

Pensions Committee

2.00 p.m., Monday, 20 March 2017

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. However, it is looking to re-appraise its position in light of the potential implementation of certain collaborative initiatives
- **Financial Conduct Authority (FCA) compliance:** LPFI Limited (LPFI) has now obtained its FCA authorisation and has continued to comply with its ongoing regulatory capital and filing requirements since. LPFI began to trade in December 2016 and that has placed an increased focus on ongoing FCA compliance.
- **Wider financial services regulation:** draft European-driven regulation within the UK may have a substantial impact on LGPS funds' ability to operate in particular investment markets. The Fund's current strategy to operate and develop an in-house investment team continues to make it well placed to work within these regulations. However, the Fund must also review and monitor the ongoing regulatory status of any other LGPS funds with which it collaborates.

Links

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Investment Controls and Compliance

Recommendations

Committee is requested to:

- 1.1 Invite the Pension Board to raise any relevant matters or concerns which the Committee should consider; and
- 1.2 Note the update on ongoing compliance, monitoring and other initiatives in relation to potentially enhancing investment controls in relation to the current activity of the LPF group and also with future collaboration in mind.

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 needed 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 advance of LPFI receiving FCA authorisation. The Committee last received an update on the Fund's progress in this regard in [March 2016] and, since then, LPFI has received its FCA authorisation and has begun to trade.
- 2.3 This report should also be read in conjunction with the report for Pensions Committee on Budget for 2017-18 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

- 3.1 *Human capital:* The Fund has recruited further resource within the investment team to cover high level strategic initiatives across its portfolios as well as to provide cover for the equity and bond portfolio managers. However, the Fund has subsequently received notice from its Bond Portfolio Manager and so is now actively recruiting for this role. Separately, the Fund has for some time identified the need to enhance its legal and compliance function to keep pace with the increased compliance and legal work. The Fund expects to complete the

recruitment process for a junior lawyer in March 2017. The Fund has also secured a legal trainee on a full time basis.

- 3.2 *Back-office resource:* The Fund continues to monitor the resource and systems within the finance and back-office function to ensure that these are appropriate for current levels of increased regulatory, accounting and other activity arising from the ongoing development of the in-house function.
- 3.3 *Internal service level agreements:* The Fund continues to be in the process of updating its existing internal service level agreements with the City of Edinburgh Council's (CEC) in order to ensure that it has certainty around the costs and service levels/deliverability of the key services on which it relies (such as IT, payroll, information compliance etc.). The Fund also continues to compare these internal services with the comparable external service providers, to assess if the internally resourced solution remains the best one – particularly as the Fund continues to develop more complex systems, controls and external relationships, resulting in a need for increasingly robust and reliable service provision and resources.
- 3.4 *Other Ongoing Initiatives:* Other control and compliance resource and initiatives will be considered as the Fund's work and collaborative initiatives develop. Specifically, the need for an automated Front Office System is under review.

LPI and FCA compliance

- 3.5 *Regulatory capital and filings:* Since receiving FCA authorisation the Fund has submitted all its quarterly filings correctly and timeously. However, due to the unprecedented post-Brexit fall in the value of Sterling and the fact that the Fund is required to maintain the sterling equivalent of €50,000 regulatory capital within LPI, the Board of LPI was required to approve the issue of a small amount of further share capital to its parent, CEC, in order to ensure that any further adverse fluctuations in the Sterling-to-Euro exchange rate would not cause it to be in breach of its regulatory capital requirements. LPI has therefore issued a further 9,999 ordinary shares of £1 each to CEC, taking its total issued share capital to £50,000.
- 3.6 *Non-executive director:* The board of LPI has now approved the appointment of Leslie Robb as a non-executive director effective from 7 February 2017, subject to Leslie receiving the requisite approvals from the FCA. Leslie is a former Partner of Baillie Gifford and Co, has held senior roles in the asset management industry, including Chief Investment Officer and Managing Director, and has significant experience as an investment advisor to both LGPS funds and the wider UK institutional investment sector. He currently acts as an independent investment advisor to certain LGPS funds in England and Wales.
- 3.7 *LPI club-deals:* LPI began trading in December of 2016 and completed its first collaborative club-deal in the infrastructure sector in January 2017. With further club-deals expected to follow in the first quarter of 2017, the Chief Risk Officer is carrying out a review of the process undertaken on the first club deal (in terms of pre-vetting LPI's clients, dealing with those clients and treating them fairly,

processes for information sharing and execution of deals etc.) to ensure that we are adopting best practice across the full process from deal sourcing to completion. The board of LPFI has no reason to expect that this is not the case, given work done in anticipation of this core aspect of LPFI's business plan, but believes it is prudent to continually assess our processes particularly at this early stage in trading.

- 3.8 *Regulatory compliance support:* The LPFI board has instructed Moore Stephens on an annual retainer to provide ongoing support services in relation to quarterly FCA filings, quarterly on-site audits of LPFI's processes and compliance with the FCA procedures/ guidance, and training.

Wider financial services regulation

- 3.9 The Fund continues to monitor the progress of the implementation of the Markets in Financial Instruments Directive (2014/65/EU) (**MiFID II**) and, in particular, its intention that local government pension scheme 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 and potentially increase fees. Whilst the detail is yet to be determined and finalised, the Fund is currently of the view that it would be able to 'opt-up' and continue to benefit from classification as a 'Professional Client', given the nature of its current authorised structure and the current, and historic, activity and expertise of its in-house investment team.
- 3.10 The Fund is therefore taking the view that its 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.
- 3.11 However, given the Fund's efforts to collaborative with other LGPS funds, it must also now monitor the position with regards to the ongoing regulatory status of those funds.
- 3.12 The Chief Risk Officer is a member of a UK wide group liaising with the FCA on behalf of UK local government pension schemes and so the Fund expects that it will remain fully apprised of the FCA's position and the timing for implementation through participation in this group.

Measures of success

- 4.1 That the Fund continues to develop efficiencies for the benefit of its members, and employer bodies, 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 and to changes arising from its own internal developments.
- 4.3 That the Fund's investment controls, resource and systems keep pace with the implementation of its business strategy.

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 The improvements in day-to-day investment controls have been met from within existing budgets.
- 5.3 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 Fund needs to continue to ensure that its governance processes and procedures (including FCA regulatory compliance, corporate governance, delegations 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.
- 6.2 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

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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 objectives

Single Outcome Agreement

Appendices None