Sackers

Finance & investment briefing

March 2017

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

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Electronic format

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Abbreviations

DC: Defined contribution

EMIR: European Market Infrastructure Regulation

ESG: Environmental, social and corporate governance

ESMA: European Securities and Markets Authority

FCA: Financial Conduct Authority

IORP: Institutions for Occupational Retirement Provision

LDI: Liability driven investment

LGPS: Local Government Pension Scheme

OTC: Over-the-counter

OTC Derivatives: Over-the-counter derivative transactions

PLSA: Pensions and Lifetime Savings Association

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

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Finance & investment focus

"Welcome to the first issue of our finance & investment briefing for 2017. Every quarter we try to provide you with an update on the relevant legal developments, and to look more broadly at trends and debates which we think will impact on investment activities. Once again, there is no shortage of issues to cover.

The FCA is honing in on the asset management industry and has published an interim report suggesting weak competition in the industry. Ralph McClelland will get you up to speed. ESG considerations in investment decisions is an area that has been bubbling away under the surface for some time – we think trustees will need to pay more attention to it in the years to come. Stuart O'Brien shares his insights. Then there is the usual regulatory upheaval: with only about six months to go before pension schemes were expected to have to clear interest rate swaps, the timetable gets pushed out further. Our regulatory round-up provides the latest.

Finally, Sackers' finance & investment group will once again be attending the PLSA investment conference this year from 8-10 March. We hope to see as many of you as possible at stand 17 in the exhibition hall (as usual, breakfast rolls will be available!). Faith Dickson will be speaking at the conference with Chris Martin of ITS on the solvent restructuring of the Halcrow Group Pension Scheme – I expect this will be of interest to many trustees, employers and advisers. If you miss the session in Edinburgh but want to know more, do get in touch."

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Upcoming seminar

Finance and investment seminar – governance and risk

Thursday 1 June 2017
Evening seminar (5.30pm – 7pm)

An interactive discussion exploring the increasing obligations on trustees concerning investment governance and risk

Register on our website www.sackers.com/events

Back to basics: arbitration v litigation

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Where a dispute arises in a pensions context, trustees may have to decide upon the best method to resolve the issue. Equally, trustees often need to think about a dispute before it has even arisen, as agreements often contain clauses that require any dispute to be handled by a particular method – for example, jurisdiction clauses or arbitration clauses.

Litigation and arbitration are two of the options which are legally binding on the parties involved; however there are key differences between them which trustees need to understand.

What does litigation involve?

Litigation occurs where parties go to court to resolve a dispute. One side will usually commence proceedings against the other and there is often the possibility of a route to appeal a judgment on either the merits of the case or on a point of law.

Courts hear cases publicly except in very limited circumstances and have wide powers to require documentary discovery, compel witnesses to testify and to provide interim relief where necessary. In very straightforward cases, the court has the ability to provide a summary judgment, speeding up the process. However, in more complex cases, significant delay in the judicial system can result in disputes going unresolved for long periods of time.

What does arbitration involve?

Arbitration is a method of alternative dispute resolution which seeks to avoid the need for litigation and provides parties with the ability to consensually agree a tribunal tailored to meet highly specialised disputes.

Arbitration is a private process where the parties are subject to confidentiality and can provide a degree of finality, as awards are subject to appeal only on the grounds of limited procedural irregularities. The New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards provides an enforcement regime for international arbitration awards for the 148 signatory nations (of which the UK is one), which means that there are very limited circumstances in which an award given in one signatory state cannot be enforced in another.

It should be noted that arbitration is not necessarily any quicker or cheaper than litigation.

Key considerations for trustees

When deciding whether to accept an arbitration or jurisdiction clause in a contract, or deciding ad hoc whether litigation or arbitration is better suited to a particular dispute, trustees should consider the following:

- does the dispute relate to any confidential information which requires appropriate discretion?
- is there an international element to the dispute which may mean that enforcement in a foreign jurisdiction could be important?
- is finality of the outcome vital commercially, or is the likelihood of an appeal preferable?
- will resolution of the dispute require documentary disclosure ordered by a court?
- does the dispute arise in a highly specialised area where a panel made up of experts would be considered expedient?
- is there a chance that interim relief may be required?

Asset management: FCA interim report

Ralph McClelland
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UK pension schemes are collectively the single largest asset manager client in the UK, with approximately £3 trillion of assets under management. As such, they will be keenly interested in the FCA's conclusions on the competitiveness of the asset management market.

The FCA recently published an interim report on its ongoing Asset Management Market Study. The report details some challenging findings for both asset managers and investment consultants. In particular, the FCA has questioned whether parts of the asset management industry are working competitively to clients' benefit, as well as raising important questions about the role of investment consultants. For some, the report is being welcomed as a bold move by the FCA to address longstanding concerns. Others are less convinced that the FCA has accurately captured the issues, or gathered sufficient responses to support its conclusions.

> **"The Evidence suggests there is weak price competition in a number of areas of the asset management industry. This has a material impact on the investment returns of investors through their payments for asset management services.**

The FCA reached this conclusion based on a number of observations arising from their review and analysis. Amongst those observations, the FCA:

- noted that many active managers offer similar exposure to passive funds whilst, in some cases, charging significantly more
- found no clear relationship between price and performance among the managers they looked at
- noted there had been little change in fees for active managers over the period reviewed.

In reaching its conclusion, the FCA also found that governance bodies (including pension scheme trustees) fail to exert pricing pressure by scrutinising managers' costs.

The FCA also looked at the role of investment consultants in advising trustees, concluding that ratings do not help investors identify better performing mangers.

FCA recommendations include:

- a strengthened **duty on asset managers to act in the best interests of investors**
- introducing an **all-in fee** approach and requiring **clearer communication of fund charges**
- requiring **clearer disclosure of fiduciary management fees and performance**
- exploring the potential benefits of **greater pooling of pension scheme assets**
- recommending that HM Treasury considers bringing the provision of **institutional investment advice within the FCA's regulatory perimeter**.

The FCA will also consult on whether to make a market investigations reference to the Competition and Markets Authority.

Asset management: FCA interim report cont.

It will be for the investment management and consulting industry to respond to the substantive findings presented by the FCA. It has been interesting to see how muted, in public at least, the responses have been to date (with one or two exceptions). Clearly, however, a lot of work is being done behind the scenes; this is an interim report and the FCA will be looking for constructive engagement from the industry.

The FCA's recommendations do have potentially significant legal implications.

Legal duty of care

The FCA is not suggesting that investment managers owe no duty of care to their investors; its proposal focuses on ways that duty could be expanded in investors' interests. Particularly interesting, is the idea that the manager might be held accountable for how they deliver "value for money". Although the FCA acknowledges that active management is likely to be more expensive than passive, it wants to see the sort of price competition that it believes has been taking place in the passive space. In addition, it thinks accountability for this could be introduced by increasing independence on fund oversight committees.

Pooling

It is not a novel observation that smaller schemes are often unable to negotiate as well as larger ones: there is a developing "tale of two cities" in pensions in this respect. The FCA suggests that, while larger schemes are able to look after themselves, smaller ones struggle and may not be as well served by investment consultants and managers. The FCA will be watching developments in the LGPS space with interest, but there are key differences here. The LGPS has a common benefit structure administered by councils whose similarities may be more important than their differences. It may be much harder to promote co-operation on this scale among disparate smaller schemes and their sponsors.

Institutional advice

It is undoubtedly a peculiarity of the current situation that some parts of investment consultants' advice to trustees is not FCA regulated. That said, those giving the advice are almost invariably regulated. It is not clear at this stage whether bringing this advice within the FCA's ambit would make a great deal of difference. It is also important to note on this point that the FCA has made very clear that it has excluded investment consultants' work on asset allocation from the scope of this review, which many would argue is a key part of the consultants' role.

Environmental, social and governance: latest news

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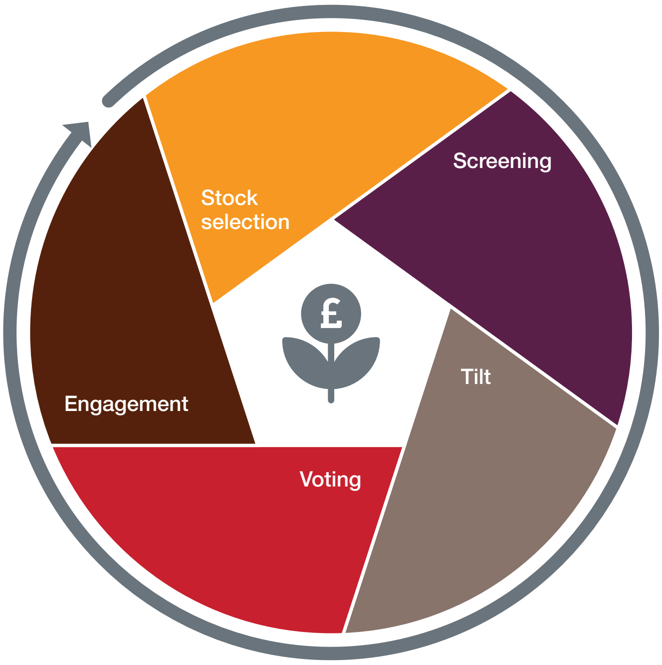
IORP II – the new Pensions Directive

A new European Pensions Directive came into force in January 2017, aiming to improve governance and accountability in relation to workplace pensions.

Among other things, the Directive includes a new obligation on Member States to "allow IORPs to take into account the potential long-term impact of investment decisions on environmental, social and governance factors". Trustees' investment decision making processes will also need to build in ESG factors and state how their investment policy takes them into account.

Member States have two years to bring the Directive's provisions into national legislation. Until the UK actually exits the EU, it remains under an obligation to do so. For more general information on the Directive, please see our Alert.



Pension Funds and Social Investment: Law Commission call for evidence

On 3 November 2016, the Minister for Civil Society, Rob Wilson MP, asked the Law Commission to look at social investment by pension funds. The project builds on the Law Commission's 2014 report, Fiduciary Duties of Investment Intermediaries, which provided guidance on when trustees could take ESG factors into account.

The latest Call for Evidence considers the legal and regulatory barriers to social investment, focusing in particular on DC pensions. Among other things, it looks at the French example of "Solidarity Investment Funds", used for workplace savings, where up to 10% of funds are invested for social impact – eg affordable housing, environmental schemes and social inclusion projects. The Law Commission is aiming to publish its final report in May 2017.

For information on the PLSA Corporate Governance Policy and Voting Guidelines see the legal update section

Adoption of ESG factors in DC

HSBC Bank UK Pension Scheme has selected Legal & General's newly created "Future World Fund" for its equity default option for DC scheme members.

The new fund, launched in November 2016, is worth £1.85 billion. The fund is described as a multi-factor global equities index fund and weights constituents according to certain defined ESG 'factors' or attributes, rather than according to their size as with a conventional index.

The fund also incorporates a 'climate tilt' to reduce exposure to companies with 'worse-than-average' carbon emissions and fossil fuel assets, and increases exposure to companies that generate revenue from low-carbon opportunities. In doing so, it becomes one of the first schemes to adopt a strategy incorporating a degree of climate change protection as its default fund.

For more information on ESG see our guide – A practical approach to ESG

Legal update

EMIR

Further delays in, and review of, the clearing obligation for pension schemes

- **Pension scheme exemption extended to 16 August 2018.** On 20 December 2016, the European Commission adopted a Delegated Regulation extending further the transitional relief for pension scheme arrangements from central clearing of their OTC derivative transactions under EMIR. The transitional period has been extended until 16 August 2018. The Commission stated that pension funds are active participants in the OTC derivatives markets and without the extension they would have to source cash for central clearing. As pension schemes do not hold significant amounts of cash or highly liquid assets, imposing central clearing requirements would require very far-reaching and costly charges to their business model, which could affect pensioners' income.
- **Consultation on application of clearing obligation to pension schemes.** On 14 November 2016, ESMA published its final report following consultation in July 2016 on the amended application of the clearing obligation for financial counterparties with a limited volume of activity (category 3 firms) under EMIR (which includes most UK pension schemes). The consultation was issued as some category 3 firms were facing difficulties in preparing for the clearing obligation. In addition, ESMA noted that the EU legislation is under review and still in the process of being finalised.

  Following the final report, ESMA proposes to delay the three EMIR Delegated Regulations on the clearing obligation by two years. It also proposes to align the three compliance dates for category 3 firms in the Delegated Regulations regarding interest rate swaps and credit default swaps. The newly proposed compliance date would be 21 June 2019.
- **EMIR review.** On 23 November 2016, the European Commission published a report following last year's Call for Evidence on financial services regulation. The report highlights that, as part of the EMIR review, the Commission will "consider adjusting the scope of EMIR clearing and margin requirements to address the diverse challenges faced by non-financial corporations, pension funds and small financial counterparties".

  The European Commission is undertaking a legislative review of EMIR pursuant to its Regulatory Fitness and Performance Programme with targeted amendments to the legislation expected in early 2017.

Corporate governance: PLSA

On 17 January 2017, the PLSA published an updated edition of its Corporate Governance Policy and Voting Guidelines. The guidelines build on the provisions of the 2014 UK Corporate Governance Code and call on investors to take a tougher stance on those who set executive pay policy.

The guidelines "are based on our members' interest in ensuring that companies are run in a sustainable, accountable fashion that generates returns for investors over the long-term while also behaving in a responsible manner and supporting the interests of wider society". In addition, the guidelines aim to ensure that the board and management of these companies are held accountable to shareholders such as pension funds.

The guidelines also call for companies to explain what steps they are taking to bring diversity to their boardroom, and suggest that annual reports should include better information about a company's corporate culture and employment practices.

Sackers

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, employers and providers on all aspects of pension scheme finance and investment.

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