

# Pensions Committee

2.30 p.m., Wednesday, 25 March 2015

## Internal Investment Controls and FCA Update

Item number	5.10
Report number	
Executive/routine	
Wards	All

### Executive summary

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This report summarises the key matters in relation to the investment controls and the development of the in-house operations. These are:

- **Investment controls and consultant's recommendations:** the Fund has now addressed most of the recommendations of an external consultant following their review of the in-house investment operations in December 2013. Certain points are still in the process of being addressed or under review.
- **Financial Conduct Authority (FCA) Authorisation:** the Fund is now in the process of finalising its structure and application for authorisation by the FCA and anticipates that the application is expected to be submitted at the end of April 2015.

### Links

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Coalition pledges

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Single Outcome Agreement

## Internal Investment Controls and FCA Update

### Recommendations

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- 1.1 It is recommended that Committee notes the progress made in relation to refining its internal controls and in establishing an FCA authorised structure.

### Background

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- 2.1 In December 2013 the Fund instructed a review of its investment operations and controls and has since been addressing the resulting recommendations.
- 2.2 The Fund has also been in the process of establishing an FCA authorised structure for the purposes of strengthening internal controls and facilitating the further development of the in-house investment function.
- 2.3 A report on progress was previously considered by the Committee in September 2014.

### Main report

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#### FCA Authorised Structure

- 3.1 **Companies established:** the investment and employer services companies were established on 11 February 2015 as wholly owned subsidiaries of the City of Edinburgh Council (CEC), in its capacity as the administering authority of the pension funds. A twin corporate structure has been preferred primarily to enable appropriately tailored governance for the investment and employer facets of the structure.

Details of the companies are as follows:

	<b>LPFI Limited (for FCA regulated activity)</b>	<b>LPFE Limited (for intra-group employer services)</b>
<b>Sole shareholder:</b>	City of Edinburgh Council	City of Edinburgh Council
<b>Share capital:</b>	1 ordinary shares of £1 (likely to increase to the sterling equivalent of circa €50,000 immediately prior to receiving authorisation from the FCA)	1 ordinary share of £1

	<b>LPFI Limited (for FCA regulated activity)</b>	<b>LPFE Limited (for intra-group employer services)</b>
<b>Directors:</b>	Alastair Maclean (Chairman), Clare Scott, Bruce Miller, Struan Fairbairn and John Burns	Alastair Maclean (Chairman), Alastair Rankin (as the Convener of the Pensions Committee), Clare Scott, Hugh Dunn and Linda Holden
<b>Company Secretary:</b>	CMS (Solicitors)	CMS (Solicitors)
<b>Registered office:</b>	4 <sup>th</sup> Floor, Saltire Court, 20 Castle Terrace, Edinburgh EH1 2EN (CMS's Offices)	4 <sup>th</sup> Floor, Saltire Court, 20 Castle Terrace, Edinburgh EH1 2EN (CMS's Offices)
<b>Accounting reference date:</b>	31 March	31 March
<b>Auditors:</b>	Scott Moncrieff	Scott Moncrieff
<b>Bankers:</b>	The Royal Bank of Scotland	The Royal Bank of Scotland

3.2 **Business plan and FCA Authorisation:** The business plan for the new structure contemplates that the operation of LPFI Limited will be limited to regulated activity in operating the pension funds; such as certain derivative use, developing investment strategies for employer(s) and informal investment collaborations with other pension funds. It is not anticipated that such activity would involve LPFI Limited providing formal investment services, receiving monies or incurring liabilities from external third parties. The structure has been established in order to be best placed to accommodate any future requirements to most efficiently operate the pension funds in the interest of its stakeholders.

3.3 The anticipated timescales for the project are set out in the table below. A verbal update will also be provided to Committee on the latest progress:

<b>Milestone</b>	<b>Completion Date</b>
Finalise detailed feasibility exercise and internal approvals	January 2015
Establish companies (inactive)	11 February 2015
Consultation with investment staff and trade unions	Mid-Late March
Transfer of investment staff to LPFE and admission of LPFE to the Lothian Pension Fund	April 2015
Submission of FCA Application (with LPFI board approval)	April 2015
Engagement with the FCA (if required)	April – June 2015
LPFI Receives decision on FCA Authorisation	Summer 2015
Implementation of business requirements through the authorised structure	Q3/4 2015 onwards

## Investment Operations

3.4 The key developments to note are as follows:

- **Notice periods:** it was identified that having staff, including key members of the management and investment team, on a one month notice period exposed the Funds to inappropriate levels of risk.

**Update:** Following consultation with staff and trade unions, key members of management and investment staff are expected to be placed on extended notice periods appropriate to their roles by the end of April 2015.

- **HR Resource:** the consultant recommended that the Fund put in place dedicated HR support to provide for its particular circumstances.

**Update:** A member of the City of Edinburgh Council's HR team has provided additional resource to assist with implementing the authorised structure. The Fund has also instructed PwC to provide discrete levels of HR support for this process. In addition, options to access HR support that the structure will require on an ongoing basis are currently being explored. Initial indications are that externalising this service will allow the Fund to access a suitably bespoke service at a relatively low cost.

- **External controls audit of in-house investment function:** the consultant noted that once assets under management exceed £5 billion most external fund managers commission an internal controls review. It was noted that the Fund does not manage external assets in the same way, but that a thorough external review would provide the relevant stakeholders with greater comfort in this area.

**Update:** Whilst the enhancements to controls are being put in place following the review, a further external review is not deemed appropriate at this stage. However, specialist pensions auditors have been utilised for internal audits via the Council's co-sourcing internal audit team with PwC. Whilst recognising that these are internal audits, they are considered an enhancement to controls. A further controls review by an external party will be considered in due course once the improvements to controls are fully implemented and FCA authorisation is achieved.

- **Separate dealing desk:** it was highlighted that where volumes of assets under management by the in-house team materially increase, the Fund should establish a central dealing desk. An interim solution was proposed that one portfolio manager could create a trade, with a different manager executing that trade.

**Update:** The dealing procedures for the Fund already require authorisation of every trade by at least two portfolio managers. The Fund's trading volumes do not justify a separate central dealing desk. However testing of an electronic trading platform is underway. It is expected that this would be operated by members of the team who do not manage portfolios. Resource implications are also being assessed but it is expected that these additional

responsibilities may be incorporated within the existing team. The system would also provide transaction cost analysis and electronic trade confirmations.

- **Ongoing review of transaction costs:** the consultant recommended that the Fund implement a regular programme of Transaction Cost Analysis (“TCA”). That should be done either via an external provider or, where that could not be justified in the context of the Fund’s current operations, via a simpler in-house TCA model using monthly transaction reports and Bloomberg pricing access.

**Update:** Transaction costs are now reported in the accounts of the Funds. The Fund’s trading volumes are currently low, so every internal transaction is routinely checked for best execution. If the testing of the electronic trading platform is successful, all transactions will be further analysed electronically.

3.5 Further work continues in the following areas:

- **Pre and post-trade compliance checks:** processes have been amended to include checks prior to trading which are signed off by the portfolio managers. In addition, weekly post-trade compliance checks have been introduced to supplement the quarterly sign-off by the portfolio manager.
- **Ongoing diligence on external managers and the custodian:** additional diligence on the Fund’s custodian has been undertaken and further due diligence on external managers will be progressed over the coming year.
- **Telephone recording:** the Fund anticipates that an appropriate telephone recording package will be in place shortly. This will be equally beneficial for the ongoing compliance of the pensions administration and investment teams.

## Measures of success

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- 4.1 That the Fund continues to develop efficiencies for the benefit of its members, employer bodies and the taxpayer, while mitigating any risk associated with the necessary arrangements, and seeks to continue to improve its service provision and adapt the operations to the wider structural changes facing public sector pension funds.

## Financial impact

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- 5.1 There is no direct financial impact associated with the update of progress in relation to the matters set out in the report. However, improved operations should reduce financial risks.
- 5.2 Costs associated with implementing investment operational improvements and seeking and maintaining FCA authorisation have been contained within the agreed budget for 2014-17, are included in the proposed budget for 2015-18 covered elsewhere on the agenda.

## Risk, policy, compliance and governance impact

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- 6.1 The review of operations highlighted areas for the improvement of governance and risk and these have largely been implemented.

## Equalities impact

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- 7.1 None.

## Sustainability impact

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- 8.1 None.

## Consultation and engagement

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- 9.1 The Consultative Panel for the Lothian Pension Funds comprises employer and member representatives who are integral to the governance of the Funds.
- 9.2 Appropriate consultation with staff and trade unions will be undertaken.

## Background reading / external references

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None.

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## Links

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### **Coalition pledges**

**Council outcomes** CO26 - The Council engages with stakeholders and works in partnerships to improve services and deliver agreed

**Single Outcome Agreement Appendices**