When to blow the whistle

The Pensions Act 2004 gives the Pensions Regulator wide powers to require employers, trustees and others to give it relevant information on request by the regulator. The Act also requires pension scheme trustees, employers and others to notify the regulator of certain events. This article looks at the duties on employers under the Act to inform the regulator (without any need for a request from the regulator). This can arise in the context of corporate transactions (for example, clearance applications in connection with the moral hazard provisions), but there are also specific notifiable events (s69) and a duty to report breaches of the law (whistleblowing – s70).

Executive summary

- The first tranche of the Pensions Act 2004 came into force on 6 April 2005 and gave the new Pensions Regulator the demanding objectives of protecting pension benefits, reducing the risk of claims on the Pension Protection Fund and promoting good administration of pension schemes.

MORAL HAZARD The so-called moral hazard provisions of the Act (see *The Treasurer*, November 2005, p26) outline the powers of the regulator, in certain circumstances, to require third parties (that is, not participating employers) to fund defined-benefit occupational pension schemes. These provisions, which can affect intra-group reorganisations as well as sales to third parties, have attracted far more press attention than any other parts of the Act.

Parties to a proposed transaction can apply to the regulator for a statutory clearance. This is not compulsory but gives comfort that, assuming full and accurate disclosure to the regulator, the transaction will not be at risk of later being the subject of a contribution notice or financial support direction.

The regulator's guidance on the clearance procedure and on moral hazard generally is available at www.thepensionsregulator.gov.uk. The guidance outlines various corporate events that could affect the ability of an employer to support the scheme. These are called type A, B and C events.

The greatest risk of a contribution notice or financial support direction being issued (in other words, where clearance may be most appropriate) is likely to arise with a type A event – a transaction that the regulator believes could have a material detrimental effect on an employer and consequently affect a defined-benefit pension scheme as a creditor. Type A events include:

- companies issuing security over material assets (other than security for new borrowings);
- returns of capital, including special dividends, share buybacks and capital reductions; and
- changes in (direct or indirect) control of employers – for example, a disposal or group reorganisation.

Type B events are certain arm's length commercial transactions (such as initial public offerings, rights issues, mergers and acquisitions) that do not affect the pension creditor and do not therefore involve a risk of contribution notices or financial support directions being issued unless they also involve one of the other type A events. Unfortunately, they frequently do.

Type C events are those that might affect the pension creditor; they point towards a deterioration in the employer's covenant and may be outside the control of the employer. Clearance is not available for these events unless they also involve a type A event.

There is currently no obligation on an employer to notify the regulator of a potential type A event, although this may change, nor to apply for a clearance. But the increased s75 debt since 2 September may now lead parties to make a clearance application even where previously they would have been happy with indemnities.

Clearance applications to date in relation to transactions indicate that clearance is usually given if additional funding is provided for the scheme and it is generally only a question of finding the right price: usually a cash payment to the pension scheme equal to the FRS 17 *Retirement Benefits* accounting deficit (although the Pension Protection Fund valuation basis can also be relevant). Generally, the payment can be spread over three to five years but is sometimes required up-front (for example, if there is a large return of capital).

OBLIGATION TO REPORT SPECIFIC EVENTS TO THE REGULATOR Section 69 of the Act imposed, from 6 April 2005, various duties on trustees and employers to make reports to the regulator.

DAVID POLLARD ADDRESSES THE CRUCIAL ISSUE OF WHEN AN EMPLOYER HAS TO INFORM THE PENSIONS REGULATOR.

Box 1. Moral hazard provisions

Contribution notices: the Pension Regulator can require contributions to schemes (broadly, most approved defined-benefit schemes) from participating employers and also from a "connected" or "associated" person. The recipient of a contribution notice is under a liability to pay the full s75 debt (see below). Contribution notices may be issued where the person was involved in an act or deliberate omission (on or after 27 April 2004 and within the last six years) which the regulator considers had as a main purpose the reduction of the recovery or (otherwise than in good faith) amount of a s75 debt.

Financial support directions: where a participating employer is, or at any time within the last 12 months was, a "service company" or "insufficiently resourced" (that is, had insufficient assets to meet 50% of the s75 debt but there was a connected or associated person who did have sufficient resources), the regulator can issue a financial support direction requiring the recipient (again, potentially including connected and associated persons but not, unlike a contribution notice, generally an individual) to ensure that financial support for the scheme (broadly, funding or guarantees) is put in place within a specified period and maintained throughout the life of the scheme. Companies must notify the regulator of anything that subsequently has an impact on the financial support.

Section 75 debt: new funding requirement. From 2 September 2005, the debt arising under s75 of the Pensions Act 1995 when an employer ceases to participate in an underfunded multi-employer scheme (but other employers continue to participate) has increased from the minimum funding requirement level to the (usually much higher) buyout level (unless an approved withdrawal arrangement is entered into – see last month's article). The debt is normally based on the outgoing employer's share of the scheme's total liabilities.

Connected persons and associates: other group companies, 33⅓ shareholders, directors and employees of the employer, and persons "connected" with a director of the employer (for example, another company which has a director in common with the employer).

What is the duty? Except where the regulator otherwise directs, the trustees or the employer (as appropriate) must give the regulator notice of any "notifiable event", as set out by the 2005 notification regulations. Almost all of these events could potentially occur in the context of a company disposal or group reorganisation. The category of persons under this duty can be extended by regulations (for example, to include a former employer or an associated person).

The regulator's directions give exceptions to the duty to notify. Broadly, fewer events need be notified if the scheme is funded above the Pension Protection Fund buyout level and is adhering to its schedule of contributions. Some events have to be notified by all trustees or employers irrespective of the funding level of the scheme.

If trustees cannot reach a consensus, or not all the trustees are aware of the event, the regulator expects an individual trustee or group of trustees to notify.

Timing and formal requirements The notice to the regulator must be given as soon as reasonably practicable after the person making it becomes aware of the notifiable event. This could be before the actual event takes place – for example, a decision to make a transfer payment must be notified before the actual transfer is made.

The notification obligation implies urgency. Where a trustee is made aware of a notifiable event on a Sunday, the regulator should be notified on Monday. The duty to notify overrides any duty of confidentiality (other than legal advice privilege), and any such duty is not breached by notifying. There are also restrictions on the extent to which the regulator can in turn pass on confidential information.

The code of practice suggests that a procedure for making notifications should be put in place. It envisages no need for specialist advice, nor the holding of a trustee or board meeting, about the notification.

The notice to the regulator must be in writing, although email and fax are acceptable.

An actuary or other person under a duty to report breaches in the law to the regulator will have to make a report if they become aware of a failure by the trustees or employer to notify under s69.

Under s68, trustees, employers and scheme advisers also have to

Table 1. Trustees: Scheme-related events (*commentary in italics*)

Regulation 2 (1)	Exemptions
(a) decision by trustees to take action which will, or is intended to, result in any debt (*from anyone*) due to the scheme not being paid in full *This throws the net very wide and could apply to a release of a guarantee, for example*	A, B & C
(b) 2+ changes in key scheme posts *(scheme auditor or actuary)* within last 12 months	A & B
(c) decision by trustees to transfer in or out (or actual transfer, where no decision required), where value of transfer is more than the lower of: (i) 5% of value of scheme assets *(as shown in most recent valuation)* and (ii) £1,500,000	A & B
(d) decision by trustees to grant any augmented benefits without either seeking advice from scheme actuary or securing any additional funding advised by actuary	None
(e) decision by trustees to grant benefits to a member (or granting of benefits, where no decision required), where cost *(not defined)* of benefits is more than the lower of: (i) 5% of scheme assets and (ii) £1,500,000 *Applies whether or not funding is provided. Could apply to large early retirement pension.*	A & B

EXEMPTION A: Scheme fully funded for purposes of a s179 valuation (likely to be a PPF buyout; MFR where no s179 valuation yet carried out).
EXEMPTION B: Trustees/managers have not incurred a duty to make a report (to the pension regulator/Opra) in last 12 months under s228(2) Pensions Act 2004 or s59(1) Pensions Act 1995 of a materially significant failure by employer to make a contribution in accordance with schedule.
EXEMPTION C: Debt compromise is of a debt with a full value of less than 0.5% of scheme assets calculated under a s179 valuation or MFR.
EXEMPTION D: Change in credit rating is not from investment to sub-investment grade where credit rating is provided by a recognised credit rating agency.

notify the regulator of any breach of statute or rule of law that relates to a scheme and may be relevant to the regulator.

Penalties Civil penalties apply for non-compliance without reasonable excuse: up to £50,000 for companies and £5,000 for individuals. If it is a corporate employer (or trustee), the individual directors and officers who were involved in the failure can be liable for the penalty (s10, Pensions Act 1995).

The regulator states in its code of practice that it will seek an explanation about any failure to notify. It can take a range of actions, including training or other assistance. It will also have regard to any failure to notify a relevant event when deciding whether or not to issue a contribution notice.

REPORTING BREACHES OF THE LAW (SECTION 70) The Pensions Act 1995 imposed a whistleblowing duty on auditors and actuaries to report to the Pension Regulator's predecessor, Opra, certain breaches of the law relating to pension schemes. Others involved were permitted, but not obliged, to whistleblow. From 6 April 2005, the Pensions Act 2004 increased both the number of whistleblowing duties and the class of people obliged to whistleblow. These duties arise even in the absence of a request from the regulator.

Who has the duty? The people subject to a reporting requirement are listed in s70 (*see Box 2*).

Note that the duty does not fall on advisers to the employer. However, the regulator states in its guidance that it regards the duty as falling on all involved individuals (for example, individual employees as well as the firm).

The duty Each of these people must give a written report of the matter to the regulator as soon as reasonably practicable where the person has reasonable cause to believe that:

- a duty relevant to the administration of the scheme has not been or is not being complied with;
- that duty is "imposed by or by virtue of an enactment or rule of law"; and
- the failure to comply is likely to be of material significance to the regulator in the exercise of any of its functions.

Reasonable cause to believe This looks like an objective test, so ignorance of the existence of the duty would be no excuse for a breach of it. Presumably building on this, the guidance issued by the regulator states that those under a reporting duty should set up a formal internal procedure for ensuring that potential reporting events are recognised and considered. Even if a breach is not reported initially (because it is minor and so not material), the regulator argues it should be recorded internally in case a pattern emerges (which could be material and so reportable). The guidance also envisages that those under a reporting duty should investigate (for example, ask questions of the trustees) if they have doubts about something, and take professional advice if uncertain whether there has been a breach of a relevant law.

What duties count It is not clear what duties are relevant here. It must be a breach of a duty relevant to the administration of the scheme. A breach is reportable if "relevant to the administration of the scheme". It is unclear what this is trying to specify, but it is wide and will catch practically all breaches by the trustees in relation to the scheme (for example, of pensions legislation) and other breaches that could be relevant, such as a criminal offence involving dishonesty under some other statute. Where the breach is by a third party (that is, the employer, an adviser, an administrator), the limitation that it must relate to the administration of the scheme is more relevant. A breach of some duty not relevant to the scheme is not reportable.

It must be imposed by an enactment This is clearly any duty laid down in any acts of parliament and statutory instruments (regulations), not just pensions legislation. It includes such statutes as the Data Protection Act, the Trustee Acts, employment legislation, discrimination legislation, and possibly even the Human Rights Act.

Table 2. Employers: Employer-related events (*commentary in italics*)

Regulation 2 (2)	Exemptions (*see Table 1*)
(a) decision by employer to take action which will, or is intended to, result in any debt (*from anyone*) due to scheme not being paid in full *This throws the net very wide and could apply to a release of a guarantee, for example*	None
b) decision by employer to cease to carry on business in UK (or actual cessation without prior decision)	None
(c) receipt by employer of advice that it is trading wrongfully (see s214 Insolvency Act 1986), or a director or former director knows there is no reasonable prospect the company will avoid going into insolvent liquidation (see s214)	None
(d) breach by employer of a covenant in an agreement between employer and a bank (or similar institution), except where bank agrees *before breach* not to enforce covenant	A & B
(e) change in employer's credit rating, or employer ceasing to have a credit rating *Applies to any change (even if an improvement) but only for an employer and not, say, the parent company*	A, B & D
(f) decision by a controlling company to relinquish control of an employer company (or actual relinquishment without prior decision) *Covers sale of any participating employer, some group restructurings, and probably decision to place participating employer in insolvency*	A & B
(g) 2+ changes in holders of any key employer posts within last 12 months *Includes CEO and any director/partner responsible in whole or part for financial affairs*	A & B
(h) conviction of an individual, in any jurisdiction, for an offence involving dishonesty committed while individual was director/partner of employer	None

It must be imposed by rule of law The term "rule of law" is more vague. Presumably it will include fiduciary duties imposed by law on trustees and many general tort duties, but whether it could extend to contractual duties seems unlikely. It is also unclear whether the implied duty of mutual trust and confidence is included.

The failure to comply is likely to be of material significance to the regulator in the exercise of any of its functions The breach of duty must be "likely" to be material to the regulator. The regulator has some fairly general functions (for example, to wind up schemes, make court applications, collect relevant information, prohibit trustees if they are not "fit and proper"), so the ambit of this duty may be pretty wide. Material significance will depend on the cause of the breach, its effect, the reaction to the breach, and the wider implications of the breach. For example, the regulator regards anything involving dishonesty or a breach that has a criminal penalty (for example, making an employer-related loan) as always being material. However, an isolated breach of a less material duty which is promptly addressed by the trustees is probably not material. The regulator's guidance includes examples which build on the traffic-light framework previously adopted by Opra, where legal breaches are classified as red, amber or green depending on the risks they pose to scheme assets and members' benefits.

FORMAL REQUIREMENTS A report to the regulator must be:

- in writing (email is acceptable); and
- given as soon as reasonably practicable after the person has reasonable cause to believe there is a reportable breach.

CONFLICTING DUTIES Any duty owed by a person is not breached merely by making a report under this section. Communications between a professional legal adviser and a client in connection with giving legal advice are protected. In the absence of legal proceedings being contemplated, this does not cover communications with third parties, such as other advisers.

PENALTIES Again, civil penalties apply for non-compliance without reasonable excuse (up to £50,000 for companies and £5,000 for individuals). If a penalty falls on a company, any director or officer who consented to or connived in the act or omission, or to whose neglect the act or omission was attributable, may also be liable for a civil penalty. Trustees will want to ensure that they do not indemnify their advisers in relation to breaches of this duty.

David Pollard is a Partner at Freshfields Bruckhaus Deringer.
david.pollard@freshfields.com
www.freshfields.com

Box 2. Who is subject to the Pension Regulator's reporting requirements?

- **Trustees/managers of occupational/personal pension schemes.**
- **A person otherwise involved in the administration of such a scheme. This could include trustee directors, pensions managers, individual employees of third parties, and insurance companies.**
- **The employer in relation to an occupational pension scheme. Regulations can extend the meaning of the term "employer" – see s318(4) – to include former employers, say.**
- **A professional adviser in relation to such a scheme. This includes the scheme actuary, scheme auditor, actuarial advisers, legal advisers (although they have privilege exemption), fund managers, and asset custodians.**
- **A person otherwise involved in advising the trustees or managers of an occupational or personal pension scheme in relation to the scheme.**