Baker McKenzie.

Pensions Update

July 2018

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In This Issue

Government sets out further proposals for strengthening the Pensions Regulator

Context

We mentioned in our June update that the Department for Work and Pensions had published a consultation on proposals to strengthen the Pensions Regulator (the Regulator). This builds on proposals first put forward in the Government's March 2018 White Paper, **Protecting Defined Benefit Schemes**.

The Government has said that the aim of the proposals is to "clarify" current rules and expectations as to how DB schemes are regulated and that it is not seeking to make fundamental changes to the existing system. Some of the proposals would, however, if they are implemented in the way in which they are outlined in the consultation, mark a significant change to the current DB regulatory regime, including the type (and timing) of information which must be provided to the Regulator, the tests which the Regulator applies when deciding whether to take action against a potential target and the penalties which the Regulator can impose against targets for non-compliance.

The consultation will be of interest not only to trustees and sponsors with DB schemes, but, also more widely, to those involved in planning corporate transactions involving DB schemes - a number of the proposals are specifically aimed at increasing the Regulator's oversight of corporate transactions.

Summary of the key proposals

Changes to the notifiable event framework

The Government is proposing to extend the range of employer-related events which must be notified to the Regulator, whilst maintaining the risk-based approach of funding triggers. In addition, the Government wants to bring forward the timing of the notification requirement for certain transactions. The Government is proposing that the notification should be made no later than when negotiations have led to agreement in principle.

The proposed new notifiable events are:

- the sale of material proportion of the business or assets of a scheme employer which has funding responsibility for at least 20% of the scheme's liabilities (if implemented, this would mark a significant change as currently only share sales are caught);
- the granting of security in respect of a debt to give it priority over the debt to the scheme;
- the significant restructuring of the employer's board of directors and certain senior management appointments; and
- the sponsoring employer taking independent pre-appointment insolvency/restructuring advice.

The Government is also proposing to remove the existing notifiable event of wrongful trading of an employer and extend the breach of banking covenant advice notification requirement to cover a wider range of circumstances.

New declaration of intent

For some notifiable event transactions, the Government is proposing that the employer will need to issue a Declaration of Intent, setting out the implications of the transaction for the pension scheme and how any risks will be mitigated. This will be required at a later stage in the transaction than the notifiable event. The Government is proposing that the declaration should be made after parties have completed due diligence and transaction financing, but before signing.

The Government is proposing that the following corporate transactions would trigger the need for a Declaration of Intent:

- the sale of a controlling interest in a scheme employer;
- the sale of the business or assets of a scheme employer (one of the proposed new notifiable events); and
- the granting of security in priority to scheme debt (another of the proposed new notifiable events).

The Government is proposing that the declaration should be addressed to the trustees from the transaction's corporate planners (usually the board) and shared with the Regulator and should:

- explain the nature of the planned transaction;
- confirm that the corporate planner has consulted on its terms with the trustees (and confirm the trustees' agreement (or not)); and
- explain any detriment to the scheme and how this is to be mitigated.

New penalties

The Government is intending to give the Regulator power to impose new penalties for non-compliance. The new system is designed to give the Regulator the flexibility to vary the level of penalty, depending on the seriousness of the breach. Key aspects of the proposed new penalty regime include:

- new criminal offences to punish "wilful or grossly reckless behaviour" in relation to a DB scheme, non-compliance with a contribution notice and failure to comply with the notifiable events regime; and

- a new power to issue a civil penalty of up to £1 million for serious breaches and criminal sanctions.

In relation to the new criminal penalties, the Government has said that "**we intend these sanctions to be used in the most serous of cases of wrongdoing, where the Regulator decides that it is appropriate to bring a prosecution.**"

The Government believes that potential targets of these penalties should include all of those who have responsibility to the pension scheme. This includes directors, sponsoring employers, and, in some circumstances trustees. The consultation includes a non-exhaustive list of potential offences, along with suggested new penalties and targets. One example given in the consultation which is of particular relevance to trustees is non-compliance with elements of the DB funding code.

Changes to the current anti-avoidance regime

The Government is consulting on a number of proposed changes to the way in which the Regulator exercises its anti-avoidance powers, including:

in relation to Contribution Notices (CNs):

- amending the reasonableness test;
- changing the date on which the cap on the level of CN is calculated; and
- creating a new limb to the material detriment test.

in relation to Financial Support Directions (FSDs), the main changes proposed are:

- creating a single-stage process, under which the FSD would create a specific and enforceable obligation on the target;
- tightening up the forms of financial support that can be put in place;
- allowing FSDs to be issued to a wider range of people, where they are associated or connected with the employer;
- "exploring" whether the 2-year lookback period could be increased (and what appropriate protections could be put in place for businesses brought within scope by a longer period); and
- providing the Regulator with the power to issue an FSD after a scheme has entered the PPF.

Next steps

The consultation in running until 21 August. Many of the proposals outlined in the consultation are still at a fairly early stage and the Government will need time to work through much of the detail before they are in a position to bring forward legislation – such as how "wilful or grossly reckless behaviour" will be defined for the purposes of the new criminal offence and how the timings for the proposed declaration of intent will work. Even once this detail has been worked out, many of the proposals will require primary legislation, something we are unlikely to see before 2020.

For now, scheme sponsors and trustees and those involved in corporate transactions with DB schemes, should take note of the proposals and should maintain a watching brief as these develop further.

The consultation on the Regulator powers forms one aspect of the reform of the DB system which the Government was considering in its White Paper, **Protecting Defined Benefit Schemes**. Further consultation on other topics, such as DB consolidation and scheme funding, are expected later this year and in 2019 respectively.

The full consultation can be viewed **here**.

Competition and Markets Authority report on the investment consultancy market

On 18 July, the Competition and Markets Authority (CMA) published its provisional report following its investigation into the investment consultancy market, focusing on the investment consultant and fiduciary management industries. The CMA carried out the investigation following a reference from the FCA in September 2017.

The CMA's main provisional findings were as follows:

- It has identified competition problems within both the investment consultancy and in the fiduciary management markets. The issues identified within the fiduciary management market are more significant (it estimates that 13% of pension schemes use fiduciary management).

- Around half of pension schemes choose the same provider for fiduciary management that they use for investment consultancy, meaning that current investment advisers can steer clients to their own fiduciary management service. Companies which offer both services therefore have an advantage over other firms.

- Many pension trustees have low levels of engagement when choosing their first fiduciary manager (only a third ask firms to tender).

The CMA is proposing the following principal changes:

- Trustees will have to run a competitive tender process when appointing their first fiduciary manager (and trustees who have already appointed a fiduciary manager must re-tender within five years).
- Fiduciary managers should provide clearer information on fees and previous performance, in order to facilitate meaningful comparisons.
- The Government should broaden the FCA's regulatory scope, to ensure greater oversight over the industry.
- The CMA is making recommendations for new guidance from the Pensions Regulator, to provide trustees with more advice on how to choose and scrutinise providers.

The CMA is seeking feedback in relation to its provisional findings and proposals prior to 24 August 2018. A copy of a summary of the report can be found **here**, and the full report can be found **here**.

Pensions Regulator issues updated guidance on the Chair's Statement

The Pensions Regulator has published a paper giving a short guide to the Chair's Statement. The paper is intended to supplement and be read alongside the Regulator's DC code of practice no. 13. The guide sets out the penalties for poor statements, and provides a checklist for trustees to use when completing the statement, comments on what the Regulator expects to see, and provides examples of good practice and common mistakes. The checklist includes the following:

- Demonstrating how the default arrangement investment strategy requirements have been met;
- Demonstrating how the requirements for processing core financial transactions have been met;
- Demonstrating how the requirements for calculating member borne charges and transaction costs have been met, and explaining how they represent value for members;
- Demonstrating how the requirements around trustees' knowledge and understanding have been met;
- For relevant multi-employer schemes: demonstrating how the requirements around non-affiliation and encouraging member feedback have been met.

The guide includes the new requirements regarding the inclusion of costs and charges information in the statement, and the requirement that parts of the statement must be published online, both of which came into force in April 2018.

The Pensions Regulator's guide can be found **here**, and the DC code of practice no. 13 can be found **here**. The Technical Appendix to the guide can be found **here**.

Pensions Regulator imposes fines for Trustee breaches

The Pensions Regulator has imposed fines on two different sets of trustees, relating to late completion of a scheme valuation, and for failure to report late contributions.

- Rentokil Initial Pension Trustee Limited was fined £25,000 for failing to take all reasonable steps to complete the valuations of the Initial Hospital Service Limited No.1 Pension Scheme by the deadlines in 2010 and 2015. The Trustee had informed the Regulator that the valuations were being delayed owing to a proposed merger with another scheme, but the Regulator had repeatedly advised the Trustee that this was not a valid reason for failing to complete the valuation. However, the Regulator only imposed the fine after neither valuation had been submitted by the end of 2017, and the scheme merger had not happened.

The Regulator noted that, since April 2017, it has issued nine Warning Notices for late valuations, as part of its "clearer, quicker, tougher" approach.

- EC2 Master Limited, the trustee of the Autoenrolment.co.uk master trust, was fined £15,000 for failing to ensure that the scheme had a proper reporting system in place. As a result, the operator of the scheme, Smart Pension Limited, failed to report to the Regulator that 498 of its employers had failed to pay contributions to the scheme, and did not tell its members that this had occurred. The issue affected 2,115 members over a period of nearly two years, and involved non-payment of £888,615 of contributions. It came to light when Smart Pension reported these non-payments to the Regulator in October 2017, and the Regulator found that they should have been reported earlier.

The Pensions Regulator's full determination notices in these cases can be found **here** and **here**.

Response to consultation on master trust Code of Practice published

The Pensions Regulator has published its response to the consultation on the draft "Code of Practice 15: Authorisation and supervision of master trusts". It sets out the feedback received, and the changes which have been made as a result both to the code of practice and to the decision-making procedure for making authorisation decisions regarding master trusts.

The Pension Schemes Act 2017 increases the regulation of master trusts. Under the new Code of Practice, the Pensions Regulator will be directly authorising and supervising master trusts, and the Code and the authorisation procedure are intended to clarify for master trusts:

- how they should apply for authorisation;
- the matters which will be taken into account in deciding whether a master trust should be (and remain) authorised;
- the legal requirements which apply to authorised schemes, including significant and triggering events; and
- the procedure under which the decision whether or not to grant authorisation will be taken.

The full master trust authorisation and supervision regime is expected to take effect from October 2018, and the Regulator notes in the response that further publications will follow over the summer, including the supervision and enforcement policy, and that the need for further guidance will also be considered.

The full consultation response can be found **here**, and the Code of Practice itself, as laid before parliament, can be found **here**.

Pension Scams Industry Group issues updated version of its Code of Good Practice

The Pension Scams Industry Group first published its Code of Good Practice in 2015. This is a voluntary code for use by the pensions industry, intended to help share good practice, and reduce the risk of successful scams. Now, the Industry Group have updated the Code to Version 2.0, and have made a number of significant changes in order to:

- promote calling members as part of due diligence information collecting;
- include referring insistent customers to the Pensions Advisory Service for impartial guidance;
- update the Code to reflect recent developments including updates to the QROPS regulations, the *Hughes v Royal London case* (see our February 2016 Update), the growth in international SIPPs being used for scams, and the cold calling ban to be put in place later this year (see further below);
- include detailed guidance on reporting to Action Fraud, and encouraging providers and schemes to report scams.

The Code now also includes expanded example letters to members and HMRC, and expanded case studies.

Version 2.0 of the Code of Good Practice can be downloaded **here**.

Cold calling ban delayed until autumn 2018

The DWP's proposed ban on cold calling, which is intended to limit direct marketing activities in order to protect consumers from pension scams, is to be delayed until autumn 2018. It had originally been proposed that the ban would take effect in June 2018. A consultation has now been launched on the draft regulations, seeking views on technical issues with the regulations, and will continue until 11.45 pm on 17 August 2018. The intention is for the regulations to be laid before parliament in the autumn.

The full text of the written statement from the Treasury can be found **here**, and the consultation documents can be found **here**.

Pensions Disputes News

Court of Appeal judgment in British Airways case

The Court of Appeal has given its judgment in the case of *British Airways PLC v Airways Pension Scheme Trustee Limited*. As reported in our Pensions Update in May 2017, the trustees of the Airways Pension Scheme had amended the Scheme rules to allow discretionary increases to be granted to pensions in payment, in response to the switch from RPI to CPI for increases under the Treasury's Pension Increase Review Orders. The trustees then used this new power to grant increases of 50% of the difference between RPI and CPI. British Airways ("**BA**") challenged this, arguing that the Trustees did not have the power to make the award and, even if they did, the power had been exercised improperly (given the opposition of BA and the fact that the Scheme was in deficit). However, in the High Court, the judge found that the trustees had the power to award the increases and had exercised the power properly (although there was no obligation to grant the increases simply because the trustees have the power to do so, even if, as was the case with the APS, the Scheme was funded on a basis designed to allow for the increase).

BA appealed, and the Court of Appeal's judgment was handed down on 5 July 2018. By a majority decision of 2:1, the Court of Appeal allowed BA's appeal, overturning the High Court's decision and ruling that the introduction of the discretionary increase power by amendment and its subsequent exercise to award the relevant increases were an improper exercise of the powers conferred on the trustees under the Scheme's rules. The majority opinions of Lewison LJ and Jackson LJ commented that, in exercising the power of amendment to introduce the discretionary increase rule, the trustees had stepped outside the bounds of their role as delineated by the constitutional documents of the Scheme. As trustees, they were given powers under the rules for the purposes of the management and administration of the Scheme. By contrast, the design of the Scheme was a matter for the employer (BA). The way in which the trustees had exercised their powers was improper because it strayed into the realms of benefit design, which was a matter for the employer.

The trustees have been granted leave to appeal to the Supreme Court, so this is unlikely to be the last word on this case.

The Court of Appeal's judgment can be found **here**.

Contact us

If you wish to discuss any of these issues further, please contact your usual Baker McKenzie lawyer.

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