A voluntary “Code of Good Practice” on Incentive Exercises (the “Code”) has been published by a Working Group drawn from organisations across the pensions industry. While not officially published by the Government, it does explicitly have the approval of Pensions Minister Steve Webb MP. The Code is designed to ensure that incentive exercises such as enhanced transfer value exercises and pension increase exchanges are undertaken in line with good practice principles. The Code is accompanied by a set of Practitioners’ Notes.

Background
Over the past few years, increasing numbers of employers have sought to reduce their defined benefit pension liabilities by incentivising members to either transfer their benefits to another scheme or to modify their benefits in some way, usually by giving up their right to annual pension increases above the statutory minimum.

The Pensions Regulator (the “Regulator”) has for some time expressed concern that member interests are not being sufficiently protected in such incentive exercises. In 2010, it published guidance on how incentive exercises should be conducted, as well as a joint statement with the Financial Services Authority (the “FSA”) on the advice to be provided to members.

However, in late 2011, the Government announced that it considered further member protection was required, and encouraged the establishment of an Industry Working Group to produce a voluntary code of good practice.

The Code
The Code applies both to exercises where members are offered the option to transfer their benefits out of the scheme (“Transfer Exercises”), and to exercises where members are offered the option to modify the nature of their benefits under the scheme in some way (“Modification Exercises”).

The Code sets out the following seven principles:

1. No cash incentives may be offered which are contingent upon the member deciding to accept the offer.
2. Members should be provided with impartial financial advice or guidance, depending on the nature of the offer being made to them.
3. Member communications should be fair, clear, unbiased and straightforward.
4. The parties involved in an incentive exercise should maintain records.
5. Members should be given sufficient time to make their decision without undue pressure being applied.
6. Incentive exercises should only be offered to members aged over 80 who expressly request that the offer be made to them, and a policy should be in place to protect members who are vulnerable by reason of their age, health, understanding etc.
7. All parties involved in an incentive exercise should be aware of their roles and responsibilities and should act in good faith.

Although the Code is voluntary and does not have the force of law, it expressly states that it is anticipated that all future incentive exercises will follow its spirit and principles. The party initiating the offer (i.e. usually the employer) is responsible for following the Code and for ensuring that the other parties involved in the offer also do so.

The Code does not over-ride or replace existing legal requirements or guidance (including the Regulator’s guidance on incentive exercises), and deliberately does not address the legal duties of the parties involved in incentive exercises. The Regulator has however stated that it will review its guidance in light of the introduction of the Code.
The Practitioners’ Notes are designed to be used in conjunction with the Code, but do not have to be followed in order to comply with the Code.

Read the full Code and Practitioners’ Notes here.

Commentary

The Code goes some way further than existing Regulator and FSA guidance and is likely to make incentive exercises more onerous for all parties. Interesting points in the Code include the following:

• **Cash incentives likely to be rare in future**
  
  Cash incentives will not be prohibited by law, but the Code states that they must not be contingent upon the member accepting the offer. Whilst employers can continue to offer cash incentives which are not contingent on acceptance of the offer, such as cash incentives to encourage the member to take financial advice, it is unlikely that many employers will wish to do so. The use of cash incentives in future is likely therefore to be limited.

• **Open-ended exercises are not caught**
  
  The Code does not apply to new benefit options in the scheme rules which will subsequently be made ordinarily available to members, such as a pension increase exchange offer which is made available to members as a matter of course on retirement. Employers and trustees may however wish to refer to the Code when deciding how best to communicate the new benefit option to members.

• **“Profits and losses” to be disclosed more clearly**
  
  Where the Code does apply and a Modification Exercise is being conducted, a “Balanced Deal Calculation” must be carried out. This calculation values members’ benefits before and after the exercise, assuming that all members take up the offer. The result, the “Balanced Deal Percentage”, must be disclosed to members in the offer documentation. This will result in the potential profit to the scheme/employer being much more transparent. Whilst offers with a Balanced Deal Percentage of less than 100% are not prohibited, it is likely to be far harder for employers to persuade members that they should accept the offer when the potential loss of value to the member is so bluntly stated. The Balanced Deal Calculation also ignores situations where the offer may still be quite acceptable to the member even if the Balanced Deal Percentage is less than 100%.

• **Content of member communications to be standardised**
  
  The bulk of the Code and the Practitioners’ Notes focus on the content of member communications and set out in detail the information which should be included in the impartial financial advice or guidance. From a member perspective, the level of focus on information to be provided is extremely positive as, the better informed the member, the more likely they are to make the best decision for their circumstances. However, the level of information recommended is likely to go beyond that which financial advisers would ordinarily provide in order to meet their obligations under the FSA Handbook. The cost of providing such advice (which will need to be met by the employer) may therefore increase.

• **Relevance of employer covenant has to be considered, though can be omitted**
  
  In past incentive exercises, queries have been raised on the extent to which member communications and financial advice should cover the strength of the employer’s covenant. The Code states that the individual or firm providing the impartial financial advice to the members should consider whether the strength of the employer’s covenant is a relevant factor, but do not impose a requirement to cover this issue in the member advice. This position will be welcomed by employers who are unlikely to want to acknowledge expressly that their covenant is weak.

• **No new legal duties on trustees**
  
  The Code does not impose any additional duties on trustees and expressly acknowledges that following the Code is not a legal duty of trustees. From that perspective, the introduction of the Code does not make it any more or less acceptable for trustees to participate in an incentive exercise. Trustees will still need to assess whether to participate in accordance with their usual trust law duties.
However, the Code clearly envisages that trustees may choose not to participate in an incentive exercise which does not comply with the Code. Trustees will therefore now need to consider the Code, and the extent to which an incentive exercise in which they are being asked to participate complies with the Code.

- **Pensions Ombudsman will enforce it?**

The Code will not have statutory force, but the Pensions Ombudsman and the Financial Ombudsman Service will have regard to the Code when investigating complaints relating to incentive exercises. It appears therefore the Regulator will not be involved directly in enforcing compliance with the Code.

If you have a question about any of the issues raised in this update, please contact your usual Mayer Brown contact or:

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