

Investment and Engagement Sub-Committee

ITEM 4 18th January 2016

Investment regulations Consultation on draft regulations

1. The consultation which is due for responses by 15th February 2016 can be summarised into the following areas.

Response to the Law Commission's Review of Fiduciary Duty

2. In their report, Fiduciary Duties of Investment Intermediaries, published in July 2014, the Law Commission called on the DCLG to review:
 - Whether the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 should transpose article 18(1) of the European Commission's 2003 Institutions for Occupational Retirement Provision (IORP) Directive, and
 - Those aspects of Regulation 9 of the 2009 Regulations which require investment managers to be appointed on a short-term basis and reviewed every three months.
3. In response to the commission's request for review, DCLG proposes to remove the requirement to review managers on a three month basis but proposes no amendments to transpose 18(1) of the IORP.
4. Article 18(1) of the IORP Directive requires assets to be invested in the best interests of members and beneficiaries and, in the event of a conflict of interest, in the sole interests of members and beneficiaries. For trust based pension schemes, regulation 4 of The Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005 No 3378) transposed Article 18(1) in full. However DCLG maintain that as a statutory (not a trust) scheme the LGPS does not have to comply with regulation 4 and furthermore existing common legislation and case law provides sufficient protection for members with regard to the result of investment decisions on their benefits.
5. In September 2014 the LGA, on behalf of the LGPS Advisory Board, sought the opinion of Nigel Giffin QC on a number of matters including the application of article 18. Although in his view the 'fiduciary duty and public law duties of the administering authority,, would in fact (and with one possible exception) impose upon it all the obligations that article 18(1) requires', he goes on to state that 'it would clearly be preferable if the relevant provisions of the Occupational Pension Schemes (Investment) Regulations 2005 were made to apply to the LGPS'.

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Proposal 1: Adopting a local approach to investment

6. The draft regulations remove provisions dealing with items such as stock lending and the number, choice and term of investment managers. Although these and other provisions have not been carried forward into the draft 2016 Regulations, the Government's view is that they would be effectively maintained by general law provisions and so specific regulation is no longer needed. For example, those making investment decisions are still required to act prudently, and there remains a statutory requirement to take and act on proper advice.
7. Also removed are the limitations in schedule 1. Instead there is a requirement for LGPS fund authorities to take a prudential approach to investment, demonstrating that they have given consideration to the suitability of different types of investment, have ensured an appropriately diverse portfolio of assets and have ensured an appropriate approach to managing risk. A key element of such demonstration will be a new Investment Strategy Statement which should cover:
 - A requirement to use a wide variety of investments.
 - The authority's assessment of the suitability of particular investments and types of investments.
 - The authority's approach to risk, including how it will be measured and managed.
 - The authority's approach to collaborative investment, including the use of collective investment vehicles and shared services.
 - The authority's environmental, social and corporate governance policy.
 - The authority's policy on the exercise of rights, including voting rights, attached to its investments.
8. This statement must be published no later than six months after the regulations come into force. However as the draft regulations would also revoke the existing 2009 Regulations when they come into effect transitional arrangements are required. The transitional arrangements proposed in draft regulation 12 would mean that the following regulations in the 2009 Regulations would remain in place until the authority publishes an investment strategy or six months lapses from the date that the regulations come into effect:
 - 11 (investment policy and investment of pension fund money)
 - 14 (restrictions on investments)
 - 15 (requirements for increased limits)
 - Schedule 1 (table of limits on investments)
9. Although there will not be a requirement to maintain a Statement of Investment Principles, the main elements, such as risk, diversification,

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corporate governance and suitability, will instead be carried forward as part of the reporting requirements of the new investment strategy

Questions from consultation

- i. Does the proposed deregulation achieve the intended policy aim of removing any unnecessary regulation while still ensuring that authorities' investments are made prudently and having taken advice?
- ii. Are there any specific issues that should be reinstated? Please explain why?
- iii. Is six months the appropriate period for the transitional arrangements to remain in place?
- iv. Should the regulation be explicit that derivatives should only be used as a risk management tool? Are there any other circumstances in which the use of derivatives would be appropriate?

Non-financial factors

10. The consultation document makes reference to forthcoming guidance to reinforce the Government's view that using pensions and procurement policies to pursue boycotts, divestments and sanctions against foreign nations and the UK defence industry are inappropriate, other than where formal legal sanctions, embargoes and restrictions have been put in place by the Government.

Proposal 2: Introducing a safeguard - Secretary of State (SoS) power of intervention

11. The power of intervention in the draft regulations consists of the following elements.

Determining to intervene

12. The Secretary of State may determine an intervention is necessary if the administering authority has failed to have regard to the regulations governing their investments or guidance issued under draft regulation 7(1). Examples of evidence of such failure may include not complying with best practice (e.g. by not giving due regard to advice from the Scheme Advisory Board), not investing via an asset pool that meets the requirements of relevant guidance or not carrying out another pension related activity effectively (e.g. an unsatisfactory 'section 13 report').
13. The SoS can provide for further investigations to be made and more evidence gathered prior to any decision to intervene being taken.

The process of intervention

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14. The power to intervene is broad and includes a provision for the SoS to seek external advice when determining what that intervention should be. However it could include:

- Requiring an administering authority to develop a new investment strategy statement that follows guidance published under draft regulation 7(1).
- Directing an administering authority to invest all or a portion of its assets in a particular way that more closely adheres to the criteria and guidance, for instance through a pooled vehicle.
- Requiring that the investment functions of the administering authority are exercised by the Secretary of State or his nominee.
- Directing the implementation of the investment strategy of the administering authority to be undertaken by another body.

15. Before any intervention, the LGPS fund would be presented with the evidence, notified of the action and timing and given the opportunity to respond.

Review

16. Draft regulations provide for any action taken to be subject to review and for the fund to be clear what is required to end the intervention.

Questions from consultation

- i. Are there any other sources of evidence that the Secretary of State might draw on to establish whether an intervention is required?
- ii. Does the intervention allow authorities sufficient scope and time to present evidence in favour of their existing arrangements when either determining an intervention in the first place, or reviewing whether one should remain in place?
- iii. Does the proposed approach allow the Secretary of State sufficient flexibility to ensure that he is able to introduce a proportionate intervention?

Committee decision

17. Committee are asked to note the contents of this report