reducing risks or facilitating efficient portfolio management. The latter encompasses "the reduction of cost or the generation of additional capital or income *with an acceptable level of risk*" (our emphasis).

Any such investment in derivatives must be both made and managed "so as to avoid excessive risk exposure to a single counterparty and to other derivative operations".

The Government has said that it is for trustees (or their delegated fund managers) to determine what amounts to an acceptable level of risk in the context of their particular scheme.

7 BORROWING / ACTING AS GUARANTOR

There is a general prohibition on trustees borrowing money or acting as a guarantor for another person where that would place a liability on scheme assets to repay such a loan or to satisfy such a guarantee. The exception is where sums are borrowed only to provide liquidity for the scheme on a temporary basis.

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[2] Directive 2004/39/EC on markets in financial instruments

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The Government's view is that these restrictions would not, for example, apply to "the use of borrowing or derivatives in indirect investment vehicles such as pooled funds, hedge funds and property unit trusts".

8 STATEMENT OF INVESTMENT PRINCIPLES (SIPs)

Under the current investment legislation trustees have to ensure that a SIP is "prepared, maintained and from time to time revised". The Investment Regulations tighten up this requirement so that a SIP will need to be reviewed at least every three years or "without delay after any significant change in investment policy". The SIP must also outline the trustees' policy towards risk and provide information on the manner in which risks are "measured and managed".

Wholly insured schemes will have to prepare a modified SIP, referring simply to the reasons why the scheme invests solely via policies of insurance.

9 CONCLUSION

Trustees who fail to comply with the Investment Regulations could face civil penalties. Therefore, given the timing of their introduction, it will be important for trustees to check with their advisers that they have got the investment balance right as soon as possible in the New Year.

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