

LGPS Reform
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Dear Sir/Madam

RE: The Investment Association response to 'Revoking and replacing the LGPS (Management and Investment of Funds) Regulations 2009'

The Investment Association represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the in-house managers of occupational pension schemes. They are responsible for the management of around £5.5 trillion of assets in the UK on behalf of domestic and overseas investors, including around £200 billion of assets belonging to LGPS funds.

We welcome the opportunity to comment on the draft regulations¹. We support the general deregulatory approach taken in drafting these regulations and believe, subject to some specific points that we make below, that they do achieve the intended policy aim of removing unnecessary regulation while still ensuring that authorities' investments are made prudently and having taken advice.

Our answers to the specific questions in the consultation accompanying the draft regulations are set out below.

We look forward to hearing from you if there is any clarification that you would find useful on the points we have raised. We would be very happy to meet to discuss our comments.

Yours Sincerely,

Guy Sears (by email)
Interim Chief Executive

¹ The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016

Answers to questions 1-4 on 'Adopting a local approach to investment'



Overall we would support regulation about investments which focus on providing clarity on what might be an investment. The question as to whether something is permitted at all, should not be conflated with whether any particular investment or strategy ought to be used for a particular LGPS fund. The appropriateness and role of derivatives and FX, for example, will be embedded in the Investment Strategy Statements.

With this in mind we believe that the draft regulations do largely achieve the intended policy aim of removing unnecessary regulation while still ensuring that authorities' investments are made prudently and having taken advice. However, we do believe that some further simplifications and clarifications would be helpful as discussed in our comments below. Reflecting our comments some suggested alternative drafting of regulation (3) is attached as an annex to this letter.

We would as an aside note that if ACS or other collective investment schemes (CIS) are used, regulation (3) on permitted investments will have little content – since the investment will be a unit in a CIS and it will be the Investment Strategy Statements that will guide and constrain investments.

Definition of investment in draft regulation (3)

In regulation (3) we suggest that for consistency and the avoidance of any doubt as to what constitutes an investment, the definition of "investments" should refer explicitly (but not exhaustively) to that set out in part III ("Specified Investments") of the Regulated Activities Order (RAO) under the Financial Services and Markets Act 2000 (FSMA). This would have the advantage of ensuring that anything listed as an investment for the purposes of FSMA would automatically be an investment for the purposes of LGPS clients, but it would not prevent other investments being included – such as real estate, Foreign Exchange (FX), repos and stock-lending. We believe that this approach would provide greater clarity for investment managers and their LGPS clients. The current wording of investment having its "normal meaning" is somewhat ambiguous in this regard.

We note the current words suggest a limitation in relation to life insurance investments. We have no particular comment on that and language could be used to state that those words qualify the otherwise broad inclusion of rights under life insurance contracts.

Unit-linked funds as permitted investments

Unit-linked funds are a type of pooled investment vehicle, offering investors tax advantages and significant investment flexibility. They are therefore commonly used throughout the life and pensions market, including by LGPS clients. It is our assumption that the Government is agnostic on the structure of funds used to serve LGPS clients but it is not clear to us whether unit-linked funds would be permitted investments under the proposed drafting.

There are concerns to ensure that the full range of unit-linked funds presently used are allowed as contracts for insurance on a 'human life' (regulation (3)(6)(a)) and/or under regulation (3)(6)(b), which could be interpreted as covering segregated contracts only. Clarification that unit-linked funds (and indeed other pooled vehicles) would be permitted investments under regulation (3)(6)(b) would therefore be helpful.

Use of derivatives

We welcome the Government's clarification of its view on the use of derivatives by LGPS clients. A further benefit of our suggestion that the FSMA definition of investments is adopted in these regulations would be that no explicit reference to derivatives would be required in regulation (3)(3), since the FSMA RAO lists explicitly certain kinds of derivative contracts.

If the Government is minded to continue with the existing form of wording in regulations (3)(1) and (3)(3), we recommend removing the references in the latter to financial futures and traded options and retaining the more general term 'derivatives'. The former contracts are types of derivative and would be covered by the more general term. Also the reference to traded options and the UK's Taxes Act definition of a stock exchange (regulation (3)(8)) seems out of place now that the usual definitions and jargon is about regulated markets and trading venues. If it has to be included, and we do not think it does, the definition in FSMA of such venues, including third country venues, is preferable.

Foreign Exchange activities

Explicit recognition in the regulations would be helpful in relation to Foreign Exchange (FX) activities that may be carried out by pension funds. Broadly speaking these can be three-fold in nature:

- Transactional – reflecting the need to purchase overseas assets in a local currency;
- Risk management – reflecting the need to mitigate the impact of adverse currency movements eroding portfolio returns; and
- Generating returns – currency exposure as a source of return in a portfolio.

Only the third activity would constitute investment in the sense of seeking a return. The first two FX activities can be characterised as being by-products of the investment process. The regulations should explicitly reflect that all these FX activities constitute an "investment" for the purposes of these regulations; this would be helpful clarification for LGPS funds and their investment managers.

Investment strategies employing leverage or short positions

Regulation (5) is concerned with limiting local authorities' ability to borrow against its pension fund to specific circumstances. Some investment strategies use techniques that may be tantamount to borrowing – short or leveraged positions. We are not sure that the current exemptions in regulation (5) would allow investment managers to employ these techniques on behalf of LGPS clients, meaning that they would not be able to benefit from these strategies if they wished to do so. For the avoidance of doubt we suggest that regulation (3) makes clear that leveraged and short investments do not constitute borrowing as prohibited by regulation (5).

Answers to questions 5-8 on 'Introducing a safeguard – Secretary of State power of intervention'



It is our view that the powers of the Secretary of State to intervene in the investment function of an administering authority and the circumstances in which he/she may do so is a matter for Government and LGPS funds.

We restrict our comments here to three points in relation to the operation of mandates by investment managers.

Firstly, it would be helpful if the regulations and/or accompanying guidance set out how the Secretary of State's power of intervention would work should it cut across contractual provisions between the Local Authority and an external investment manager, for example under an Investment Management Agreement (IMA).

Secondly, on the need for the new Investment Strategy Statements to reflect considerations of foreign policy and related issues, it is our belief that it is the responsibility of the LGPS client to ensure that the mandate(s) ensuing from this policy is/are compliant with the Government's foreign policy objectives. The responsibility of the Investment Manager is to execute the mandate they are given.

Thirdly, when interventions by the Secretary of State are planned, it should be borne in mind that investment strategies are long term and that certain investments can take time to exit from. Any intervention will therefore require thoughtful and timely engagement on the part of the Secretary of State if operational risks associated with altering an investment strategy are to be minimised.

Annex: Suggested changes to draft regulation (3)



“Investment

3.—(1) In these Regulations “investment” and related expressions have their normal meaning.

(2) But the following provisions of this regulation specify things which count as investments for these Regulations, although they might not otherwise do so, and exclude things which might otherwise count.

(3) Any kind of investment specified for the purposes of section 22 of the 2000 Act is an investment, unless it is a contract of insurance in which case paragraph (4) specifies what counts as an investment.

~~(3) A contract entered into in the course of dealing in financial futures, traded options or derivatives is an investment.~~

(3A) The sale or purchase of currency of the United Kingdom or any other country or territory and any future for the sale or purchase of any such currency is also an investment.

(3B) For the avoidance of doubt, the use of leveraged investments or the short-selling of investments shall not constitute borrowing prohibited by regulation 5 below.

(4) A contract of insurance is an investment if it is a contract of a relevant class, and is entered into with a person within paragraph (5) for whom entering into the contract constitutes the carrying on of a regulated activity within the meaning of section 22 of the 2000 Act(c).

(5) The persons within this paragraph are—

(a) a person who has permission under Part 4A of the 2000 Act (permission to carry on regulated activities) to effect or carry out contracts of insurance of a relevant class;

(b) an EEA firm of the kind mentioned in paragraph 5(d) of Schedule 3 to the 2000 Act (EEA passport rights), which has permission under paragraph 15 of that Schedule(d) to effect or carry out contracts of insurance of a relevant class; and

(c) a person who does not fall within sub-paragraph (a) or (b) whose head office is in an EEA state other than the United Kingdom, and who is permitted by the law of that state to effect or carry out contracts of insurance of a relevant class.

(6) A contract of insurance is of a relevant class for the purposes of paragraphs (4) and (5) if it is—

(a) a contract of insurance on human life or a contract to pay an annuity on human life where the benefits are wholly or partly to be determined by reference to the value of, or income from, property of any description (whether or not specified in the contract) or by reference to fluctuations in, or an index of, the value of property of any description (whether or not so specified); or

(b) a contract to manage the investments of pension funds, whether or not combined with contracts of insurance covering either conservation of capital or payment of minimum interest.

(7) It is an investment to contribute to a limited partnership in an unquoted securities investment partnership.

(8) For the purposes of this regulation—

“limited partnership” has the meaning given in the Limited Partnerships Act 1907(a);

~~“recognised stock exchange” has the same meaning as in section 1005 of the Income Tax Act 2007(b);~~

~~“traded option” means an option quoted on a recognised stock exchange; and~~

“unquoted securities investment partnership” means a partnership for investing in securities which are not quoted on a recognised stock exchange when the partnership buys them.”

