Linklaters

Pensions Investment Practice: Investor Agenda

WINTER | 2018

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Introduction

Welcome to the Winter 2018 edition of *Investor Agenda*.

A bit of a mixed bag this month reflecting a number of developments – including more on taking account of climate change risks in investment and a Brexit-related item: legislation starting to come through to import EU-derived legislation into UK law for the time being; and make minor modifications to prepare for the UK no longer being an EU member state. Expect more of this to follow…

We also include the first in a series of items about trends in the market in the terms on offer in European private equity funds – this first item discusses terms for removing a general partner.

As always, we welcome your comments and feedback and if there are any topics you would like us to cover in Investor Agenda, please do let us know.

This of course will be the last Investor Agenda for 2018, so I wish all our readers, and their pension schemes, a successful and prosperous 2019.

R Knowles

Rosalind Knowles

Summary

Brexit: UK UCITS and AIFMD regime to be introduced

> In advance of Brexit, draft statutory instruments (SIs) have been published to set out a UK regime for UCITS and AIF investments. These SIs propose amendments to parts of existing UK law which relate to fund management in order to ensure that the law continues to operate after the UK leaves the EU.

> The changes will be relevant to pension scheme trustees who already invest in UCITS or AIFs, or who intend to invest in UCITS or AIFs in the run up to exit day.

European private equity market – recent trends in fund manager removal provisions

> Our Investment Funds team have recently conducted a market study exploring the terms that apply to removal of fund managers in the current European private equity market. The study looked at the basis upon which a fund manager can be removed, the thresholds to remove a fund manager, and the amounts required to be paid out to a fund manager following their removal.

FCA investment platforms market study

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> The FCA has taken a broad view of what constitutes an investment platform. Although the FCA's report will principally be of interest to financial advisers, wealth and asset managers and investment platform providers, it is relevant to pension platform providers and insurance providers.

What does the ISDA Benchmark Supplement mean for trustees?

> The BMR introduced new obligations on administrators of, contributors to and users of benchmarks from 1 January 2018.

> The new Benchmark Supplement is an elective supplement which is intended to be incorporated into existing ISDA master agreements to help users comply with the BMR.

IIGCC issues practical guidance on climate change risks

> The Institutional Investors Group on Climate Change (IIGCC) launched a publication in October 2018 addressing climate risks and opportunities in the investment process. The publication is intended to be a practical guide for trustees on adopting an investment strategy which takes into account climate change risks.

New investment and disclosure obligations

> Trustees of pension schemes have been grappling with the question of how they should take account of environmental, social and governance (ESG) factors in their investment decisions.

> The government has confirmed that, from 1 October 2019, trustees will be required to consider the impact on their investments of ESG factors, explain the extent to which they take account of members' views and set out their policies on stewardship. In addition, trustees of defined contribution (DC) schemes will be subject to new reporting and disclosure obligations.

Brexit: UK UCITS and AIFMD regime to be introduced

In advance of Brexit, draft statutory instruments (SIs) have been published to set out a UK regime for UCITS and AIF investments. These SIs propose amendments to parts of existing UK law which relate to fund management in order to ensure that the law continues to operate after the UK leaves the EU.

EU regulations, which are currently directly applicable in the UK, will also be retained in UK law as at exit day. These retained EU rules will need to be adapted so that they work in a UK-only context. The draft SIs propose changes to those regulations under their respective European regimes. These changes are intended to take effect on exit day in the event of a no deal outcome.

The changes will be relevant to pension scheme trustees who already invest in UCITS or AIFs, or who intend to invest in UCITS or AIFs in the run up to exit day.

The current regime

A UCITS (undertakings for collective investment in transferable securities) is a highly regulated fund that can be marketed and sold to both retail and institutional investors throughout the EEA. UCITS are governed primarily by the UCITS IV Directive. This was supplemented by the UCITS V Directive in 2014. The UK has harmonised rules regulating the authorisation, structure and activities of UCITS in the UK.

The AIFMD (Alternative Investment Fund Managers Directive) is a regulatory framework for alternative investment fund managers (AIFMs). It covers the management, administration and marketing of alternative investment funds (AIFs). The UK has implemented AIFMD, the main instrument being the Alternative Investment Fund Managers Regulations 2013.

The proposed new regime

The changes set out in the SIs below are intended to take effect on exit day in the event of a no deal outcome.

The Alternative Investment Fund Management (Amendment) (EU Exit) Regulations 2018 (“**AIFM SI**”)

The Collective Investment Schemes (Amendment etc.) (EU Exit) Regulations 2018 (“**UCITS SI**”)

HM Treasury have also published policy notes for the AIFM and UCITS SIs.

Separately, the FCA has published a consultation on changes to its rulebook and EU technical standards as well as a consultation on how it proposes to implement the temporary permissions regime (explained below) which covers how the regime is intended to work for investment funds.

Linklaters has also produced a detailed client note on the topic.

Key changes

The main changes of interest to pension fund investors are as follows:

Definitions

- AIFM: The definition of an AIF will be amended to capture any non-UK UCITS funds. This means that all EEA UCITS will be treated as AIFs going forward and must be marketed in the UK under the UK equivalent provisions of Article 42 of AIFMD, i.e. the UK national private placement regime (**NPPR**) or recognised under section 272 of FSMA 2000 as an overseas regulated fund (unless the UK temporary permissions regime applies – see below).
- UCITS: A UK UCITS regime will be implemented to regulate UK UCITS funds, including a new regulated activity under FSMA 2000 of 'managing a UK UCITS'.

Passporting (temporary permissions regime)

- Investment funds can be marketed across the EEA under the passporting regime. If there is no deal when the UK withdraws from the EU, the UK becomes a "third country" and so EEA funds would not be able to be marketed in the UK. As such, EEA firms would need to seek recognition or authorisation from the FCA in the UK to continue to access the UK market.
- UCITS or AIFs marketed in the UK via a passport immediately before exit day can benefit from the temporary permissions regime if the EEA AIFM or UCITS operator notifies the FCA prior to exit day. Under the temporary permissions regime, fund managers will be able to market their funds in the UK on the same terms and conditions as they are currently marketed under European rules.
- The temporary permissions regime will last for a period of up to three years.

Eligible/qualifying investments

- UCITS are only permitted under the UCITS Directive to invest in "eligible investments". These include transferable securities, money market instruments, bank deposits and financial derivative instruments. The UCITS SI continues the eligible investment requirements under the UCITS Directive, which helpfully maintains the status quo for UK UCITS managers.
- It is unclear whether EEA UCITS funds (which will be treated as AIFs outside of the temporary permissions regime) can be qualifying investments for investment products / entities subject to investment restrictions (e.g. ISAs and SIPPs) or whether the relevant rules will be relaxed to include EEA UCITS funds as a permitted investment.

What happens next?

The SIs are still in draft. The Treasury has announced plans to lay them before Parliament "in the autumn", so the draft SIs are subject to change. There is no formal consultation process for commenting on these SIs.

The changes contained in the draft SIs are intended to take effect on exit day in the event of a no deal. If a Withdrawal Agreement is concluded, a transition period is expected to extend all rights and obligations under EU law to the UK until the end of 2020. In that case, the changes under the Brexit SIs, including the AIFM and UCITS SIs, would not be required until the end of that transition.

The regulators have said that firms do not need to prepare now to implement changes arising from SIs. This is because the working assumption is that there will be a Withdrawal Agreement which includes a transition period. This approach will be kept under review as negotiations progress.

In the event of a no deal, firms may struggle to make the operational changes necessary for a March 2019 Brexit. This includes EEA firms benefitting from temporary permissions who may need to apply different rules after exit day. Therefore, the Treasury intends to grant the FCA and PRA temporary power to waive or modify firms' regulatory obligations where they change because of Brexit. This will be covered by a separate SI which has not yet been published.

Relevant issues for trustees

For trustee investors proposing to invest in UCITS or AIFs in the run up to exit day or who are already invested in EEA UCITS, this is something to be aware of.

Whilst compliance is an issue for the fund manager in question, the manager may be in touch with trustee investors in the run up to exit day to make changes to the terms of their investments by a side letter.

Most managers have an overriding ability to make changes to investment documentation where there is a change in law or regulatory environment which requires those changes, and it may be that these powers are exercised if the new regime comes into force.

We will keep you updated with any further developments.

European private equity market – recent trends in fund manager removal provisions

Our Investment Funds team have recently conducted a market study exploring the terms that apply to removal of fund managers in the current European private equity market. The study looked at the basis upon which a fund manager can be removed, the thresholds to remove a fund manager, and the amounts required to be paid out to a fund manager following their removal.

> "While investors may ultimately decide not to remove a fund manager, the threat of doing so can put investors in a strong negotiating position."

Why would you remove your fund manager?

Fund manager removal is uncommon; it is still very much a "nuclear option". That said, it is one of the terms considered when reviewing the legal documentation for a proposed investment and can be an important protection in circumstances where the fund manager has not met the standards expected by investors. While investors may ultimately decide not to remove a fund manager, the threat of doing so can put investors in a strong negotiating position. The strength of this position will in turn depend on how easily the removal provisions can be applied by investors.

Fund managers can be removed for "cause" (i.e. where they are at fault) or without cause. The most common grounds for cause removal are: material breach of the governing fund documents, gross negligence, fraud, wilful default, wilful illegal acts and wilful or gross professional misconduct. In the current market, in addition to the relevant cause, there must also have been a material financial disadvantage to the fund before investors are able to exercise their removal right. While in certain cases this may be understandable (such as material breach of the fund documents) given the severe consequences of a removal action, in other cases such as fraud or wilful default, it is arguable that the act alone should be a sufficient basis for removal given that it calls into question whether the fund manager is suitable to act as a fiduciary.

Increasingly it is becoming common to require that cause must be determined by a final judgement of a court (i.e. non-appealable) before investors are able to exercise their removal right. Given the length of time it may take reach a non-appealable decision, this requirement makes it significantly more difficult for investors to apply the removal provision.

How do you remove your fund manager?

Investors are typically required to vote to remove a fund manager. Historically, a 50% vote was required to remove the fund manager for cause and 75% to remove where there is no fault. In practice however, in many instances in order to facilitate the removal of the fund manager the fund documents require investors to agree to terminate the fund and then reconstitute the fund with a new fund manager (effectively a two-step process). In the current European private equity market, there has been a trend which requires a higher percentage vote to reconstitute the fund in the case of cause removal. In this way, while the vote to terminate the fund following cause is only 50%, investors will need to meet a higher threshold to continue the fund with a new fund manager, making it more difficult for investors to remove a fund manager for cause and replace it with a new manager.

Amounts to be paid out to the fund manager following removal

The fund manager will usually be required to be paid out any accrued performance fee (i.e. carried interest) following removal. Where removal occurs following a cause event, the typical level of "haircut" (i.e. reduction in amount of performance fee paid) in the current market is 25%-35%. Where removal occurs without cause, no haircut applies and the full amount of carried interest is paid, based on the value of carried interest at the time of removal. In addition, more recently we are seeing that where a fund manager has been removed without cause it is required to be paid additional carried interest if investments are ultimately realised for an amount that is greater than the carried interest valuation at the time the fund manager is removed.

Where a fund manager is removed without cause, they will also usually be entitled to a one-year management fee.

Why does this matter?

Fund manager removal terms in the European private equity market have become increasingly manager-friendly. They are more difficult for investors to apply and therefore weaken the protection they afford investors. These provisions should be reviewed carefully when making investments to ensure that trustee investors are sufficiently protected.

Next steps

The CMA's provisional decision is expected in July 2018, while the statutory deadline for the CMA to publish its final report is 13 March 2019.

Looking at the working papers in the round, it is clear that the CMA has identified some competition issues in relation to the supply and acquisition of investment consultancy and fiduciary management services. It therefore seems likely that a package of remedies will follow. The outcome could be a considerable shake-up of the investment consultancy and fiduciary management market, with potentially significant benefits for pension scheme trustees. Some of the potential remedies the CMA has identified to date may also have a direct impact on trustees, such as mandatory tendering for fiduciary management services.

Is any action required?

No action is required for the time being. However, trustees will be keen to watch this space and we will report on the CMA's provisional decision when this is published in the summer.

FCA investment platforms market study

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The FCA has taken a broad view of what constitutes an investment platform

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The FCA has published an interim report of the findings from its market study into investment platforms. The FCA launched the market study in July 2017, after identifying potential competition issues in the platform sector as part of its asset management market study. The FCA's terms of reference for the investment platforms study focussed on assessing whether platforms help investors and their financial advisers make informed investment decisions, whether their investment solutions offer investors value for money (e.g. by placing competitive pricing pressure on product providers / asset managers), and how platforms generally compete on price and quality.

The FCA has taken a broad view of what constitutes an investment platform. Although the FCA's report will principally be of interest to financial advisers, wealth and asset managers and investment platform providers, it is relevant to pension platform providers and insurance providers.

Results of the report

The interim report, published on 16 July 2018, found that the market is working well for most consumers using investment platforms (on both an advised and non-advised basis). However, the FCA is concerned that competition between platforms is not working well in the following areas:

> facilitating consumers' ability to shop around and switch between platforms,

> risk-return disclosures provided for model portfolios,

> investors that hold large amounts of cash on platforms, and

> 'orphan clients' that pay for an ongoing advisory service but only receive limited or no advisory services.

The FCA has proposed a package of measures to address these problems.

What does the ISDA Benchmark Supplement mean for trustees?

In our Autumn 2017 Investor Agenda we reported on the EU Benchmark Regulation (BMR). The BMR introduced new obligations on administrators of, contributors to and users of benchmarks from 1 January 2018.

A benchmark is, broadly, an index which is used to determine the value of or an amount payable under a financial instrument, or to measure the performance of an investment fund. The broad definition captures a wide range of indices or references including LIBOR.

The BMR applies requirements to certain "supervised entities" which includes pension funds.

Users of benchmarks are required by the BMR to maintain robust written plans setting out the actions they would take in the event that a benchmark materially changes or ceases to be provided. Where feasible and appropriate, those plans must nominate one or several alternative benchmarks that could be referenced to substitute the benchmarks no longer provided.

A pension fund is only permitted to use a benchmark or combination of benchmarks in the EU if the benchmark (or the administrator) is included in a register maintained by ESMA.

This is particularly relevant in the context of LIBOR, which is due to be phased out over the next few years. Possible replacements for LIBOR include SONIA (Sterling Overnight Index Average).

"A pension fund is only permitted to use a benchmark or combination of benchmarks in the EU if the benchmark (or the administrator) is included in a register maintained by ESMA."

Why does the Benchmark Supplement matter to trustees?

The new Benchmark Supplement is an elective supplement which is intended to be incorporated into existing ISDA master agreements to help users comply with the BMR.

It includes supplemental terms to govern trigger events relating to benchmarks, and fallbacks which apply upon the occurrence of one of these triggers. Trustees who are counterparties to ISDA master agreements can choose to incorporate these changes into their existing agreements to comply with the BMR, and it is expected that many will wish to do so as the effect is to enhance the contractual robustness of benchmarks.

What are the new terms?

Where transactions under an ISDA, or netting of transactions, are calculated by reference to a certain benchmark, the new terms are intended to govern what happens if that benchmark is no longer ailable or approved.

The Supplement introduces two new triggers:

- Index Cessation Event (permanent cessation of a benchmark).
- Administrator/Benchmark Event (if a benchmark or administrator is not approved).

Where either of these trigger events occur, the Supplement requires the parties to consider a number of fallbacks. The parties must act in good faith and use commercially reasonable efforts to try and apply these fallbacks during a specified period of time. For example, the fallbacks include:

> Agreement between the parties.

> Use of a replacement benchmark nominated by the parties at the time of trading plus an adjustment payment/adjustment spread.

> Use of a substantially equivalent replacement benchmark nominated by the Calculation Agent plus an adjustment payment/adjustment spread.

Additional provisions are also included which deal with (i) what should happen if the benchmark is required under the contract before the fallback process is completed, (ii) disputes in relation to calculation agent determinations and (iii) fallbacks that do not otherwise comply with applicable law or regulation.

How can trustees incorporate these terms?

ISDA plans to publish a protocol to facilitate incorporation of the Benchmarks Supplement. If the trustee has existing ISDA agreements in place, managers or bank counterparties are likely to be in contact with amendment letters in due course to update the agreement.

If trustees are negotiating new ISDA agreements, they should bear these in mind and decide how they would like to proceed where a benchmark is discontinued. Trustees should incorporate the Supplement into any new ISDA Master Agreements as part of the negotiations.

For further information, please see our FAQs.

IIGCC issues practical guidance on climate change risks

"Trustees will be required to update their Statement of Investment Principles by 1 October 2019"

The Institutional Investors Group on Climate Change (IIGCC) launched a publication in October 2018 addressing climate risks and opportunities in the investment process. The publication is intended to be a practical guide for trustees on adopting an investment strategy which takes into account climate change risks. The IIGCC publication can be found here.

Trustees will be required to update their Statement of Investment Principles by 1 October 2019 to set out, among other things, how they take into account financially material considerations including environmental, social and governance (**ESG**) factors. The IIGCC publication provides a toolkit to do so, as well as practical examples and implementable guidelines, which we consider could be helpful for many trustee boards.

Among other things, the IIGCC publication provides practical guidance on:

- integrating climate change into investment processes and achieving oversight of climate-related risks;
- developing governance mechanisms to build knowledge of climate change risk on the board;
- engaging with stakeholders and members on climate change; and
- implementing processes and strategies that can reduce portfolio-wide exposure to climate related risks.

The IIGCC publication contains helpful practical examples and practical guidance and can be utilised by trustees in developing and implementing an investment strategy that takes into account ESG considerations.

New investment and disclosure obligations

Trustees of pension schemes have been grappling with the question of how they should take account of environmental, social and governance (ESG) factors in their investment decisions. Following a consultation earlier this year, the government has published a response confirming that trustees will be subject to new requirements from 1 October 2019. They will be required to consider the impact on their investments of ESG factors, explain the extent to which they take account of members' views and set out their policies on stewardship (described in the response as the activity of investors engaging with the managers of the underlying investments in order to promote the investments' long-term success). In addition, trustees of defined contribution (DC) schemes will be subject to new reporting and disclosure obligations.

The government's aim is to dispel confusion about the extent to which trustees can take account of ESG factors, and give schemes the confidence (if they so choose) to begin or increase the allocation of capital to investment opportunities such as unlisted firms, green finance and social impact investment. We think the new requirements will support this aim, providing a clear framework for trustees to take account of financial and (if they wish) non-financial factors in their investment decisions. However, trustees will need to put more time and thought into preparing their statement of investment principles (SIP), and trustees of DC schemes will face more onerous reporting and disclosure obligations.

What are the new requirements?

Statement of investment principles

By 1 October 2019, trustees will be required to update their SIP to set out:

> How they take account of financially material considerations over the appropriate time horizon of the investments. "Financially material considerations" include (but are not limited to) ESG considerations (including climate change), which the trustees consider financially material. "Appropriate time horizon" is defined as the length of time the trustees consider is needed for the funding of future benefits by the investments of the scheme. This will replace the existing requirement to report the trustees' policy on the extent (if at all) to which social, environmental or ethical considerations are taken into account.

> The extent (if at all) to which non-financial matters are taken into account. "Non-financial matters" are defined as the views of the members, including their ethical views and their views in relation to social and environmental impact and present and future quality of life of the members.

> Their policies in relation to (i) the exercise of the rights (including voting rights) attaching to the investments; and (ii) undertaking engagement activities in respect of the investments (including the methods by which, and the circumstances under which, trustees would monitor and engage with relevant persons about relevant matters). "Relevant persons" include an issuer of debt or equity, an investment manager or another holder of debt or equity. "Relevant matters" include matters concerning an issuer of debt or equity, including their performance, strategy, risks, social and environmental impact and corporate governance. This will replace the current requirement to report the trustees' policy (if any) in relation to the exercise of rights attaching to the investments.

DC schemes will need to update their default strategy to set out how they take account of financially material considerations and the extent (if at all) to which members' views on non-financial matters are taken into account. If the scheme has 100 or more members, the default strategy will also need to be updated to set out their policies on stewardship.

In relation to stewardship, the government recognises that smaller schemes will have less direct influence over firms in which they invest, but maintains that a stewardship policy is still viable, even if it is limited to the recruitment, monitoring and where necessary switching of investment managers.

Trustees will not be required to produce a separate statement on members' views, as originally proposed, following concerns raised by respondents that trustees would need to survey their members and act on members' views. The government has confirmed that this is not the intention.

Implementation statement

From 1 October 2020, trustees of DC schemes will be required to produce an annual implementation statement which must:

> set out the extent to which the SIP has been followed during the scheme year;

> describe any review of the SIP during the year;

> explain any change made to the SIP during the year and the reason for the change; and

> where there hasn't been a review, give the date of the last review.

Disclosure requirements

From 1 October 2019 (or 1 October 2020 in relation to the implementation statement), trustees of DC schemes will be required to:

> publish the SIP and the implementation statement on a website which is publicly available and free of charge; and

> inform scheme members of their availability via the annual benefit statement.

The government has published updated statutory guidance, covering how trustees should meet the requirements to publish the SIP and the implementation statement.

Summary of new requirements

The following table summarises the new requirements:

Type of scheme	Less than 100 members	More than 100 members
DB schemes	No new requirements.	By 1 October 2019 – Update SIP to take account of financially material considerations, stewardship and any policy on non-financial matters.
DC schemes	By 1 October 2019 – Update default strategy to take account of financially material considerations and any policy on non-financial matters.	By 1 October 2019 – Update SIP and default strategy to take account of financially material considerations, stewardship and any policy on non-financial matters. By 1 October 2019 – Publish SIP. From 1 October 2020 – Produce and publish implementation statement.

Is any action required?

Trustees will need to update their SIP and their default strategy by 1 October 2019 to take account of the new requirements. The Pensions Regulator is expected to publish further guidance by the end of November 2018, so it would be worth waiting for this before starting work on updating the SIP.

Trustees of DC schemes will then need to publish the updated SIP online and inform members of its availability via the annual benefit statement. From 1 October 2020, they will also need to produce and publish an annual implementation statement.

Contacts

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For trustees, this means:

> Cost-effective advice leveraging off class-leading experience;

> The most rigorous legal advice to protect you and your members;

> Pragmatic advice that is solution-focused;

> Advice that meets your deadlines;

> Seamless access to the broader firm's expertise through your usual pensions contact.

Please get in touch with your usual pensions contact to find out how the Pensions Investment Practice can work for you.

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