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Beware the Pensions Regulator: stronger powers and criminal penalties

Highlights

- The government has issued its response to its consultation paper on proposals to strengthen the Pensions Regulator's powers in relation to corporate activity. Those proposals were aimed at deterring behaviours by pension scheme sponsors and their corporate groups that could detrimentally impact on a defined benefit pension scheme.

- Company directors could face up to 7 years' imprisonment if they are found guilty of a new criminal offence of reckless or wilful behaviour in relation to a pension scheme.

- Proposals to expand the corporate events requiring mandatory notification to the Pensions Regulator have been somewhat watered down but a failure to comply with the notification requirements could result in a civil penalty of up to £1m.

- There will be no mandatory clearance but "corporate planners" will be required to provide a statement to the Pensions Regulator, prepared in consultation with the pension scheme trustees, setting out the pensions impact of a transaction and any mitigation proposed. These statements will be required for (i) change of control of an employer, (ii) sale of material assets and (iii) granting security which ranks ahead of the pension scheme. The government suggests that the legislation won't specify the timing for the statement, even though failure to comply will carry a potential civil penalty of up to £1m.

- There will be various changes to streamline the Pensions Regulator's moral hazard powers and make it easier for the Pensions Regulator to impose liability for pensions deficits on connected third parties.

- The "financial support direction" regime (under which liability can be imposed on a "no fault" basis) will be extended so that individuals who are controlling shareholders can be targets (currently only companies can normally be targets).

- These proposals will be implemented through legislation and/or guidance form the Pensions Regulator. Although the government has not specified a timescale, and any new legislation will be subject to space in the Parliamentary timetable, we understand that primary legislation to implement these reforms will be included in a Pensions Bill which is expected to be published in early summer.

- As a result of the proposals in the consultation paper and the Pensions Regulator's mantra to be "clearer, quicker, tougher", it will continue to be crucial for corporate groups to ensure that the impact of corporate activity on their defined benefit pension schemes is carefully considered and appropriately mitigated.

Introduction

As a result of the intense scrutiny faced by the Pensions Regulator following the high profile insolvencies of BHS and Carillion, the government published a consultation (the "***Consultation***") last year, "Protecting Defined Benefit Pension Schemes – A Stronger Pensions Regulator" setting out proposals to strengthen the Pensions Regulator's powers (see our alert "Pensions Regulator to have stronger powers in corporate transactions"). These proposals were initially outlined in the pensions White Paper "Protecting Defined Benefit Pension Schemes" (published in March last year) and support the Pensions Regulator's new aim to be a "clearer, quicker, tougher" regulator (see our alert "The Pensions Regulator's new approach: more scrutiny of pension schemes, employers and corporate activity").

The government has now published its response to the Consultation ("Government Response to the Consultation on Protecting Defined Benefit Pension Schemes – A stronger Pensions Regulator"), confirming which of the proposals it will take forward. Once the proposals are implemented, corporate groups that sponsor defined benefit schemes will become subject to additional scrutiny and reporting requirements when undertaking corporate activity.

Scrutinising corporate transactions

Expansion of corporate events requiring notification to the Pensions Regulator

- There is already a requirement on employers and trustees to notify the Pensions Regulator on the occurrence of certain events. The Consultation proposed expanding the list of events that need to be notified to the Pensions Regulator by employers in order to give the Regulator earlier warning of events which could potentially have a detrimental impact on a pension scheme. The government's response confirms that the existing list of events that trigger mandatory notification to the Pensions Regulator will be expanded to include:
  - the sale of a "material proportion" of the business or assets of a scheme employer which has funding responsibility for at least 20% of the scheme's liabilities; and
  - granting security to a creditor to give it priority over the debt to the pension scheme.

- The government recognises that it will be crucial to define these events clearly and has committed to working with the Pensions Regulator to develop these definitions. There will also be a consultation on draft regulations to amend the existing reporting framework.

- The Consultation had proposed other events that would have required mandatory notification to the Pensions Regulator but, after reviewing the responses to the Consultation, the government has dropped these from the new notification proposals.

- These events include: (i) a significant restructuring of a scheme employer's board of directors and other senior management appointments; (ii) the sponsoring employer taking independent pre-appointment insolvency/ restructuring advice (such as an independent business review); and (iii) deferral or waiver of a banking covenant (breach of a banking covenant is already a notifiable event).

- Although dividend payments have been a significant issue in the recent high profile insolvencies, the government response confirms that dividend payments will not be a notifiable event. The framework surrounding dividend payments is being considered as part of a separate consultation by BEIS on corporate governance and insolvency. However, the Pensions Regulator will consider whether the level of dividend payments made by a corporate group are appropriate as part of its review of individual schemes' actuarial valuations as well as its wider review of the Code of Practice on Funding Defined Benefits, which is intended to clarify funding standards (that work is expected to begin in the next few months).

Timing of notification

- The Consultation had suggested that there should be a requirement to notify some events earlier than is currently required and proposed that notification should be made at the "heads of term" stage. The government has not yet confirmed the timing requirements for making notifications but it seems to have accepted that its proposal would not provide sufficient clarity. The consultation response indicates that legislation is only one of the options that the government is considering for setting out timing requirements and it may be that after further work is carried out, timing requirements will be set out in supporting guidance and/or a revised code of practice from the Pensions Regulator on notifiable events.

Penalty for failure to report

- The Consultation had proposed that failing to report a prescribed corporate event should be a criminal offence but this proposal has now been dropped. The penalty for not complying with the new notifiable events framework will instead be a civil penalty of up to £1m.

Declaration of intent statements relating to the impact of corporate transactions

- Whilst the White Paper stopped short of proposing mandatory clearance by the Pensions Regulator of certain corporate transactions, the Consultation expanded on the initial proposal in the White Paper to require companies to prepare a "declaration of intent" to show the Pensions Regulator and trustees that companies have appropriately considered the impact of certain transactions on their defined benefit pension schemes.

- New legislation will be introduced requiring "corporate planners" (which includes, but is not restricted to the sponsoring employer or parent company) to prepare a declaration of intent statement in consultation with pension scheme trustees setting out details of the transaction and any mitigation proposed to address any detrimental impact on the pension scheme. This statement would have to be shared with the Pensions Regulator and confirm whether agreement has been reached with the trustee.

- A declaration of intent will be required for transactions involving:
  - sale of controlling interest in a sponsoring employer (currently, a notifiable event);
  - sale of business or assets of sponsoring employer (a new notifiable event); and
  - granting of security on a debt to give it priority over debt to the scheme (a new notifiable event).

Timing of sharing declaration of intent

- At this stage, the government is not planning on legislating to specify the timing of when the declaration of intent should be shared with the pensions scheme trustees and the Pensions Regulator. The Consultation proposed that this should happen before a transaction takes but the government acknowledged concerns about commercial sensitivity and says it will work with the Pensions Regulator to identify a flexible approach that takes into account the particular circumstances of individual transactions. However, engagement with the trustees is expected at the earliest opportunity.

Penalty for failure to provide a declaration of intent

- Failure to provide a declaration of intent statement for a relevant transaction could result in a civil penalty of £1m under the new proposals. The Consultation did not suggest that a transaction would be unwound if the statement is not provided. However, as well as the civil penalty, companies who fail to comply would also be at risk of the Pensions Regulator exercising its "moral hazard" powers if the transaction resulted in a material detriment to the pension scheme.

Voluntary clearance regime

- The government has confirmed that the declaration of intent will not replace voluntary clearance. As announced in the Consultation, the Pensions Regulator will review its clearance guidance to "clarify" certain aspects of the clearance regime and to provide more information on the clearance process and expectations around timing of a clearance application.

New criminal penalties

- The government has announced that a maximum penalty of 7 years' imprisonment and/or unlimited fines for a new offence to punish "wilful or reckless" behaviour of parties connected to the sponsoring employer (which would include directors and persons who are deemed to control the employer) in relation to a pension scheme. Despite the serious penalty that could be imposed, there are still no details of how the offence would actually be framed and what defences might be available. There is no suggestion in the response that this offence will be introduced with retrospective effect, although the White Paper did suggest that acts or omissions after 19 March 2018 (when the White Paper was published) could be caught by proposed new penalty regime.

- The government has confirmed that it will not take forwards a proposal to impose a custodial sentence as a penalty for failure to comply with a contribution notice, i.e. a requirement to make a payment to the pension scheme that can be imposed by the Pensions Regulator under the existing "moral hazard" regime. It now proposes that this will still be a criminal offence but the Pensions Regulator will have the power to issue unlimited fines. Civil penalties of up to £1m will also be possible.

- As proposed in the Consultation, the possible targets of the new criminal sanctions (and civil sanctions) include all of those who have responsibility to the pension scheme – directors, sponsoring employers and any associated or connected persons (and in some circumstances, trustees).

Changes to the Pensions Regulator's existing "moral hazard" powers

- The Consultation proposed a number of changes to "strengthen" the existing contribution notice ("CN") and financial support direction ("FSD") regimes.

- A proposal to give the Pensions Regulator power to issue FSDs against individuals, including directors, who are associated with or connected to the sponsoring employer, will not be taken forward.

However, the government will introduce legislation to allow FSDs to be issued against individuals who are controlling shareholders of the sponsoring employer. We would not expect this legislation to be brought in retrospectively but as with the current FSD legislation, acts or omissions by individual controlling shareholders at any time in the past could be taken into account by the Pensions Regulator when considering whether it is "reasonable" to issue an FSD against such individuals.

- Other changes include a renaming of the FSD regime to the Financial Support Notice ("FSN") regime and simplifying the FSD/FSN process into a single-stage process, so that the initial FSN specifies the support to the provided to the pension scheme (rather than the current regime under which negotiating the support to be provided is a second stage after the FSD is issued).

- The government also considered whether to increase the current 'lookback' period for FSDs beyond two years. Although it will not be extended at this time, the government will keep this under review and consider it further in light of other changes – such as moving to a single-stage process for FSDs.

What action should companies be taking?

Although the proposed changes will not be implemented for some time, the clear commitment of the government to strengthening the Pensions Regulators powers means that it will continue to be critical for corporate groups, their controlling shareholders and directors to manage pension scheme risks carefully when planning corporate activity. As a result, it will be more important than ever for employers to ensure that the impact of corporate activity on their defined benefit pension schemes is carefully considered and appropriately mitigated if necessary, and that such steps are properly documented, with the aim of both reducing the risk of future regulatory action being instigated and being in the best possible position to defend any such action if it arises.

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