SLAUGHTER AND MAY/

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PENSIONS BULLETIN

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Welcome to the October 2020 Pensions Bulletin from Slaughter and May. In this month's edition, we analyse the Pensions Regulator's guidance for employers and trustees on transfers to DB superfunds. We report on the Pension Protection Fund's proposed levy rules for next year, the progress of the Pension Schemes Bill, and two recent cases on rectification and on VAT. We highlight potential problems for DC schemes caused by temporary closures of self-select funds and the effect of Brexit on derivatives contracts, and conclude with a look at the PLSA's Vote Reporting Template.

DB SUPERFUNDS: THE PENSIONS REGULATOR ISSUES GUIDANCE ON TRANSFERS

*For those trustees and sponsors looking to take advantage of a DB commercial consolidator ("superfund"), or one of the other alternative capital financing models, the Pensions Regulator (TPR's) updated **guidance** is a significant development. The requirements are largely as expected, with tough gateway tests and the need to apply for TPR clearance and with trustees needing to demonstrate that they have undertaken appropriate due diligence.*

TPR's new guidance replaces, with immediate effect, the December 2018 two-part guidance for trustees and employers respectively. It follows on from TPR's guidance in June 2020 for those running superfunds; for more details see our publication on DB superfunds. TPR emphasises that this is an interim regime pending legislation and the superfunds having been "assessed" by TPR in accordance with the criteria set out in the June guidance.

The guidance sets out in detail how trustees and employers must demonstrate why the transfer is in members' best interests and how it meets "gateway" principles. These principles will be a key area TPR considers in a clearance application; consequently, trustees and employers will have to collaborate in evidencing that they are satisfied.

Employers and trustees wishing to transfer to a DB superfund must demonstrate to TPR:

- Why they believe the transfer is in members' best interests, and
- How it meets the three "gateway principles":
    1. That the scheme cannot afford to buy-out now
    2. That there is no realistic prospect of buy-out "in the foreseeable future" (broadly speaking, a period of up to five years), given potential employer contributions and the employer's insolvency risk
    3. That the transfer improves the likelihood of members receiving full benefits.

There is detailed guidance on how to assess and demonstrate that the principles are met; for example, what the "foreseeable future" is for the scheme (an independent covenant assessment is likely to be a key component) and how the analysis of gateway

principle 3 should be addressed. Where that analysis does not demonstrate a clear improvement resulting from a transfer (but principles 1 and 2 are satisfied), the guidance lists other factors that may be taken into account, including the prior behaviour of the sponsoring employer.

TPR expects to see, as part of the clearance application, evidence of the consideration by trustees and employers of why it is preferable to move to a superfund rather than to stay with the employer and look for other forms of support to improve member security. Details of what other options have been considered will have to be provided. Trustees should subject their decision to "*proportionate discussions and review, including challenge*".

Another area of importance for TPR is the need for trustees to demonstrate they have considered past significant corporate activity (for example, mergers and acquisitions or bank refinances) for any potential material detriment or value extraction and whether the specifics of the proposed transfer to a superfund mitigate any detriment.

TPR expects employers to provide trustees (who will ultimately make the decision as to whether to transfer) with all the resources and information they need, and to pay for any professional advice. It also suggests that trustees consider appointing an independent trustee. TPR warns that, once a clearance application has been submitted, applicants should allow at least three months for a decision to be made.

PPF CONSULTATION ON 2021/22 LEVY RULES

The impact of COVID-19 is yet to filter through to an increase in Pension Protection Fund (PPF) levies. The ***consultation*** *on the 2021/22 levy rules adopts a new, one-year, approach, estimating a decrease in the levy collection amount for next year, but with levy invoices rising in 2022/23 as the pandemic affects company accounts.*

The Pension Protection Fund (PPF) published its consultation on the 2021/22 levy rules on 29 September 2020, including a draft levy determination and appendices on insolvency risk, contingent assets and transfers. The consultation closes on 24 November 2020 and the PPF expects to publish final levy rules at the end of January 2021. The deadline for submissions would be 31 March 2021.

The consultation sets rules for the next year only, instead of the usual three-year period. The levy estimate for 2021/22 is £520 million, £100 million less than the 2020/21 figure. The PPF expects this to mean that the "great majority" of schemes will see a reduction in levy compared to their 2020/21 invoice.

The consultation makes the following proposals:

- **Small scheme adjustment:** For schemes with liabilities of less than £20 million, levies would be reduced by applying a factor of 0.5 to the uncapped calculation of liabilities. For schemes with liabilities between £20 million and £50 million, there would be a gradual reduction.
- **Risk-based levy cap:** The cap, which limits the maximum risk-based levy, would be reduced from 0.5% to 0.25% of liabilities. The combined effect of this and the small scheme adjustment would be to reduce the number of schemes for which the levy is a high proportion of recovery plan payments.
- **Levy rules:** Changes to the rules reflect the revised methodology for calculating employer insolvency risk following the appointment of Dun & Bradstreet as the PPF's insolvency risk provider in place of Experian (see our Pensions Bulletin February 2020).
- **Asset information:** The PPF says it expects the new scheme funding Code from the Pensions Regulator (TPR) to take effect in 2022. The PPF will review, with TPR, amendments to the asset information which schemes are required to submit. Changes would be implemented for the 2022/23 levy year.

One issue the PPF has not mentioned is the impact of Brexit on contingent assets. From 1 January 2021, absent agreement with the EU, enforcement of an overseas guarantee from an entity based in the EEA will be subject to national rules and so could potentially be more difficult to achieve for trustees.

PENSION SCHEMES BILL RETURNS TO THE HOUSE OF COMMONS

In the current debate on the Pension Schemes Bill, there remains support for requiring different treatment for open schemes under the proposed new scheme funding Code. However, despite lobbying from MPs and industry groups, it

appears unlikely that there will be changes to the scope of the Pensions Regulator (TPR) powers and new criminal offences.

Following the summer recess, the Pension Schemes Bill returned to Parliament and the Second Reading on 7 October included debate on two key areas of the Bill:

- **New powers for TPR:** The Bill includes two new criminal offences in relation to corporate activity where there is a defined benefit (DB) scheme - avoidance of employer debt and conduct risking accrued benefits. These offences would apply to any person regardless of any connection to the scheme or sponsoring employer, potentially exposing to TPR action a very wide range of parties, including trustees, banks that lend to employers, insurers and investment counterparties. Therese Coffey, Secretary of State for Work and Pensions, re-iterated that the Government's objective is *"not to stop or interfere with routine business activity, or to deter people from becoming trustees"*. She confirmed that an offence would be committed only if the person did not have a "reasonable excuse" and it would be for TPR to prove that the action was not reasonable. TPR will publish guidance on the new powers, after consultation. However, the Labour Party spokesperson noted that the new provisions have the potential to criminalise "*a much wider group of people than can possibly be necessary or sensible*" and asked the Minister to consider again whether the net has been cast too wide.
- **Funding of open DB schemes:** MPs from Opposition parties expressed support for an amendment to the Bill requiring there to be different funding rules for DB schemes open to new members. The amendment was not sponsored by the Government but was voted through in the House of Lords in July. The MPs warned that if open schemes were required to treat accrued benefits in the same way as closed schemes, trustees would be forced to de-risk and the resulting increased employer contributions would make open schemes unaffordable. One Labour MP also drew attention to the danger of TPR "*setting pensions policy*" through its new funding Code. The Pensions Minister, Guy Opperman MP, replied that the Government continues to engage with the schemes and other stakeholders and that he is willing to "*continue that dialogue*". However, the Government has now given notice that it intends to remove or alter the wording of the amendment.

The Bill now goes to Committee, with the aim of completing that stage by 5 November. This makes it possible that the Bill itself (although not the regulations made under it or TPR guidance) could be in place by the end of this year.

RECTIFICATION GRANTED WHERE DRAFTING ERROR REPEATED IN SUBSEQUENT DEEDS

A further example that rectification of mistakes can be achieved, even where the mistake has been repeated in subsequent documents. This case is noteworthy as it relates to a scheme with a unilateral amendment power.

In *SPS Technologies Ltd v Moitt* (11 September 2020), the High Court allowed rectification to correct a drafting mistake in scheme rules governing actuarial reductions for early retirement, an error that was repeated in two later documents. There was a "compelling case" for rectification.

Facts: When a new set of definitive deed and rules of the pension plan was drafted in 1998, an error was made in the provisions on early retirement of transferred-in members. The effect was to disapply the actuarial reduction if a transferred-in member took early retirement from deferment, but to apply it if the member took early retirement from pensionable service. The error was repeated when the rules were updated in 1999 and again in 2003 in a deed of amendment. The plan was administered on a basis that ignored the error.

Decision: The High Court ordered rectification of the 1998 and 1999 rules and the 2003 deed. The sponsoring employer had undertaken a lengthy investigation into how the difference between the rules came about and had provided the Court with convincing proof that a drafting error occurred in 1998 and remained embedded through two further changes to the plan. There was detailed evidence that the company and the trustees intended transferred-in members in service and in deferment to be treated in the same way.

The power to amend was a unilateral one; only the company needed to approve amendments. As a result, it was the subjective collective intention of the company board that was relevant, although the Court took account of evidence from the trustees. The Court confirmed that the established principles of rectification apply in the same way for both unilateral and bilateral powers.

The result of the error in this case was to allow deferred members to be favoured over those in active service – an outcome that was clearly illogical, not least because members could simply terminate their pensionable service in order to receive higher benefits. However, applying common sense and logic was insufficient to enable the Court to grant an order for rectification – the company had to provide convincing proof, on the balance of probabilities, that an error had occurred.

The Court also followed the established principle that conduct after the date of the document could be evidence of intention. This could include the absence of a change to the way the plan was administered, and the content of plan booklets published after the event which reflected the same position as before. Where serial rectification of successive deeds was sought, a powerful evidential factor was that the "error" had not disturbed the status quo from the first mistake and through the successive deeds.

EUROPEAN COURT CONFIRMS PENSION FUND MANAGEMENT SERVICES NOT EXEMPT FROM VAT

The European Court decision represents the end of the road for challenges made to the provision of VAT on fund management services provided by non-insurers. This is separate from the question of deduction of VAT for services to the employer and the exemption of supplies to the employer of a defined contribution scheme.

The European Court, in *United Biscuits (Pension Trustees) Limited v Commissioners for HMRC* (8 October 2020), held that trustees of defined benefit (DB) schemes that use third party investment management companies to administer their pension schemes must pay VAT on the service.

Historically, in the UK, HMRC allowed all pension fund management services supplied by regulated insurers to be treated as exempt but those provided by non-insurers were subject to VAT. From 2019, pension fund management services supplied by insurers to DB schemes also became subject to VAT, so the differing VAT treatment between insurers and non-insurers no longer exists. However, non-insurers with historic claims standing behind this case will be affected.

The previous exception for insurers arose because "insurance transactions" are an exempt activity for VAT purposes. HMRC had interpreted this as including all the activities of a regulated insurer. EU VAT law, on the other hand, allows only pure insurance activity (the underwriting of specified risk for a premium) to be an exempt supply.

The trustee of the United Biscuits' DB pension scheme argued that there was a breach of "fiscal neutrality": supplies of goods or services which are identical or similar must be taxed in the same way, given that regulated insurers benefited from an exemption not afforded to others. The trustee claimed a refund of 40 years' VAT paid on management fees to non-insurers, which it argued should have been exempt.

The Court concluded that the investment management activities could not be classed as insurance transactions as indemnity for risk, the essential element of an insurance transaction, was missing.

Whilst unsurprising, the decision will be a blow to United Biscuits and other claimants in a similar position, as the historic unequal treatment will be allowed to stand. It is also likely to see the end of the claim by the Wheels Common Investment Fund Trustees against HMRC that Common Investment Funds in which DB scheme assets were pooled for investment purposes were exempt from paying VAT on investment management services on the basis they were "special investment funds". After the European Court rejected Wheels' argument in 2013, Wheels amended its claim to adopt the arguments being advanced by the United Biscuits claimants. We expect to hear that Wheels' claim has now fallen away.

The UK has frequently adopted a broader interpretation of the scope of VAT exemptions for supplies of insurance services and for supplies of financial services (at least until EU pressure forced it to narrow the scope). Therefore, this is an area to be watched for divergence from EU law at the end of the Brexit transition period.

GUIDANCE FROM THE PENSIONS REGULATOR ON REOPENING OF GATED FUNDS

The Pensions Regulator (TPR) has amended its ***Guidance*** *where trustees have had to temporarily close funds to new investments or disinvestment (known as "gating"). The Guidance help clarifies that recommencing contributions to the gated fund will not make that fund a default arrangement if the members' original instructions can cover the return to the original fund.*

Many property funds were gated because of valuation issues arising out of the market impact of COVID-19 and contributions were redirected to an alternative (usually cash) fund. TPR issued guidance, in their *DC Scheme Management and Investment: COVID-19: Guidance for Trustees*, warning that both the redirection of contributions to alternative funds and the subsequent redirection back to the original fund could create an unintended defined contribution (DC) default arrangement. This would mean that the funds would become subject to the charges cap (if the scheme was used for auto enrolment), as well as requiring a separate Statement of Investment Principles for the default arrangement (see our Pensions Bulletin May 2020).

Property funds are starting to reopen and TPR has amended its guidance to highlight the circumstances where the members' "pre-existing expression of choice" still applies and a redirection back to the original fund would not give rise to a default arrangement. TPR's view is that the pre-existing expression of choice will still apply where:

- members have consented to the redirection of the contributions on a temporary basis, until the original fund ceases to be gated; or
- they have been informed by the trustees that their contributions are being diverted into a default fund but that this will be corrected as soon as the original fund reopens; or
- the trustees (1) inform members whose contributions have been diverted that, in the trustees' view, the pre-existing expression of choice remains in place; and (2) give them the opportunity to object before those contributions are redirected back into the original fund.

TPR recommends that trustees should take advice and, if they conclude that the pre-existing expression of choice no longer applies, they should offer members the option of completing a new choice to enable contributions to be redirected back to the original fund. If contributions are redirected without doing this, the original fund would constitute a default arrangement.

OVER-THE-COUNTER DERIVATIVES CONTRACTS AND BREXIT

The current clearing exemption under EU law for over-the-counter derivatives contracts is to be introduced into UK law for contracts clearing in the UK. However, this does not appear to cover UK pension schemes with derivatives contracts that clear in the EU.

The EU rules on over-the-counter (OTC) derivatives require certain classes of OTC derivatives contracts to be cleared through a central counterparty. Many pension schemes use OTC derivatives to hedge against inflation and interest rate risk. Although the requirement has a significant impact on a large number of counterparties that engage in derivatives trading, pension schemes currently benefit from a temporary EU exemption.

The Government confirmed in 2019 that the EU exemption would be introduced into UK law for both UK and EEA pension scheme arrangements clearing derivatives transactions in the UK. The position for UK pension schemes clearing in the EU is less clear, however. The UK's International Swaps and Derivatives Association (ISDA) has asked the European Commission and the European Securities and Markets Authority to take action to ensure that, post-31 December 2020, the pension fund clearing exemption continues to be available to EU counterparties which enter into new OTC derivatives with UK pension arrangements, but the issue has yet to be resolved.

For more details on this and other Brexit issues for pension schemes, please see our recently updated briefing: Brexit: pension scheme preparedness.

PLSA'S VOTE REPORTING TEMPLATE FOR TRUSTEE IMPLEMENTATION STATEMENTS

Schemes that are looking to publish their annual reports shortly should consider the Pensions and Lifetime Savings Association (PLSA) ***Vote Reporting Templates and guidance****. Statements on compliance with the policy on stewardship and engagement activities and voting behaviour is required in annual reports for scheme years which are published on or after 1 October 2020, for all schemes required to produce a Statement of Investment Principles (SIP).*

From 1 October 2020, all occupational pension scheme trustees will have to produce annual statements describing their policy on asset management arrangements and how their policies on exercising voting rights and undertaking engagement on their investments have been followed during the year. (There are wider requirements for defined

contribution schemes – their implementation statements have to disclose against other aspects of their SIP investment policies.)

Trustees will have to describe the voting behaviour by them, or on their behalf, during the year (including the most significant votes cast by trustees or on their behalf) and state any use of the services of a proxy voter during that year. To produce these statements, the PLSA suggests that trustees will need more detailed voting information than they currently receive from their asset managers.

The PLSA notes that, in many cases (for example where trustees invest through pooled funds or via fund platforms), the voting rights might be held by the fund rather than the trustee. However, these votes are still cast by the manager of the fund "on behalf of" the fund's investors in a broader sense and the PLSA's view is that the policy intent is that it should be covered by the implementation statement. The Template asks investment managers to disclose information including the voting process or use of any proxy voting services; whether the manager voted contrary to the recommendation of any proxy advisor; details of the "most significant" votes cast; and information on how the manager managed and mitigated any stewardship conflicts.

The Template accompanies the PLSA's Implementation Statement Guidance issued in August. As with its Implementation Statement Guidance, some of the suggestions in the notes to the Template go beyond the requirements for compliance with the legislation, the PLSA's view being that there will be a significant level of interest in the statements from external bodies, including regulators.

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