Sackers

FIFTY YEARS OF PARTNERSHIP 50

Finance & investment briefing

March 2016

Sackers' finance & investment group takes a look at current issues of interest to pension scheme investors

Finance & investment briefing

March 2016

In this issue

Shareholder litigation: FAQs 3

Focus on ESG 4

Legal update 6

Back to basics: pooled investment funds 7

Abbreviations

AGM: Annual General Meeting

ECON: Economic and Monetary Affairs Committee

EMIR: European Market Infrastructure Regulation

ESMA: European Securities and Markets Authority

ESG: Environment, social and corporate governance

FCA: Financial Conduct Authority

IMA: Investment management agreement

MiFID II: Markets in Financial Instruments Directive II

MIFIR: Markets in Financial Instruments Regulation

OEIC: Open Ended Investment Company

OTC: Over-the-counter

PLSA: Pensions and Lifetime Savings Association

SIP: Statement of Investment Principles

TPR: The Pensions Regulator

Finance & investment focus

"ESG is a subject which continues to dominate headlines. In the PLSA's 2015 stewardship survey, which examines how pension funds engage with their investments, 93% of respondents said they consider ESG factors to be material to investment funds. The figure is up slightly on 2014 (90%) and a significant jump from 2013. But what exactly are trustees' responsibilities in this area and what can or should trustees take into account in their investment decision making? Stuart O'Brien examines the duties behind the headlines.

Shareholder litigation (sometimes referred to by its US label "class actions") has been increasing in popularity in the UK. Katherine Dandy and Peter Murphy from our pensions & investment litigation team answer some frequently asked questions and examine key considerations for pension fund trustees.

Also in this issue we go "back to basics" and look at some important aspects for trustees of pooled fund investing.

Once again, Sackers' finance & investment group look forward to attending the PLSA Investment Conference this month where Associate Director, Jacqui Reid, will be speaking in the DC investments stream on understanding transaction costs. We hope to see as many of you as possible at stand 29 in the exhibition hall (breakfast rolls will be available as usual!)."

Ian Cormican
Partner, finance & investment group

ian.cormican@sackers.com

Electronic format

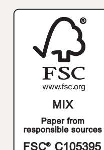
You can access electronic copies of all our publications at:

www.sackers.com/knowledge/publications

Environment

In line with our approach to corporate social responsibility (CSR), we monitor closely the number of copies printed of this publication. The paper and print manufacturing has been done in compliance with ISO14001 environmental management standards. Our paper, Cocoon 50, contains 50% post-consumer waste and 50% virgin fibres, which are certified for FSC chain of custody.

For more information on our CSR policy, please visit our website at www.sackers.com/about/csr



Shareholder litigation: FAQs

Shareholder litigation has arrived in the UK and is here to stay.

The involvement of UK pension schemes in shareholder litigation has grown steadily over the past 10 years, but the recent RBS litigation was a watershed moment for many UK pension schemes who decided to participate. Here are some of the commonly asked questions our litigation team receives from clients about participating in shareholder litigation.

Katherine Dandy
Partner, pensions & investment litigation

katherine.dandy@sackers.com

Peter Murphy
Partner, pensions & investment litigation

peter.murphy@sackers.com

1

Are trustees under a duty to participate?

No. There is no overriding duty for trustees to participate in every shareholder claim that comes across their desk. However, in our opinion, trustees should put in place processes which ensure they become aware of relevant shareholder litigation and then consider properly whether to become involved. Trustees cannot simply adopt a blanket policy not to participate, for example because they regard it as a form of "ambulance chasing". Such an approach would not be in members' best financial interests. A duty "to consider the merits" of a particular claim can be easily addressed by trustees putting in place a simple protocol and checklist to enable them to review the headline issues and decide whether or not there is any merit in exploring the case further.

2

Why the recent growth in shareholder litigation in the UK and elsewhere?

There are two reasons. As a result of a US case in 2010, many non-US investors are now effectively prevented from participating in US style shareholder litigation. As such, there are now more claims in other jurisdictions, such as the Netherlands, Australia and England. And the way in which group actions are now packaged has made it more attractive for investors, particularly pension schemes, to sign up. These effectively mirror US style class actions, based on the "no win, no fee" cost principle, and generally consist of a combination of a contingency fee arrangement with the group action solicitors, an insurance policy covering any adverse cost risk and all upfront legal fees and expenses being paid by a third party funder. The day-to-day conduct of the action is often led by a supervising board of investors. Most pension schemes therefore have little continuing involvement, once the initial decision to participate has been made.

3

Are there any risks attached to shareholder litigation?

Yes. When deciding to participate in shareholder litigation, trustees should approach the decision making process in the same way as any other form of litigation. In other words, they need to look at the prospects of success, the credentials of those bringing the class action and undertake a cost/benefit analysis. Whilst the risk can be considerably reduced by packaging the claim as described in box 2, it will still be necessary to undertake some form of due diligence to ensure the benefits outweigh the risks. As with all other decision-making, when embarking upon a new area of "investment" many features of shareholder litigation may seem strange at first. But once the concepts are understood, many trustee boards are now comfortable in handling these claims.

4

Is it relevant to pension schemes that only invest in pooled vehicles?

Not directly, as the trustees of the pension scheme are not the legal owners of the shares. However, we would recommend asking pooled fund providers to explain the processes they have in place to monitor and consider participating in shareholder litigation.

Focus on ESG

Stuart O'Brien
Partner

stuart.obrien@
sackers.com

Commonly a source of confusion for trustees, "environmental, social and governance" (or ESG) factors are steadily working their way up trustee and investment sub-committee agendas.

The question of climate change risk and low carbon investment recently came under the spotlight when the trustee of the Environment Agency Pension Fund announced its commitment in October 2015 to cut coal exposure in its equity portfolio by 90% and reduce oil and gas exposure by 50% by 2020. Client Earth has also recently stated that asset managers and pension trustees who ignore the risks of climate change on the value of their stock may "run the risk of legal action".

So what are the duties of trustees and what can or should trustees take into account in their investment decision making?

The Law Commission's consultation and guidance

In July 2014 the Law Commission published its findings on trustee fiduciary duties, making clear that a trustee's core duty is to promote the purpose for which the trust was created. For pension scheme trustees, this is the duty to provide pensions and is usually taken to mean the best "financial interests" of the scheme's beneficiaries.

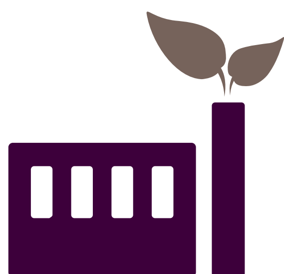
When taking investment decisions, trustees therefore need to distinguish between financially relevant factors (which they should take into account) and financially irrelevant factors (which they must ignore).

Putting this into the jargon of socially responsible investing, there is a distinction between the wider financial factors which trustees may take into account when making investment decisions (and which may specifically include ESG factors) and pure "ethical" issues. The Law Commission published helpful guidance for Trustees on their duties when setting an investment strategy.

Key points from the Law Commission guidance

- Pure "ethical" issues, unrelated to risks, returns or the interests of beneficiaries should only be taken into account by trustees where they have a good reason to think members will share the moral viewpoint and where they will not result in lower returns for the scheme.
- Trustees *may* take into account ESG factors in so far as a set of trustees believe they are relevant to the investment as a financial proposition, taking into account the long-term sustainability of the investment.
- Trustees should always take into account financially material risks. But the law does not prescribe a particular approach. It is for trustees' discretion, acting on proper advice, to evaluate which risks are financially material and how to take them into account.

Focus on ESG cont.



The Occupational Pension Schemes (Investment) Regulations 2005

The Investment Regulations are often a starting point for trustees but they only tell part of the story.

The regulations refer to “social”, “environmental” and “ethical” considerations in the same breath (which the DWP disappointingly chose not to amend last year). But this is something of a red herring, given that the regulations themselves don’t invoke any particular factors which trustees may/must/must not take into account in this area. Instead they set out what trustees have to disclose in their SIP in terms of the extent (if at all) to which any of these factors are taken into account in trustee investment decision making.

So for the time being at least, trustees need to look further afield for guidance on their duties.

Stewardship and corporate governance

Beyond the question of choosing which investments to hold (or making a conscious decision not to hold certain stocks – known as “negative screening”) trustees may wish to ask themselves how they can best engage with the companies in which they invest.

As shareholders, trustees may guide their investee companies by entering into dialogue with them and considering whether and how to exercise voting rights. Stewardship activities may include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure and corporate governance, including culture and remuneration.

Many trustees are signatories to the UK Stewardship Code, which encourages all institutional investors to disclose publicly how they discharge their stewardship responsibilities.

At one end of the spectrum trustees can organise their own voting activities at company AGMs and undertake other engagement activities directly. However, this is unlikely to be practical for all but the very largest pension schemes. Fortunately, direct engagement is not the only answer. For many schemes, stewardship activities will be considered indirectly in terms of the mandates given by trustees to their asset managers, communication of stewardship policies to those managers, and by holding asset managers to account for the stewardship activities they do or do not undertake.

Trustees can also pool their stewardship activities with other pension funds, either through collective engagement or by outsourcing stewardship activities to engagement and/or voting overlay service providers. Most recently the Association of Member Nominated Trustees launched its “Red Line Voting” initiative to allow trustees of smaller pension funds to direct how the votes associated with the companies they invest in are cast.

Practical considerations

It is up to trustees to take their own advice and reach their own conclusions on the factors and risks they consider financially material to their investments.

The “ESG” label is not always helpful because it can lead trustees to misconstrue it as a stand-alone issue somewhere between ethical and financial investment decision making. The reality is that ESG issues are merely a subset of wider financial factors to be considered in the long-term sustainability of an investment. The Law Commission’s guidance puts the duty succinctly: “When investing in equities over the long-term, trustees should consider, in discussion with their advisers and investment managers, how to assess risks. This includes risks to a company’s long-term sustainability.”

Taking climate change by way of example, to the extent that trustees consider the risk of climate change to be financially material to their investments (in the short or long-term), they should take steps to ensure their managers take this into account.

Beyond that, it becomes a matter of degree as to whether the steps trustees wish to take are proportionate to the risk posed. A different approach, for example, may be used in relation to active and passively managed funds. Where trustees are minded to take a particular view on a single issue, they should take advice and carefully consider their options within a framework of financial factors. The wider implications of a decision to impose an in-house view on the trustees’ managers in relation to one particular ESG issue, while at the same time leaving all other financial decisions (including in relation to other ESG matters) to be determined by the manager should also be considered.

Legal update

See our February 2016 DC hot topic for highlights of the report

How safe are your DC assets?

In February 2016, the Security of Assets working party published a guide designed to help trustees explore the types of questions they should think about asking their investment consultants and lawyers, with a view to improving the level of understanding of the protections currently in place for scheme members.

The guide also aims to help trustees focus on some of the key areas to explore when seeking to change their platform provider or fund managers.

See our Alert on Pension transfers and early exit charges for more details

Pension transfers and early exit charges

Proposals have been announced which will place a duty on the FCA to cap excessive early exit charges facing those wishing to take advantage of the pension freedoms. To ensure similar protection, the requirements will be mirrored for trust-based schemes.

FCA data collected through its consultation on options to address possible barriers to pension switching showed that nearly 700,000 customers (16%) in contract-based schemes, who are able to flexibly access their pension, face potential early exit charges.

The joint FCA / HMT Financial Advice Market Review seeks to improve the accessibility and affordability of financial advice, including advice in relation to pensions. Because of the potential impact of the review on the nature of and need for advice, the Government intends to await its outcome before taking any specific action on the advice requirement. Recommendations are due to be published around the Budget on 16 March 2016.

More time sought to implement national rules

MiFID II implementation delayed until 2018?

MiFID II applies to defined categories of investment services and activities relating to defined categories of financial instruments, including equities and non-equities. The reform package is designed to introduce new market structures and attempt to close loopholes to ensure that, when appropriate, trading will take place on a regulated market.

MiFID and associated regulation, MiFIR, were originally due to be implemented by EU member states by 3 June 2016 and brought into force by 3 January 2017. But with the implementing legislation still unavailable, draft reports on both MiFID II and MiFIR by the EU Parliament's ECON committee propose pushing both deadlines back 12 months (in line with the overall delay) to allow enough time for national rules to be put in place.

ESMA lists exempt arrangements

EMIR: ESMA supports clearing exemption for UK pension funds

Designed to improve the stability of the OTC derivative markets throughout the EU, EMIR requires standard derivative contracts to be cleared through central counterparties (CCPs) and establishes stringent organisational, business conduct and prudential requirements for these CCPs.

Under transitional provisions, certain pension schemes are exempt from the clearing obligation for all OTC derivative transactions which are "objectively measurable as reducing investment risks directly relating to the financial solvency of pension schemes". ESMA is required to list the types of entities that have been granted an exemption from the clearing requirement and on 19 February 2016 published a list of UK pension scheme arrangements which have permission from the FCA (supported by ESMA) to use the temporary exemption. Although the individual arrangements are not named, they include buyout schemes and pooled funds.

Back to basics: pooled investment funds

Ralph McClelland,
Associate Director
ralph.mcclelland@sackers.com

Overview

Pooled investment vehicles are the building blocks of most pension schemes' investment portfolios. Even schemes with large segregated mandates are likely to use pooled products for their alternatives allocations. It is important for trustees to understand the legal features of pooled investment funds.

It is true that many products will be difficult to negotiate, particularly if they are constituted in a more regulated regime. However, pension funds are substantial investors and should not be afraid to seek side terms or additional comfort. You won't know what accommodations can be made until you ask. At the very least, a trustee will want comfort that the asset it is buying does not contain anything unexpected or off-market.

What do you own?

Pooled investment products are typically structured as a company, limited partnership, trust or a contractual vehicle (which may or may not be an insurance policy).

A key point to understand in any such relationship is that, by committing to the fund, the trustees will become entitled to the bundle of rights attached to participation in the vehicle. Trustees should not expect to have any direct (or even indirect) interest in the assets of the investment vehicle itself.

By way of example, if you are buying shares in a UK OEIC, you own shares in that company and have no entitlement to the investments owned by the OEIC. Trustees therefore need to look very closely at the rights and obligations associated with owning the OEIC's shares.

Limited liability

This is the single most important legal question in pooled fund investing.

Trustees will want to be absolutely confident that its liability is limited: they should not be assuming any responsibility for the debts and obligations of the vehicle in which it is investing. To know this, the trustees need to understand the legal structure of the investment.

Liquidity

A key feature of any investment will be liquidity, or lack thereof. How often does the fund deal, when will redemption proceeds be paid and will it always be in cash? Most liquid pooled funds have gating and or suspension provisions. This is not necessarily a bad thing, but there are instances of investors being caught out when they were unable to redeem promptly from a fund they had considered to be liquid.

Manager discretion

The key selling point of any pooled fund is the talent of the management team. However the biggest problems have arisen where a manager is not behaving as its investors expect. Trustees should go into a fund (particularly an illiquid fund) with a clear understanding of what investment restrictions exist to control a manager's discretions. In some cases, there will be almost none. This may be fine, but the trustees will at least want to have their eyes open.

Provider removal

If you are investing in a closed ended fund with a long duration, you will want to look very closely at what controls you have over the fund's general partner or investment manager.

At very least, you will want to see "for cause" removal provisions and to understand what percentage of investor buy-in is needed before the removal can be effected.

Sackers 50 FIFTY YEARS OF PARTNERSHIP

Contact

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.

Paul Phillips
Partner
D 020 7615 9523
E paul.phillips@sackers.com

Key areas of expertise include: de-risking, LDI, longevity transactions, OTC derivatives and repurchase agreements, investment management, transition and custody arrangements.

Ian Cormican
Partner
D 020 7615 9501
E ian.cormican@sackers.com

Key areas of expertise include: longevity swaps, buy-ins and buy-outs, liability driven investment (LDI), fiduciary management and governance.

Stuart O'Brien
Partner
D 020 7615 9539
E stuart.obrien@sackers.com

Key areas of expertise include: investment management agreements, buy-ins and buy-outs, LDI, ESG issues, stewardship, socially-responsible and ethical investing.

Vicky Carr
Partner
D 020 7615 9570
E vicky.carr@sackers.com

Key areas of expertise include: guarantees, escrow arrangements, other contingent assets, in-specie contributions, asset-backed funding structures and banking reform.

Sebastian Reger
Partner
D 020 7615 9039
E sebastian.reger@sackers.com

Key areas of expertise include: longevity swaps, LDI, OTC derivatives, managed and static security and collateral structures, transfer of asset portfolios, repurchase transactions and securities lending.

Ralph McClelland
Associate Director
D 020 7615 9532
E ralph.mcclelland@sackers.com

Key areas of expertise include: fiduciary management, custody, the Local Government Pension Scheme, and all types of pooled investment products including private equity, hedge funds and infrastructure.

Sign up

Stay up to date with all the latest developments in pensions law by signing up to our free publications on www.sackers.com/knowledge/publications. These include 7 Days, our weekly round up, Alerts where topical issues in pensions are covered in depth and Briefings which summarise essential issues in pensions.

Sacker & Partners LLP
20 Gresham Street
London EC2V 7JE
T +44 (0)20 7329 6699
E enquiries@sackers.com
www.sackers.com

Nothing stated in this document should be treated as an authoritative statement of the law on any particular aspect or in any specific case. Action should not be taken on the basis of this document alone. For specific advice on any particular aspect you should speak to your usual Sackers contact. © Sacker & Partners LLP March 2016