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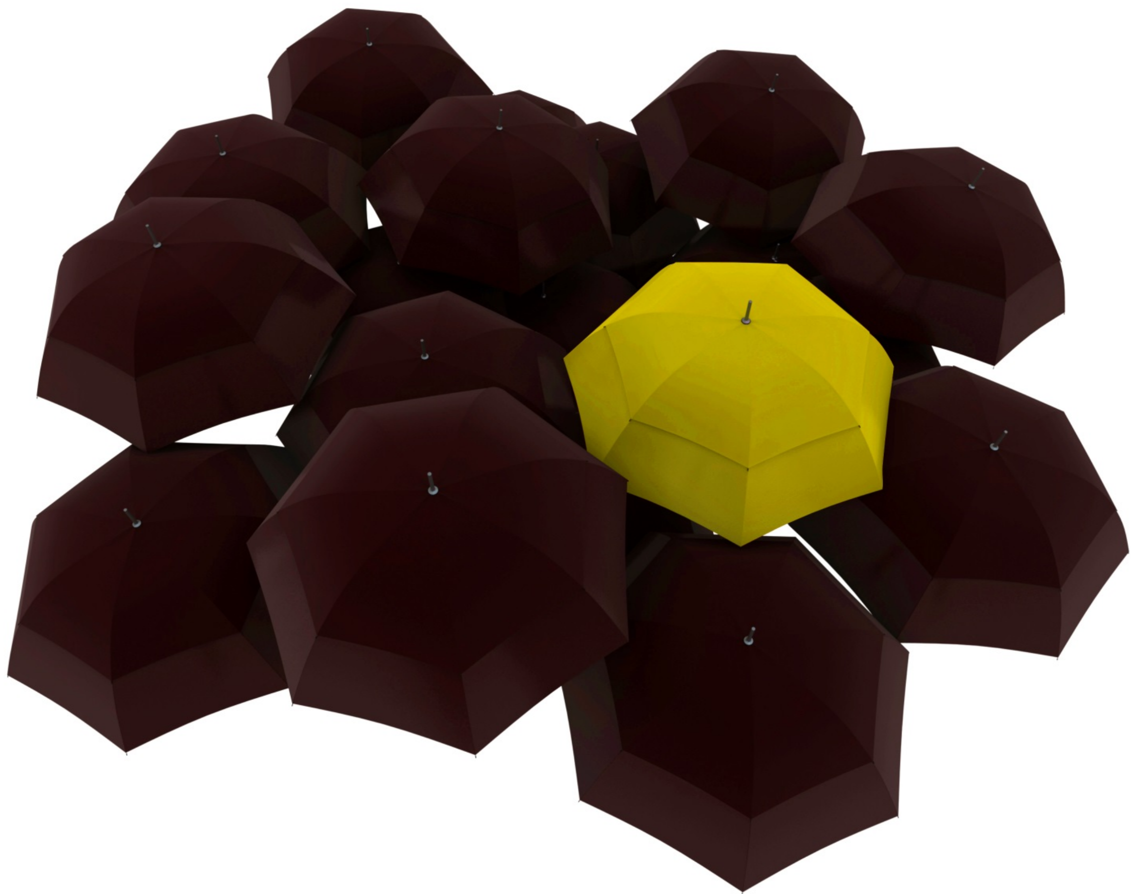

Pension scheme investing

Current hot topics

October 2016

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CHAMBERS, UK, 2015 – PENSIONS

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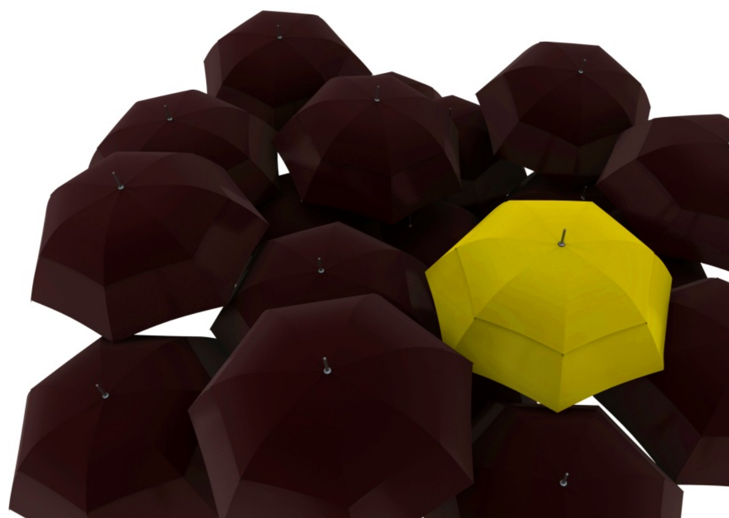


Post-referendum investment issues

Investment volatility was a key focus of attention in the days following the EU referendum, with a severe shock to UK and European equity markets, and sterling falling to its lowest level in more than 30 years.

In many ways, this was simply an extreme example of markets doing what markets do. The Pensions Regulator issued guidance reminding trustees to be vigilant but to keep their focus on the long term rather than reacting to immediate events.

In this note we examine some of the specific legal issues around pension investing which should be considered in the wake of the vote.

Pensions 'stretched to breaking point'?

Sharp increases in the funding deficits of defined benefit pension schemes make good headlines but they are, of course, artificial numbers – just snapshots based on specific calculation methodologies at a particular point in time. A deficit shown on a pension scheme valuation is not an immediate demand for cash from the scheme sponsor. Increased deficits do, however, cause headaches for corporate sponsors who have to deal with knock-on implications for corporate investment decisions, M&A activity, accounting issues and other matters.

Working within their integrated risk management framework, trustees must monitor scheme funding, investment strategy and the strength of the employer's covenant as inter-related elements. For organisations which look to an overseas parent for funding support, the cost of providing that support to a UK scheme may be reduced when the value of sterling falls; so, for some schemes, this may provide an opportunity to seek additional deficit repair contributions (which the sponsor or its parent may want to link to a wider review of the scheme's investment strategy).

Lower gilt yields – and therefore greater actuarial funding deficits – are now expected to be a long-term feature of the UK pensions landscape, and so schemes are focusing both on closing funding gaps and mitigating the impact of fluctuating deficits. Liability-driven investment (**LDI**) is characterised by its preservation of long term stability using inflation-linked bonds, derivatives, repo markets and other tools to hedge against variables such as inflation and interest rates. Even in the context of falling gilt yields, LDI strategies remain popular as an asset management approach for pension schemes.

Schemes with comprehensive LDI strategies in place before the referendum were somewhat protected from the immediate post-vote storm – some schemes even reported gains from unhedged overseas equity exposures. The differing results generated by variations in LDI strategies highlight the need for trustees – and the sponsors supporting their schemes – to fully understand the risks in a liability-matching portfolio investment strategy.

WHAT ABOUT DC MEMBERS?

For DC members, the impact of market volatility may be felt by those who crystallise losses – either though purchasing an annuity which has become more expensive due to reduced gilt yields, or taking a cash sum.

Many members may be able to wait out the immediate crisis, but some may be unaware of the implications or

have no choice but to implement existing retirement plans. Good trustee communications are key, together with signposting to Pension Wise or other guidance where relevant.

Liquidity issues and macro-economic market dislocation factors – 'gating'

Initially, several commercial property funds suspended trading in the days after the vote – a practice known as 'gating'. The idea is to protect the interests of all fund investors by preventing mass withdrawals, which could force 'fire sales' of illiquid property assets. For DB schemes, this essentially translates to a loss of control – trustees who expect the commercial property (or other relevant) market to fall further may not be able to disinvest, and will remain exposed to this risk until the fund manager reopens the fund.

In fact, gating provisions are relatively widespread – open-ended investment funds commonly include provisions allowing the fund manager to suspend dealing whenever it thinks this is necessary to protect the interests of investors, even if the fund is marketed as being highly liquid. Scheme investments in such a fund could, in the worst case scenario, change very quickly from being available on a daily dealing basis to being inaccessible.

In order to stem the flow of mass redemptions, regulators may introduce further controls, including liquidity requirements for fund managers and the imposition of notice periods before investors can redeem their invested capital. As an alternative to gating, some fund managers may apply a pricing adjustment to reflect market conditions, so that it costs investors more to redeem their funds. In some less-regulated offshore pooled funds, the managers may give preferential liquidity rights to some investors, potentially to the disadvantage of other investors.

Trustees should review current investment arrangements, and check carefully for liquidity provisions (and any preferential redemption rights) before investing in a particular commingled fund. Even when terms are expressed as standard, there is usually some room for negotiation (for example, through a side letter). Larger schemes may consider the use of 'fund of one' vehicles which normally afford better liquidity provisions than funds with multiple investors. Any preferential liquidity rights can be addressed via a 'most-favoured nation' provision.

Liquidity issues may also prompt fund managers to effect distributions in kind (i.e. physical securities or property). Trustees should resist such provisions – apart from practical inconvenience, accepting in-kind redemptions may put trustees in breach of FSMA (unless another manager takes over those securities). If in-kind redemptions are permitted, the fund manager should be obliged to manage them on the trustees' behalf until their liquidation or transfer to another manager.

These provisions should also be considered as part of ongoing monitoring and review processes for individual funds and overall strategy – if gating provisions were invoked in relevant funds, would there still be sufficient liquidity within the wider investment portfolio to comply with timing constraints on transfers, for example? Maintaining an open line of communication with fund managers is key to the monitoring process, especially if you are preparing to liquidate assets to meet benefit payments and other scheme obligations.

WHAT ABOUT DC MEMBERS?

For DC members, the implications are more tricky – it's easy to imagine that a member may invest in a fund without being aware of the possibility of gating or understanding how he or she might be affected by it. It's important for trustees to ensure that warnings are provided about this possibility. We may in the future see complaints made by members (as happened after the 2008 financial crisis) where communications were misleading or transfers which should have been completed were still outstanding when gating was imposed – see our feature on trustee liability. In the current climate of revised redemption pricing and changes in gating and redemption suspension policies by fund managers, transparent member communications are critical.

Ideally, a member will have diversified their investments across a range of funds. As well as potentially helping to mitigate overall losses, this may also mean that a member who wants access to their pension savings is still able to achieve this, via lump sum cash withdrawal or a partial transfer of their funds (if the scheme rules provide for this).

What can trustees do about hidden risks?

Where trustees have a funding vehicle or contingent asset in place, it may be appropriate to review the impact of the crisis on the underlying asset. For example, some asset-backed contribution structures are based on income streams from real estate assets – in the worst case scenario of employer insolvency, would those assets still provide the expected level of value to the scheme? Has any deterioration in the employer covenant compromised the value of the underlying assets? If funding arrangements depend on an assumed income stream, is that assumption still valid, and what back-up arrangements are in place if the income stream fails? The scheme's investment in this type of structure should be monitored alongside other scheme assets. Some structures include a cash buffer to offset any potential decrease in value (and this has more recently been a feature of the Regulator's guidance in this area). Is that buffer still sufficient?

Asset diversification is another key area – for example, are trustees aware of which assets underlie pooled fund investments? Could these disguise interdependencies or concentration risks in a particular market or geographical area? For example, if you hold investments in the market sector in which the scheme sponsor operates, and that market is affected by future Brexit developments, is the scheme able to withstand a deterioration in its sponsor covenant at the same time as a decrease in asset values? Is there an over-concentration in sterling- (or Euro-) denominated assets?

If you are changing investments, is your transition process as streamlined and effective as possible? Market conditions tend to be sensitive to political developments, and there is potential for greater volatility over a prolonged period, as it may be some time before there is a settled view of the Brexit-related political landscape. To take advantage of an investment opportunity swiftly, in the right conditions, you may need to review your processes for taking and implementing investment decisions. We have assisted some schemes with pre-arranging a panel of transition managers (with all necessary documents in place) so that a transition can be activated swiftly, as and when needed.

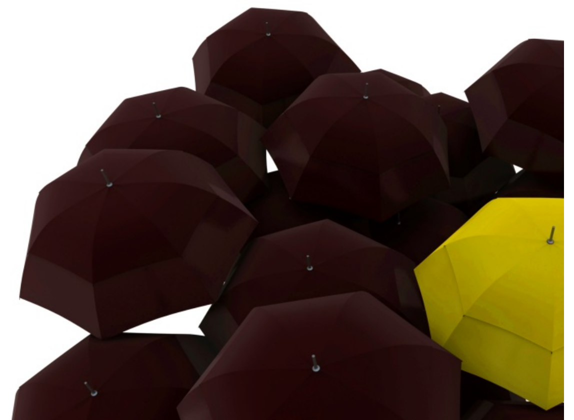
Your scheme's swaps and stock-lending arrangements are likely to be collateralised, but it's important to understand (in consultation with the relevant investment managers and custodians) how robust the terms of collateralisation are and what this means in practice – for example, monitoring:

- the difference between the collateral value and the collateralised liability;
- the frequency with which collateral is posted; and
- the nature and liquidity of assets permitted as collateral,

to accurately assess ongoing exposure. Where the scheme faces additional or increased margin calls, does the current investment strategy allow for enough liquidity to meet those calls? You may also wish to review uncollateralised arrangements to see whether these remain appropriate in the current climate.

Trustees should also bear in mind regulatory obligations on collateralisation in the European Market Infrastructure Regulation (EMIR). When fully implemented, EMIR will require trustees to have in place procedures for the timely, accurate and appropriately segregated exchange of collateral with respect to all over the counter derivatives. In addition, under the Securities Financing Transactions Regulation (the SFTR), a party receiving collateral is required to disclose to the other party the risks involved in entering into a title transfer arrangement or granting a right to re-use collateral under a security arrangement.

It is possible that termination rights in derivatives contracts could be triggered as a result of a credit rating downgrade or other credit-related triggers linked to a counterparty. You may wish to consider carrying out a due diligence exercise to determine whether any existing contracts might be affected and what the triggers may be.



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Counterparty risk

Counterparty risk should also be considered. In the wake of the collapse of Lehman Brothers, some schemes discovered that they had a range of exposures to Lehmans – for example, through swaps/derivative contracts, stock-lending, collective investment schemes, brokerage or cash deposits – and that this aggregate exposure was much greater than they had previously thought. This may be a good time to analyse your scheme's aggregate exposures to counterparties and custodians and identify available protection mechanisms and any scope for mitigating the associated risks, bearing in mind the requirement to diversify assets to avoid accumulations of risk.

Hedge funds have traditionally 'parked' their assets with a prime broker (such as Morgan Stanley or Goldman Sachs). The prime broker can use these assets for its own account, which exposes the scheme to the prime broker's insolvency risk. In the U.S., there is a regulatory limit on the right of use, but London-based prime brokers are not subject to any regulatory limit. It's worth asking your hedge fund manager to confirm whether there is any cap on the value of assets which the prime broker can use and, if not, checking whether the manager can, as part of the fund negotiations, agree a cap (documented by a side letter).

Investing in a buy-in?

The Trustee of the ICI Pension Fund made headlines in summer 2016 by 'slipstreaming' Brexit to secure a further tranche of liabilities via a buy-in contract within its 'umbrella' framework. We are proud to have advised on this structure, the first of its kind, which enables the trustee to transact easily and swiftly when market opportunities arise.

Changes in gilt yields – particularly as compared to the yield on high-quality corporate bonds – can be a trigger for favourable pricing, and it's important for schemes to be ready to transact when opportunities arise.

With activity levels reported as being relatively low so far in 2016, we could see a repeat of the 'end of year discounts', which have sometimes been available in previous years, as insurers seek to attract deals to use up the capital that they have set aside for this purpose.

For help and further advice on the issues raised in this briefing, please get in touch with any of our experts listed at the back of this document.

Issues to consider

1. What are the Brexit opportunities for your scheme? Could this be a good time to seek a cash contribution from an overseas parent, or to scope the costs of risk reduction via a buy-in?
2. How did your investment strategy serve you in the immediate aftermath of the vote? Should it be reviewed in light of a potentially prolonged period of uncertainty? Are you sufficiently protected in relation to market volatility, currency movements, and interest rates that are set to remain lower for longer, as well as possible inflation risk?
3. Do you know where gating provisions apply in your investment portfolio? Do other investors in a commingled vehicle have better liquidity terms, or can they redeem ahead of you? Is that position still appropriate? Consider negotiating scheme-specific provisions rather than accepting standard terms.
4. It is likely that Brexit will result in some changes in London managers' investment platforms. It's worth checking whether any such restructuring costs could be pushed through to you by managers. With many funds, it is possible to fix the total expense ratio, so that these costs are borne by the manager.
5. Have you reviewed your communications, particularly in relation to DC arrangements? Are fund options properly described, and are members aware of the implications and process of switching funds?
6. Have you checked for hidden risks – for example, in relation to asset-backed funding structures, collateral arrangements, asset diversification and counterparty risk? Are your investment transition processes streamlined and efficient?
7. Are you fully aware of your regulatory obligations under EMIR and SFTR? Most of these obligations will be delegated to managers, but trustees remain responsible for compliance.

‘Ethical investing’: what does it mean in practice for pension schemes?

The Pensions Regulator was recently quoted as saying that trustees should ‘wake up and smell the coffee’ on ethical investing issues and the extent to which these present financial risks to pension schemes.

This comes in the context of mounting concern about the risk of ‘stranded assets’ – that is, the risk that environmentally unsustainable assets might be subject to unanticipated or premature reductions in value (or even conversion to liabilities) as a result of environmental, regulatory or market developments linked to sustainability.

This note looks at what ethical investing means in the pension scheme context – what the legal framework is, and how it is developing in this area.

How are trustees required to invest?

Trustees generally have a wide investment power under their trust deed. This must be exercised with ‘such care as an ordinary prudent man would take in making an investment for others for whom he felt morally bound to provide’.

Alongside this, pensions legislation requires that an investment power should be exercised in a manner ‘calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole’, that assets should be diversified, and that the assets of an occupational pension scheme must be invested in the best interests of members. This reflects a fundamental principle of trust law.

Pension schemes invest for the long term, so is there too much emphasis on short or medium-term financial returns? How far can or should issues about sustainability, or environmental and social impact, or the ethical views of members, direct or restrict trustees’ investment decisions?

At the moment, the law might appear rather ambivalent on this issue, requiring trustees to explain, within their scheme’s Statement of Investment Principles ‘the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments’ – in other words, it is an available option for trustees, but the law is neutral as to best practice in this area (reflecting a traditional split in thinking about financial considerations on one hand, and ‘ethical’ considerations on the other).

The Law Commission’s 2014 report, ‘Fiduciary Duties of Investment Intermediaries’ looked at this area in detail; a summary of its findings is in the box below.

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Findings of the Law Commission

- Trustees do not have to maximise returns in the short term at the expense of risks over the longer term.
- Where trustees think ethical or environmental, social or governance (EESG) issues are financially material (that is, for example, a risk to the long-term sustainability of the asset) they **should** take them into account – but it is for trustees, acting on advice, to assess which risks are material and how to take them into account.
- Trustees **may** make investment decisions that are based on non-financial factors (for example, to show disapproval of a particular corporate or industry), provided that:
  - they have good reason to think that scheme members share the concern (which may require a formal survey or consultation on members' views, rather than taking the views only of the trustees); and
  - there is no risk of significant financial detriment to the fund. If there is a risk of significant financial detriment, they should not normally proceed.

How does this apply in the context of pension scheme investments?

For many years, discussion of EESG issues centred on fossil fuels, arms and tobacco, but the debate now reaches into many other areas. Water stress risk (i.e. shortage of water, or risk to hydro-electric power supplies), for example, is a key issue for investors in some parts of the world. On some issues, there are strongly held ethical views on both sides of the argument – for example, around stem cell research. More recently, questions about business practices have come into focus as an ethical issue – for example, in relation to investing in payday lenders.

Trustees may feel a greater need to take a proactive stance in areas where scheme members – or the sponsor – are understood to take a particularly strong view. It's no coincidence, for example, that the Church of England pension fund found itself in the media spotlight in 2013 for having assets invested in one of Wonga's financial backers, only days after the Archbishop of Canterbury had spoken out against payday lenders. The holding in this case was via a pooled investment vehicle, which underlines the difficulty trustees may experience in ensuring that all scheme assets are invested in line with their preferred ethical principles, particularly where indirect holdings of unlisted assets are concerned.

The Law Commission's guidelines anticipate that trustees may have more flexibility to take non-financial EESG factors into account where the scheme is sponsored by a particular charity or political group, or a religious organisation. In this context it may be easier to establish a consensus view among members, although trustees shouldn't take for granted that they know what members think.

In addition, the Law Commission noted that it may be possible to exclude a sector of the market while remaining sufficiently diversified and without risking significant detriment (for example, on the basis that equally good returns are available elsewhere). It might be easier to take a decision to divest from fossil fuel than, for example, to invest specifically in a particular form of renewable energy.

What about the employer's view?

If EESG issues generally, or in specific areas, are important to a corporate organisation, it may want its scheme trustees to operate an investment policy consistent with its own values. This approach could reduce the kind of PR/reputational risk suffered by the Church of England in the incident mentioned above.

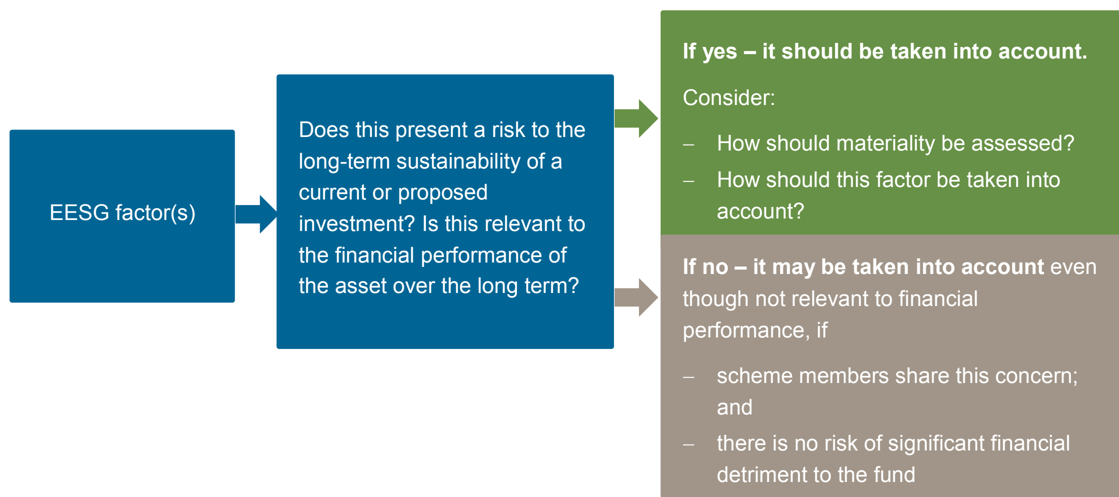
However, trustees should be cautious about agreeing to this. Trustees are required to consult the employer before preparing or revising a statement of investment principles[1], but their investment power, either under the scheme rules or the SIP, cannot be restricted or vetoed by the employer[2].

In some cases, it may be that the organisation falls within a specific interest category, where scheme members may have a consensus view on specific EESG issues; or that, having considered the long-term financial risks of particular factors to its own organisation, the

[1] Regulation 2 of the Occupational Pension Schemes (Investment) Regulations 2005.
[2] Section 35(5) Pensions Act 1995.

sponsor is able to demonstrate the relevance of those risks to the trustees for their consideration. In all cases, however, the key questions for trustees remain the same (see below).

The critical questions for trustees:



EESG investment approaches are evolving

Trustees have become relatively used to the concept of considering whether to take EESG factors into account in relation to decisions about their equity and bond investments, voting activity, and so on. However, wider approaches are now gaining traction. For example:

– How would consideration of carbon emissions and/or climate change risk affect trustees' view of real estate and infrastructure investments?
– If sustainability – in relation to environmental, social or governance factors – is considered to be a financial risk in relation to the entities in which the scheme invests, then should it also be considered in relation to the entity supporting the scheme? How would EESG factors affect trustees' assessment of the sponsor covenant which supports a defined benefit scheme?

Workforce culture and practices

The Law Commission's report divided risks into financial and non-financial factors, and noted that a wide range of risks, including 'the risks to a company's reputation arising from the way it treats its customers, suppliers or employees' could be material to the long-term sustainability of a company's performance. Viewed in this way, ethical investing is potentially very subjective – one person's unacceptable practice is another's clever business model.

Issues around workplace culture and practices are now receiving greater attention. The Modern Slavery Act 2015, for example, obliges certain commercial organisations to prepare a slavery and human trafficking statement for financial years ending on or after 31 March 2016. This is a statement of the steps (or, if applicable, the lack of any such steps) that a commercial organisation has taken to ensure that slavery and human trafficking is not taking place in any of its supply chains or any part of its business. There are no penalties for failing to produce a statement when required to do so, but the government believes that public opinion and reputational damage is likely to be a significant compliance tool. Its hope is that publication of the

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statements will trigger a 'race to the top', with organisations demonstrating progress year on year.

On a connected theme, but perhaps at the other end of the spectrum of working practices, the Pensions and Lifetime Savings Association published a toolkit in July 2016 on 'Understanding the worth of the workforce', aimed at encouraging pension fund investors to request information from the companies in which they invest, about their workforces and corporate cultures – the idea being that the extent to which companies are good employers is another important element in long-term corporate success. This would include a focus on gender diversity, employment type (for example, use of zero-hours contracts), accident and illness rates, staff training and turnover, and pay ratios between the highest paid and median and lowest quartile workers, as indicators contributing to investors' views on long-term corporate performance.

What about DC investments?

In the DC context, the member chooses their specific investment, but trustees are responsible for determining the overall strategy and choosing the funds offered to members. Some schemes offer a fund labelled as 'ethical' as an option available to members, but trustees may take the view that it is no longer appropriate that all other funds may be perceived to be, by contrast, 'non-ethical'. Schemes which do not currently offer any funds of this type to members should review whether this remains appropriate (for example, whether there is member demand for an investment option of this type), and should look closely at the composition of any proposed 'ethical' offering.

The most significant issue for DC trustees will be the default fund – to what extent should EESG factors be taken into account here? The Law Commission's principles are helpful in this context in directing a focus on the longer term, while still allowing trustees to factor financially material EESG issues into their considerations. The requirement for schemes which are used to meet auto-enrolment duties to publish a default-specific statement of investment principles will focus attention on EESG investing in the DC default context.

The Regulator refers to the Law Commission's principles in its DC investment guidance, and suggests that trustees might potentially consider a wide range of factors such as climate change, unsustainable business practices and unsound corporate governance as longer term financial risks. Again, however, the Regulator is not prescriptive as to how trustees should respond, once they have considered the relevance of longer term sustainability issues.

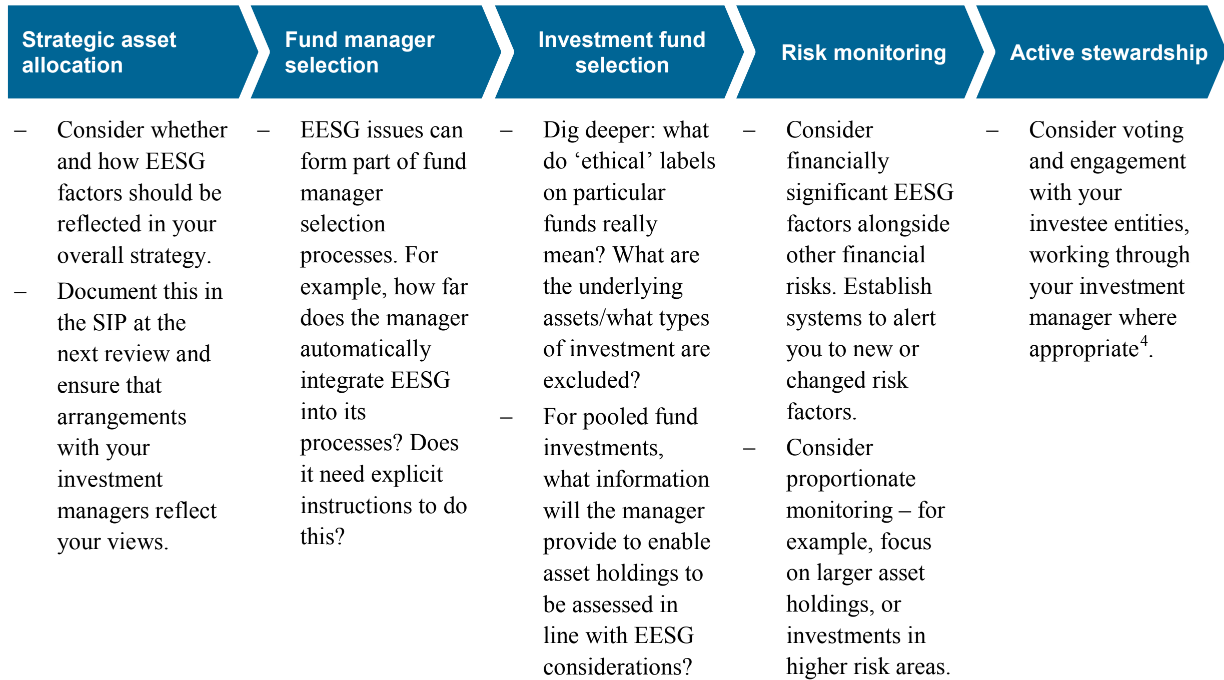
In any event, once they have decided on their approach, trustees should engage with their investment managers and consultants to ensure that any statement they make in the SIP is implemented in practice – for example, by ensuring that key requirements are reflected in their contractual arrangements, and that they keep EESG considerations under review.

Where next for trustees and EESG?

Some major schemes and other organisations are working together to spread best practice[3] in investment decision-making and in stewardship activities, and even schemes which take a passive approach may see any exposure in this area reduced as asset managers respond to pressure from more active investors. However, many schemes may feel that they need to take a more active approach – for example, in response to members' views or a desire to take a particular stand in this area.

Trustee views will, of course, differ both individually and from scheme to scheme, and are also likely to evolve over time. Different approaches will be proportionate for schemes of different sizes, but one or more of the approaches below is likely to be possible for any scheme:

[3] See for example 'A Guide to Responsible Investment Reporting in Public Equity', January 2015: click here; see also 'Ethical investing made simple, published by the Pensions and Lifetime Savings Association, May 2016: click here.



Is the law changing?

Currently, UK schemes with 100 or more members are required to describe the extent (if at all) to which social, environmental and ethical (rather than 'governance') factors are taken into account. The revised EU Directive, IORP 2, sets out requirements for schemes to take account of EESG factors in a variety of ways – in their scheme governance in relation to investment decisions, in the scheme's risk management function in relation to the investment portfolio; and in the new three-yearly 'own risk assessment' requirement. In relation to the documented risk assessment, IORP 2 states that 'where environmental, social and governance factors are considered in investment decisions,' the assessment must include 'an assessment of new or emerging risks, including risks related to climate change, use of resources and the environment, social risks and risks related to the depreciation of assets due to regulatory change (i.e. stranded asset risk)'. As now, however, schemes may decide that EESG factors should not be separately distinguished in their investment policy, or that risk monitoring costs would be disproportionate, and may comply with the disclosure requirements on this basis.

For the moment, it is uncertain whether, and how far, the UK will continue to comply with EU Directives post-Brexit; the timing of IORP 2 implementation (probably late 2018) as compared to any eventual exit date is also unknown. However, assuming for the moment that the UK will either be required to, or will agree to, implement IORP 2, reflecting these EESG points in UK legislation is likely to require fine-tuning rather than radical change. The new language of IORP 2 may push ethical investing higher up the agenda for trustees, and in the context of increasing media and public interest in this area, it seems unlikely that many schemes will decide to ignore EESG altogether.

For help and further advice on the issues raised in this briefing, please get in touch with any of our experts listed at the back of this document.

[4] See, for example, the UK Stewardship Code published by the Financial Reporting Council, September 2012.

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Trustee liability and scheme investments: current risk issues

Decisions about how to invest pension scheme assets present a range of risks for trustees. The impact for scheme members and sponsors can be significant, and some of the instruments and techniques on offer, particularly for DB schemes, are complex.

Trustees need to understand not only the risks involved in investment decision-making, but also who is liable when things go wrong. Here, we look at some specific risk issues relating to the security of scheme assets and investment matters, and how they can be mitigated.

Trustee investment basics

As a matter of pensions law[5], trustees are required to appoint a professional person (often referred to as an investment consultant) to provide professional advice on investments. They will also then either delegate the exercise of their investment power to one or more investment managers on a 'segregated' basis (in order to comply with the Financial Services and Markets Act (the Act) and obtain the necessary expertise) or invest in a pooled investment vehicle. Investment activities regulated under this Act (including dealing, arranging and managing investments and giving investment advice) must be undertaken by an authorised person.

Only exceptionally, in very large schemes or as part of legacy arrangements, might the trustees themselves seek authorisation under the Act. It's worth noting that the requirement for authorisation depends on the specific investments chosen – for example, trustees do not need to be authorised to invest in a pooled investment vehicle, though they would still require prior advice from a regulated person about that investment decision.

5 Sections 34 and 36, Pensions Act 1995.

Trustees cannot exclude or restrict liability for breach of their duty to take care and exercise skill in relation to an investment function. However, where investment functions are delegated to an investment manager, trustees will not be responsible for the manager's acts or defaults in carrying out the delegated functions, provided that they take all reasonable steps to ensure that the manager has appropriate knowledge and experience, and is carrying out the work competently and choosing the investments appropriately[6] (for example, ensuring that investments are suitably diversified[7]). In addition, trustees would not be liable for the acts or defaults of the fund manager of a pooled vehicle in which the scheme invested based on external investment advice.

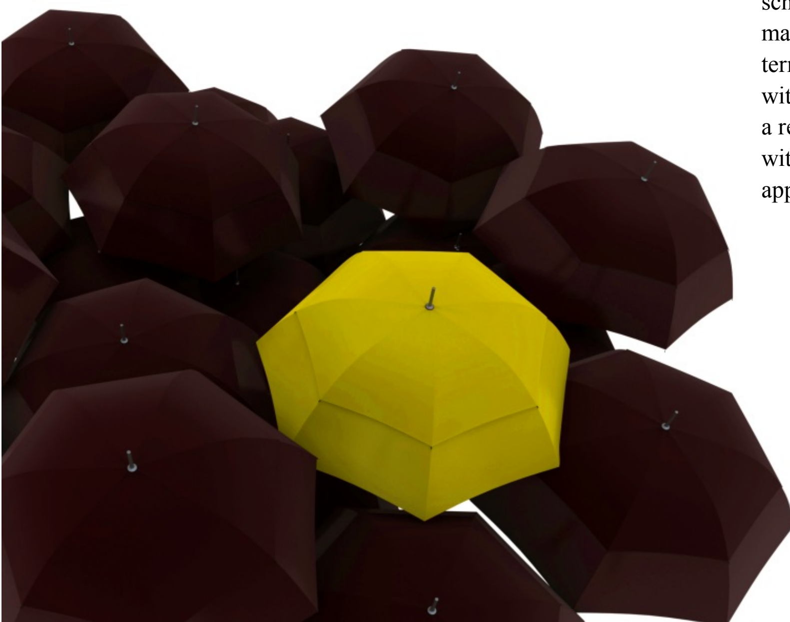
Trustees have wide investment powers under statute[8] and the scheme's trust deed, but are subject to a number of restrictions. One of these is a limit on employer-related investment (ERI)[9]. The terms of the trustees' contract with their investment manager will be

6 Sections 33 and 34, Pensions Act 1995.
7 See the requirements in regulation 4 of the Occupational Pension Schemes (Investment) Regulations 2005 (the **Investment Regulations**).
8 Section 34(1), Pensions Act 1995.
9 Section 40, Pensions Act 1995 – see also regulation 4 of the Investment Regulations.

set out in an investment management agreement (IMA), and this should require the fund manager to monitor ERI (if it is permitted at all) – breach of the statutory restrictions in this area is a criminal offence. Trustees investing in a pooled vehicle will not normally be able to exclude ERI and will have to monitor ERI for themselves, or restrict their investment to a 'safe' level. Trustees should put in place a side letter which requires the fund manager to report ERI in the pooled fund, and the scheme's pro rata share of them, on a periodic basis – for example monthly or quarterly, depending on the likelihood of encountering ERI in the fund's portfolio and the scheme's other ERI exposures.

The trustee/fund manager relationship

It's essential to understand the terms of the IMA and pooled funds, which should provide trustee protection. Trustees are often told that the IMA or a fund is in 'standard form', but they are usually negotiable (with the degree of flexibility depending on the trustees' bargaining power). It's worth getting a legal check for non-standard terms – for instance, any clause that seeks to limit an investment or fund manager's liability for his own or his delegates' actions. This kind of clause could expose a scheme to significant loss. It's worth noting that in some cases (for example, alternative pooled funds), managers will limit their liability to gross negligence, although simple negligence remains a prevailing standard for IMAs and more regulated funds.



Trustees must have systems in place for monitoring and reviewing the investment manager's performance against agreed benchmarks, which should be documented. A legal review is important to ensure that any key terms discussed, for example at a new business pitch, are included in the contract. It may be the case that the fund manager was appointed on the strength of an oral representation. If any such representation is this important, it needs to be enforceable.

Legal input is also crucial for trustees who are considering investing in a pooled fund – side letter provisions are normally required to ensure equal treatment with other investors (for example, in respect of redemption terms, disclosure of ERI, handling of in-kind redemptions, etc). Most managers are amenable to such side letter terms. Larger schemes may consider the use of 'funds of one' which typically afford better contractual terms and retain the benefits of a separate investment vehicle (such as limitation of liability).

It's crucial that the investment manager knows and accepts the terms of the investment power that is being delegated; any limits should be expressly dealt with in the IMA, otherwise the manager might inadvertently make an investment which is outside the scope of the power (placing the trustees in breach of trust).

The trustees' objective will be that the investment manager should exercise delegated investment powers with a view to giving effect to the scheme's statement of investment principles (SIP), which documents the trustees' attitude to risk and the scheme's current investment strategy. In practice, the key elements of the SIP are normally reflected in the investment guidelines schedule within the IMA. This is a crucial document: many managers will not agree to comply with the full terms of the SIP, but will comply with the guidelines within the IMA. Trustees will often be required to make a representation in the IMA that the IMA is compliant with the SIP, trust deed and all regulatory obligations applicable to the scheme.

Case study: mandate not breached where objective was not recorded

Cases in this area are relatively rare, but in 2012 the High Court ruled against a group of pension schemes which claimed against a fund manager for investment loss following an alleged breach of mandate[10]. The claimants apparently intended the fund (set up under a limited partnership structure) to invest solely in private finance initiative (PFI) projects, but this was not reflected in the documents either overall or for key initial years of the investment period. In fact, the partnership agreement gave the manager full power and authority to bind the partnership in doing acts which 'are necessary or desirable in the reasonable opinion of the Manager'. The court held that if the manager reasonably took the view that an act was necessary or desirable, the act was then authorised; where there was room for a reasonable difference of view, the benefit of any doubt should be given to the manager.

Even if the manager had breached its duties, exclusion of liability and indemnity provisions in the agreement would have relieved it of liability. The ruling is a reminder of the importance of ensuring that any terms that trustees regard as critical are accurately recorded in investment agreements and that obligations are appropriately enforceable.

DC-specific issues

Investment governance in DC arrangements has gained a much higher profile in recent years (both in DC schemes or sections of schemes, and for additional voluntary contributions in defined benefit schemes). This area is now subject to specific regulation, both in law and in the Pensions Regulator's DC Code, and trustees are expected to be familiar with these provisions.

In the DC context, the trustees determine the overall investment strategy and are responsible for choosing the funds offered to members. The strategy and funds must be chosen after receiving advice from an investment specialist appointed under the statutory requirement (see above). The members then choose from the funds on offer. It is generally understood that trustees are not responsible for members' choices. As we've seen, by law, trustees cannot exclude or restrict the duty to take care or exercise skill in the performance of any investment function – this applies where 'the function is exercisable' by the trustees or their delegates. The understanding is that, by giving the member total freedom to choose between the funds offered, the actual investment choice is removed from the trustees' investment function – if a member chooses a fund which is inappropriate for his circumstances (for example, a volatile equity fund when he is close to retirement) then that is at his own risk. The scheme rules should be written on this basis, but the principle has not yet been tested in the courts.

Trustees are certainly responsible for monitoring investment performance and removing a fund if expected future performance is sub-standard. To what extent should trustees keep members informed about material developments which could significantly affect a fund's performance, when they receive information as part of their ongoing monitoring processes? Typically, trustees do not pass on this type of information. Normally, it would form part of a wider discussion when a particular option comes up for review, about whether to keep or drop a particular fund. However, that can be a slow process – what if a member suffers a loss due to their continued investment in the meantime, when trustees had material information which they could have, but did not, pass on?

It's arguable, particularly with advances in technology, that if members are to bear the investment risk they need to have up-to-date investment information. In the past, there might have been some defence that it was impractical to expect trustees to issue a member communication every time they received this sort of information. But today, with pension scheme websites and intranets being the norm, this argument might not protect trustees – it's an issue worth considering in terms of overall trustee liability.

Performance information should be accompanied by appropriate warnings – it must not appear that trustees are advising members to disinvest or switch funds in response to poor performance, but only that information is being provided on the basis of which members can take fully informed decisions on their own behalf.

[10] Certain Limited Partners in Henderson PFI Secondary Fund II LLP v Henderson PFI Secondary Fund II LLP and another

Trustees should make sure that this is clear in member communications.

Since the 'pension freedoms' introduced in 2015, communications issues have come into sharper focus. Members now have much greater flexibility over when to take their benefits, how much to take in cash, and how any remaining funds should be used. Most DC schemes have revamped their default investment funds to try to take account of this – but since even members themselves may not know what they intend to do and when, until quite close to the point of decision, it is impossible for trustees to get this right for everyone. An important element of trustee protection in future will be greater proactivity on member communications and engagement, together with an ongoing focus on suitability of funds and strategies.

Case study: Pensions Ombudsman awards compensation for misleading fund information

A fund which was offered as an investment option in an AVC arrangement was misleadingly promoted as a low-risk 'secure fund', when in fact it was heavily invested in mortgage-backed securities. The member complained that he had been exposed to risky investments in the period immediately preceding his retirement. The trustees argued that it was the member's decision whether or not to invest in a particular fund. The Ombudsman agreed that the member had, to some extent, accepted the risk of losses by continuing to make contributions after the date when he should have been aware that the fund value could fall. However, the particular fall which led to the member's complaint could not have been foreseen.

Compensation was ordered for the specific fall in fund value about which the member complained, because he had invested based on misleading information. In this case, the key information on which the member relied was originally prepared by the fund provider, so the provider (rather than the trustees) was liable to compensate the member for his financial loss and distress and inconvenience. However, the decision highlights the risk for trustees of passing on provider information without ensuring they fully understand the funds offered. The labelling and description of fund choices requires careful attention from trustees.

Other issues to consider

Counterparty risk

Assessing the scheme's level of protection from investment risk requires a wide review of the arrangements the scheme has in place. It's possible, for example, for a scheme to have an unexpected concentration of risk in one counterparty through a mix of different exposures such as swaps/derivative contracts, private equity funds, stock-lending and cash deposits. Trustees should be aware of aggregate exposures to key counterparties[11]. Any brokers and custodians should be required to hold scheme cash in a separate client account, money market fund or other appropriate form to mitigate the risk associated with the broker or custodian failing.

Protection of DC assets

In the DC context, the Regulator has recently emphasised the need for trustees to understand the different asset protection mechanisms which may apply, for example in the event of provider failure. Please get in touch with any of the contacts listed on the back page for a copy of our separate guide to the security of DC assets.

New investment opportunities

New types of funds appear from time to time – for example, a recent entrant to the DC market offers access to private equity funds. Trustees need to go back to basics when considering this type of proposition. Do the scheme rules include any express restriction on this type of investment? Does it fit with the requirement that investments in assets not traded on regulated markets must be kept to a prudent level? It seems unlikely that a fund which is not admitted to trading on regulated markets would normally be appropriate as a stand-alone option for self-selection by members of an occupational pension scheme – and the DC Code suggests that if such a fund option were to be offered, trustees should identify it as such in their SIP and explain why it is appropriate to include it (including how the investment aligns with the objectives set out in the SIP). Potentially, this type of fund could be blended with other funds as one element within a default fund offering. If this is proposed by a

[11] See, for example, the diversification requirement in regulation 4(7) of the Occupational Pension Schemes (Investment) Regulations 2005.

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fund manager, trustees should obtain written investment advice on suitability (and legal advice as to any restrictions on their power to invest).

The terms of private equity funds tend to be more onerous than most other funds and they are governed by lengthy and complex documents.

System risks

New technology can also bring new risks: another Pensions Ombudsman case concerned a DC scheme which offered an online facility enabling members to monitor and actively manage their investments. When the system failed, a member was unable to manage his investments for several months, and the administrator was ordered to pay compensation for the claimant's loss of opportunity to manage his funds and mitigate investment losses, together with compensation for significant annoyance and distress caused by the administrator's failings. In a world where schemes are increasingly facilitating online member access, members may claim against trustees when things go wrong. Trustees should actively consider how their agreements with administrators deal with this risk, and whether they are appropriately protected against any failures by the administrator.

Protecting trustees

In this article we've looked at ways in which trustee risk can be mitigated through agreements with providers and through other mechanisms. However, it's not possible either to eliminate all risk on a practical level or to exclude or restrict liability for breach of duty in relation to investment functions, except where investment functions are properly delegated to an authorised fund manager. To the extent that liability can be excluded or restricted, the scheme rules will normally provide a wide exclusion of liability, except for cases of bad faith and deliberate breach of duty.

In practice, trustees also rely on:

– **Indemnities**: Trustees have a right under general trust law to reimburse themselves out of scheme assets for expenses incurred in relation to the scheme. However, this right is narrow and does not apply if the trustees have acted outside their powers (even innocently). There is usually a wider express indemnity in the scheme rules. However, even this cannot indemnify trustees out of scheme assets for fines or civil penalties, or for insurance to cover these costs, so the employer often provides an additional indemnity. In the case of directors of a corporate trustee, indemnities must comply with the rules on indemnities under the Companies Act 2006.

– **Insurance**: Liability insurance can provide another layer of protection and is commonly provided and paid for by the employer. Insurance works in tandem with an indemnity in the scheme rules, providing 'first call' cover for many claims, for the benefit of both the employer and the scheme. A key point to check is that the policy allows for the expenses of handling a claim to be advanced even if the claim is futile or ultimately fails. The employer's indemnity in the scheme rules typically acts as a fallback for excluded claims and excess costs.

Trustees remain liable even after leaving office for decisions and actions during the period of their trusteeship, so it's important that both insurance and indemnity protections should cover former trustees and trustee directors for an appropriate period after they cease to be a trustee or trustee director.

On that note, it's important to be aware that the rules around disclosing risks to insurers have changed under

the Insurance Act 2015. From 12 August 2016, employers or trustees taking out, or renewing, a contract such as a trustee liability insurance policy need to have processes in place to comply with the duty of ‘fair presentation of risk’. Effectively, this will require a reasonable search of information available to policyholders, and presentation of the information to the insurer in a way that a prudent insurer would find reasonably clear and accessible (rather than a ‘data dump’ of all possible information). Contact us for more details about the new rules.

Schemes with individual trustees should limit their contractual liability to the scheme’s assets with every counterparty and provider, to ensure that there is no risk of individual trustee being liable in their personal capacity to the counterparty/provider.

For help and further advice on the issues raised in this briefing, please get in touch with any of our experts listed at the back of this document.

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Pension investing: jargon buster

This glossary explains some of the most frequently used words and terms in the context of investment funds in the pensions arena.

Active / passive fund management	–	The management of assets using a professional fund manager's expertise to choose certain stocks at specific times. **Active fund management means** targeting higher-than-average growth rates in order to meet the **investment fund**'s objectives. **Passive fund management** means managing assets by aiming to replicate the performance of a specific index or indices so that the assets move in line with the specific index or indices.
AIFMD	–	This is the Alternative Investment Fund Managers Directive (2011/61/EU) – an EU Directive which regulates funds and investment firms in the European Union.
Closed-ended fund	–	A fund that has very restricted or no redemption rights for investors in respect of their units or shares. Units or shares are issued in a limited number in an initial offering/fundraising.
Collective investment scheme	–	An **investment fund** with more than one investor, such as a **unit trust**, **OEIC** or certain **limited partnerships**. It is managed by a professional manager. The definition of a collective investment scheme is contained in the **FSMA 2000**.
Commingled fund	–	This is a professionally managed fund made up of assets from several investor accounts that are blended together, resulting in lower legal and operating costs.
Custodian	–	This is a financial institution with a specialised custody division, whose function is the safekeeping and ring-fencing of a scheme's assets and the interests of its stakeholders, the collection of income, the maintenance of accurate records and other administrative duties.
Default fund	–	If a member of a defined contribution pension plan does not actively choose one or more specific investment fund(s) to which their contributions should be directed, then contributions will be paid into the default fund. In practice, the majority of members in most DC schemes invest via the default fund.
Employer-related investment (ERI)	–	Trustees must ensure that investments in the sponsoring employer, or parties associated or connected with it, and property (including land) owned or used by the employer, are restricted to 5% of the current market value of scheme assets. This includes assets held indirectly (for example, via a **pooled fund**).
Equity fund	–	This is an **open or closed-ended**, **actively or passively-managed** fund that mainly invests in publicly-traded businesses by buying stocks.
Exchange-traded funds	–	ETFs are **open-ended funds** which own the underlying assets so that investors can buy or sell in and out of them on an exchange. They can track almost any stock market index in the world.

FSMA 2000	–	The Financial Services and Markets Act 2000. This Act provides the framework for the Prudential Regulation Authority and the Financial Conduct Authority.
Fund of funds	–	This is a fund that invests in several other underlying funds to create a diversified investment portfolio, rather than investing directly in stocks, bonds or securities.
Fund manager	–	This is manager of a **pooled investment fund**, who is responsible for the implementation of the investment strategy of the fund.
General partner	–	In a **limited partnership**, the general partner manages the fund day-to-day and takes final decisions regarding the purchase and sale of the fund's investments. The general partner has unlimited liability.
Hedge funds	–	Hedge funds use pooled funds and complex speculative strategies and techniques such as leverage to make alternative investments, but mainly focus on investments in listed equities. They tend to be **open-ended**, so they provide for rights to redeem capital from the fund. They are commonly established offshore in zero-rated tax jurisdictions.
Index tracker or passive funds	–	This is a mutual fund closely mirroring the performance of an index instead of relying on a professional fund manager to actively manage it.
Infrastructure funds	–	These are funds in which infrastructure (toll roads, airports, rail) constitutes the underlying asset. They tend to be **closed-ended**.
Investment fund	–	A fund that pools capital from various investors to make investments collectively in assets such as cash, equities, bonds, derivatives or property via leveraged buyouts, venture capital, infrastructure, distressed debt and other funds. It is managed by a professional **fund manager**.
Investment management agreement	–	This is an agreement between an investment (fund) manager and the trustee(s) of a scheme setting out how the manager will manage and provide services regarding a specified investment portfolio comprising various assets for the trustee(s).
Investment manager	–	This is the professionally-qualified investment manager to whom trustees delegate the management of some or all of the scheme's assets. The investment manager is responsible for the implementation of the investment strategy of the fund.
Life wrapper	–	A unit-linked insurance product that contains a range of underlying securities. An insurance policy 'wraps' around an investment to make it tax efficient.
Limited partner	–	In a **limited partnership**, the limited partner(s) are external independent investors who are not involved in the day-to-day running or investment decisions of the fund. Unlike the **general partner**, they enjoy limited liability.
Limited partnership	–	Most private equity funds are structured as a fixed-life limited partnership or series of parallel/feeder partnerships whose partners have contractually agreed to make capital contributions to the fund in order for it to make investments. The specific characteristics of a limited partnership will depend on its jurisdiction of establishment, but a limited partnership governed by English law is tax transparent and is not a separate legal entity.

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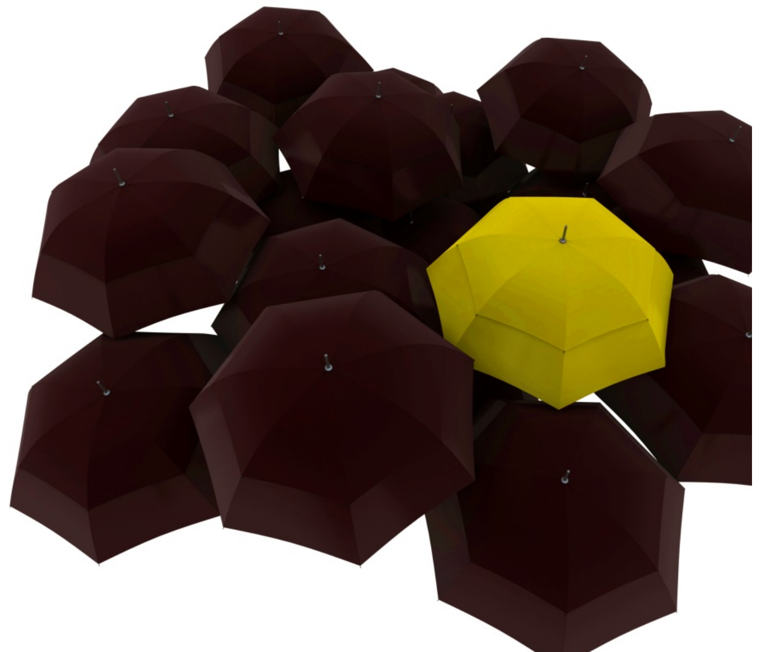
Term		Definition
Limited partnership agreement	–	This is the formal legal document for private equity funds formed as limited partnerships. It governs the fund and contains the structuring and key relationship terms between the **general partner** and **limited partners**.
Money market fund	–	This is an **open-ended** fund which offers a basket of short-term financial instruments with high liquidity and varied tax treatment depending on the types of financial instrument invested in.
Open-ended investment companies (OEICs)	–	Authorised UK umbrella OEICs (also known as ICVCs or investment companies of variable capital) are **pooled**, **open-ended investment funds** set up as companies that issue shares to investors. OEICs are similar to unit trusts operationally and in terms of tax treatment, and are often comprised of a series of sub-funds. The number of shares in issue and investment criteria is adjusted according to investor demand.
Open-ended fund	–	A fund that is divided into shares which vary in price in direct proportion to the variation in value of the fund's net asset value and in which the investors have a right to redeem or sell their interest. There are no restrictions on the amount of shares the fund can issue or redeem.
Pooled investment fund / pooled investment vehicle	–	This is where a large number of investors hold units in a fund comprising assets aggregated in a pool. The underlying commingled assets are managed by a fund manager. They are not owned directly by the investors. The main benefit of investing in a pooled fund is the collective nature of the vehicle which provides the ability to pool (combine) the capital from numerous investors in a single investment fund that is professionally managed.
Private equity funds	–	There are many types of private equity funds with varying strategies and products. These invest capital raised into selected portfolio investments (primarily unquoted companies) with a view to exiting them later at a profit. They include buyout funds, venture capital funds, real estate funds, infrastructure funds, debt and special situations funds and **funds of funds**.
Real estate/property funds	–	These are funds where real estate is the underlying core asset and the investment strategies used are mainly based on a targeted return known as Core/Core+, Value-add or Opportunistic. They tend to be **closed-ended** due to the illiquid nature of the underlying investment.
REIT	–	A fund can sometimes be organised to qualify as a private Real Estate Investment Trust in order to eliminate certain tax liabilities. It invests in income-producing real estate.
Side letter	–	This is an agreement which supplements or modifies the terms of a fund's offering memorandum, limited partnership agreement or subscription agreement. It is drafted in a bespoke way to accommodate the specific issues (commercial, policy, legal, tax and regulatory) of a particular investor with respect to their investment. It is executed between that investor and the fund and/or its investment manager.
UCITS	–	UCITS stands for 'undertakings for collective investments in transferable securities'. These are **open-ended collective investment vehicles** that are governed by the UCITS Directive (2009/65/EC) as amended.

Units	–	These are the equal rights or interests into which **investment funds** are divided and that are bought and sold by investors.
Unit trust	–	This is defined in **FSMA 2000** as a **collective investment scheme** under which the portfolio of property is held in trust for the participants. It involves a management company, trustee and unitholders and is constituted by a trust deed. Funds are invested by the managers (subject to general supervision by the trustees) to produce the highest returns possible for the unitholders, whether the unit trust is concerned with income or capital growth.



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