NORTON ROSE FULBRIGHT

Pension scheme trustees

Changes to the trustee board structure – internal reorganisations and the Pensions Regulator's approach

February 2020

This briefing examines the evolving structure of pension scheme trustee boards. The Pensions Regulator is focusing increasingly on improving scheme governance. We look at its initiatives in this area and its views on the future of trustee knowledge and understanding, scheme governance structures and the appointment of professional trustees.

In addition, a number of our clients are replacing individual trustees with a sole corporate trustee. When a corporate trustee is set up the individual trustees become directors of the trustee company. This note summarises the advantages and disadvantages of adopting such a structure.

The Pensions Regulator's expectations

Plan for the next three years

The Regulator's intentions and aims for each three-year period are set out in its annually published corporate plan. The corporate plan for 2019-2022 reveals that key priorities over that period are to provide clarity, to promote and to enforce the high standards of trusteeship, governance and administration that are expected.

The Regulator responded to its July 2019 consultation document, *the Future of trusteeship and governance*, on 10 February 2020. In that response, it set out its proposals for the future of trustee knowledge and understanding (TKU), scheme governance structures and the implementation of defined contribution (DC) scheme consolidation. The Regulator has particular concerns about the governance of small (12-99 members) and micro (fewer than 12 members) DC schemes.

The Regulator's consultation response outlined the changes it proposes to implement in each of these three areas:

Updating TKU - the Regulator proposes to consult on a revised code of practice in the first half of 2021. The revised TKU content aims to be simpler, clearer and easier for trustees to translate into good governance behaviours. Guidance will also be provided to help trustees establish an effective system of governance. The Regulator is considering revisiting the TKU code and scope guidance to increase the TKU levels expected of professional trustees, in line with the approach taken in the voluntary industry standards in place for professional trustees. However, it does not intend to require all schemes to have a professional trustee.

Scheme governance structures - the Regulator consider how trustee boards could become more diverse, inclusive and able to demonstrate they have the right mix of skills, knowledge and understanding for running the scheme.

There are plans to set up an industry working group on improving trustee board diversity, while examining the possibility of developing an industry code on sole trusteeship – see further below.

DC scheme consolidation - the Regulator makes clear that it expects many of the schemes that are unable to meet the required standards of trusteeship and governance to be encouraged to consolidate into a master trust, although some employers may choose to provide a group personal pension plan. The Regulator plans to improve its winding up guidance to address some of the perceived barriers to consolidation.

Accreditation process for professional trustees

The consultation response confirmed that the Regulator does not currently intend to require schemes to have a professional trustee. However, it hopes that the Association of Professional Pension Trustees (APPT) standards for professional trustees and the accompanying accreditation process will *"help to bring greater consistency in the quality of professional trustees and in turn provide greater confidence that accredited professional trustees meet the standards we expect".*

Following delays to the launch, the APPT's professional pension trustee accreditation process is open to applications from the start of the 2020/21 financial year. There is a parallel process being promoted by the Pensions Management Institute. Accredited trustees will then be required to comply with a *"rigorous professional standards code"* developed by the APPT in consultation with the Regulator.

Why replace individual trustees with a corporate trustee?

Liability

Protection from personal liability

This is a key advantage of having a corporate trustee. Whereas individual trustees act in their personal capacity and can be sued directly by scheme members, a corporate trustee is a distinct legal entity, capable of suing and being sued in its own name. The liability protection afforded to directors as a result of incorporation is referred to as the 'corporate veil.' Claims by scheme members are generally brought against the trustee company rather than against the individual trustees in their personal capacity.

There are exceptions to this general rule and trustee directors can still be personally liable in certain circumstances including, for example, if a director dishonestly assists in a breach of trust.

Directors' & Officers' (D&O) insurance

If the corporate trustee is a subsidiary of the sponsoring employer it is usually straightforward to extend any existing D&O insurance to cover the trustee directors.

If the trustee directors are covered by D&O insurance they will benefit from personal asset protection in the event that the indemnity from the sponsoring employer fails.

Tax issues

If the trustee company and the sponsoring employer are members of a VAT group this can in certain circumstances provide a VAT advantage.

Joining the sponsoring employer's VAT group also reduces the trustees' VAT compliance costs as only one VAT return needs to be submitted by the representative member for the whole VAT group.

If trustees are considering an asset-backed funding solution it is necessary to have a corporate trustee due to stamp duty land tax issues.

Concerns have been raised that where a corporate trustee is VAT grouped, HMRC would be entitled to recover a VAT debt of the VAT group from the pension scheme assets. HMRC has confirmed that its position is, and remains, that it is unable to recover VAT from the scheme assets except to the extent that the relevant VAT debt is attributable to the administration and operations of the pension scheme.

All group members remain jointly and severally liable for tax due from the representative member. However, in the case of a corporate trustee this liability does not extend to the assets of any fund(s) that they are responsible for managing as these are not the trustee's assets and cannot be used to pay debts that are not the result of the trustees fulfilling their duties as trustees.

Administration

Execution of documents

It is much simpler for a corporate trustee to execute deeds. Rather than each individual trustee having to sign, once a matter has been approved by the board, the deed may be signed on behalf of the trustee company by two directors, a director and the secretary or a director with a witness.

This is a particular advantage if, for example, the trustees are geographically dispersed or if any of the trustees are frequently overseas or otherwise unavailable to sign.

It also reduces the risk of one individual trustee not executing a deed (particularly if it is executed in counterpart) and the deed subsequently being held by a court to be invalid.

Appointment and replacement of trustee directors

It is much simpler to appoint and remove trustee directors than individual trustees, with no deed of appointment or removal required.

Instead, only a member resolution and a Companies House form notifying the change are needed. The latter must be sent to Companies House within 14 days.

In addition, when individual trustees change, notifications must be made to the Pensions Regulator (by updating the online scheme return) and to HMRC if the scheme is contracted-out and the primary contact changes. These notifications are not required when changing trustee directors.

Member nominated trustee arrangements can simply be repeated in the articles of association to form a member-nominated director policy.

Changes of trustees may be simpler to document or notify under investment management agreements if there is a corporate trustee.

What are the drawbacks?

Liability

Penalties

The Pensions Regulator's maximum civil penalties are higher for corporate trustees than for individual trustees, being £50,000 rather than £5,000.

Indemnity protection

The indemnity protection provided by a group company or by the corporate trustee itself to the directors in connection with their activities as trustees is limited under the Companies Act. No indemnity may be provided against a fine imposed in criminal proceedings, a penalty payable to a regulatory authority in respect of non-compliance with any regulatory requirement or any liability incurred by a director in defending criminal proceedings in which he is convicted. In contrast, individual trustees can generally be indemnified out of the assets of the scheme, or by the sponsoring employer, free from the restrictions in the Companies Act.

This disadvantage may be mitigated to a certain degree if the trustee directors are covered by D&O insurance (depending on the terms of the policy).

Pension scheme indemnity provisions must also be disclosed in the directors' reports of the trustee company and the sponsoring employer and members may request copies of these reports.

Administration

Paperwork

A certain amount of paperwork is required when setting up the trustee company (including articles of association and appointments of directors which must be filed at Companies House).

Annual returns must be submitted to Companies House and annual accounts must be prepared, but provided the company is 'dormant' (which is usually the case) it will not need to be audited.

Less transparency

Individual trustees may be more visible than trustee directors and hence preferred by members.

However in practise member nominated trustee arrangements are preserved in the company's articles.

Sole trusteeship

Instead of replacing individual trustees with a corporate trustee, some schemes are appointing a sole independent corporate trustee. Are there advantages to this approach?

What is the Regulator's view?

The Regulator still believes that there is clear evidence that diverse groups make better decisions than those which are non-diverse, and it will create an industry working group to help pension schemes (and employers) improve the diversity of scheme boards. However, it does not currently intend to pursue the introduction of a requirement for schemes to report on the steps they are taking to increase board diversity.

The Regulator is not planning to make changes to the way it regulates sole trustee schemes although it states *"we'll continue to scrutinise those schemes".* The Regulator will support the APPT in the development of an industry code for sole trusteeship.

Sole corporate trustees have the potential advantages of:

avoiding potential difficulties in recruiting individual volunteers to be appointed to the board;

benefitting from the wide-ranging experience over many schemes of a professional independent trustee, which may become more relevant as the Regulator increases its expectations of trustees; and

potentially fewer conflicts of interest.

However, disadvantages include:

a possible membership perception that a sole trustee appointed and paid for by the employer cannot be truly independent; and

a potential lack of diversity of views, as found on boards comprising several individuals.

Actions for trustees to take or consider

Whatever the compilation of your trustee board, care should be taken to ensure all members are aware of the changes on the horizon and the Regulator's expectations.

Any schemes considering a sole corporate trustee should ensure that there is a clear policy for managing conflicts of interest as they arise. The future APPT industry code may be of assistance.

The approach of the trustee board to training should be reviewed, in order that the new TKU requirements can be readily adopted once they are implemented.

Summary

What are the possible effects of potential changes on member-nominated trustees (MNTs)? There is a perception among some MNTs that the Regulator's current proposals on future policy may result in the disappearance of member representation from the UK's pensions system.

However, the Regulator's concerns are that some of the wider lay trustee community (particularly those involved in the governance of small and micro schemes) may lack the skills required to be effective stewards. Just one per cent of small DC schemes are meeting all the Regulator's expectations, and this is one of the principal reasons that the Regulator advocates consolidation into master trusts for small DC schemes.

The two main advantages of converting to a corporate trustee are increased protection against personal liability and that a corporate trustee is administratively more straightforward, particularly when it comes to the execution of deeds. The main disadvantage is the paperwork involved in setting up the company and the various filing obligations. Whether this disadvantage outweighs the potentially significant advantages largely depends on the experience and resources available to the trustees.

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