


Non-Executive Report of the: PENSIONS BOARD 31 July 2017	 TOWER HAMLETS
Report of: Zena Cooke, Corporate Director of Resources	Classification:
LGPS Latest Development and Update: <i>FCA MiFID II Policy Statement on LGPS Classification, Judicial review on DCLG statutory guidance, LGPS Investment Code of Transparency and London Collective Investment Vehicle (CIV)</i>	

Originating Officer(s)	Bola Tobun, Investment and Treasury Manager
Wards affected	All

Introduction

This report provides the Committee with an update on general developments in Local Government Pensions Scheme arena and also the progress of the London Collective Investment Vehicle (CIV).

The second Markets in Financial Instruments Directive (MiFID II) builds on the original MiFID and is the framework of European legislation governing investment firms providing certain investment services to clients and the organised trading of financial instruments. MiFID II takes effect on 3rd January 2018 and the proposed changes to the Financial Conduct Authority (FCA) Handbook will have significant implications for LGPS administering authorities.

On 16th May 2017, the LGPS Scheme Advisory Board issued the Local Government Pension Scheme (LGPS) Investment Code of Transparency. The background, nature of the Code and the implications of its introduction are briefly discussed in this report.

The High Court ruled on judicial review that the section on boycotting foreign nations and the UK defence industry in the DCLG statutory guidance on preparing and maintaining an investment strategy statement published in September last year is unlawful. The reason given is that the Secretary of State had exceeded his regulation making powers by using the guidance to protect government foreign policy and UK defence policy, which, in the judges view, were not policies for “pension purposes” The Secretary of State was held to have acted for an unauthorised purpose and therefore unlawfully. Although not expressly referred to in the judgement, the inference is that that part of the statutory guidance referred to in paragraph 1 of the judgement is struck out.

Recommendations:

- Members of the Pensions Board are asked to note the contents of the report which covers the following matters.
 - a) FCA MiFID II Policy Statement on LGPS Classification;
 - b) Judicial review on DCLG statutory guidance;
 - c) LGPS Investment Code of Transparency and
 - d) London Collective Investment Vehicle (CIV).

1. REASONS FOR THE DECISIONS

- 1.1 For effective and efficient management of the Fund.

2. ALTERNATIVE OPTIONS

- 2.1 No alternative.

3. DETAILS OF REPORT

The FCA on Markets in Financial Instruments Directive Implementation - Policy Statement II

- 3.1 Under MiFID II, UK local authorities will be re-classified as "retail" clients as opposed to their current classification of "professional per se" clients. If the local authority retains the retail client classification, it will be restricted in the investment managers it can use and the investments it can make as there are fewer investment managers permitted to deal with retail clients and certain investments are not deemed suitable for retail clients.
- 3.2 The UK regulator has introduced a workaround for the country's local government pension scheme (LGPS) to avoid European rules that could have forced some funds into a potential urgent sale of assets. The Financial Conduct Authority (FCA) published a 1,068-page policy document regarding the implementation of the Markets in Financial Instruments Directive (MiFID II). In it, the watchdog added wording to the rules making it easier for LGPS schemes to be "opted up" to professional investor status.
- 3.3 MiFID II requires all local authorities to be treated as retail clients by their asset managers, which would severely restrict their ability to invest in illiquid asset classes. While it was introduced to protect the treasury management functions of local governments across Europe, it raised concerns within the LGPS that it would hamper efforts to pool assets and boost infrastructure spending.
- 3.4 There is an option for local authorities to opt up to "elective professional" client status with individual asset managers in order to continue 'complex' investments. This procedure will include both a qualitative and quantitative test to be assessed by the asset manager. It is proposed that the opt up criteria will be applied separately for local authorities depending on the

capacity in which they are acting (i.e. either as treasury managers or as pension fund administrators).

- 3.5 After lobbying from the LGPS Scheme Advisory Board, the Local Government Association (LGA) and the Investment Association, the FCA made changes to the “quantitative” and “qualitative” tests for clients to be classified as professional.

Opt Up to Elective Professional Status

- 3.6 The Financial Conduct Authority’s (FCA) policy objective is to provide a clear and straightforward path to opt-up which enables LGPS administering authorities to attain “elective professional” status. This will be achieved via two tests: qualitative and quantitative.

Qualitative Test

- 3.5 ***The qualitative test states that:*** Firms must undertake an adequate assessment of the expertise, experience and knowledge of the client to give reasonable assurance in light of the nature of the transactions or services envisaged, that the client is capable of making his own investment decisions and understanding the risks involved (COBS 3.5.3R(1)) .
- 3.6 ***The existing COBS 3.5.4 states that:*** If the client is an entity, the qualitative test should be performed in relation to the person authorised to carry out transactions on its behalf.
- 3.7 Asset managers must also assess the “expertise, experience, and knowledge” of their clients in order to opt them up to professional status. MiFID II refers to an individual person, but the FCA’s policy statement made it clear that “firms may take a collective view of the expertise, experience and knowledge of committee members, taking into account any assistance from authority officers and external advisers where it contributes to the expertise, experience and knowledge of those making the decisions”.
- 3.8 The regulator added: “Given different governance arrangements, we cannot be prescriptive, but we would stress the importance of firms exercising judgement and ensuring that they understand the arrangements of the local authority and the clear purpose of this test. It remains a test of the individual, or respectively the individuals who are ultimately making the investment decisions, but governance and advice arrangements supporting those individuals can inform and contribute to the firm’s assessment.”
- 3.8 The qualitative test will reference the key officer individual but will make clear that this can include the legal entity rather than just individual persons, i.e., the collective decision making structure can be taken into account (officers, consultants and the decision making committee).

Quantitative Test

- 3.9 The quantitative test (based on COBS 3.5.3R (2)) requires that the criteria in paragraph (a) and one of the criteria in paragraphs (b), (c) or (d) must be satisfied:
- a) the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds £10m
 - b) the client has carried out transactions, in significant size, on the relevant market at an average frequency of ten per quarter over the previous four quarters.
 - c) the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged.
 - d) the client is an administering authority of the LGPS.
- 3.10 It is expected that asset managers will take the opt up questionnaire information at the outset, approve the document if satisfactory, and periodically review the information, probably annually.

LGPS Investment Code of Transparency

- 3.11 On 16th May 2017, the LGPS Advisory Board issued the Local Government Pension Scheme (LGPS) Investment Code of Transparency.
- 3.12 The quoted fee paid to an external asset manager does not represent the full cost incurred by an LGPS Fund when it engages the services of an external investment (asset) manager. There have long been concerns regarding investment management fees. Therefore, the Scheme Advisory Board in consultation with LGPS stakeholders including the Investment Association which is the investment managers trade body, has developed the LGPS Investment Code of Transparency. This is a voluntary Code but it is anticipated that most asset managers, to whom the Code applies will, in due course, sign up to it.
- 3.13 The purpose of the Code is to improve the reporting and understanding of investment management charges and costs. Investment managers who sign up to the Code will report their fees costs and income using standard Templates.
- 3.14 Potentially, the information provided by participating managers has a number of benefits for the Tower Hamlets Pension Fund including a greater ability to challenge investment managers' fees and costs, improved reporting in the Annual Pension Fund Accounts and a greater ability to assure stakeholders that the Fund understands its asset management fees and costs and is in a position to undertake meaningful discussions with its investment managers in relation to this issue.
- 3.15 At present the Code only covers listed assets such as Listed Equities and Bonds. Listed assets however form the majority of the assets of the Tower

Hamlets Pension Fund. The Scheme Advisory Board intends, in due course, to extend the Code to cover unlisted assets. It will however be considerably more challenging to develop Templates for alternative asset classes where fees/cost structures are more complex.

- 3.16 As noted in the independent advisors note the Scheme Advisory Board is considering whether to seek to establish/utilise a third party body to collate and check the data on behalf of LGPS Funds. This would be an independent not for profit body which would enable individual LGPS Funds to receive the asset managers' data in a format they can readily use rather than having to analyse it themselves and recruit/train staff to undertake this task.
- 3.17 However, the capacity to undertake this work should be well within the capacity of individual pools working with individual funds and there is no guarantee that the advisory board has the expertise to commission such work.

The Government rules on Local Government Pension Scheme (LGPS) investments were deemed unlawful.

- 3.18 The investment guidance, issued last September, requires LGPS funds to have policies on environmental, social and governance (ESG) issues but also added they could not pursue policies contrary to central government foreign and defence policy.
- 3.19 The guidance said "pension policies to pursue boycotts, divestment and sanctions [BDS] against foreign nations and UK defence industries are inappropriate, other than where formal legal sanctions, embargoes and restrictions have been put in place by the government" and funds could not "pursue policies that are contrary to UK foreign policy or UK defence policy".
- 3.20 The policy was particularly contentious as LGPS funds and campaigners said this limited their ability to take up ethical investment, particularly BDS action against companies operating in Israeli settlements in Palestine.
- 3.21 A bid was launched in the courts by the Palestine Solidarity Campaign (PSC) to overturn the regulations via a judicial review, where it argued the government had acted outside of its powers, and it was "lacking in certainty".
- 3.22 It also cited Article 18.4 of the EU's directive on the Activities and Supervision of Institutions for Occupational Pension Provision (IORP), which states "member states shall not subject the investment decisions of an institution... to any kind of prior approval or systematic notification requirements".
- 3.23 However, the judgment, issued by judge Sir Ross Cranston only agreed with the first argument, stating the Minister for the Department for Communities and Local Government (DCLG) Sajid Javid had "acted for an unauthorised purpose and therefore unlawfully".
- 3.24 His reasoning was the "guidance has singled out certain types of non-financial factors, concerned with foreign/defence... and stated that administering

authorities cannot base investment decisions upon them. In doing this, I cannot see how the secretary of state has acted for a pensions' purpose".

- 3.25 He stated specifically that this guidance could preclude LGPS funds taking ESG factors into account even if there no "significant risk" of financial detriment or "no good reason" to believe members would object.
- 3.26 Cranston therefore granted a judicial review, meaning the government may have to rethink its approach to the rules if it wishes them to take effect.
- 3.27 DCLG made a statement that the government would consider whether to appeal: "It is an important principle that foreign policy matters are for the UK Government to decide. We will consider the judgement and next steps."
- 3.28 This will mean that the LGPS funds must invest in the best interests of scheme members, as all other pension schemes in the UK must do. The best interests of scheme members are aligned with all sponsoring employers in seeing that their pensions are delivered in the most efficient manner.
- 3.29 The High Court was also asked to judge whether (a) the guidance lacked clarity and certainty and (b) whether Article 18(4) of the 2003 IORP Directive applied to prevent the Secretary of State from imposing a form of approval before investment decisions are made. On both matters, the judge ruled in favour of the Secretary of State.

London CIV Update

- 3.30 The first quarter of 2017/18 has been positive and LCIV has achieved the majority of their quarterly KPI targets. They launched two additional funds, taking AUM just short of £5bn, by having an additional LLA invested directly in one of the sub-fund. (Bexley through the LCIV NW Global Equity Fund, managed on a delegated basis by Newton Investment Management Ltd.).

Q1 2017 Sub-Fund AuM Status

Q1 2017 AuM Status (£Mn)			
FUNDS	30 June Value	MTFS Plan	Variance
London LGPS CIV Global Equity Alpha (Allianz)	691	602	89
London LGPS CIV Global Alpha Growth Fund (Baillie Gifford)	1,674	1,455	219
Lodnon LGPS CIV Diversified Growth Fund (Baillie Gifford)	362	336	26
LCIV PY Gloval Total Return Fund (Pyrford)	225	199	26
LCIV RF Absolute Return Fund (Ruffer)	473	330	143
LCIV NW Real Return Fund (Newton)	346	330	16
LCIV NW Global Equity Fund (Newton 22 May launch)	659	500	159
LCIV MJ UK Equity Fund (Majedie 18 May Launch)	510	530	-20
Longview (to launch in July)	0	450	-450
	4,941	4,732	209

- 3.31 Also reported to be on target to launch are four further funds in the second quarter of 217 with two funds opening in July and two in September.

3.32 LCIV reported that costs are lower than planned at this stage, mainly due to lower staff and facilities costs. They have appointed four additional members of staff and are in discussion with a number of very good candidates and are optimistic that further staff will soon be joining the team; details of the appointments are below.

3.33 To date in 2017/18 LCIV has hired the following:

- a) Chief Risk Officer; this role will cover both risk and performance reporting and LCIV are, therefore, reviewing the role requirement for the AD Investment Oversight & Performance.
- b) Head of Fixed Income & Alternatives; brought forward into Q2 as this asset class has taken a higher degree of urgency and prioritisation.
- c) Client Relations Executive.
- d) Corporate Development Director (New role / 1 year fixed term contract); new role added to structure, but contained within budget envelope, to bring support to the Executive team in delivering key organisational development projects, for example supporting the governance review, client reporting and operating model development.

3.34 LCIV is currently reviewing the roles and requirements of the Q2 planned hires and will revise plans as required. The table below provides a summary status against the Business Plan.

MTFS Plan Hire Dates	Resource	Job Posted	Interviews Initiated	Offer Made	Hire On-Boarded
Q1	Head of Global Equities ¹	✓	✓		
	AD Investment Oversight/Performance ²				
	Client Relationship Assistant (retitled Client Relations Executive)	✓	✓	✓	✓
	Fund Accountant	✓	✓	✓	September
	Systems/Data Manager ³	✓			
Q2	Head of Fixed Income/Alternatives	✓	✓	✓	✓
	Management Accountant				
	Operations Assistant ⁴				
	Project Manager ⁴				
Q3	Head of Real Estate/Infrastructure ⁵				
	Risk Officer (retitled Chief Risk Officer)	✓	✓	✓	✓
Q4	Client Relationship Assistant (retitled Client Relations Executive)				
	Administrative Assistant				

1. Engagement delayed as offer made to initial candidate was eventually turned down
2. Role and requirements under review due to integrating performance reporting into Chief Risk Officer role
3. Role on hold pending wider IT infrastructure and system decisions
4. Role and requirements under review
5. Role being brought forward in plans in light of client demand for products in this areas

- 3.35 The process for recruiting two additional Non-Executive Directors (NEDs) has been completed and LCIV are going through the process to sign contracts and on-board the two successful candidates, Linda Selman and Paul Niven, for a three year term. Both candidates will bring extensive knowledge and experience of investment and fund management and will add additional strength to the Board.
- 3.36 A full Invitation to Tender was released to three potential providers for a Governance review. The purpose of the review is to consider the governance structures associated with the Pooling arrangements for the London LGPS funds as currently undertaken through LCIV and recommend potential improvements to ensure that all stakeholders have the necessary and appropriate level of engagement and influence, and that decision making is correctly positioned and defined. This would take into account the fiduciary, regulatory and statutory responsibilities of LCIV, its directors and officer and the investing LGPS funds.
- 3.37 Responses have been received from two of the three, the third dropped out due to resource constraints and other commitments. Having reviewed the submissions the process for engaging with an independent provider to carry out the review is nearing completion. A Project Steering Committee has been set up to review the submissions and, if content, award the contract at its meeting on 12 July.
- 3.38 The Steering Committee has been established to scope, resource, and oversee the delivery of the London CIV Governance Review project and ensure the project is aligned with stakeholder needs and meets the overall objectives of the review. The Steering Committee will also be the leadership group reviewing the draft final report and recommendations and providing any necessary clarifications to finalise the report.
- 3.39 The Project Steering Committee is responsible for:
- a) Ensuring the project is aligned with all stakeholder needs;
 - b) Establishing the project scope, deliverables and timelines;
 - c) Agreeing the approach for selecting the service provider to complete the governance review;
 - d) Overseeing delivery of the project;
 - e) Resolving any strategic issues or potential scope, timeline or budget changes to the project;
 - f) Reviewing and approving final project deliverables;
 - g) Reviewing recommendations and making proposals for action to the Board, the Pensions CIV Joint Committee and London Councils Leaders' Committee;
 - h) Establishing an effective plan to communicate findings, recommendations and action points to broader stakeholder groups.

- 3.38 The Project Steering Committee comprised of:
- Mark Boleat (City of London) (Chair of the Committee)
 - Lord Kerslake (Vice Chair of the Committee)
 - Eric Mackay (LCIV NED)
 - Cllrs Johnson (Ealing) and Heaster(Wandsworth)(PSJC Party Group Chairs)
 - Ian Williams (Hackney) and Gerald Almeroth (Sutton) (SLT representatives)
- 3.39 It is planned that research will happen through July and August. The draft report and recommendations will be considered by the Steering Committee, this Joint Committee, and the Board, before being presented to London Councils' Leaders' Committee as a final report for adoption at its meeting of 10 October.
- 3.40 LCIV had submitted a statement of compliance with the Stewardship Code to the FRC. This has been accepted by FRC as meeting the requirements of a Tier One Asset Owner for the purpose of assessment against the Code i.e. the highest tier for an asset owner. A copy of the Statement can be found on the FRC website: <https://www.frc.org.uk/FRC-Documents/Corporate-Governance/Stewardship-Code/London-CIV.pdf>
- 3.41 For asset managers there are 3 levels of compliance with the Code against which asset managers are assessed. In terms of LCIV's external managers, both current and those scheduled for sub-fund launch over the coming months, the table below sets out the levels of compliance with the Code:

External Manager	Stewardship Code Compliance Tier	Asset Class	Additional Comments
Allianz	1	Global Equity	
Baillie Gifford	1	Global Equity DGF	
EPOCH	TBA	Global Equity Income	Statement of Compliance submitted to FRC for evaluation
Henderson	1	Emerging Markets	
Longview	1	Global Equity	
Majedie	1	UK Equity	
Newton	1	Global Equity Real Return	
Pyrford	2	Total Return	Manager seeking to upgrade to Tier 1
RBC	1	Sustainable Global Equity	
Ruffer	1	Absolute Return	
Passive Manager			
LGIM	1	Passive Life Funds	External to LCIV platform
BlackRock	1	Passive Life Funds	External to LCIV platform

- 3.42 Members of the Pensions Sectoral Joint Committee has agreed a voting policy which recognises the importance of collaborative working and to use as a basis for voting, the alerts issued by LAPFF in connection with voting. The alerts issued by LAPFF are forwarded to LCIV's external managers and asked to vote in accordance with the alert and for clear explanations to be provided where for wider investment or company reasons they have not followed the alert.
- 3.43 Over the quarter to 30th June 2017, LCIV received 11 voting alerts from LAPFF which were passed across to the LCIV delegated and direct managers for action. The table below sets out the voting alerts received and the manager response. Where they did not vote in line with the alerts, fuller explanations have been sought.

LAPFF Voting Alerts		Equities				DGF/ TRF				Passive LGM
Voting Alert	Date	Allianz	BG GAG	Majedie UK	Newton GE	BGDGF	Pyrford	Ruffer	Newton TR	
Fund Inception Date		02/12/2015	11/04/2016	18/05/2017	22/07/2017	15/02/2016	17/06/2016	21/06/2016	16/12/2016	
Smith & Nephew - Oppose Remuneration Policy	03/04/2017	Nil holdings	Nil holdings	N/A	N/A	Nil holdings	Nil holdings	Nil holdings	Nil holdings	Voted for policy post consideration of issues
GlaxoSmithKline - Oppose pay policy	21/04/2017	Nil holdings	Nil holdings	N/A	N/A	Nil holdings	Vote in line with alert	Nil holdings	Voted for management	Voted for policy post consideration of issues
Wells Fargo - Vote for reviewing business standards	21/04/2017	Nil holdings	Nil holdings	N/A	N/A	Nil holdings	Nil holdings	Nil holdings	Nil holdings	Voted in line with alert
PPL - Vote for providing 2 degree analysis	02/05/2017	Nil holdings	Nil holdings	N/A	N/A	Nil holdings	Nil holdings	Nil holdings	Nil holdings	Voted in line with alert
BP - Vote for pay policy	02/05/2017	Nil holdings	Nil holdings	N/A	N/A	Nil holdings	Voted in line with alert	Vote in line with alert	Nil holdings	Vote in line with alert
EnQuest - Oppose re-election of Chair of nomination committee	08/05/2017	Nil holdings	Nil holdings	N/A	N/A	Nil holdings	Nil holdings	Nil holdings	Nil holdings	Voted in line with alert
Shell - Vote for pay policy	09/05/2017	Nil holdings	Nil holdings	N/A	N/A	Nil holdings	Vote in line with alert	Nil holdings	TBA	Voted in line with alert
Exxon - Climate Change Policy Impact Reporting	17/05/2017	Nil holdings	Nil holdings	N/A	N/A	Nil holdings	Nil holdings	Vote in line with alert	Nil holdings	Voted in line with alert
Chevron - Produce a report on its low carbon transition efforts	17/05/2017	Nil holdings	Nil holdings	N/A	N/A	Nil holdings	Nil holdings	Nil holdings	Nil holdings	Voted in line with alert
WPP - Oppose Pay Policy	19/05/2017	Voted for policy post consideration of issues	Nil holdings	Nil holdings	Nil holdings	Nil holdings	Nil holdings	Nil holdings	Nil holdings	Voted for policy post consideration of issues
Babcock - Oppose Pay Policy	29/06/2017	Nil holdings	Nil holdings	Nil holdings	Nil holdings	Nil holdings	Nil holdings	Nil holdings	Nil holdings	TBA

4. COMMENTS OF THE CHIEF FINANCE OFFICER

- 4.1 The Corporate Director, Resources is satisfied that all material, financial and business issues and possibility of risks have been considered and addressed and that the proposed MiFID II process offers a clear structure to opting up to elective professional status.

5. LEGAL COMMENTS

- 5.1 The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 requires administering authorities to formulate and to publish a statement of its investment strategy by 1 April 2017.

6. ONE TOWER HAMLETS CONSIDERATIONS

- 6.1 The employer's contribution is a significant element of the Council's budget and consequently any improvement in investment management and performance will reduce the contribution and increase the funds available for other corporate priorities.
- 6.2 A viable pension scheme also represents an asset for the recruitment and retention of staff to deliver services to the residents.

7. BEST VALUE (BV) IMPLICATIONS

- 7.1 The effective and efficient management of Fund assets and achievement of performance targets are key to the achievement of the funding strategy objectives and this is considered to be a good decision which can result in greater cost savings to the fund.

8. SUSTAINABLE ACTION FOR A GREENER ENVIRONMENT

- 8.1 There is no Sustainable Action for A Greener Environment implication arising from this report.

9. RISK MANAGEMENT IMPLICATIONS

- 9.1 The overall objective of MiFID II is to reduce the risk of mis-selling by the investment industry. By classifying local authority clients as "retail" clients by default, thus requiring the elective professional opt up process, asset managers are required to assess the knowledge of the collective decision making group before taking them on as clients.
- 9.2 The rigorous robust management of LBTH Pension Fund results in better quicker and more effective decision making which can lead to better Fund performance and reduction in the contribution required from the Council towards the Fund. The monitoring arrangement for the Pension Fund and the work of the Pensions Committee should ensure that the Fund optimises the use of its resources in achieving the best returns for the Council and members of the Fund.

10. CRIME AND DISORDER REDUCTION IMPLICATIONS

- 10.1 There are no crime and disorder reduction implications arising from this report.

Linked Reports, Appendices and Background Documents

Linked Report

- NONE

Appendices

Local Government Act, 1972 Section 100D (As amended)

List of “Background Papers” used in the preparation of this report

- NONE

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