October 12, 2022

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BENEFITS & COMPENSATION UNIVERSITY

Employment & Benefits Issues in International M&A

Giles Bywater
Partner, London
+44 20 3130 3157
gbywater@mayerbrown.com

Aline Fidelis
Partner, São Paulo
+55 11 2504 4666
afidelis@mayerbrown.com

Julien Haure
Partner, Paris
+33 1 53 53 36 48
jhaure@mayerbrown.com

Hagen Köckeritz
Partner, Frankfurt
+49 69 7941 2323
hkockeritz@mayerbrown.com

Hong Tran
Partner, Hong Kong
+852 2843 4233
hong.tran@mayerbrown.com

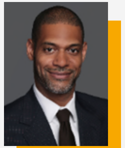
Stephanie Vasconcellos
Partner, Chicago
+1 312 701 8621
svasconcellos@mayerbrown.com

Guido Zeppenfeld
Partner, Frankfurt
+49 69 7941 1701
gzeppenfeld@mayerbrown.com

Today's Speakers

Giles Bywater
Partner
gbywater@mayerbrown.com
London
+44 20 3130 3157

Giles Bywater is an Employment & Benefits partner in Mayer Brown's London office focusing on UK pensions issues. Giles advises trustees and sponsoring employers of UK occupational pension schemes on both contentious and non-contentious matters. Prior to moving into pensions law, Giles focused on corporate law for 10 years—so he is able to use this experience when advising on the UK pensions aspects of M&A transactions, including a US$2.7 billion disposal last year.



Julien Haure
Partner
jhaure@mayerbrown.com
Paris
+33 1 53 53 36 48

Julien Haure has many years' experience as an employment law advisor and has developed significant expertise in complex employment and collective action matters, such as shut down of activity, reorganizations implying reduction in force plans (including social plans), negotiation with unions and employee representative bodies, implementation of collective agreements, sensitive litigations, etc.

Aline Fidelis
Partner
afidelis@mayerbrown.com
São Paulo (T&C)
+55 11 2504 4666

Aline Fidelis is the partner in charge of the Employment & Benefits practice group at Tauil & Chequer Advogados in association with Mayer Brown. She has extensive experience in strategic labor litigation and counseling, with over 20 years representing clients in the following sectors: oil & gas, capital markets, banking, education, life sciences, technology and energy, among others. She assists clients with her unique negotiation skills and ability to develop innovative solutions.

Hagen Köckeritz
Partner
hkockeritz@mayerbrown.com
Frankfurt
+49 69 7941 2323

Hagen Köckeritz is a partner in the Frankfurt office of Mayer Brown and heads the firm's German Employment & Benefits practice. He advises on all labor and employment-related aspects of multi-jurisdictional and national projects, particularly in conjunction with complex company reorganizations, national and international mergers and acquisitions and outsourcing of activities.

Today’s Speakers

Hong Tran
Partner
hong.tran@mayerbrown.com
Hong Kong
+852 2843 4233

Hong Tran is a partner of Mayer Brown and is a Co-Firm Practice Leader of the global Employment and Benefits Group. He advises employers on compliance with employment, discrimination and privacy legislation. He also advises on strategic labor force issues including the structure of work force relationships; risk management in the employment and discrimination context; diversity and inclusion, the introduction of changes to employment arrangements; the handling of union relations; and recruitment, disciplinary and termination issues.

Guido Zeppenfeld
Partner
gzeppenfeld@mayerbrown.com
Frankfurt / Düsseldorf
+49 69 7941 1701

Guido Zeppenfeld the Managing Partner in Germany, one of the leaders of the firmwide Employment & Benefits group and responsible for the firm’s German Technology Transactions practice. He advises and represents national and international client organizations in connection with all legal matters regarding the management of human capital, including employment law, restructuring and reorganization measures, executive compensation, employee incentives, benefits and company pension schemes as well as employee data privacy.

Stephanie Vasconcellos
Partner
svasconcellos@mayerbrown.com
Chicago
+1 312 701 8621

Stephanie Vasconcellos counsels clients regarding employee benefits and executive compensation issues that arise in corporate transactions involving public and private companies. She advises public and private companies on day-to-day executive compensation matters, including assisting clients with implementing, amending and terminating equity compensation plans and agreements, and on health, welfare and retirement plan matters, including the effects of the Dobbs decision on plan sponsors and benefit plans.

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Agenda

- Impact of Pension Liabilities on Purchase Price
- Transaction Structure
- Pension Reps and Warranties
- HR Due Diligence: Environmental, Social and Governance Aspects of Compensation and Benefits Schemes

Impact of Pension Liabilities on Purchase Price

Pension funding mechanisms

How to deal with unfunded pension liabilities

Impact of Pension Liabilities on Purchase Price
Brazil (1/2)

- In Brazil, employers are required to comply with mandatory social security contributions on a monthly basis based on employees' salary and may provide employees with complementary pension schemes, granting a range of benefits based on the plan's regulation
- As a consequence, Pension Liabilities generally result from the issues regarding the mandatory contribution to the social security system and the complementary pension scheme adopted by the company
  - Pension Liabilities
    - **Mandatory contribution to social security system:** contribution, applicable to all employers, monthly calculated upon the employees' salary
    - **Complementary pension schemes:** private pension plan offered by the employer to its employees that may be (i) a defined benefits scheme; (ii) defined contributions scheme; or (iii) variable contributions scheme
  - In the context of M&A operations, the stakeholders must consider the following aspects during negotiations in regards to pension liabilities:
    - Assessment of the Seller's compliance with the mandatory contribution to social security system
    - Analysis of the pension scheme granted by the employer in regards to (i) its actuarial aspects in case of defined benefits plan; (ii) the benefits granted and the eventual amount spent by the Seller to its maintenance; and (iii) the scheme's compliance with the provisions of the Brazilian regulatory agency related to private pension plans ("Superinendência Nacional de Previdência Complementar" or "PREVIC")

Impact of Pension Liabilities on Purchase Price
Brazil (2/2)

- Key issue: Determination of actual value of PL
  - Require due diligence with respect to lawsuits discussing both (i) the statutory contributions to social security system, and (ii) compliance of the benefits granted with legal and regulatory provisions, as well as the pension plan's regulation, and the amounts involved
  - Require actuarial assessment related to the potential exposure of benefits schemes liabilities
  - Analysis of administrative costs and procedures involved in any potential pension scheme transition executed by the Buyer after the corporate operation
- The purchase price must be determined considering the assessment of the PL in its legal and actuarial dimensions, in addition to other labor charges that affect the Seller's operation and have particular relevance in an M&A context
- The alteration of the pension schemes' rules is complex, as it involves unavailable rights of employees. This is a factor that, by itself, demands careful analysis from the Buyer

Impact of Pension Liabilities on Purchase Price
France (1/2)

- In France, the pension system is built on the Pay-as-you-go pension system ("*PAYGO*"), as opposed to market capitalization
- As a consequence:
  - Pension Liabilities mainly result from the statutory base and complementary pension schemes ("*régime de base*" and "*retraites complémentaires ARRCO/AGIRC*")
    - These schemes are funded by the withholding of mandatory contributions on every employee's salary
    - Every employer is required to proceed to such withholding every month when paying the employees
  - In M&A context, the stake around PL is thus limited, in practice, to the following situations:
    - Defined Benefits pension schemes (known as "*Retraite Chapeau article 39,*" in reference to the article of the French Tax code that provides it) – ***quite rare*** *(because of removal since 2019 of the preceding condition of the to-be-retired employee's presence at the time of the retirement)*
    - Defined Contributions pension schemes (known as "*Retraite Chapeau article 83,*" in reference to the article of the French Tax code that provides it) – ***Frequent in sizeable companies***
    - Company retirement saving plan (formerly named "*PERCO*" and now "*PERECO*") – ***Frequent in sizeable companies***
    - Retirement Indemnities (known as "IDR") – ***Existing in all companies***

Impact of Pension Liabilities on Purchase Price
France (2/2)

- Key issue 1: Determination of compliance of the setting up process
  - DB, DC and PERCO/PERECO schemes benefit from social security contributions and tax exemptions subject to complying with several rules (e.g., way of setting up the plan, collective feature, level of contributions, registration with the labor administration, etc.)
  - Non-compliance may thus lead to reassessment in case of control from the administration
- Key issue 2: Determination of actual value of PL
  - Need to involve actuarial services providers to assess the potential exposure of DB schemes liabilities and IDR
  - Need to obtain precise and accurate information on (i) the plan that set up the DC scheme and PERCO/PERECO (e.g., to determine the employer's level of contributions), (ii) the number of employees concerned and (iii) the potential non monetarized savings in the PERCO/PERECO
- Results of pension due diligence (legal and actuarial) to be reflected in the purchase price mechanism (typically by purchase price adjustments or indemnities)

Impact of Pension Liabilities on Purchase Price
Germany (1/2)

- In Germany PL very often are of particular relevance for the purchase price in an M&A context
- Key reasons:
  - Variety of legal basis for pension commitments (collective or individual agreements, operation customs, equal treatment)
  - Variety of funding mechanisms and combination of mechanisms (direct promises, retirement funds, support funds, pensions funds, direct insurances, CTAs)
  - Historically, DB pension schemes dominating; over the past 2 decades pension gradual de-risking by transfer to DC schemes
  - Regardless of funding mechanism, employer remains primary debtor of PL
- Key issue 1: Determination of actual value of PL
  - German tax or commercial balance sheets in principle only reflect direct pension commitments
  - Evaluation pursuant to US-GAAP, IFRS, IAS: German law does not recognize employer's release of debt in DC schemes
  - Tricky to comply with legal framework and evolving case law in evaluation of actual PL (particularly, in case of historic changes to pension schemes)
    - Anti-discrimination/equal treatment/operational customs
    - Invalid pay-offs, waivers or transfers
    - Invalid changes or closures of pension schemes
    - Invalid omission of retirees' pension payment adjustments

Impact of Pension Liabilities on Purchase Price
Germany (2/2)

- Key issue 2: Determination of funding status
  - Congruency of funding assets
    - Impact of capital market interest rates (eg: by the end of 2021 German DAX 40 companies' PL funding ratio has been at 72%, which is likely to materially fall behind in the current market environment; nB: non-DAX 40 companies typically have a much lower funding level)
  - Mortgaging or disposal over funding assets
  - Transferability of funding assets
- Results of pension DD (legal, actuarial, commercial) to be reflected in the purchase price mechanism (typically by purchase price adjustments or indemnities)

Impact of Pension Liabilities on Purchase Price
Hong Kong

- Not usually a driver of purchase price but can be if Seller has an ORSO scheme
- MPF – DC scheme – straightforward
- ORSO – DC and DB schemes
  - If share sale - no need to transfer any funds
  - If multi-employer scheme
    - For DC scheme – buyer will want transferred full value of Employer's Account and Members' Account for each Transferring Member
    - For DB scheme – amount transferred to be calculated by reference to actuarial assumptions

Impact of Pension Liabilities on Purchase Price
United Kingdom (1/2)

- Two main types of pension benefit in UK:
  - Defined benefit (“DB”) – employer’s obligation is to pay agreed contributions into scheme, and ultimately to fund any shortfall (deficit) between scheme assets and benefits payable for members of scheme
  - Defined contribution (“DC”) – employer’s obligation is just to pay agreed contributions into scheme
- Two main types of pension scheme in UK:
  - Occupational pension scheme – run by trustees of scheme and can provide DB or DC benefits (or both)
  - Personal pension scheme – run by an insurance company and usually provides only DC benefits
- Employer can offer its UK employees membership of an occupational pension scheme or a personal pension scheme
- Automatic enrollment requirements under UK law:
  - Broadly, employer is required to offer all employees between age 22 and state pension age membership of a pension scheme which meets minimum quality criteria
  - If the scheme provides DC benefits, there are minimum contributions which must be paid into the scheme
  - If the scheme provides DB benefits, there are minimum benefits which must be provided for members of the scheme

Impact of Pension Liabilities on Purchase Price
United Kingdom (2/2)

- Where a target's pension scheme provides just DC benefits, the PL are generally not material in M&A context
- However, where there is a DB pension scheme involved, the PL can be very significant
- Key issue 1: Determination of whether the target has liability for any DB pension scheme(s)
  - Could be a scheme which the target **currently** operates
  - Could be a scheme which is operated by another company in the same corporate group, and in which the target **currently** participates
  - Could be a scheme in which the target has participated **in the past**
  - Importance of due diligence exercise to investigate past and present DB pension schemes
- Key issue 2: Determination of whether M&A transaction will trigger obligation under UK law for target to pay into DB pension scheme its share of funding deficit in scheme ("*Section 75 Debt*")
  - When calculating a Section 75 Debt, funding deficit is calculated by reference to cost of securing the scheme's liabilities with an insurance company
  - Section 75 debt can therefore be substantial and can have material impact on Purchase Price
  - Trustees of scheme can only agree not to collect a Section 75 Debt in full if certain conditions under UK law are met, with possible involvement of UK Pensions Regulator
  - Importance of actuarial due diligence in relation to scheme

Transaction Structure

Severability of pension liabilities (retired vs. working population)

Workarounds to minimize/exclude buyer’s financial burden in respect of pension liabilities

Transaction Structure
Brazil

- In Brazil, the transaction structure must consider the Buyer's future obligation towards the Seller's pension scheme:
  - Deals lead to transfer of all PL born by the Seller:
    - As a rule, all rights and obligations related to the Seller are transferred to the Buyer during corporate transactions, which include the Seller's obligations with respect to pension schemes, considering both retirees and the working population, under the provisions of the plan's regulation
- It is necessary to precisely assess the plan's structure to include indemnification clauses related to both the obligations that will be assumed by the Buyer and the administrative procedures that will be adopted in regards to the pension schemes once the transaction is completed
  - Buyers may consider the following possibilities in regard to the Seller's pension schemes:
    - Withdrawal of sponsorship
    - Liquidation of the pension scheme
    - Transference of pension scheme's management
- Brazilian regulatory agency on complementary pension is highly protective and provides for several rules in regards to pension schemes' transitions that shall be observed by the Seller

Transaction Structure
France

- Under French law the transaction structure (share deal/asset deal/TUPE transfer) impacts Buyer's obligations regarding PL:
  - Share deal leads to transfer of past and future PL:
    - For past PL, Buyer will bear the related costs for employees but also retirees (i.e., retirees being concerned in case of DB scheme only – ***so quite rare in practice***)
    - For future PL, Buyer will bear the related costs for employees and future retirees. But, Buyer has the possibility to mitigate PL by ending the schemes (the way to do it depends on the way the schemes have been initially set up, i.e., through collective agreement vs. unilaterally)
  - Asset deal/TUPE transfer leads to the transfer of PL for the past and the future on active employees and retirees (in case of DB schemes):
    - Up to the end of the pension schemes. Those implemented:
      - through collective agreement, will continue to apply since a substitution agreement has been entered into force, or if no, during a maximum of a 15-month period following the transaction
      - unilaterally, will continue to apply up until a proper denunciation from the employer (individual information of the concerned employees, information of the works council and reasonable notice period)
    - As per law, Seller is however accountable for all liabilities born before the transaction – meaning that Buyer can ask for reimbursement/compensation for any PL it assumes the costs of on behalf of the Seller
- It is the Buyer's burden to ensure that the IDR/DB/PERCO/PERECO liabilities born before the transaction are determined as precisely as possible, in order to be properly indemnified by the Seller

Transaction Structure
Germany (1/2)

- Under German law the transaction structure (share deal/asset deal/TUPE transfer) is relevant for actual PL carried by the company to be sold/bought/carved-out/divested/etc. as well as for related employer obligations (e.g., pension admin, insolvency protection)
- The key issue: Seller wants to maximize purchase price. Buyer does not want to assume PL. Hence transfer of PL pursuant to transaction structure is decisive.
- Principles: Transfer of PL vs-a-vis current employees (working population)
  - Stock transfer
    - Principle: all PL transfer to buyer (past and future service)
    - Options: assumption of debt (non vested PL vis-à-vis active employees; individual beneficiary's consent required), partial pay-off vis-à-vis active employees (reduction of past service PL)
  - Asset transfer
    - Principle: all PL vis-à-vis active employees transfer. Exception: non-regular employees (e.g., board members)
    - PL vis-à-vis retirees or former employees remain at seller

Transaction Structure
Germany (2/2)

- Principles: Transfer of PL vis-à-vis former employees (including retirees)
  - Stock transfer
    - All PL transfer to buyer
    - Options: pre-closing spin-off/carve-out of PL
  - Asset transfer
    - PL vis-à-vis retirees or former employees remain at seller
- Options: Excluding/minimizing financial burden of buyer in connection with transferred PL
  - Contractual undertaking of obligation/indemnification (buyer continues to be sole debtor; PL to be reflected on commercial balance sheet of buyer)
  - Collateral promise (direct claim of beneficiaries vis-à-vis seller; PL to be reflected on commercial balance sheet of buyer)
  - Combined approach
  - "Outsourcing" of PL (pension funds or CTA)

Transaction Structure
Hong Kong

- Not usually a driver of transaction structure

Transaction Structure
United Kingdom

- Transaction structure will impact the PL which are assumed by Buyer
- Share sale:
  - Historic PL – key issue for a DB pension scheme (as already discussed); risk of Buyer assuming responsibility for PL relating to retirees it may never have employed
  - Future PL
    - Terms of employment remain in place with target, including those relating to pensions
    - Continuation of target's contractual obligations relating to occupational pension schemes **and** personal pension schemes
    - Continuation of target's automatic enrollment requirements
- Asset sale:
  - Historic PL – will usually remain with Seller
  - Future PL
    - Terms of employment transfer to Buyer under TUPE – subject to exclusion for terms relating to occupational pension schemes – but Buyer must provide prescribed minimum replacement pension benefits
    - Any contractual obligations relating to personal pension schemes will transfer to Buyer
    - Automatic enrollment requirements will apply to Buyer
- Harmonization of pension terms after closing the transaction can be complex

M&A Contracts

Pension reps and warranties

M&A Contracts
Brazil

- In Brazil, the coverage of R&W may vary according to PL in each operation
  - R&W generally guarantees the Seller has complied with the following aspects:
    - The pension scheme has been established, maintained, administered, granted and operated in accordance with its terms and in compliance with applicable law and regulations
    - All material contributions, premiums and payments that are due have been made for the Closed-End Pension Plan within the time periods prescribed by the terms of applicable Law and the related instruments regulating the establishment, maintenance, administration and operation of the Closed-End Pension Plan
    - The pension scheme is not under investigation by any relevant governmental authority
    - The legal and regulatory obligations regarding solvency, liquidity and financial, economic and actuarial balance are fulfilled
- The R&W clauses may provide for indemnification in case of verification of any irregularities on the above

M&A Contracts
France

- In France, R&W:
  - Usually only covers:
    - Improper disclosure by the Seller of existing non mandatory pension schemes and/or of its beneficiaries
    - Improper disclosure by the Seller of any individual commitment regarding retirement liabilities (e.g., increase of the statutory retirement indemnities or "golden parachute" in case of retirement, etc.)
    - Non-compliant withholding of the mandatory pension schemes' contributions
    - Undue benefit from tax and social security exemptions on pension schemes has not been implemented as per French law requirements (e.g., neither collective agreement nor formal unilateral decision of the employer, no registration with the authorities, not collective application, etc.)
  - Are usually drafted as largely as possible
- As a consequence, common that Seller subscribes W&I insurance to cover for losses arising from any breach of a R&W

M&A Contracts
Germany (1/2)

- In Germany, R&W:
  - Clauses are fairly sophisticated and typically cover the following:
    - Complete list of all individual and collective pension schemes and promises (regardless of legal basis), incl. number of active beneficiaries, former employees with vested rights, and pensioners
    - Confirmation regarding effectiveness of closures of/amendments to pension plans
    - Status of funding or accruals made in accordance with plan rules, correct employee census data, latest legal requirements and actuarial assumptions
    - Adequate implementation of deferred compensation schemes (incl. advance waiver of compensation claims; payment of mandatory employer matching contributions)
    - Correct historic adjustment of pension payments to retirees
    - Correct payment of mandatory contributions to German Pension Guarantee Association (PSVaG)
    - Disclosure of pension-related disputes/litigation
    - Compliance with equal treatment requirements

M&A Contracts
Germany (2/2)

- Key Issues:
  - Natural conflict between seller's and purchaser's demands → sellers want to commit to as little as possible; purchasers want most far-reaching R&Ws
  - Indemnities/R&Ws in pension context have a lifespan of several decades resulting in various practical issues
  - Knowledge qualifiers, *de minimis* clauses, baskets, caps, statute of limitation → exclusion of such limitations tbd
  - W&I insurance usually excludes pension R&W (but at least adequacy of pension accruals) → reduces the value of any pension R&Ws
  - R&Ws in a pension context should always be the second best option for a purchaser → preference for a purchaser should be to consider potential risks in the purchase price

M&A Contracts
Hong Kong

- R&W given by Seller
  - Full and complete details of the retirement scheme and arrangements have been disclosed, including rates of contributions, balances, etc.
  - There has been no breach of trust and no material actions, suits or claims (other than routine claims for benefits) pending
  - Arrangement has been administered in accordance with the governing documentation and law
  - It is a little bit more complicated when it comes to DB schemes. This will depend on the arrangements agreed upon. It will need to deal with the calculation of the "Transfer Amount" to Buyer
- Indemnities to Buyer where irregularities identified

M&A Contracts
United Kingdom

- Key purpose of R&W is to encourage Seller to disclose to Buyer full information about the PL, so that appropriate arrangements can be agreed – for example:
  - Adjustment to Purchase Price
  - Indemnity protection
- Typical R&W:
  - No past or present participation by target in any DB pension schemes, or in any pension schemes other than those disclosed to Buyer
  - Copies of all scheme documents have been provided to Buyer
  - Target has complied with all obligations under the scheme's governing documentation and legislation, and has made all required contributions
- Damages for breach of R&W:
  - Buyer must prove breach and financial loss as result of breach
  - Possible impact of knowledge qualifiers (i.e., Buyer gets no protection if Seller not aware of issue)
- Claim under indemnity:
  - Easier to make successful claim than breach of R&W
  - But ultimate value of an indemnity depends on financial strength of entity giving it

HR Due Diligence

Environmental, social and governance aspects of compensation and benefits schemes

HR Due Diligence
Brazil

- In Brazil, the ESG aspects regarding pension schemes due diligences shall consider the following topics:
  - The amounts granted as benefits considering social and economic aspects
  - Non-discrimination in all aspects, including with respect to the protection granted to employees' dependents
  - The assessment of financial health and viability of the pension schemes
  - Compliance with regulatory and legal provisions that govern Brazilian private pension schemes
  - Information and consultation of the working population and retirees in the event of any potential modification to be executed that may affect the protection extension

HR Due Diligence
France

- In France, the ESG aspects of compensation and benefits scrutinized during HR due diligence are in practice limited to:
  - Respect of minimum wages
  - Gender equality (in light of the scoring of the related index to be implemented in every company of 50 employees or more)
  - Absence of discrimination, notably based on health condition, employee representative status, gender, sexual orientation
  - Compliance with the rules potentially applicable – from time to time – in certain sectors of activity (e.g. finance)
  - Information and consultation of the works council in any decision impacting the collectivity of employees
- Reputational impact of inappropriate (even though not illegal per se) practices pertaining (e.g., significant golden parachute, generous DB schemes to top management)

HR Due Diligence
Germany

- In Germany, the social factors of ESG become increasingly relevant in an HR due diligence context. There are various aspects that companies need to comply with in the compensation and benefits context. Besides certain hard legal requirements, there are an increasing number of soft factors that determine a company's ESG rating
- Background:
  - The EU Corporate Sustainability Reporting Directive (CSRD) is expected to enter into force this month (October 2022). It will then need to be implemented by the EU Member States. Certain larger companies will have to report in line with the CSRD already in their 2024 annual reports to be published in 2025. Other larger companies will be added in 2026, and finally listed SMEs in 2027
  - Standardization due to so-called EFRAG standards (13 ESRs in total)
- Relevant topics are:
  - respect of minimum wages, equal pay / absence of discrimination in compensation and benefit schemes
  - Integration of ESG in executive compensation schemes
  - Sustainable investments in connection with pension plans
  - Consultation rights of works councils in compensation and benefit context; applicability of collective bargaining agreements

HR Due Diligence
Hong Kong

- No dedicated law on ESG in HR
- But HR due diligence will include compliance with employment laws like minimum wage, compliance with retirement scheme laws, anti-discrimination/harassment laws, leave, benefits, health and safety record, etc.

HR Due Diligence
United Kingdom

- ESG issues affect investment decisions made by trustees of occupational pension schemes
- Compliance is not strictly an employer issue, but Buyer may still be interested from a Due Diligence perspective because of reputational issues and impact on scheme running costs
- Occupational pension schemes must maintain a statement of investment principles ("*SIP*"). The SIP must include policies of the trustees of the scheme on:
  - Financially material considerations including ESG factors
  - Non-financial matters including the members' views on the social and ethical impact of investments
  - Exercise of rights attaching to investments and undertaking engagement activities in relation to investments
- Occupational pension schemes with assets of GBP£1 billion or more must comply with a range of climate risk-related governance and reporting requirements
- Related information must be made publicly available free of charge on a website

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