KEY POINTS

- The question whether repos constitute borrowing within reg 5 of the Occupational Pension Schemes (Investment) Regulations 2005 is a live one on which there is no clear consensus among practitioners.
- There is an obvious tension between the relevant public bodies, who have apparently proceeded on the basis of legal form, concluding that repos are not within the scope of reg 5, and the commentators who point to the economic effects.
- The authors think the court would be likely to approach the construction of reg 5 by reference to IORP I rather than IORP II.
- A decision that repos do constitute borrowing (in both the legal and the economic sense) would be capable of producing wide-ranging and unwelcome consequences as to the validity of transactions, depending on the scope of trustees' borrowing powers under their governing documentation and the relationship between those powers and reg 5.

Authors Keith Rowley KC and Elizabeth Ovey

Are leveraged LDI strategies lawful? How the courts would construe reg 5 of the OPSRs

This article builds on the recent articles by, first, Richard Salter KC and, second, Professor Iain Clacher and Dr Con Keating in which the question whether repos constitute borrowing within reg 5 of the Occupational Pension Schemes (Investment) Regulations 2005 is examined. It offers some reflections on points which might arise if the issue came to be litigated from the perspective of practitioners in the pensions field.

INTRODUCTION

As advisers to employers under and trustees and members of defined benefit occupational pension schemes, as well as previous advisers whose advice is under attack, we have read with great interest the article 'Are Leveraged LDI Strategies Lawful?' by Richard Salter KC in the February issue (2023) 2 JIBFL 71 examining the question whether the use of repos by pension scheme trustees as part of an LDI strategy is lawful and the further article *'Are Leveraged LDI Strategies Lawful? A Rejoinder and a Request'* by Professor Iain Clacher and Dr Con Keating in the April issue (2023) 4 JIBFL 219. The latter includes a request for the views of legal scholars on the issues raised, noting that it seems likely that at some point the question will be litigated. We offer these further thoughts from the perspective of legal advisers and litigators rather than as legal scholars.

Richard Salter KC's article pays tribute to the "lengthy and powerfully argued written evidence", published on 23 November 2022, of Professor Clacher and Dr Keating to the inquiry being conducted by the Work and Pensions Committee into Defined Benefit Pensions with Liability Driven Investments. (The Committee has not yet reported, although it is no longer accepting evidence.) That evidence sets out their view that repos are to be regarded as borrowing for the purposes of reg 5 of the Occupational Pension Schemes (Investment) Regulations 2005, SI 2005 No. 3378 (Investment Regulations), and accordingly are not lawful.

Richard Salter KC expresses the view that it is very doubtful in law whether the current practices involving the use of repos are unlawful, as opposed to unwise. In their rejoinder Professor Clacher and Dr Keating restate the grounds for their view that a scheme with 100 or more members cannot use repos as part of a segregated leveraged LDI strategy (as distinct from a pooled fund) because to do so would constitute unlawful borrowing.

We share the view expressed by all three authors that, as explained by Briggs J in *Re Lehman Brothers International (Europe) (In Administration)* [2010] EWHC 2914 (Ch) at paras 78 and 79, repos do not constitute borrowing in the legal sense. We also share the view that, as used in connection with leveraged LDI strategies, repos do constitute borrowing in the economic sense, since such a transaction provides the trustees with immediate funds in return for their accepting an obligation to pay an equivalent sum, adjusted by an amount representing the charge for the original provision of funds. What we shall do is to analyse some points which might be relevant to the question how the courts would construe reg 5 of the Investment Regulations. We shall not address the further issues raised as to the use of derivatives.

THE ATTITUDE OF PUBLIC BODIES

The Pensions Regulator (tPR) appears to see no legal difficulty if the trustees of occupational pension schemes enter into repos. There is a specific reference to gilt repurchase arrangements in the LDI section of tPR's matching investments guidance on DB investment issued in March 2017 and last updated in September 2019 (guidance which, as Professor Clacher and Dr Keating observe, implies that repos are a form of derivative investment) and the latest guidance specifically on using leveraged LDI, published on 24 April 2023, still refers to the earlier guidance and contains no suggestion that there is a potential legal difficulty, despite some strong views to the contrary expressed by members of the Work and Pensions Committee when receiving oral evidence from tPR on 15 November 2022. Similarly, the FCA's statement on LDI made on 30 November 2022 focuses on what should be done to improve resilience rather than the existence of any legal risk and its guidance and recommendations for LDI managers published on 24 April 2023 say nothing about lawfulness. Both regulators acted in response to the Bank of England's Financial Policy Committee recommendations published on 29 March 2023, which were again silent on any legal issue. Further, the Pension Protection Fund also apparently takes the view that gilt repos are a form of gilt derivative, as appears from para 30 of the Investment Risk Appendix to its determination of the levy for the year 2022/23.

REGULATION 5 AND IORP I: RELEVANT PROVISIONS

Article 18 of IORP I (Institutions for Occupational Retirement Provision Directive 2003/41/EC) is headed "Investment Rules" and includes provisions relating to investment in accordance with the "prudent person" rule (Art 18.1), borrowing (Art 18.2) and a power for member states to make more detailed rules, subject, however, to a proviso (among others) that member states must not prevent institutions from investing in risk capital markets (Art 18.5). Regulation 5 of the Investment Regulations (which by reg 7 does not apply to schemes with fewer than 100 members) was intended, as set out in the Explanatory Memorandum, to transpose into domestic law the provisions of Art 18.2 of IORP I, which reads:

> "The home Member State shall prohibit the institution from borrowing or acting as a guarantor on behalf of third parties. However, Member States may authorise institutions to carry out some borrowing only for liquidity purposes and on a temporary basis."

It is clear from the Memorandum as a whole that the Department of Work and Pensions (DWP) took the view that the Investment Regulations would change very little in the light of the existing common law and statutory provisions relating to trustee investment, but para 7.3 of the Explanatory Memorandum suggests it was advised that legislation was needed to demonstrate implementation of the Directive where the applicable principles were otherwise to be found in the common law. The Regulatory Impact Assessment (there quoted) stated:

> "On borrowing, responses received to the consultation paper confirmed that there will not be significant costs to business from the requirement for pension schemes to cease borrowing (except where it can be justified on temporary and liquidity grounds). The responses received indicated that it would be unusual for a scheme to currently justify borrowing as prudential unless it was on temporary or liquidity grounds."

Regulation 5 duly provides:

> "(1)Except as provided in paragraph (2), the trustees of a trust scheme, and a fund manager to whom any discretion has been delegated under section 35 of the [Pensions Act 1995], must not borrow money or act as a guarantor in respect of the obligations of another person where the borrowing is liable to be repaid, or liability under a guarantee is liable to be satisfied, out of the assets or the scheme.
>
> (2)Paragraph (1) does not preclude borrowing made only for the purpose of providing liquidity for the scheme and on a temporary basis."

In commenting on the task of construing reg 5 by attempting to interpret IORP I we begin by entering the caveat that we have not referred to different language texts of the Directive or to relevant *travaux preparatoire* and we have not attempted a comprehensive survey of decisions of the European Court. We have simply followed Professor Clacher and Dr Keating in considering its recitals. We note, however, that the recitals to IORP 1 are less extensive than the recitals to Directive 2016/2341/EU (IORP II), which not only consolidated but also amended further the already amended IORP I. Thus, IORP I includes the following:

> "(7)The prudential rules laid down in this Directive are intended both to guarantee a high degree of security for all future pensioners through the imposition of stringent supervisory standard, and to clear the way for the sound, prudent and efficient management of occupational pension schemes.
>
> (17) In order to protect members and beneficiaries, IORPs should limit their activities to those referred to in this Directive and to those arising therefrom.
>
> (31) Institutions are very long-term investors. Redemption of the assets held by these institutions cannot, in general, be made for any purpose other than providing retirement benefits. Furthermore, in order to protect adequately the rights of members and beneficiaries, institutions should be able to opt for an asset allocation that suits the precise nature and duration of their liabilities. These aspects call for efficient supervision and an approach towards investment rules allowing institutions sufficient flexibility to decide on the most secure and efficient investment policy and obliging them to act prudently. Compliance with the 'prudent person' rule therefore requires an investment policy geared to the membership structure of the individual institution for occupational retirement provision."

Those recitals appear unchanged as recitals (17), (29) and (45) in IORP II and it cannot be doubted that ensuring the security of members and their protection was a principal purpose of IORP I. The IORP I recitals do not, however, include the text of recitals (2), (4) and (6) to IORP II, which are also quoted by Professor Clacher and Dr Keating and (if they are thought to add anything to the argument), we think it must be doubtful whether, as subsequent legislation, they can be treated as contributing to the elucidation of Art 18.2 of IORP I for the purpose of construing reg 5.

Finally, recital (48) of IORP II, also quoted, is in different terms from the IORP I version in recital (33), which reads:

> "As very long-term investors with low liquidity risks, institutions for occupational retirement provision are in a position to invest in non-liquid assets such as shares as well as in risk capital markets within prudent limits. They can also benefit from the advantages of international diversification.

Investments in shares, risk capital markets and currencies other than those of the liabilities should therefore not be restricted except on prudential grounds."

IORP II refers to investments "in other instruments that have a long-term economic profile and are not traded on regulated markets, multilateral trading facilities or organised trading facilities" instead of to "risk capital markets". This difference in language is reflected in the terms of Art 18.5 of IORP I and Art 19.5 of IORP II and seems to point to a more restrictive approach in IORP II. Moreover, recital (16) of IORP II states that the current minimum level of protection for members and beneficiaries needs to be improved.

Given these differences between the original and the recast Directive and that the latter was intended to provide increased protection, we think the court would be likely to approach the construction of reg 5 by reference to IORP I rather than IORP II. We recognise that in *Marleasing S.A. v La Comercial Internacional de Alimentacion S.A.* [1993] B.C.C. 421 the European Court envisaged that existing domestic legislation might be purposively interpreted in the light of a subsequent Directive, but the court was not addressing the situation where the domestic legislation itself implemented a Directive and (again if the IORP II recitals add anything) the argument is that the effect would be to change the meaning of the domestic legislation. In any event, having regard to the European principles of certainty and non-retroactivity, it appears that any change in meaning would not apply to transactions entered into before the time limit for implementing IORP II, which was 13 January 2019.

A PURPOSIVE CONSTRUCTION

We accept the force of the argument that if Art 18.2 of IORP I is to be construed as extending to economic borrowing then reg 5 should be construed correspondingly and we therefore concentrate on the construction of IORP I.

It is well known that the approach of the European Court was (and is) to construe the provisions of European legislation so as to achieve the purpose of the legislation. As stated above, clearly a principal purpose of IORP I was to ensure the security of members and their protection. That, however, was in the context of promoting the internal market for financial services in circumstances where there was no coherent Community framework which would assist: see recital (4). IORP I dealt with a number of matters in addition to investment requirements, not least by imposing the technical provisions funding requirements for pension schemes. At a high level the purpose of IORP I was to promote the internal market by the introduction of a Community-wide framework which would provide an appropriate level of security and protection for members.

What we would regard as the crucial paragraph in Professor Clacher and Dr Keating's article reads:

> "The key question then becomes what was the purpose of the borrowing restriction in the IORP II Directive? If the correct answer is to protect the pension fund assets backing the pension rights of the members of the pension fund from speculation using repos to finance that speculation, then a transaction, generally recognised as economic borrowing, that amounts to economic borrowing in the pension fund …, is borrowing for the purposes of the IORP I Directive, now consolidated and replaced by Article 19(3) of the IORP II Directive."

This formulation is arguably too specific in its reference to repos. Read literally, it implies that the only purpose of the borrowing restriction is to protect the assets from speculation using repos as means of finance. We assume, however, that the answer should be read as, in effect, "to protect the pension fund … inter alia from speculation using repos", thus leaving room for the purpose to extend more widely to preventing any transactions involving the use of finance raised by means which are generally accepted as constituting economic, if not legal, borrowing. Even so, there are other possible answers: for example, "to protect the pension fund assets … from risk caused by raising money on credit where such finance is not required to provide liquidity on a temporary basis". This might be said to be the better fit with the associated prohibition on guaranteeing the obligations of a third party and with the common understanding of what borrowing is.

Anecdotally, we understand that the question whether reg 5 prohibits economic as well as legal borrowing is a live one among pensions practitioners, at least now that it has emerged into the limelight as a result of the events of the autumn of 2022, and there is as yet no general consensus. We see the force of the argument that it is irrational to distinguish between legal borrowing and economic borrowing when both may have the same damaging effect on the assets of the pension scheme.

As against that, there is potential uncertainty if the question whether reg 5 applies has to be determined by reference to economic effect rather than legal concepts. What would be the position if trustees decided to sell asset A, use the proceeds for short-term investment in the hope of making short-term gains and then in the longer term to use the proceeds of the short-term investments in the acquisition of a replacement for asset A? That looks like an investment strategy which does not involve borrowing. Does it become borrowing if at the same time as selling asset A the trustees have committed themselves to acquire its replacement in the future from a third party? Does it make all the difference that the trustees commit themselves to acquire a future replacement from the party to whom asset A was sold?

It is also to be recalled that members are not left defenceless if the funds raised by repo transactions do not constitute borrowing for the purposes of IORP I and reg 5. The funds have to be invested in accordance with the provisions of Art 18.1 of IORP I, transposed by reg 4 of the Investment Regulations. The prudent person requirements therefore have to be satisfied. Much of the heat of the debate arises from the fact that there is increasing doubt about the prudence of leveraged LDI strategies. This factor may also point against extending the scope of reg 5 beyond borrowing as a matter of law.

OTHER CONSIDERATIONS

We agree that reg 5 of the Investment Regulations falls within the definition of "EU-derived domestic legislation" in s 1(B)(7)

Biog box
Keith Rowley KC and Elizabeth Ovey are barristers at Radcliffe Chambers, 11 New Square, Lincoln's Inn, London WC2A 3QB.
Email: krowley@radcliffechambers.com and eovey@radcliffechambers.com

of the European Union Withdrawal Act 2018 and therefore continues to have effect as it had before 31 December 2020 (IP completion day). It is also retained EU law within the meaning of s 6(7) and so, under that section, is broadly to be construed as it would have been before IP completion day. As we have said, in our view that means it is likely to be construed in accordance with IORP I, and we think the court, having done so, would be resistant to holding that the meaning changed as a result of IORP II. We note that amendments to s 6 are proposed in the Retained EU Law (Revocation and Reform) Bill, but it does not immediately appear that the changes are likely to affect the position for present purposes, even if the Bill survives unscathed in this respect.

The question may arise whether the views of the public bodies discussed above have any relevance to the issue of construction. Guidance published or statements made by sponsoring departments or public authorities concerned with the administration of the relevant legislation may have some relevance, as explained in *Bennion, Bailey and Norbury on Statutory Interpretation*, 8th ed. (2020), at s 24.17, although the weight which may be given to such material will depend on the quality of the reasoning. It is debatable how far the material we have mentioned falls within this principle. The views of the DWP as set out in public statements such as the Explanatory Memorandum may also be taken into account (see Bennion at s 24.10), but in the present case do not appear to shed light on the particular issue.

It nevertheless seems that the approach of the public bodies will have contributed to a general understanding that leveraged LDI strategies involving repos are not unlawful on the ground that repos constitute borrowing. The courts are generally reluctant to upset settled practice and might wish to consider the practical consequences of construing the reg 5 prohibition as extending to borrowing in economic terms.

At this point we observe that trustees have no unrestricted borrowing power under the general law: see *Lewin on Trusts*, 20th ed, paras 36-120 and 36-121. The practice has grown up of conferring wide borrowing powers in the trust deed or other governing instrument. In the case of occupational pension schemes, however, the exercise of such powers may require the consent of the principal employer. This is the case in the trust deed precedent at Form A.1.1 in *The Encyclopaedia of Forms and Precedents*, vol 31, which requires the written consent of the employer. A random survey of some sets of scheme documentation currently before us suggests that a requirement for employer consent, if not necessarily in writing, is not uncommon.

Scheme documentation also provides for trustees' investment powers, which are invariably (in our experience) specified separately from the borrowing power. Under s 35(5) of the Pensions Act 1995 (PA95), an investment power may not be made subject to employer consent. Interestingly, in the precedent mentioned above, the investment power includes the following as a permitted investment activity:

> "stocklending, lending or entering into a sale, repurchase or exchange of assets in the Fund, whether overnight or for any longer or shorter period of time."

On this somewhat anecdotal basis, it seems that, encouraged by the stance of public bodies, many trustees who have adopted leveraged LDI strategies will have done so on the basis that entry into repos is an investment activity to be conducted in accordance with the investment power and not a borrowing activity to be conducted in accordance with the borrowing power which may impose an additional consent requirement. In particular, it is at least possible that where employer consent is required to borrowing, such consent was not obtained. If repos constitute borrowing for reg 5 purposes, this gives rise to two possibilities:

1. That the trustees' powers under the scheme documentation are to be construed in the usual legal way, so that a repo would not constitute borrowing for the purposes of that documentation and the transaction would not be ultra vires as a result of failure to comply with the requirements of the borrowing power, but that at the same time the repo would nevertheless be borrowing rather than investment for the purposes of reg 5 and so would be "unlawful" (a term to which we return below);
2. That the scheme borrowing power is to be understood as the relevant power for reg 5 borrowing and a repo would be ultra vires.

The first approach would have the effect that entry into a repo would be an investment activity for some purposes and a borrowing activity for others, which is a recipe for confusion. The second would have the effect that where a consent requirement applied some bodies of trustees would be acting ultra vires while where it did not, others would merely be acting unlawfully, which is a recipe for anomalous outcomes. Both results are unattractive, but the second involves potentially the more serious consequences.

It will be appreciated that where a transaction is ultra vires, it is void and LDI strategies would be seriously affected. Those with long memories may recall the prolonged litigation associated with the decision of the House of Lords in *Hazell v Hammersmith and Fulham London Borough Council* [1992] 2 A.C. 1 that swap contracts entered into by the Council were ultra vires.

By contrast, it seems to us that reg 5 assumes that the trustees have power to enter into borrowing transactions and imposes a restriction on the exercise of that power by reference to the purpose for which it may be exercised. Failure to observe that restriction is likely to give rise to liability for breach of trust and may expose trustees to a liability to civil penalties under s 36 of PA95, but will not affect the validity of the transaction.

CONCLUSION

We are aware that employers and trustees are already taking advice on possible claims as a result of leveraged LDI strategies. The question of the lawfulness of such strategies may indeed arise in litigation sooner rather than later. ■

Further Reading:

- Are leveraged LDI strategies lawful? (2023) 2 JIBFL 71.
- Are leveraged LDI strategies lawful? A rejoinder and a request (2023) 4 JIBFL 219.
- Lexis+® UK: Pensions: Overviews: The LDI crisis: overview.