

Finance & investment briefing

June 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
DC: Defined contribution
DWP: Department for Work and Pensions
EEA: European Economic Area
EMIR: European Market Infrastructure Regulation
ESG: Environmental, social and governance
EU: European Union
FCA: Financial Conduct Authority
FRC: Financial Reporting Council
HMT: Her Majesty's Treasury
ICMA: International Capital Market Association
LDI: Liability-driven investment
OTC: Over-the-counter
SIP: Statement of Investment Principles
TPR: The Pension Regulator

Finance & investment focus

“Our finance & investment briefings over the past year or so have been dominated by Brexit (who would have guessed) and Environmental, Social and Governance (ESG) issues. In this briefing, we have managed to largely avoid focussing on Brexit. However, with climate change protests featuring high on the news agenda in recent weeks, we take another look at ESG. While climate change is an integral part of ESG, it is important to remember that it is not the only consideration. In this issue, we take a closer look at the Stewardship Code and the Shareholders Rights Directive II. The Directive, to be implemented into UK law by 10 June 2019, imposes significant new disclosure obligations on pension scheme trustees.

If you would like discuss any of the matters covered in this briefing please speak to your usual Sackers contact.”



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Stewardship – update

We have seen ESG factors rising swiftly up trustees' agendas (see our latest [guide](#)) and stewardship is one element that is gaining prominence.

Under the [Investment Regulations](#), from 1 October 2019, scheme SIPs will need to include a statement covering the trustees' policy on engagement activities. In addition, the requirements for DC schemes have gone further, requiring scheme annual reports to include a statement in relation to the default fund, setting out how the SIP has been met in the previous year.

Perhaps less well publicised are additional requirements expected later in 2019.



Stewardship code

On 30 January 2019, the FRC published for consultation [proposed revisions to the FRC UK Stewardship Code](#), that aim to set “substantially higher expectations for investor stewardship policy and practice”.

Adoption of the UK Stewardship Code has historically been a convenient approach to stewardship. This has, unfortunately, in some cases meant adoption of the code without taking any material steps to ensure it was adhered to.

The majority of the current 2012 UK Stewardship Code's principles and guidance have been retained by the proposed revisions, but there may now be important, and potentially burdensome, requirements if trustees wish to remain signatories.

Under the revised code, all signatories will be required to make public disclosures about their stewardship activities and an assessment of how effectively they have achieved their objectives. Reporting will be made up of a “Policy and Practice Statement” (required on signing) and an annual “Activities and Outcomes Report”. Taking a more passive approach to the code will no longer be an option if these proposals are adopted.

In addition:

- ✓ investors must report how their purpose, values and culture enable them to meet their obligations to clients and beneficiaries. This aligns the code with the UK Corporate Governance Code and encourages embedding behaviour conducive to effective stewardship in the investor community
- ✓ the proposed code now specifically refers to ESG factors. Signatories are expected to take material ESG issues into account when fulfilling their stewardship responsibilities. The consultation also suggests expanding the code to include non-equity assets such as fixed income bonds and infrastructure equity (which will be of particular significance to the many schemes which have moved into these asset classes)
- ✓ the revised code aims to encourage greater demand for an engaged approach to stewardship aligned to investors' time horizons (which for pension schemes will generally be long-term).

The deadline for responding to the consultation was 29 March 2019. The 2019 version of the code is due to be published and come into effect in July 2019.

It is worth noting that, pursuant to the Independent Review of the FRC (the Kingman Review) in December 2018, it has been recommended that the FRC be replaced with an independent statutory regulator, accountable to Parliament, with a new mandate, new clarity of mission, new leadership and new powers. However, it is not expected that the approach of the new regulator (to be called the Audit, Reporting and Governance Authority) would differ materially in relation to the revised code.



Shareholders Rights Directive II

The amended Shareholders Rights Directive came into force in June 2017 and the deadline for implementing it into UK law is 10 June 2019. At the time of writing, the timing of Brexit makes the implementation of the Directive somewhat uncertain, but assuming that the UK has not left the EU by 10 June (or has left with a deal and is in a transition period at that point) we expect the UK to implement the Directive into UK legislation this year.

Stewardship – update cont.

The Directive imposes two significant new obligations on occupational pension schemes, which we would expect to be transposed into UK legislation. In both these cases, the disclosures must be made publicly on a website.

1

Development and disclosure of a shareholder engagement policy



Trustees will need to develop, and publicly disclose on their or their asset manager's website, a shareholder engagement policy which must describe:

- how shareholder engagement is integrated in the investment strategy
- how investee companies are monitored on matters such as strategy, financial and non-financial performance and risk, capital structure, social and environmental impact, and corporate governance
- how dialogue is conducted with investee companies
- the exercise of voting and other rights attached to shares
- cooperation with shareholders
- communication with investee company stakeholders
- the management of actual and potential conflicts of interest.

Each year, schemes will be required to publicly disclose how this engagement policy has been implemented, including describing voting behaviour, explanation of the most significant votes and the use of proxy advisor services. Schemes will also need to disclose how they have cast any significant votes, in the general meetings of companies in which they hold shares.

Where a scheme does not comply with one or more of the above requirements, they must publicly disclose a clear and reasoned explanation as to why.

2

Disclosure of main elements of equity investment strategy and arrangements with asset managers



Trustees will need to publicly disclose on their website how the main elements of their equity investment strategy are consistent with the profile and duration of their liabilities and how they contribute to the medium to long-term performance of their assets.

Where an asset manager invests on behalf of a scheme, the scheme must disclose (and update annually) on its website the following arrangements:

- how the asset manager is incentivised to align its investment strategy, and decisions with the profile and duration of the schemes liabilities, particularly long-term liabilities
- how the asset manager is incentivised to make investment decisions based on assessments about medium to long-term financial and non-financial performance of the investee company, and to engage with investee companies in order to improve their performance in the medium to long-term
- how the method and time horizon of the evaluation of the asset manager's performance and the remuneration for asset manager services are in line with the profile and duration of the scheme's liabilities, in particular long-term liabilities, and how absolute long-term performance is taken into account
- how the scheme monitors portfolio turnover costs incurred by the asset manager, and how the scheme defines and monitors a targeted portfolio turnover or turnover range
- the duration of the arrangement with the asset manager.

Where a scheme does not comply with one or more of the above requirements, they must publicly disclose a clear and reasoned explanation as to why.

In addition, asset managers themselves must also make annual disclosures to the scheme.

In January 2019, the FCA consulted on rules to implement the Directive ahead of the June 2019 deadline. The consultation closed for comment on 27 March 2019.

HMT confirms intention to extend EMIR clearing exemption

Clearing exemption

On 21 February 2019, HMT published a [statement confirming its intention that the clearing exemption](#) under EMIR will apply to both UK and EEA pension scheme arrangements, should the UK leave the EU without a deal or an implementation period. The statement also confirms that HMT intends to incorporate a temporary clearing exemption for both UK and EEA pension scheme arrangements into domestic law.

EMIR, meanwhile, is undergoing a significant refit, with a view to amending and simplifying the regulation. Following [agreement between the Council of the EU and the EU Parliament](#) on the “Refit Regulation” on 5 February 2019, further technical work is being carried out before the final texts are adopted.

Draft regulations expected later in 2019

CMA order

On 12 March 2019, the DWP, TPR and HMT published their [response](#) to the CMA’s investment consultants market investigation, addressing [the recommendations the CMA had made in its final report](#). The remedies included the introduction of mandatory tendering when trustees first purchase fiduciary management services, and a requirement to run a competitive tender within five years if a mandate was previously awarded without one.

The response confirms that:

- the DWP will look to pass the necessary legislation to enable TPR to oversee duties on trustees. It intends to produce draft regulations and consult on them this year. Subject to the outcome of that consultation, and Parliamentary time, it aims to bring regulations into force and to replace the CMA order in 2020
- TPR will develop guidance to help trustees in running a competitive tender process for fiduciary managers and will consider how to support trustees tendering for investment consultancy services. It will also consider broader guidance on engaging with fiduciary managers and investment consultants to support trustees in gaining the most benefit from the package of remedies. TPR aims to consult on the guidance in Summer 2019
- HMT will consider the CMA’s recommendation that it extend the FCA’s regulatory perimeter to cover services provided by investment consultants.

New due diligence requirements for occupational pension schemes and their investment managers

EU Securitisation Regulation (Regulation (EU) 2017/2402)

The [EU Securitisation Regulation](#) came into force on 1 January 2019. The regulations create new due diligence requirements for EU “Institutional investors”, which includes occupational pension schemes and their investment managers.

The new regulations require occupational pension schemes, in relation to any securitisation in which they invest, to:

- verify that the relevant risk retention requirements have been fulfilled
- verify that credit granting standards have been satisfied
- carry out due a due diligence assessment which permits them to:
 - understand the risks involved in the position that they are taking in the securitisation and the relevant exposures underlying them
 - understand the structural features of the securitisation
 - establish appropriate written procedures to ensure compliance with the above requirements.

The new regulations will need trustees to ensure that there are policies and procedures in place to comply with the new due diligence requirements. We expect that in practice trustees will be delegating this responsibility to their managers.

On 31 January 2019, the ICMA’s Asset Management and Investor’s Council published a [guide](#) to the due diligence requirements for investing in a securitised position. It includes a broad explanation of those requirements.

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.



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