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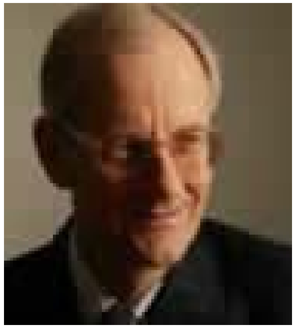
Global Benefits and Compensation Roundtable Webinar:

UK Regulators and the Underfunded UK Pension “Scheme”: What the US Parent Company Needs to Know

June 26, 2017

Presenters

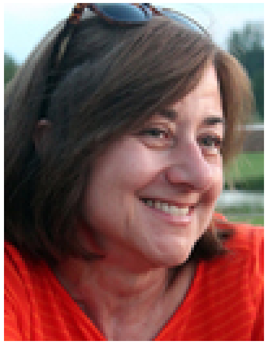


Philip Bennett
Partner
Slaughter and May

Lynn Dudley
(Moderator)
Senior Vice President, Global Retirement and Compensation Policy
American Benefits Council

Howard Pianko
Partner
Seyfarth Shaw LLP

Christopher Massey
Senior Consultant
Willis Towers Watson



Janet VanAlsten
(Moderator)
Program Director
The Conference Board

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Roundtable Mission

- The mission of the Roundtable is to:
  - ✓ provide education in an area that is becoming increasingly important and where knowledge is not concentrated in a small number of source materials or among a discreet group of professionals; and
  - ✓ address current topics that inherently involve cross-border considerations as contrasted with a country by country review.

How to participate in this webcast

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Introduction: What are we talking about today?

- The role of UK pension plan Trustees
- Pension plan funding requirements in the UK
- The role and powers of the UK Pensions Regulator (including potential changes in the near future)
- The potential impact of this UK framework on:
  - Corporate transactions
  - Changes to pension plan benefits (e.g. closure to future accrual)

Appendix - US Parent Guaranty of UK Subsidiary Pension Scheme Obligations

Why UK Defined Benefit Plans Can Create Headaches for U.S. Parent Companies

- Governance of the Plan is different
  - ✓ The Trustee is independent and has a broader role
- Pension regulations give more oversight power
  - ✓ The Pensions Regulator has an active role even in plans not in distress
- Funding of the Plan is more prescribed
  - ✓ Strict rules on when a plan is underfunded and what happens next
- Significant pension pitfalls in corporate transactions are not just possible, but likely

The role of UK pension plan Trustees

The role of UK pension plan Trustees

Trustees often have more power than US plan fiduciaries for three key reasons:

1. The legal structure of UK pension plans
2. Requirements of UK legislation
3. Trustees are supported and guided by the Pensions Regulator

The role of UK pension plan Trustees
Difference in legal structure

- Employment contract generally only confers a right to be a member of the plan
- All matters relating to:
    I. contributions
    II. benefits
    III. plan amendments and termination
    IV. balance of power between sponsor and trustees
    V. investment
    VI. administration

  regulated by plan's Trust Deed and Rules and overriding legislation

The role of UK pension plan Trustees
Requirements of UK legislation

A selection of the statutory requirements that enhance trustee powers:

- fiduciary duties to act in the best interests of all plan beneficiaries
- The trustee board must have **at least** one-third of its directors member-nominated directors (“**MNDs**”)
- The trustee alone has power to invest plan assets and is only required to consult the sponsor on investment strategy
- The trustee is solely responsible for appointing the plan actuary, investment advisers/managers, employer covenant adviser and a range of other advisers

The role of UK pension plan Trustees
Requirements of UK legislation (cont’d)

- Agree a funding plan with the sponsor based on prudent assumptions
- Actuarial valuations and negotiations on contributions normally take place every 3 years, but the trustee has the power to call an out of cycle valuation at anytime
- Wind-up or partially wind-up the plan and collect an associated debt from the employer (more on this later)
- Notify the Pensions Regulator in certain prescribed circumstances
- Disclose an extensive range of prescribed information to members
- Satisfy “knowledge and understanding” requirements

The role of UK pension plan Trustees
Requirements of UK legislation (cont'd)

The trustee and Pensions Regulator cannot ignore the interests of the sponsor:

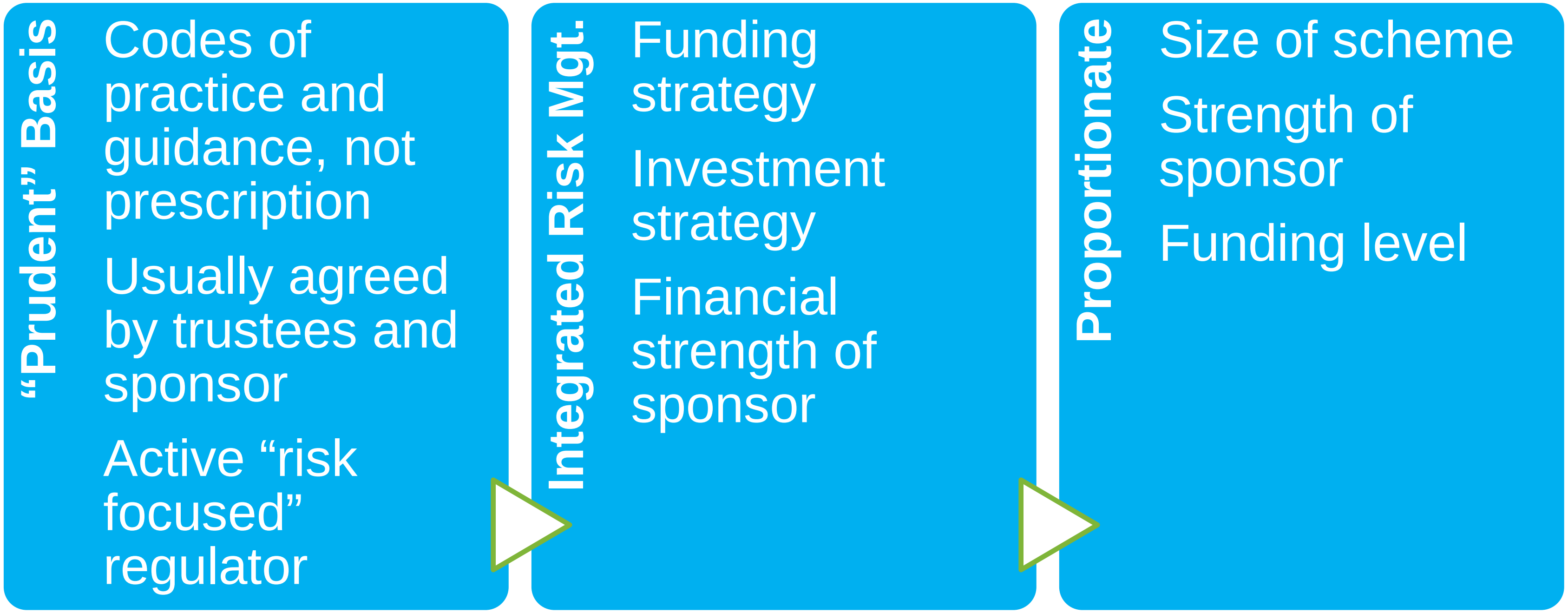
- The trustee owes certain duties to sponsors (e.g. when investing) under the provisions of UK trust law
- In exercising its functions in relation to plan funding, the Pensions Regulator has a statutory objective to minimise any adverse impact on the sustainable growth of a sponsor

The role of UK pension plan Trustees
Support and guidance from the Pensions Regulator

- The Pensions Regulator regards trustees as central to protecting plan beneficiaries and largely uses its powers in support of trustees
- The Regulator has issued extensive codes of practice and guidance to trustees (more later)
- The Pension Protection Fund also has mandatory requirements that trustees must follow and provides associated guidance
- The Regulator has bought sanctions against trustees that have not discharged their duties and trustees are not rewarded for taking risks

Pension plan funding requirements in the UK

Pension Funding for an ongoing plan
Overview of minimum funding requirements

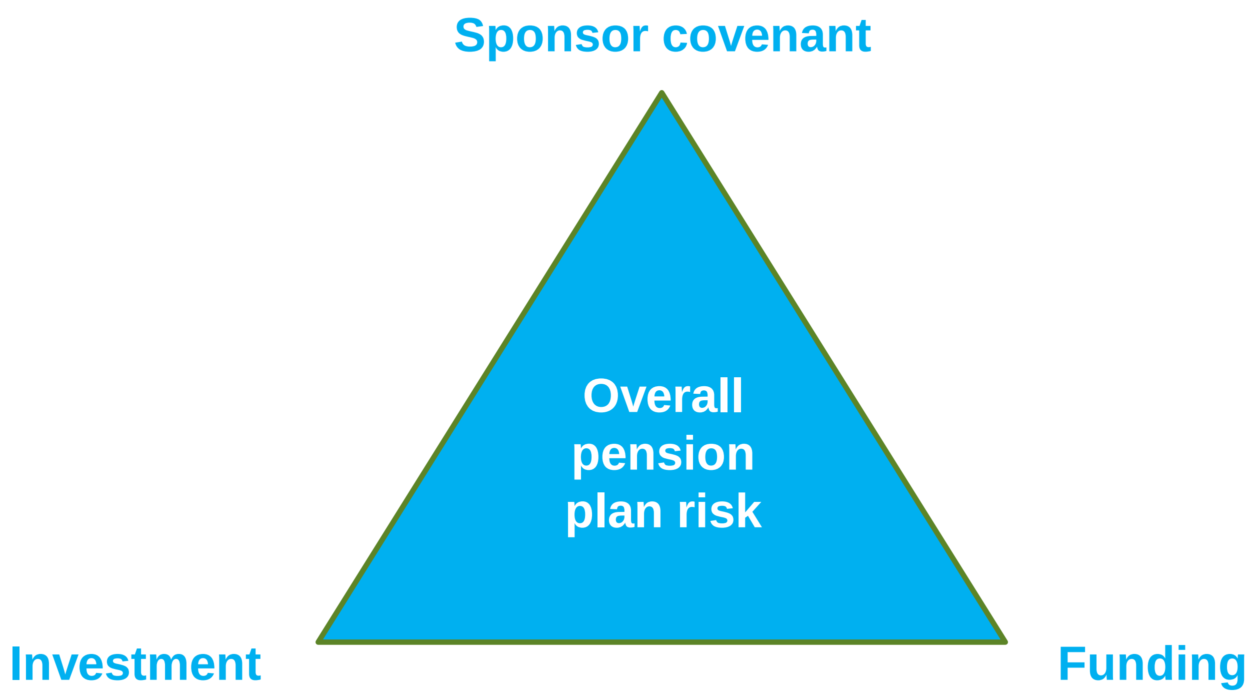


Note – The plan trust deed and rules may impose additional requirements

Pension Funding for an ongoing plan
Important differences in detail

	US	UK
Assumption/method selection	Some assumptions and methods selected by the sponsor	All assumptions agreed by the trustees and sponsor
Liability calculation method	Accumulated Benefit Obligation (ABO)	Projected Benefit Obligation (PBO)
Asset calculation method	Option to use market value or smoothed value	Market value
Shortfall amortization period	7 years	Trustees and sponsor negotiate the period and a shortfall may be met by assumed investment out-performance
Interest (discount) rates	Based on a "modified" corporate bond yield curve with corridors around a 25-year average	"Prudent" discount rate that takes account of investment strategy and sponsor strength, no averaging

An integrated approach to funding strategy



Additional funding required if “Section 75” is triggered

- If a Section 75 trigger event occurs, then statutory debt due from the sponsor is equal to plan’s “buy-out deficit” (additional funding required to annuitize benefits and meet wind-up expenses)

The Section 75 trigger events are (for a single employer scheme):

> plan wind-up starts and trustee fixes time for calculation of Section 75 debt

> employer becomes insolvent

> employer goes into member’s voluntary winding-up while solvent

Note: “Once an employer, always an employer” unless you pay your Section 75 bill

Additional funding required if “Section 75” is triggered

- Where there is more than one employer sponsoring the plan, a partial Section 75 debt is triggered if:
  - > one employer ceases to employ active members, at a time when
  - > one or more other employers in relation to scheme continue to employ active members
- This is an “employment cessation event”

The role and powers of the UK Pensions Regulator

Scary Regulatory powers

- Enforcement of Section 75 of the Pensions Act 1995 (debt on employer)
- Issue a contribution notice
- Issue financial support direction
- Determine valuation assumptions/recovery plan/ schedule of contributions if the sponsor and trustees do not reach a satisfactory agreement
- Replace trustees
- Wind up a plan (triggering Section 75 debt)
- Power to intervene where Directors have not given due consideration to the interests of the pension plan (stated intention to step-up the use of this power)

Contributions notices

- An order to pay contributions to a plan where there has been an act or omission which has a materially detrimental effect on the pension plan (including the strength of the “employer covenant”)
- The maximum amount is equal to the Section 75 debt
- Potential targets for a notice:
  - Directors of sponsoring employer (e.g. declaring special dividend)
  - Any subsidiary or holding company in the same group
  - Anyone who directly or indirectly “controls” (the right to control at least one-third of the votes in general meeting) the sponsoring employer

Financial Support Directions

- Same targets as for contribution notices (except employees and directors are excluded)
- Direction from Pensions Regulator to put in place “financial support” in respect of obligations of sponsoring employer (e.g. guarantee)
- “Deep pocket” based, not “act/omission” based
- Pensions Regulator may issue if:
  - sponsoring employer is a “service company”, or
  - Sponsoring employer is “insufficiently resourced”
- The regulator must consider that it is reasonable to impose the requirements of a financial support direction

Codes of practice and guidance

The Pensions Regulator has issued extensive codes of practice and regulatory guidance covering many areas, including:

- Plan funding and integrated risk management
- Corporate transactions
- Assessing and monitoring employer covenant
- Alternatives to cash funding (e.g. asset backed funding)
- Events that must be notified to the Regulator

The Pension Protection Fund also has mandatory requirements that trustees must follow and provides associated guidance

Potential impact on corporate transactions and plan changes

Corporate transactions and “material detriment”

- Key point: If a corporate transaction will have a material detrimental effect on a UK pension plan, then
  - need to put in place measures to remove material detriment, or
  - exposed to Pensions Regulator issuing contribution notice (“**CN**”) or financial support direction (“**FSD**”)
- The Regulator is currently petitioning for mandatory pre-clearance of material corporate transactions, which will delay transactions

Cross-border jurisdiction

- Pensions Regulator says yes
- To be tested (is this a “tax” or is it something different?)
- High profile examples of FSDs being issued include:
  - > Nortel (US/Canada/UK insolvency)
  - > Lehman Brothers (insolvency)

Corporate transactions and trustees

- How does the transaction affect the trustees' view on employer covenant? Will they:
  - Change investment strategy?
  - Close the plan to accrual?
  - Call for a new actuarial valuation?
  - Ask for guarantees from the parent company, or else…..?
  - Involve the Pensions Regulator?

Corporate transactions and Notifiable Events

- Certain events must be notified by a UK sponsoring employer to Pensions Regulator by way of "early warning" of events that may be interest to the Pensions Regulator
- Usual example on corporate transactions is a decision to "relinquish control" of the sponsoring employer
- Once a UK sponsoring employer becomes aware of decision to relinquish control, it must notify the Pensions Regulator within 48 hours

Plan changes

- What does the employment contract say:
  - Simply a right to join a plan on unspecified terms (common); or,
  - A right to specific benefits (rare) that will need to be compensated if reduced?
- What do the trust deed and rules say:
  - Is the agreement of the trustees needed to amend the rules and if so, what will be their price?
  - Regardless of whether trustee agreement is needed, are they likely to change their investment and/or funding strategy?
  - Could Section 75 be triggered?

Appendix - US Parent Guaranty of UK Subsidiary Pension Scheme Obligations

US Parent Guaranty of UK Subsidiary Pension Scheme Obligations

- Guaranteed obligations typically very broad and include:
  - punctual performance by UK subsidiary of obligations to the Pension Scheme;
  - payment on demand to Trustees of any amount not paid by UK subsidiary when due; and
  - indemnification of the Trustee against guaranteed obligation that become unenforceable.
- Term of guaranty: cannot be terminated by the U.S. guarantor until all amounts payable by the UK subsidiary to the Scheme have been irrevocably paid in full.
- Generally, unsecured but, presumably, Trustees could require collateral security.
- U.S. guarantor should ensure that :
  - it is permitted under the terms of its various credit facilities and other contractual arrangements to issue guarantees or to provide liens securing the obligations if required; and
  - the guarantee would not create solvency issues.

US Legal Opinion by Counsel to the Guarantor

- Opinion issued in favor of the Trustees by counsel to the U.S. guarantor.
- Documents reviewed generally include the guaranty (and security documents, if any), and basic constitutional documents of the guarantor (charter, by-laws, resolutions, and good standing certificates)
- Typical opinions may include:
  - valid existence and good standing;
  - full corporate power to issue the guaranty;
  - due authorization and execution;
  - no contravention with constitutional documents or applicable law;
  - no governmental approvals;

US Legal Opinion by Counsel to the Guarantor (cont'd)

- Typical opinions may also include:
  - guaranteed obligations at least pari-passu in priority with all other unsecured obligations of Guarantor; and
  - US courts would:
    - apply English law in any dispute over the guaranty; and
    - enforce an English law judgment.

Questions

