Pensions Committee

2.00 p.m., Wednesday, 16 December 2015

Investment Controls and Compliance

Item number	5.7
Report number	
Executive/routine	
Wards	All

Executive summary

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

- **Investment controls:** the Fund has now finalised its process of reviewing and implementing the appropriate recommendations of the external consultant following a review of the in-house investment operations in December 2013.
- **Financial Conduct Authority (FCA) authorisation:** the FCA application was approved for submission by the LPFI board on 15 October 2015 and the Fund will continue to liaise with the FCA during the coming months to facilitate a conclusion to this process.
- **Investment pooling**: the UK Government has recently announced a national agenda to ensure the effective collaboration of LGPS funds in England and Wales to pool their investments. The Fund, together with a number of internally managed pension funds, is exploring the options for collaboration.
- **Wider financial services regulation:** draft European driven regulation within the UK may have a substantial impact on LGPS fund's ability to operate in particular investment markets. The Fund's current strategy to operate and develop an in-house investment team makes it well placed to work within these regulations.

Links

Coalition pledges	
Council outcomes	[CO26]
Single Outcome Agreement	

Report

Investment Controls and Compliance

Recommendations

1.1 That Committee invites the Pension Board to raise any relevant matters or concerns which the Committee should consider.

1.2 That Committee notes the progress made in relation to implementing the recommendations of the external consultant, the establishment of an FCA authorised structure, the Fund's involvement in the investment pooling discussions and the potential impact of new financial service regulation on the Fund.

Background

2.1 The Fund instructed a review of its in-house investment operations by a consultant in December 2013 in order to ensure that its systems and controls were fit for purpose and also to benchmark them against those for full FCA compliance (albeit not currently a requirement for the Fund).

2.2 The consultant's report concluded that the Fund's systems were fit for its current purpose, but that certain improvements could be made and would be required in anticipation of it operating an FCA authorised vehicle. The Fund has since been phasing in appropriate operational and compliance improvements generally and in anticipation of LPFI's application for FCA authorisation. The Committee last received an update on the Fund's progress in this regard on 25 March 2015.

2.3 This report should also be read in conjunction with the report for Pensions Committee on 16 December as regards the costs associated with the ongoing initiatives and the Risk Management Overview for a more detailed update on the associated risk analysis.

Main report

Investment controls and consultant's recommendations

3.1 *Human capital:* Following the consultant's recommendation to put in place arrangements that would allow staff involved in the in-house investment function to be placed on terms and conditions appropriate to their roles (including extended notice periods), the Fund has established a special purpose staffing vehicle, LPFE Limited ("**LPFE**"), and transferred the employment of those staff into LPFE. LPFE has now appointed an external HR provider (121 Solutions

Limited) to provide it with dedicated services. The LPFE board is expected to meet prior to the meeting of the Pensions Committee in order to discuss and agree the implementation of the remainder of its employer systems and procedures, including any revisions to the current remuneration policy and terms and conditions to ensure they are appropriate for the employment of investment professionals.

3.2 *Transaction execution:* An electronic trading platform is being put in place to ensure that dual authorisation of a trade takes place. The system also requires unique trader identifications which will support improved compliance in this area. The Fund will not, however, be looking to implement a full central dealing desk due to this not being required, or cost effective, for its current volumes of trading and because the Fund will not be managing the assets of any other external parties.

3.3 *Transaction testing:* Transaction testing is undertaken and signed off post-trade by the front office. This testing has also now been included within the Fund's compliance checks. The introduction of electronic trading will also permit transaction cost analysis via Bloomberg.

3.4 *Operational due diligence:* The Fund's process for reviewing external managers has been extended and amended to include regular reviews of those managers on its current framework but with whom the Fund does not have an existing mandate. These reviews will now also formally include an assessment of the appropriateness of the underlying manager's operational infrastructure. Similarly, the Fund's review process for its custodian, currently The Northern Trust Company, has been updated so that it includes at least one "on-site" review per year. This will ensure we are aware of their on-site capabilities. Two such visits have subsequently taken place with satisfactory observations and outcomes.

3.5 *Telephone recording:* A telephone recording system is now in operation across the Fund and has been fully tested. Discussions are currently ongoing around how long the resulting call data should be retained for.

3.6 *Internal service level agreements:* The Fund is in the process of updating its existing internal service level agreement for cash management with the City of Edinburgh Council's ("**CEC**") treasury team. The Fund is also looking to put in place internal service level agreements for certain other key services which it receives from CEC divisions, such as IT, payroll/treasury etc.

FCA authorisation

3.7 The board of LPFI approved the business plan and FCA application for submission on 15 October 2015, subject to it being updated to include the appoint of a non-executive director to the board and to make some minor amendments to the proposed investment services agreement between CEC and LPFI. These changes have now been made with the intention that the application will be submitted in early course. The additional appointment of a non-executive to the LPFI board is in line with the Corporate Governance Code and is viewed as an important means of supporting the senior management of the investment function and an additional check and balance on its governance. The Fund will keep Committee updated on the appointment process.

3.8 The Fund will continue to liaise with the FCA over the coming months in order to facilitate the process and will keep the Committee up to date on developments. The Fund would anticipate that the FCA will take somewhere between four and six months to process the application, although it could potentially take longer.

3.9 By way of a reminder, LPFI is seeking limited investment advisory and arranging permissions in support of the development of its own internal in-house investment function (e.g. in collaborating with other institutional investors, unitising its internal strategies for the benefit of employers and for operational and other governance improvements). LPFI will not therefore be seeking permissions to manage or hold third party assets as part of this process.

LGPS Investment pooling

3.10 The UK Government has recently announced a national agenda to ensure the effective collaboration of LGPS funds in England and Wales to pool their investments in order to generate cost efficiencies and savings for the scheme and to facilitate infrastructure investment within the United Kingdom. This was most recently formalised in the summer budget of 2015 (section 2.19), a subsequent conference speech by the Chancellor and consultations released on 25 November 2015. A link to the recent publication from the UK government is provided at the end of this report.

3.11 The Fund continues to monitor the position south of the border and is directly involved in a project with other LGPS funds, being coordinated by Hymans Robertson in consultation with the UK Treasury Department and the Department for Communities and Local Government (DCLG), to inform the best outcomes and approach to implement investment pooling. This includes a detailed analysis of the benefits of internal management and the different ways in which LGPS funds could collaborate and further exploit the benefits of internal management.

3.12 In Scotland, a review of structure of the Local Government Pension Scheme is expected to be taken forward by the Scheme Advisory Board (SAB). The scope of this review is not yet clear. However, a recent report from the Scottish Government's Local Government and Regeneration Committee (a link to which is provided at the end of this report) indicates that Scottish Government is less inclined to formal pooling. Paragraph 45 of the report...

> *'We agree investment in infrastructure is vital to a successful economy, but we are less attracted to the UK's formal pooling arrangements for Scottish pension funds. During our inquiry we heard how informal collaborations worked well because there was a willingness to work together for a shared vision and benefit. Strathclyde, Falkirk and Lothian and a few others are already working with other funds to increase their investment options. This is to be applauded and we encourage funds to seek out opportunities to work*

collaboratively to benefit from shared expertise in identifying suitable infrastructure investment and to reduce investment costs such as management fees. Being proactive in this regard has particular importance given the potential changes to investment rules.'

3.13 The Fund believes that its existing strategy and initiatives makes it well placed to adapt to any future change and collaborate effectively with other LGPS funds if that would be appropriate. Conclusions of the project will be reported to Committee for consideration in due course.

Wider financial services regulation

3.14 Some important European/financial services legislation is currently under consultation which may significantly impact on the types of investment that local authority administering authorities can invest in and could result in many LGPS schemes having to divest from certain otherwise illiquid investments at a substantial cost to their respective stakeholders. In short, the Markets in Financial Instruments Directive (2014/65/EU) ("**MiFID II**") is proposing that local government administering authorities will default to being classified as 'Retail Clients' rather than 'Professional Clients', resulting in their being regulated within the more onerous and restrictive retail regulatory regime. This classification would be based on such local authorities not having sufficient investment knowledge and expertise to properly assess and make their own investments in particular sectors. It would effectively exclude such funds from the more sophisticated private markets (e.g. private equity/infrastructure/timberland/debt funds, co-investments, single asset opportunities etc.) and therefore meaningfully reduce their investment universe and ability to diversify their investment strategies. Whilst the detail is yet to be determined and finalised, the Fund is currently of the view that it would be able to 'opt out' and continue to benefit from classification as a 'Professional Client', given the nature of its current structure and in-house investment team.

3.15 The Fund's current strategy of retaining an in-house investment function, and further developing this capability through its new structure, will make it well placed to deal with this (and any other) regulatory change. This will allow the Fund to mitigate the potentially significant costs and constraints that such regulation could potentially impose.

3.16 The Fund will continue to closely monitor the position and keep the Committee and Pension Board appraised of this and any other equivalent area of regulatory development.

Measures of success

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.

4.2 That the Fund seeks to improve its service provision and adapts its operations to the wider structural and regulatory changes facing public sector funds.

Financial impact

5.1 There is no direct financial impact associated with the update of progress in relation to the matters set out in this report.

5.2 A report elsewhere on the Committee's agenda shows how the Fund's investment costs compare favourably (approximately £5.5m p.a.) with an average pension fund, largely due to its internal management operations.

5.3 The improvements in day-to-day investment controls have been met from within existing budgets.

5.4 The Fund has incurred approximately £64,000 in legal, accounting and tax advisory costs in order to establish LPFI and LPFE and operate them to this point. The Fund has saved a very significant amount of costs (while continuing to mitigate risks through seeking appropriate levels of external advice) through its ability to design the structure, manage external advisors and put in place the necessary documentation/systems etc. through its internal legal and accounting expertise. The Fund has also incurred other lower level costs in relation to implementing bespoke payroll, HR and time-recording systems for LPFE, but these have been absorbed within existing budgets.

5.5 An update on the impact of the review of employer systems and procedures, including any revisions to the current remuneration policy and terms and conditions, will be provided to Committee following the LPFE Board meeting.

5.6 There continue to be very significant cost implications in not ensuring that the Fund's internal investment operation is best placed to adapt to the market and regulatory changes currently affecting the sector.

Risk, policy, compliance and governance impact

6.1 The review of investment operations highlighted areas for improvement in governance and risk and these have been implemented.

6.2 In particular, the Fund needs to continue to ensure that its governance processes and procedures (including delegations, signing authorities etc.) adapt to any organisational changes within the Council and are sufficient to allow it to continue to carry out its business effectively and to exercise its functions with sufficient fiduciary independence.

6.3 There are significant risk and compliance considerations for the Fund to consider around any implementation of MIFID II within the United Kingdom in the manner currently proposed.

Equalities impact

7.1 None.

Sustainability impact

8.1 The review of investment operations and the implementation of actions resulting from that review are intended to secure the long-term sustainability of the internal investment operations for the benefit of the pension funds.

Consultation and engagement

9.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the Funds.

Background reading/external references

https://www.gov.uk/government/publications/local-government-pension-scheme-investment-reform-criteria-and-guidance

http://www.scottish.parliament.uk/parliamentarybusiness/CurrentCommittees/94373.aspx

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Links

Coalition pledges	
Council outcomes	CO26 - The Council engages with stakeholders and works in partnerships to improve services and deliver agreed
Single Outcome Agreement	
Appendices	