Sackers

Finance & investment briefing

March 2015

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

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Abbreviations

AIF: Alternative Investment Funds

AIFMs: Alternative Investment Fund Managers

CCP: Central Counterparty

CMU: Capital Markets Union

DB: Defined benefit

DWP: Department for Work and Pensions

ECON: Economic and Monetary Affairs

ELTIF: European long-term investment funds

EMIR: European Market Infrastructure Regulation

ESMA: European Securities and Markets Authority

FTT: Financial Transaction Tax

MiFID: Markets in Financial Instruments Directive

MiFIR: Markets in Financial Instruments Regulation

NAPF: National Association of Pension Funds

OTC: Over the counter derivatives

PRAG: Pension Research Accountants Group

RI: Responsible Investment

SORP: Statement of Recommended Accounting Practice

Finance & investment focus

“‘I never put off till tomorrow what I can possibly do - the day after.’

I wonder if this Oscar Wilde quote was in the EU Commission’s mind when it recommended extending the current exemption for pension schemes from EMIR’s central clearing requirements for a further two years. In any event, many will breathe a sigh of relief to be given more time to establish a practical way for pension schemes to clear their derivatives transactions.

But what is given with one hand is often taken away with the other. The EU’s review of MiFID continues apace, with the introduction of MiFID II and MiFIR set for 2016/17. Separately, the introduction of a European Financial Transaction Tax inches closer. Although the UK is not in the “FTT zone”, it could still have a practical impact since it will result in tax where there is a link between the transaction and the FTT zone.

With all this and more, it is little wonder that many trustees look to fiduciary management for help with the ever increasing complexity in their investment strategies. In this issue, Ian Cormican turns the spotlight on fiduciary management, with five key points to be addressed at an early stage in the appointment of a fiduciary manager.

Finally, Sackers’ Finance & Investment Group is looking forward to attending the NAPF Investment Conference this month. We hope to see as many of you as possible at Stand 10 in the exhibition hall (morning bacon sandwiches will be available….!).”

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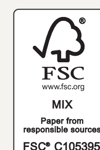

Five things to know about fiduciary management

Ian Cormican provides an overview of fiduciary management

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Fiduciary management is often promoted as a solution to speed up investment governance and improve the quality of decision making. It allows trustees to focus on their investment strategy, while the detailed implementation of that strategy, including the choice of asset manager, is delegated to the fiduciary manager.

Here are a few key points which trustees should address at an early stage, if they are contemplating appointing a fiduciary manager.

Scope

As with any provider relationship, it is important to identify clearly the services which the fiduciary manager is to provide, and the parameters within which they may act. This is relevant not just to the investment guidelines which apply to the mandate, but also to the contractual terms to which the fiduciary manager can commit trustees when entering into agreements with underlying managers or providers on their behalf.

Conflicts of interest and monitoring

Does implementation of the trustees' strategy give rise to conflicts of interest, for example, if the trustees are trying to de-risk? How are conflicts managed and reported? How transparent is the fiduciary manager's reporting? Will the trustees need third party expertise in order to monitor adequately and challenge actions taken by the fiduciary manager?

Costs

How is the fiduciary manager benchmarked and rewarded? Is the relationship between the fiduciary manager's fees and the underlying providers' fees transparent? If the fiduciary manager's appointment is terminated, will the underlying providers honour the same fee arrangements or will discounts negotiated by the fiduciary manager be lost?

Liability

A fiduciary manager has no overriding "fiduciary" duties or obligations. Rather, those obligations are as set out in the contract between the fiduciary manager and the trustees. As the trustees are ultimately responsible for investment of the scheme assets, and for the acts and omissions of their delegates, care needs to be taken to ensure that the fiduciary manager's responsibilities are clearly established in the contract.

Termination

Whilst hoping for a long and fruitful relationship, it is critical that trustees understand the practical steps required to terminate a fiduciary management arrangement and the consequences of termination. Are there liquidity constraints on the underlying assets? How would any derivative transactions be dealt with? What impact does termination have on the underlying agreements, in particular any fee arrangements?

Focus on MiFID II

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Times are a changing

It is almost five years since the EU Commission began its review of MiFID. MiFID, which introduced the harmonisation of EU legislation relating to firms engaged in the provision of investment services, is set to be amended and replaced by MiFID II and MiFIR.

The overhaul is happening for a number of reasons. The EU Commission was already under an obligation to review MiFID two years after its implementation. The review also coincided with the financial crisis and the resulting G20 commitments for reform.

What are the reforms?

The MiFID II reforms are intended to cover both equities and non-equities (bonds, structured finance products, derivatives) and to bolster investor confidence.

The reform package will introduce new market structures and attempt to close market loopholes to ensure that, when appropriate, trading will take place on a regulated market. It will aim to bring increased transparency to both equity and non-equity markets. In addition, minimum rules will be introduced to ensure that EU Member States apply appropriate administrative sanctions and measures to breaches of MiFID II.

Bringing light to the dark

The new transparency will affect the use of "dark pools". These are designed to allow pension funds to trade large blocks of equities discretely at non-public prices. Anonymous trading will be capped at 4% of the total volume of trading in a particular equity, and at 8% of the total amount of that equity traded in all trading venues across the EU.

Use of the capping mechanism and greater pre-trade transparency may erode some of the value that pension schemes have typically derived from dark pools. This is because the cap may restrict pension schemes' ability to get the best price for an equity. Transparency can also ultimately hurt the end user, as the impact on the public market can be significant.

Knowledge is a good thing

Dealing commissions – the amount paid by an investment manager to a broker primarily for its execution services – may also be used to pay for other services, such as research. The current regime does not prevent bundling for execution related and research related goods and services. The recommendations fall short of imposing a complete ban on the use of dealing commission for research. But the new regime will require managers to pay for the research out of a separate account and for the client to pay separately for this.

The biggest impact is likely to be in the fixed income markets, where a deal's spread pays for the trade, and research has been seen as a free component. Dividing the payment for research in this way may result in smaller spreads.

When is it happening?

Each EU Member State is required to implement MiFID II into national law by 3 July 2016. As a regulation, MiFIR is directly applicable and does not need to be implemented. Both will be effective on and from 3 January 2017.

ESMA is consulting on draft regulatory and implementing technical standards for MiFID II / MiFIR. A subsequent consultation looks further at transparency in respect of non-equity asset classes. The consultations close on 2 and 20 March 2015 respectively.

Derivatives clearing: latest news

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Update on EMIR

A renewed focus on the clearing exemption

EMIR imposes an obligation on pension schemes to clear those OTC derivative transactions which the European Regulator, ESMA, mandates for clearing. (For further background information, please refer to the earlier Finance & Investment Briefings on our website.)

There is currently no legal obligation (whether for banks, insurers or pension schemes) to clear any OTC derivative transactions. However, whilst the first clearing obligation in respect of interest rate swaps had been delayed, this now looks to be back on track, with phasing-in of the obligation set to begin later this year.

Pension schemes will enjoy an exemption from the clearing obligation (once in force) for all OTC derivative transactions which are "objectively measurable as reducing investment risks directly relating to the financial solvency of pension schemes". On 3 February 2015, the EU Commission recommended extending the exemption for a further two years (to August 2017), with a view to giving CCPs time to establish a practical way for pension schemes to clear their OTC derivative transactions. The exemption means that pension schemes could elect not to clear OTC derivative transactions which otherwise would need to be cleared, provided the OTC derivative transaction falls within the scope of the exemption. Trustees should therefore consider whether they wish to delay the clearing of OTC transactions in reliance on the exemption.

The pension scheme exemption has recently attracted a certain amount of attention. This is because European banks can apply a favourable capital treatment to OTC derivative transactions which would be exempt from clearing on the basis of the pension scheme exemption. There is therefore an expectation that banks may ask pension schemes for a representation that an OTC derivative transaction, or series of transactions, would be exempt from clearing on the basis that they are objectively measurable as reducing investment risks directly relating to the financial solvency of pension schemes.

Trustees should therefore be thinking about the application and scope of the exemption, and how it should be applied by their investment managers.

Other issues for 2015

2015 will see mandatory collateral rules for non-cleared OTC derivative transactions starting to apply. If they have not already done so, trustees should start to consider how this will affect their current collateral arrangements.

With the EMIR collateral and clearing obligations coming into effect, it will become increasingly important for trustees to consider whether their OTC derivative transactions and relationships have a cross-border dimension. If so, trustees may be required to comply, not just with EMIR, but also similar provisions under the US Dodd-Frank regime.

Legal update

New Statement of Recommended Accounting Practice

Applies to accounting periods on / after January 2015

New accounting standards came fully into force in the UK on 1 January 2015, including changes to the requirements for financial reports for pension schemes in FRS 102 – the Financial Reporting Standard applicable in the UK and Republic of Ireland. To reflect the changes, PRAG published guidance in the form of a new SORP which applies to pension scheme accounting periods beginning on or after 1 January 2015.

The SORP has been updated in a number of areas, to provide guidance on applying FRS 102 and to reflect other changes to pensions legislation, industry developments and investment practices since the SORP's last revision in 2007.

Changes to the SORP include the introduction of a pricing hierarchy to determine fair value of investments, guidance on the valuation of annuities and disclosure of transaction costs.

Changes to the law governing investments in occupational pension schemes

Back in July 2014, the Law Commission published a report on the Fiduciary duties of Investment Intermediaries. Among other things, the Law Commission made a number of recommendations in connection with the Occupational Pension Schemes (Investment Regulations) 2005 which it considered could be usefully reviewed, to ensure that the regulations support trustees in understanding and meeting their duties. In the light of the Law Commission's report, on 27 February 2015, the DWP published a consultation on potential amendments to the Investment Regulations relating to two key themes:

- the difference between financial and non-financial factors when taking decisions about investments, and
- the role that a 'stewardship' approach can play when taking decisions about investments.

The consultation, to which Sackers will be responding, closes on 24 April 2015.

Financial Transaction Tax Directive

Implementation by January 2016?

In December 2014, the EU Commission's ECON committee reviewed progress on the FTT, noting that:

- whilst there had been progress on the scope of the FTT for transactions in shares, the scope of the FTT for derivatives, as well as the taxation principles for both transactions in shares and derivatives, remain key outstanding issues
- further work is required on the scope of transactions in financial derivatives, including on the principles of residence and issuance
- further work is also needed on the mechanism to be used for collecting the FTT.

Eleven EU Member States have, in principle, agreed to the adoption of this Directive. Although the UK is not in the FTT zone, the Directive will have a practical impact as it will result in tax where there is some link between the transaction and the FTT zone.

Although progress on the Directive has been slow, the EU Commission said in January 2015 that it "strongly encourages the eleven Member States to come to an agreement on the first step of the progressive implementation of a common FTT early in 2015".

In late January, the French and Austrian finance ministers sought to restart the discussion. Rather than identifying specific asset classes that should be subject to the tax, they propose to explore a tax with the widest possible base and low rates. The current intention is to implement the FTT by 1 January 2016.

Legal update cont.

European long-term investment funds

The EU Commission plans to introduce 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. Pension funds are recognised as key players in this area, given their need for long-term assets to match their long-term liabilities.

Only AIFs managed by authorised AIFMs will be able to market themselves as ELTIFs. ELTIFs will be subject to a number of additional rules, including a requirement to invest at least 70% of their capital in clearly defined categories of eligible assets. Trading in assets other than long-term investments will only be permitted up to a maximum of 30% of their capital.

On 10 December 2015, the EU Council announced that it had reached political agreement with the EU Parliament on a compromise text of the ELTIF regulation. It is anticipated that the ELTIF regulation will be adopted at first reading.

Investment news from the NAPF

Model confirms improvements in life expectancy

NAPF longevity model

In conjunction with Club Vita, the NAPF has looked at the difference in future life expectancy between the national population and DB scheme members.

Using the NAPF's Longevity Model, the NAPF and Club Vita set out to give trustees access to analysis drawn from data on 2.5 million pensioners from a number of the largest DB schemes across the UK. In particular, the report aims to understand how people with certain longevity trends can be grouped and how those groups affect liabilities.

The findings confirm that, for DB schemes, average life expectancy of pensioners has improved by 2.3 years during the past 10 years, close to that for the population in general. However, a narrowing of the gap between more affluent DB pensioners and those living in more hard-pressed regions of the UK is revealed.

Guide to responsible investment

Responsible Investment reporting can help improve the transparency and accountability between asset owners and their fund managers. With this in mind, the NAPF published a Guide to Responsible Investment Reporting in Public Equity in January 2015. The guide was produced following a number of roundtable meetings with sixteen pension funds with combined assets of over £200bn and open consultation with fund managers. It builds on the Principles for Responsible Investment to clarify expectations in terms of RI investing in fund manager selection and monitoring processes.

Engagement survey

Shareholder engagement is an activity often delegated by pension funds to their asset managers. The NAPF's tenth annual Survey on pension funds' engagement with investee companies illustrates the growing expectations of UK pension funds in this area. Pension funds are challenging their assets managers to meet these in an increasingly transparent manner.

Sackers

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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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