Hogan Lovells

New restrictions on employer related investments

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Pensions Briefing

HIGHLIGHTS

Under the Pensions Act 1995 (section 40) and the Occupational Pension Schemes (Investment) Regulations 2005 (the **Investment Regulations**) there are restrictions on the extent to which the trustees of an occupational scheme are allowed to make investments that are connected with employers that sponsor or participate in the scheme. This is part of the policy of divorcing trust funds from the assets of the employer to help minimise any loss of value of employees' pensions in a situation where the sponsoring employer becomes insolvent. The main restrictions are summarised in the box below. Breach of the restrictions is a criminal offence, and as such can potentially lead to an unlimited fine and/or imprisonment.

The UK is required to implement provisions of the European Directive on Institutions for Occupational Retirement Provision (IORP) relating to diversification of investments, by 23 September 2010. This requires the removal of two exceptions contained in the Investment Regulations: those relating to investment in collective investment schemes and transitional arrangements for schemes that exceeded the employer related investment limits before their introduction in 1997.

Schemes which are invested in collective investment schemes or are taking advantage of transitional protection will need to take action.

Employer related investment restrictions

Investments of no more than 5% of the current market value of the scheme's assets in employer related investments. These include:

- shares issued by the employer or anyone connected with, or an associate of, the employer
- land occupied or used by the employer
- other property used for the purposes of the employer's business
- units in a collective investment scheme that holds an employer related investment at a level that would have been prohibited had that investment in the employer been made directly
- any premiums or payments from an insurance policy which are invested in the employer.

No employer related loans. However, there are special provisions allowing trustees to keep (for a limited period) loans which become employer related as a result of a change in ownership of the employer or person to whom a loan has been made.

No employer related investments that would constitute transactions at an undervalue. For example, the trustees pay less than market value for shares in a private company connected with the employer.

The employer related investment restrictions do not apply to "small schemes"; that is, schemes with fewer than 12 members where all the members are trustees and either all trustee decisions require unanimity among the trustees or the scheme has an independent trustee.

In the case of a non-sectionalised multi-employer scheme, the 5% limit on employer investment applies to the entire scheme. In a sectionalised scheme, each section is treated as though it were a separate scheme (provided there is no cross-subsidy between the sections), and the 5% limit applies to each section.

The changes in detail

The IORP Directive requires Member States to impose a limit (of 5% of the market value of the scheme's investments) on the amount an occupational pension scheme can invest in the sponsoring employer. The Directive has to be implemented by 23 September 2010. The Investment Regulations already impose the 5% limit in most cases but retain two key exceptions:

- employer related investment through a collective investment scheme (CIS) is permitted subject to certain conditions (the CIS is operated by an authorised person; there are at least 10 other participants; not more than 10% of scheme assets are invested through the CIS; not more than 10% of the CIS assets are in shares from the same company); and

- schemes that breached the restrictions before 6 April 1997, but were unable to disinvest can continue to hold the offending investments until disinvestment is possible.

The Occupational Pension Schemes (Investment) (Amendment) Regulations 2010 (SI 2010/2161) remove these exceptions.

The amendments were originally included in the draft of miscellaneous regulations (which became the Occupational, Personal and Stakeholder Pensions (Miscellaneous Amendments) Regulations 2009 (SI 2009/615) - the 2009 Regulations) but were removed following responses to the consultation on the regulations. Widespread concern was expressed about the way in which investments in CISs, which are treated as separate entities from their components under tax law and under the Financial Services and Markets Act 2000, were affected. The Government promised to give the proposals further thought. However, it appears that the Department for Work and Pensions has concluded that it should interpret the Directive to require a look through.

Other changes

Also taking effect from 23 September are some minor and less contentious changes to the Investment Regulations made by the 2009 Regulations, including the removal of an exemption from the employer related investment rules for premiums paid into insurance policies where the insurer issuing the policy is also the sponsoring employer. This means that schemes with insurance policies (including those issued by an insurance company in the employer's group), where either the premiums or any payments from the policy can be invested in the sponsoring employer, should count any amount that is invested in the employer as employer related investment. It does not stop trustees using insurance policies issued by companies in the group.

Implications

The removal of the CIS exemption is a worry for trustees, particularly given the potentially draconian penalties for breach of the employer related investment rules. Whilst it is relatively straightforward for schemes to control the level of their direct investment in the sponsoring company, it is a different matter to monitor accurately their indirect holdings through pooled vehicles such as unit trusts over whose investment decisions they have no control. Trustees of schemes with employers in the FTSE 100 need to be especially vigilant, because investments can easily be made in those employers, through index-tracking funds for example, without the trustees being aware. Schemes of smaller employers who hold some employer investments (perhaps from before 1997) may also be tripped up by the new approach. The Pensions Regulator and the Department for Work and Pensions are working on guidance for trustees but in the meantime schemes that hold potentially affected investments will need to review their holdings and make any necessary changes to comply with the 5% limit before 23 September 2010. To be on the safe side, all schemes should be looking to include a reference to the restrictions in their investment management agreements.

This note is written as a general guide only. It should not be relied upon as a substitute for specific legal advice.

KEY HOGAN LOVELLS CONTACTS

Jane Samsworth	**(Partner)**	**+44 20 7296 2974**	**jane.samsworth@hoganlovells.com**
Stephen Ito	**(Partner)**	**+44 20 7296 2330**	**stephen.ito@hoganlovells.com**
Katie Banks	**(Partner)**	**+44 20 7296 2545**	**katie.banks@hoganlovells.com**
Duncan Buchanan	**(Partner)**	**+44 20 7296 2323**	**duncan.buchanan@hoganlovells.com**
Claire Southern	**(Partner)**	**+44 20 7296 5316**	**claire.southern@hoganlovells.com**

www.hoganlovells.com

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