Sackers

Finance & investment briefing

March 2019

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

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Abbreviations

CMA: Competition and Markets Authority

DB: Defined benefit

DC: Defined contribution

DWP: Department for Work and Pensions

EMIR: European Market Infrastructure Regulation

ESG: Environmental, social and governance

EU: European Union

FCA: Financial Conduct Authority

IGC: Independent governance committee

LDI: Liability-driven investment

OTC: Over-the-counter

PLSA: Pensions and Lifetime Savings Association

SIP: Statement of Investment Principles

TPR: The Pensions Regulator

Finance & investment focus

"In our March 2019 finance & investment briefing, we set out our thoughts on how to navigate the implications of Brexit on pension scheme investment arrangements. Whilst, at the time of writing, there is uncertainty around Brexit and the landscape of financial services post 29 March 2019, we can at least define "prorogation" and explain the "Italian Torpedo" in relation to the reliability of international agreements.

The buy-in/out market shows no signs of slowing, and Sackers remains at the forefront of this work. We are refreshing our guidance to reflect developments in the market over the past 12 months and to set out how trustees should prepare for a buy-in/out, together with the trickier issues they may be faced with.

We are publishing our third guide on ESG which will help trustees prepare for the changes to the SIP requirements and the options of implementing ESG policies over coming years. Look out for these guides on our website.

Our legal update focuses on the CMA's final report on the investment consultancy market and what this means for trustees' relationships with fiduciary managers.

The Sackers investment team will be at the PLSA investment conference in Edinburgh between 6-8 March 2019. We would be delighted to see you at our stand."

Ralph McClelland
Partner, finance & investment group

ralph.mcclelland@sackers.com

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Navigating Brexit

At the time of writing, in January, the House of Commons has just delivered the largest Parliamentary defeat of any Prime Minister with MPs rejecting Theresa May's Brexit deal. Subsequently, the Prime Minister narrowly survived a confidence vote, and has promised to reach out to party leaders to find a consensus. The result of any negotiations, the Prime Minister's future and Brexit itself are all uncertain, but from the perspective of pension scheme investment arrangements, the complexity of this area can be managed by focusing on key questions.

1 Will EU 27 banks, managers and other counterparties currently operating in the UK still be authorised to do so?

This is a matter of regulatory status. Pension schemes routinely deal with EU 27 counterparties carrying out activities requiring FCA authorisation within the UK. They currently rely on the EU passporting regime to do so.

Under the withdrawal arrangements, the transition period would run to 31 December 2020 preserving the status quo for the time being.

Following a no deal Brexit, the current regime will fall away. To minimise the disruption to services, the FCA has put in place the temporary permissions regime, which was approved on 6 November 2018. The FCA has confirmed that EU 27 organisations who are currently operating in the UK will be given temporary permission to continue to do so while they either apply for permanent permission under the UK rules or make alternative arrangements. Firms wishing to take advantage of this regime will need to do so by notifying the FCA of their intentions before 28 March 2019.

Trustees may want to check in with their EU 27 providers to ensure that they have sought temporary permission, if required.

2 Can we rely on agreements with non-UK firms?

One of the very effective parts of the EU framework was the establishment of relatively simple rules around which courts would deal with an international dispute. Historically this has not always been a straightforward matter, so that a person based in one European country might need to think carefully about how any dispute with a person from another country would be dealt with, in terms of which countries' laws would apply, in which country any claim might be brought (referred to as "prorogation" by some lawyers), and whether any judgment handed down by that court would be recognised in another jurisdiction.

Before the EU's Brussels Regulation, it was possible to frustrate international disputes by bringing a claim in a European jurisdiction with no connection to the dispute but known to be slow, inefficient or labouring under a backlog of cases. The claim would then need to be processed in that system before any other court could consider the matter, a tactic commonly referred to as the "Italian Torpedo".

From the pension scheme perspective, this is particularly relevant because scheme investment portfolios are now often international. Many pension scheme investments already operate outside the EU, particularly in the alternatives space. These arrangements will not be directly affected by Brexit. So, for example, a private equity fund structured as an exempted limited partnership in the Cayman Islands should be unaffected.

By contrast, in relation to an investment structured, for example, as a Luxembourg special limited partnership, the trustee will no longer have the benefit of the overarching European rules prescribing how any choice of law clause will be governed. In the overwhelming majority of cases, this will not matter. However, should a dispute arise, there could be additional cost and delay if the parties cannot agree which courts should hear the matter or potentially, how to enforce any judgment handed down by a court.

The government sought to address some of these concerns in late December 2018 by acceding to the 2005 Hague Convention on Choice of Courts Agreements with effect from 1 April 2019 (in a no deal scenario). While this will provide certainty for exclusive choice of jurisdiction clauses in new agreements, it does not necessarily assist with pre-existing agreements. This remains an area to watch, but it would be a great shame if Brexit caused a step backward in terms of the clarity and certainty in this area provided by the current regime, as it is hard to see who (other than the lawyers) would benefit.

Navigating Brexit cont.

3 Derivatives

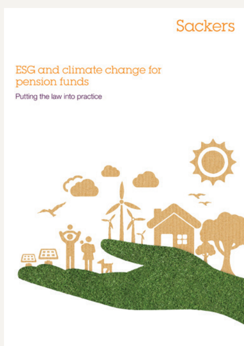
Pension schemes with segregated derivatives portfolios will need to consider the points mentioned above in relation to their counterparty banks: any EU 27 banks without UK branches will need to seek temporary permission or to make other arrangements.

In addition, trustees will be aware of the importance of EMIR which is, inconveniently, in the middle of a significant refit.

The UK has, in effect, "cut and pasted" the EMIR rules into UK law with a view to preserving the status quo. How the refit will be dealt with is less clear at this time, but we do not expect Brexit to presage a material shift in the regulatory framework for derivatives (or, indeed, pension scheme investing generally) in the short to medium term.

Environmental, social and governance investment

See our Alert "Government response: clarifying and strengthening trustees' investment duties" for full details



We are expecting 2019 to be another big year for ESG. Most trustees will now be aware of the DWP's consultation during summer 2018 and the resulting changes to the Occupational Pension Schemes (Investment) Regulations 2005. Following the consultation, pension trustees must now update their schemes' SIPs by October 2019 to set out their policies on ESG, climate change and stewardship activities, with additional requirements applying to trust based DC schemes.

However, the changes to the investment regulations are not the only legal development that will impact pension schemes during 2019. The Occupational Pension Schemes (Governance) (Amendment) Regulations 2018 came into force on 13 January 2019, designed to implement the second European Pensions Directive ("IORP II"), and have potentially more far reaching implications in terms of integration of ESG into trustee risk control processes. Further changes are expected to flow from the Shareholder Rights Directive II and the European Commission's Action Plan on Sustainable Finance. In addition, we are anticipating a consultation from the FCA imminently on how ESG and climate change factors should be taken into account by trustees and their IGCs in contract based pension schemes.

For more information on the forthcoming changes, please look out for our new guide "ESG and climate change for pension funds". As well as summarising the actions trustees need to take to comply, the guide will look at how trustee fiduciary duties require a prudent assessment of risks and set out a next steps guide for pension schemes, both for those trustees just getting started and for those who want to go further in terms of ESG integration.

Buy-ins, buy-outs and longevity

In our forthcoming 2019 guide to buy-ins, buy-outs and longevity transactions we look back at a record breaking year in 2018 in which bulk annuity volumes exceeded £20bn. Sackers are proud to have advised on eight separate bulk annuity transactions during the year, of all sizes and structures and at an aggregate deal volume of more than £3.2bn.

With 2019 predicted to be yet another big year for bulk annuities, our guide focuses on how trustees should prepare for a buy-in or buy-out, together with the trickier issues trustees may be faced with. As always, the schemes best placed to take advantage of pricing opportunities will always be those which have a clear idea of what they are trying to achieve and already have their data and benefit specifications in order long before they go to market.

Legal update

CMA publishes final report on the investment consultancy market

On 12 December 2018, the CMA published the final report in its Investment consultants market investigation. The provisional report was published on 18 July 2018 (for further information please see our September 2018 finance & investment briefing). The findings and outcomes of the report are set out below with a consultation on proposed draft legislation expected early this year. The CMA's proposals, if/when imposed, will impact how trustees engage with their consultants and fiduciary managers.

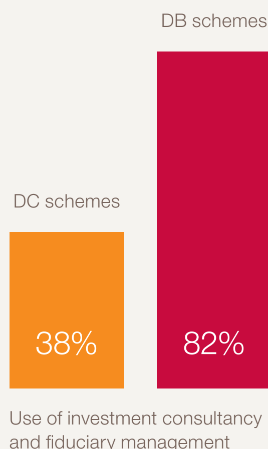
The report found that there is an adverse effect on competition in the investment consultancy and (to a greater degree) the fiduciary management markets, from which "substantial customer detriment may be expected to result". The report concludes that there is a low level of engagement by some customers when choosing and monitoring their investment consultant, it being difficult for customers to access the information needed to evaluate the quality of their consultant and to identify if an alternative provider would be preferable. Firms providing both investment consultancy and fiduciary management have an incumbency advantage with respect to their advisory customers. There is low customer engagement at the point at which pension schemes first purchase fiduciary management, meaning investment consultants steer advisory customers towards their own fiduciary management service.

The CMA has therefore proposed various remedies (many of which were suggested in its provisional decision published in July 2018) aimed at addressing the problems it has found "in an effective and proportionate way".

The remedies include:

- the introduction of mandatory tendering when pension trustees first purchase fiduciary management services in relation to 20% or more of scheme assets, and a requirement to run a competitive tender within five years if a mandate was awarded without one
- a requirement on investment consultants to separate marketing of their fiduciary management service from their investment advice, and to inform customers of their duty to tender in most cases before buying fiduciary management
- requirements on fiduciary management firms to provide better and more comparable information on fees and performance for prospective customers, and on fees for existing customers
- a requirement for trustees to set objectives for their investment consultant, in order to assess the quality of investment advice they receive
- a requirement on investment consultancy and fiduciary management providers to report performance of any recommended asset management products or funds using basic minimum standards
- TPR giving greater support for trustees when running tenders.

The CMA is also making recommendations to government to enable TPR to oversee the trustee remedies and to extend the FCA's remit to include all of the main activities of investment consultants.



Use of investment consultancy and fiduciary management

In addition, as in the provisional report, the CMA has confirmed their findings that "DC schemes' use of investment consultancy and fiduciary management is much lower at 38%, compared to 82% for DB schemes; and, when they do use them, we found that they have lower levels of engagement as measured, for example, by switching: 16% have switched in the past five years, compared to 28% of DB schemes". The CMA "encourage" regulators and policy makers to continue to consider how best to ensure that DC scheme trustees are sufficiently focused on investment matters.

The remedies will be implemented by way of CMA order. Draft legislation setting out the new requirements will be issued for consultation in February 2019. The statutory deadline for implementing remedial action is 11 June 2019. TPR is expected to issue guidance within six months of the order being made.

Sackers

Contact

Sackers is the UK's leading commercial law firm for pension scheme trustees and employers. Over sixty 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, corporate investors and providers 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: derisking, 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, funding negotiations, buy-ins and buy-outs, 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.

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

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

Mike Fallow
Associate
D 020 7615 9503
E mike.fallow@sackers.com

Key areas of expertise include: investment management agreements, pooled and segregated mandates and custody arrangements, and ESG issues.

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

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