



One of the criminal ones: an overview of section 40, Pensions Act 1995 and employer-related investments

EMPLOYMENT, PENSIONS AND BENEFITS (EPB) BRIEFING 194

This briefing provides an overview of the issues raised by the limitation on employer-related investment imposed by section 40 of the Pensions Act 1995.

These provisions can be technically difficult, but potentially severe civil and criminal penalties apply for trustees and managers who breach them. There may also be secondary criminal liability for employers who persuade trustees to invest in employer-related investments.

Segregation of a pension scheme's funds from the employer's assets, so that they will not be available to the employer's creditors, is a key control mechanism in safeguarding the security of benefit provision by private sector funded pension schemes. If trustees invest part of the pension fund in the sponsoring employer, the invested assets become part of the employer's general assets and the scheme's dependence on the ability of the employer to pay is increased.

To protect against this, the legislation imposes limits on such investments.

However, the legislative provisions are complex and lead to a number of unexpected pitfalls. It is important that trustees, fund managers and employers understand these issues because they arise surprisingly often and have the potential to lead to severe civil and criminal consequences. In addition, the legislation is changing from 23 September 2010, so trustees will need to ensure that their current arrangements will still be permitted following those changes.

An overview of the law

Section 40 of the Pensions Act 1995, together with the Occupational Pension Schemes (Investment) Regulations 2005 (the 2005 Regulations), restrict 'employer-related investments' by occupational pension schemes (including both defined benefit and money purchase schemes).

The restrictions reflect and expand upon the obligations under the EU directive on the activities and supervision

of institutions for occupational retirement provision (the IORP Directive), but take advantage of provisions that allow the application of the IORP Directive requirements to be postponed until 23 September 2010. However, from that date the legislation will change to bring the restrictions fully in line with the IORP Directive.

Broadly, section 40 and the 2005 Regulations:

- limit the proportion of a scheme's assets that may be invested in employer-related investments to a maximum of 5 per cent of the current market value of the scheme's resources;
- prohibit 'employer-related loans' altogether; and
- prohibit any employer-related investment that involves the trustees entering into a transaction at an undervalue.

There are civil and criminal penalties for breach. The Pensions Regulator has no power to validate arrangements that would otherwise contravene the restrictions on employer-related investment, regardless of the merits of any particular proposal and the interests of scheme members.

Employer-related investments and loans

The definition of employer-related investment is quite technical and it is important to consider whether a particular transaction or investment will fall within its scope. It includes the categories of investments set out in the box on the following page.

What are employer-related investments?

- Shares or other securities issued by the employer or by any person who is connected with, or an associate of, the employer.
- Land occupied or used by or leased to the employer (or any connected or associated person).
- Property other than land used for the purposes of any business carried on by the employer (or any connected or associated person).
- *Loans to an employer (or any connected or associated person).*
- Investments made through a collective investment scheme, which would have been prohibited had they been made directly.
- *Any guarantee of, or security given to secure, obligations of the employer (or of any person who is connected with, or an associate of, the employer).*
- *Any loan arrangements entered into with any person where repayment depends on the employer's actions or situation.*
- Investment in some insurance policies to the extent that the investments held under the policy would be employer-related investments if held directly by the scheme.

Having established that an investment falls within the categories of employer-related investments, it is of crucial importance to establish whether it is also an employer-related loan. This is because there is a total prohibition on employer-related loans (rather than the 5 per cent limit for other employer-related investments).

An employer-related loan would include the categories of employer-related investments highlighted in italics in the box above. It would also include:

- debentures, loan stock, bonds, certificates of deposit or similar instruments (unless such securities are listed on a recognised stock exchange) of an employer (or connected or associated person); and
- leaving amounts outstanding to a scheme that are due and payable by an employer (or a connected or associated person).

Transactions at an undervalue

Transactions in which the trustees make a gift to the employer (or a connected or associated person), or receive significantly less than market value in a transaction with such a person, are also prohibited. This could, for example, occur if a trustee leases property to the employer at significantly less than market rent.

Penalties for non-compliance

Civil liabilities

The Pensions Regulator can issue a civil penalty (up to £5,000 for an individual or £50,000 for a company) on

trustees or managers who fail to take all reasonable steps to secure compliance with section 40.

Trustees will have the burden of proving they took all reasonable steps and so should carefully minute decisions. Reasonable steps could include having restrictions in their agreements with investment managers (and monitoring compliance) in addition to undertaking due diligence to try to ensure that the requirements of section 40 are met.

Further, contravention of section 40 might (this is not clear) result in the investment being unauthorised for trust purposes, meaning the trustees would be personally liable for any resulting losses.

Criminal penalty

A trustee or manager who agrees in the determination to make an investment that is in contravention of section 40 is guilty of a criminal offence, which can result in an unlimited fine, a maximum period of imprisonment of two years or both.

There should be no criminal liability on a trustee if, for example, a fund manager made the investment decision or if that particular trustee was outvoted.

Both the criminal and civil penalties can extend to directors and other officers of a corporate trustee if the breach is due to his 'consent, connivance or neglect'. Further, there can be no indemnity (or insurance cover) paid from scheme assets against a criminal or civil liability.

Employer concerns

No civil penalty can be issued against an employer. However, because there is also a criminal offence there could be secondary criminal liability for an employer – for example, if the employer persuaded the trustees to invest in employer-related investments contrary to section 40 and so 'aided, abetted, counselled or procured' their offence.

The employer may also be concerned about employer-related investments because of the knock-on effects for scheme funding.

- Assets invested in breach of section 40 do not count for the purposes of scheme specific funding valuations under the Pensions Act 2004.

- Such assets also do not count for the purposes of calculating a debt under section 75 of the Pensions Act 1995.

Therefore, prohibited employer-related investments can increase an employer's liability to fund the scheme on an ongoing basis or if a statutory debt is triggered.

Don't get caught out – what are the pitfalls?

Identifying employer-related investments: how wide is the net?

Given the severity and scope of penalties, it can be disconcerting to trustees to find that identifying employer-related investments can be difficult because of the broad 'net' of persons that the restrictions will apply to for any particular scheme.

The term 'employer' is very wide and may include companies that the trustees would not normally consider to be an employer for the purposes of the scheme.

- Following the recent *Cemex* case (2009), it appears that an employer can include a company that has ceased to employ any active members but has employees who are eligible to join the scheme or employs deferred or pensioner members of the scheme (for more information see EPB briefing 191: *Cemex decision on section 75 of the Pensions Act 1995* (2010)).
- In a multi-employer scheme, an employer will also include a former employer following an employment-cessation event, until the section 75 debt has been paid.
- In a frozen scheme, the last set of employers before the freezing event are treated as employers (unless and until they trigger and pay their section 75 debt).

The restrictions also extend to investments with a person who is 'connected or associated' with the employer (as defined in the Insolvency Act 1986).

- This definition is also very broad. It includes holding companies and subsidiary companies of the employers but may extend beyond the employers' accounting groups. For example, it will include a company in which the employer has a shareholding of one-third or more (for more information see EPB briefing 178: *Who is connected or associated?* (2009)).
- There is a specific exclusion for employer-related investment purposes if the only reason for the

connection is that another company and the employer have a common director. However, the exclusion may not apply if there is any other connection (eg if the director is also an employee).

Due diligence will be important for trustees to establish the extent of the net for employer-related investment purposes.

Do you hold an interest in a pooled investment?

In some cases there can be a 'look through' to treat pension schemes as owning underlying employer-related investments. This can apply if a scheme holds an interest in a pooled investment (eg an insurance policy, a unit trust or a collective investment scheme) and that pooled vehicle holds employer-related investments.

What if a permitted employer-related investment subsequently exceeds the limit?

There is no periodic testing of whether a scheme's investments breach the 5 per cent limit on employer-related investments: the test is applicable at all times. If the trustees have invested in employer-related investments below this limit, the limit could be broken as a result of investment performance (ie either the value of the employer-related investment going up or the value of the rest of the fund going down).

This may make trustees extremely cautious about having any significant employer-related investment (unless well below the 5 per cent limit) because it will be extremely difficult to ensure that on a day-to-day basis the limit is not breached.

What if an investment unexpectedly becomes employer-related?

Because the restrictions apply to persons who are connected and associated with the employer, investments or loans that were not employer-related when made could become so subsequently, for example following a change in the ownership of the employer. In these circumstances, a loan would not immediately become prohibited. There is an exemption, which enables it to be held for a limited period (normally two years). However, from 23 September 2010, the value of such a loan will count towards the overall 5 per cent limit. There is no similar exemption for an investment that is not a loan.

Therefore, if the 5 per cent limit is breached, the trustees will need to take reasonable steps to disinvest.

What about contingent asset arrangements?

Section 40 provides that to the extent that 'sums due and payable by a person to the trustees or managers of an occupational pension scheme remain unpaid', this shall be treated as a loan and the resources of the scheme shall be treated as invested accordingly. This means any arrangement with an employer (or person associated or connected with an employer) that might result in a payment being due to the scheme from such a person would, if there were a default on the obligation, become a prohibited employer-related loan. This could include parent company guarantees and other contingent assets.

Guidance from the Pensions Regulator, on contingent assets, acknowledges that 'when considering the issues which relate to contingent assets, the trustees are likely to require specialist legal advice'. In practice, the key concern for trustees will be to ensure that, if the obligation is defaulted on, they take all reasonable steps to recover the amounts due.

What is excluded and what is going to change in September 2010?

There are a number of investments that do not count as employer-related investments and do not need to be taken into account for the purposes of the 5 per cent market value test or the prohibition on employer-related loans.

The exemptions for some of these investments will change from 23 September 2010: see the box to the right.

Trustees should start considering the implications for them of the changes to these exemptions. Unhelpfully, the position in relation to excluded collective investment schemes and the transitional protection afforded to pre-6 April 1997 investments is unclear. In April 2009, the Department for Work and Pensions (DWP) decided not to implement proposals to remove these exemptions but indicated that this 'should not be taken as an indication that the exemptions are to remain indefinitely'.

We understand that the DWP is still considering whether there is an alternative to removing the exemptions that would still comply with the IORP, but may publish regulations after April 2010 removing these exemptions with effect from 23 September 2010.

Changes to exemptions from 23 September 2010

Current exemption	Position following 23 September 2010
<input type="checkbox"/> Small schemes (less than 12 members).	<input type="checkbox"/> No change: exemption continues.
<input type="checkbox"/> Amounts due under the statutory schedule of contributions or section 75.	<input type="checkbox"/> No change: exemption continues.
<input type="checkbox"/> Additional Voluntary Contributions (AVCs) invested with member written agreement.	<input type="checkbox"/> Will count towards 5 per cent limit.
<input type="checkbox"/> Authorised bank and building society accounts.	<input type="checkbox"/> Will still not count as a prohibited loan. <input type="checkbox"/> Will now count towards the 5 per cent limit.
<input type="checkbox"/> Excluded collective investment schemes.	<input type="checkbox"/> Unclear, DWP still considering.
<input type="checkbox"/> Excluded insurance policies.	<input type="checkbox"/> Will now count towards the 5 per cent limit.
<input type="checkbox"/> Investments held prior to 6 April 1997.	<input type="checkbox"/> Unclear, DWP still considering.

One of the concerns, if the exemptions are removed, is the potentially significant valuation costs attached to disinvesting in the current economic climate. The difficulty is that if the DWP continues to delay its decision but ultimately decides to remove the exemptions by 23 September 2010, trustees and managers will have even less control over the market conditions in which they choose to disinvest.

For further information please contact	David Pollard T +44 20 7832 7060 E david.pollard@freshfields.com
	Dawn Heath T +44 20 7427 3220 E dawn.heath@freshfields.com
To request a (much longer) technical paper on this subject please contact	Josh Gabriel T +44 20 7785 2420 E josh.gabriel@freshfields.com

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