Sackers

Investment & Finance Briefing

March 2014

Sackers' Finance and Investment Group takes a look at current issues of interest to pension scheme investors

Update on EMIR

- The European Market Infrastructure Regulation (EMIR) requires users of over the counter derivatives (OTCs) to comply with a number of risk mitigation measures. At the heart of EMIR is the requirement for central clearing of designated OTCs with central counterparties (CCPs), but the regulations encompass a range of different measures.
- Our July and October 2013 Investment Briefings set out key aspects, including the limited exemption from central clearing for pension schemes.

Reporting requirement in force

- From 12 February 2014, all counterparties need to report details of all derivative contracts (OTC or exchange traded) that they have concluded, modified or terminated, to a registered or recognised trade repository (TR). The reporting obligation also extends to existing (and some terminated) OTCs. There are now six TRs available for trade reporting in the EU.
- If it has not already done so, each counterparty (including pension schemes) must obtain a Legal Entity Identifier (LEI) to report its derivatives.
- The first clearing obligations are expected to apply in the second half of 2014, subject to authorisation of a relevant CCP. Pension schemes still benefit from an exemption to the clearing obligation for all OTCs which reduce investment risk until 15 August 2015 (unless extended). However, despite the exemption, we are already seeing a move among investment managers to get ready to clear OTCs as there may be pricing advantages.
- The margin requirements for non-centrally cleared trades are due to apply from 1 December 2015, with initial margining requirements to be phased in between 1 December 2015 and 1 December 2019. The exact margin requirements are yet to be specified and all dates are subject to change, depending on implementation progress at EU level.
- The various obligations that have come/are intended to come into force are as follows (Source: Financial Conduct Authority (FCA)):

Year	Effective Date	Obligation coming into force
2013	15 March	Confirmation of all legal and contractual terms of non-centrally cleared OTC derivative transactions required between counterparties within specified timeframes. Financial counterparties required to mark-to-market/mark-to-model each non-centrally cleared OTC derivative transaction entered into on or after, or outstanding on, 15 March 2013.
	15 September	Risk management of non-cleared OTC derivatives through portfolio reconciliation, dispute resolution and trade compression.
2014	12 February	Details of all classes of derivative contracts must be reported to recognised trade repositories.
	Q3/Q4 (expected)	First clearing obligation expected to apply. Occupational pension schemes subject to an exemption for OTC derivative transactions which reduce investment risk.
2015	15 August	Exemption from clearing ceases to apply to occupational pension schemes (unless extended).
	1 December	Variation margin requirements for non-centrally cleared trades to apply (initial margining requirements to be phased in between 1 December 2015 and 1 December 2019).

Recovery of VAT on investment management fees

- HMRC has announced a change of its policy on employers reclaiming input tax in the light of the PPG Holdings case.[1]
- Previously HMRC distinguished between:
  - administration costs, which it regarded as overheads of the employer, having a “direct and immediate link” to its business activities; and
  - costs of investment activities, which it considered to be the costs of the pension scheme itself, on the basis that they related solely to the activities of the pension scheme.
- Employers were therefore only permitted to deduct VAT incurred in relation to the administration of a scheme.
- Whilst in theory pension schemes could reclaim VAT, most are not registered for VAT or engaged in taxable business activities. In practice, HMRC operated a concessionary policy under which, where a single invoice was issued covering both administration and the management of investments, the employer could claim 30% of the VAT and the pension scheme 70%.

New HMRC policy

- In the PPG case, the Court of Justice of the European Union ruled that an employer with a DB pension scheme is, as a taxable person, entitled to deduct the VAT paid on services relating to the management and operation of a pension fund set up for employees and former employees (both the day-to-day management costs and investment management fees) where there is a direct and immediate link between the cost of these services and the employer’s economic activity as a whole.
- Following the judgment in the PPG case, HMRC has clarified its view that specific investment management costs do not have a “direct and immediate link” to the employer’s general costs. It has taken the opportunity to remove the concessionary treatment for mixed administration and investment services, subject to a six month transitional period.
- In future, it will only be possible for employers to recover VAT if they can show that some of the services were supplied to the employer and went further than the management of investments. This is a narrow interpretation of the European Court’s ruling and it is likely that the withdrawal of the concession will disadvantage some organisations.
- Further, if the employer receives the supply and recharges the cost to the pension scheme, HMRC will require an equivalent amount of output VAT to be accounted for, which is potentially deductible by the pension scheme to the extent it is engaged in taxable business activities. In practice, most pension schemes will not (at least not to any material extent) be engaged in such activities.
- HMRC will permit retrospective claims for overpaid VAT for periods ending within four years of the date on which the claim is made.
- Trustees and employers should look at their existing arrangements to ensure that future VAT reclaims fall within the new guidance. They should also consider whether any protective claims should be made for overpaid VAT.

1 *Fiscale eenheid PPG Holdings BV cs te Hoogezand v Inspecteur van de Belastingdienst/Noord/kantoor Groningen* (Court of Justice of the European Union, Case C 26/12))

Fiduciary duties

- On 22 October 2013, the Law Commission published a consultation paper on the fiduciary duties of investment intermediaries. The Department for Business, Innovation and Skills and the Department for Work and Pensions had asked the Law Commission to investigate how the law of fiduciary duties applies to investment intermediaries and to evaluate whether the law works in the interests of end investors. The Law Commission chose the pensions landscape in which to conduct its investigations. Some of its key findings are as follows, although they remain subject to the outcome of the consultation process.[2]
- The Law Commission does not consider that an overhaul of the current law of fiduciary duties is required. It believes that the current law on fiduciary duties is clear that a trustee's core duty is to promote the purpose for which the trust was created. For pension scheme trustees, the duty is to provide pensions.

No overhaul of current law required

- The Law Commission hopes to dispel any myths or misconceptions that such a fiduciary duty equates simply to maximising short-term profit at all costs. Instead, trustees may take a wide range of factors into account when determining which investments are likely to be in the financial best interests of a scheme's beneficiaries, including environmental, social and governance (ESG) factors.
- However, ethical or moral considerations may only be taken into account in very limited circumstances, where members share the moral view point and doing so will not result in lower returns.
- An industry structure and regulatory framework is required to encourage independent review of investment strategies in workplace DC pension schemes.

2 For more details, see our Alert: "Law Commission consults on fiduciary duties of investment intermediaries" dated 15 November 2013 and response to the Law Commission's consultation, both of which are available on our website.

FTT Directive

- Back in February 2013, the European Commission published its proposal for a new Directive on a common system of financial transaction tax (FTT). Very broadly, the tax would be levied on trades in "financial instruments" (including shares, bonds, derivatives and shares in collective instrument undertakings) that involve "financial institutions" – this term is widely defined and includes pension funds. Although the European Parliament had earlier voted to exempt pension schemes, this was not included in the final proposal on the basis that an exemption would give pension schemes an unfair advantage over certain other retirement and savings products.
- Eleven EU member states have agreed the adoption of this Directive. Although the UK is not one of them, it will still have a practical impact if taken forward.

Negotiations ongoing

- Whilst negotiations on the Directive slowed during 2013 owing to disagreements between the eleven participating nations, the new German Government has made clear its commitment to the FTT, leaving the way clear for negotiations to recommence.
- France and Germany have pledged to reach a deal on the FTT. The two countries are looking at a progressive approach, so that the tax would initially apply to equities based on the issuance principle. Debt instruments and derivatives would be included with the FTT at a later stage, although it is unclear at this stage whether the tax will apply to equity derivatives and equities simultaneously.
- In 2013, the UK challenged the legality of the decision by the EU Council on 22 January 2013 to authorise the eleven member states to authorise enhanced cooperation on a common framework of FTT and the scope and objectives of the Commission's initial proposal. This challenge does not have the effect of suspending the negotiations.

FCA review of transition management

- The FCA published a report on the transition management market in February 2014. The report was triggered by information received by the FCA alleging overcharging and a failure by providers to manage conflicts of interest.
- The review identified a number of inherent risks in transition management including:
  - conflicts between a client's need for an accurate assessment of the complexity and cost of the transition and the provider's desire to win business by providing an unrealistically low estimate
  - transition management providers acting as both agent and principal
  - use of internal crossing opportunities where these occur at a worse price than could have been obtained in the open market, or are delayed to allow buy and sell orders to be crossed with another client of the provider
  - difficulty in ascertaining whether best execution has occurred, where execution of the mandate occurs through an entity affiliated to the provider.

FCA seeks to strengthen investor protection

- Whilst noting that providers look to demonstrate their level of control over these risks by disclosing information during the mandate and through pre- and post-implementation reports, the FCA recognised that there is significant variation in the level of detail and clarity provided.
- Despite this, the FCA concludes that its existing rules and guidance set a high standard and are fit to govern transition management practices. In the course of its supervisory work the FCA will therefore focus on:
  - management of conflicts of interest
  - oversight, governance and controls at transition management firms
  - transparency and communication
  - client understanding, in particular, whether providers understand their clients' information requirements.

Asset-backed contributions

- The Financial Reporting Council (FRC) announced in January 2014 that it had examined the accounting treatment of several asset-backed contribution (ABC) structures put in place to fund pension deficits.
- Some ABC structures have, the FRC noted, included additional features to achieve an accounting outcome under which the company's obligation to make future payments to its pension scheme is transformed into an equity instrument in the company's accounts that has a favourable impact on the sponsor's financial solvency, gearing and reported comprehensive income.
- It has recently been reported that the car dealership, Pendragon, has seen the deficit in its pension scheme increase on an IAS 19 basis following intervention by the FRC in relation to this.
- The accounting treatment of an ABC structure is very much an employer issue and should not affect trustees' consideration of whether an ABC structure is in the best interests of scheme members.

EU round-up

Forthcoming developments in the regulation of financial markets

European long-term investment funds (ELTIFs)

Framework on long-term investing proposed

- In June 2013, the EU Commission published a legislative proposal for the introduction of a framework for collective investments that would allow investors to put money into companies and projects requiring long-term capital, with opportunities for both institutional and private investors (ELTIFs). Pension funds are recognised as key players in this area, given their need for long-term assets to match their long-term liabilities.
- Related to this, the EU Commission's green paper on the long-term financing of the European economy set out to initiate debate on the challenges faced in relation to strengthening long-term investment in the EU economy.
- ELTIFs aim to increase the amount of non-bank finance available for companies investing in the EU. Action is being taken with a view to creating consistency among the funding vehicles used in Member States. It is intended that ELTIF funds will be available from alternative investment managers, who will have a marketing passport for ELTIFs.
- A vote on the draft report of the EU Parliament's Committee on Economic and Monetary affairs is expected in March 2014, and is due to be considered by the EU Parliament in plenary sitting in April 2014.

EU round-up (cont.)

Credit Ratings Agencies Regulations (CRA III)

- Aimed at reducing over-reliance by financial institutions on credit rating agencies and to ensure quality and transparency in the ratings process, CRA III amends the current EU regulatory framework in this area.
- In force since 20 June 2013, Member States have until 21 December 2014 to incorporate the regulations into national law. Guidelines from the European Securities and Markets Authority (ESMA) on reducing reliance on CRAs are expected to be published in the first half of 2014.

MiFID II subject to EU Parliament approval

Market in Financial Instruments Directive II (MiFID II)

- MiFID II applies to certain categories of investment services and activities relating to defined categories of financial instruments. In particular, it sets out new rules for anonymous trading venues (known as dark pools), electronic trading controls and measures to increase competition in the derivatives market. The aim of the proposals is to make financial markets more efficient, resilient and transparent.
- Lengthy negotiations between the EU Parliament, Council and Commission on proposals to replace the original MiFID with a new directive and regulation finally resulted in an informal agreement between the three institutions in January 2014. The European Parliament is now set to consider the MiFID II legislative proposals in March 2014.

Money Market Funds (MMF) Regulations

- As part of its work on shadow banking, the EU Commission is also considering a proposal for a regulation on money market funds (mutual funds operated by asset managers and which invest in short-term debt, for example money market instruments issued by banks, governments or corporates). The proposal is set to be considered by the EU Parliament in April 2014.
- The regulation is intended to apply to all MMFs that invest in money market instruments, irrespective of whether they are also governed by the UCITS framework or operate as an Alternative Investment Fund.

Exclusion of pension scheme liabilities

Recovery and Resolution Directive

- The EU Commission plans to introduce an EU-wide framework for the recovery and resolution of credit institutions and investment firms. The Directive aims to address weaknesses exposed during the recent financial crisis.
- Liabilities of a failing institution to its pension scheme are set to be excluded from the bail-in provisions, save where they relate to pensionable bonuses.
- The text of the Directive has been agreed and is subject to a final vote. Adoption by Member States of the Directive into national laws is slated for December 2014, with a proposed deadline of 1 January 2016 for applying the provisions of the bail-in tool.

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Sackers is the UK's leading commercial law firm for pension scheme trustees and employers. Over fifty lawyers focus on pensions and its related areas, including Sackers' Finance and Investment Group, a team of lawyers who provide cutting edge advice to trustees and employers on all aspects of pension scheme finance and investment.

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