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Cabinet Office and Department for Communities and Local Government

Design of the structure and governance of efficient and effective CIVs for LGPS Funds

Cabinet Office and DCLG

November 2015

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Cabinet Office
70 Whitehall
London, SW1A 2AS

and

Department for Communities and Local Government
2 Marsham Street
London, SW1P 4DF

20th November 2015

Dear Sirs,

Design of the structure and governance of efficient and effective CIVs for LGPS Funds

We enclose our revised report on the design of the structure and governance of efficient and effective collective investment vehicles ("CIVs") for LGPS Funds (the "Report"). The Report has been produced in accordance with the instructions in the Award Letter dated 4th December 2014.

The Report sets out our analysis of certain technical aspects (legal, regulatory and tax) for the CIV structure as well as some governance and operational considerations. The analysis in this Report is based on the law and our understanding of the prevailing interpretation and practice of the relevant authorities as at 22nd December 2014.

The Report has been adjusted at your request from an earlier report on the same subject so that it is consistent with paragraph 2.19 of the red book issued as part of the Chancellor's Summer 2015 Budget, which invited ambitious proposals for pooling.

In accordance with the Award Letter and discussions with the Cabinet Office and the Department for Communities and Local Government ("DCLG") we address this Report solely to the Cabinet Office and DCLG.

It has been a pleasure to work with you on these matters. If you have any queries please do not hesitate to contact us.

Yours faithfully,

Amanda Rowland
Partner, Asset Management Regulatory

Mark Packham
Director, Public Sector Pensions

cc Clifford Sims, Squire Patton Boggs

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1. Executive Summary

1.1 Introduction

This Report, in accordance with the agreed scope for our work, sets out a possible approach for Collective Investment Vehicles ("CIVs") for LGPS Funds, using the Authorised Contractual Scheme ("ACS"). In our view, based on the scope and objectives, the ACS structure is the best way for the LGPS to establish suitable and effective CIVs from a legal, tax and regulatory perspective.

We have examined the ACS structure for its applicability in pooling the listed assets of the 89 LGPS Funds in England and Wales. We have drawn up a number of options for the construction or procurement of ACS Operators for further consideration, and we have suggested a governance context that would allow effective participation by groups of LGPS Funds.

This Executive Summary provides a brief outline of the main characteristics of the proposed structures and entities. We strongly recommend that it is read in the context of the detailed sections which follow (having reference to the Glossary in appendix 1) as they provide further context and develop important themes introduced here.

The scope and your instructions did not include consideration of structures other than CIVs, such as Joint Committees, Frameworks or Joint Procurement, or the best approach for holding unlisted assets within a CIV.

1.2 Features of the ACS structure

We have concluded that the ACS is the most appropriate model for the pooling of certain assets of the 89 LGPS Funds into CIVs. The ACS was introduced into the UK funds landscape in 2013.

Of the two available forms for an ACS the co-ownership model whereby the LGPS Funds will hold units in the ACS is the most suitable for this purpose. This model permits the operation of a number of sub-funds under the one vehicle resulting in greater efficiency in terms of both establishment and ongoing costs than other alternatives.

A co-ownership ACS is not itself subject to UK corporation tax, income tax or capital gains tax. The co-ownership ACS is tax transparent for income. Pension funds typically favour tax transparent vehicles so that they do not suffer 'tax drag' on their overseas investment returns. Management services supplied to the ACS should be exempt from VAT under the management of 'special investment funds' exemption. The tax position is described in greater detail in Section 3.4.

ACSs and their Operators will require authorisation by the FCA and will be subject to its ongoing supervision. Each sub fund of the ACS may have its own investment objectives and different investment managers may be appointed for each thereby allowing the ACS to benefit from the full range of cost efficiency, expertise and market performance available in the market.

The preferred investment scheme for an ACS is the Qualified Investor Scheme ("QIS"). A QIS has very wide powers of investment, both in terms of asset type and concentration. It will therefore offer a wide range of investment freedoms and gives the potential for one type of CIV that can accommodate many asset classes should this be desirable.

1.3 Delivery models for the Operator

The ACS structure requires there to be an Operator, to be authorised by the FCA. There are two main potential delivery models for an Operator: build or appoint. Both options are set out with an analysis for decision-making. Ultimately, the choice between them will depend on the priority given to the criteria used to decide between them.

- Building an Operator may score highly as a way to engage participating LGPS Funds and to ensure value for money.
- Appointing an Operator is the faster and the lowest initial cost route to setting up an ACS, but the route would rely on successful initial commercial negotiation, partnership working and rigorous change management during the contractual period if unforeseen costs are to be avoided.

Delivery models involving private sector partners have lower initial set up costs. However, it is very likely that these costs will ultimately be passed back as operating costs over the life of commercial agreements.

1.4 The governance context

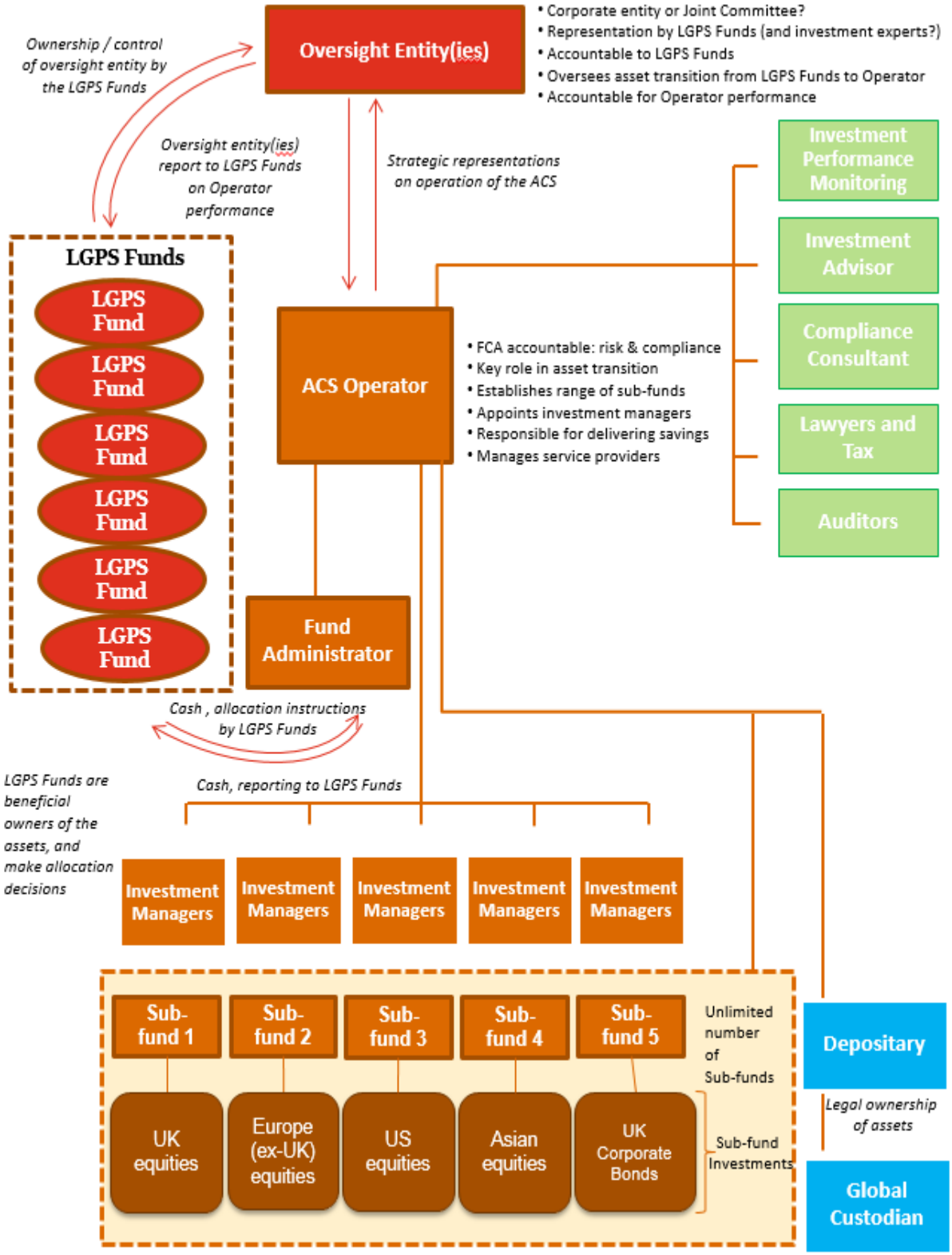
A practical way to separate the operational and oversight functions will be needed. The Operator would be responsible for delivering the envisaged savings, and its key functions will be to establish investment sub-funds, and to appoint, manage and dismiss investment managers to operate them.

Oversight would then be by a separate body or bodies. These might include a Joint Committee or a corporate entity, or a combination of entities. They would be accountable to the LGPS Funds which participate in a given CIV or ACS for the performance of the Operator.

The primary benefits of the separation of the operator and oversight functions are:

- As a body that does not require FCA regulation, the oversight entities could bring a range of perspectives to the oversight role. The participating LGPS Funds would be properly represented, channelling their voices through the oversight entities.
- The Operator can focus solely on meeting investment challenges, to deliver investment savings and performance for the LGPS as a whole, delivering long term investment performance, at scale, in each asset class that it offers.
- The ability, if using the build model, to deliver an Operator that meets the precise investment needs of the participating LGPS Funds.

The wider governance context is illustrated in the schematic below. From the perspective of the participating LGPS Funds, there would be non-executive input through the oversight entities. Day to day interactions involving cash flows and asset allocation instructions would be through the Administrator appointed by the Operator. The investment performance of each LGPS Fund would depend on its choice of asset allocation, with reliance on the Operator to deliver effective performance from each sub-fund.


Ownership / control of oversight entity by the LGPS Funds
Oversight Entity(ies)
• Corporate entity or Joint Committee?
• Representation by LGPS Funds (and investment experts?)
• Accountable to LGPS Funds
• Oversees asset transition from LGPS Funds to Operator
• Accountable for Operator performance
Oversight entity(ies) report to LGPS Funds on Operator performance
Strategic representations on operation of the ACS
Investment Performance Monitoring
Investment Advisor
Compliance Consultant
Lawyers and Tax
Auditors
LGPS Funds
LGPS Fund
LGPS Fund
LGPS Fund
LGPS Fund
LGPS Fund
LGPS Fund
ACS Operator
• FCA accountable: risk & compliance
• Key role in asset transition
• Establishes range of sub-funds
• Appoints investment managers
• Responsible for delivering savings
• Manages service providers
Fund Administrator
Cash , allocation instructions by LGPS Funds
LGPS Funds are beneficial owners of the assets, and make allocation decisions
Cash, reporting to LGPS Funds
Investment Managers
Investment Managers
Investment Managers
Investment Managers
Investment Managers
Sub-fund 1
Sub-fund 2
Sub-fund 3
Sub-fund 4
Sub-fund 5
Unlimited number of Sub-funds
UK equities
Europe (ex-UK) equities
US equities
Asian equities
UK Corporate Bonds
Sub-fund Investments
Depositary
Legal ownership of assets
Global Custodian

2. Introduction

2.1 Background

At the time we conducted research for this Report, the Cabinet Office and DCLG were working together to consider potential reforms to the way in which the 89 LGPS Funds in England and Wales could be operated and invested. The overall aim of any proposed reform was understood to be the delivery of administration and investment management savings to support the long term sustainability of LGPS. It had been recognised that by far the greater savings would arise from new investment approaches. This Report considers only the investment management structure and its operation, as described below.

The prior Consultation on the subject (which opened on 1 May 2014 and closed on 11 July 2014) was predicated on the basis that the LGPS Funds would not merge and would retain responsibility for asset allocation between asset classes. There was also an assumption that significant savings can be achieved from greater use of passive management within some listed asset classes and that a CIV or CIVs should be established for listed and alternative asset classes.

Before putting proposals to Ministers, the Cabinet Office and DCLG wished to obtain advice on various technical and operational considerations, associated with the CIV approach. PwC ("We") were therefore engaged to provide advice in the specific areas set out below.

Acronyms and other defined terms are listed in the Glossary (Appendix 1) for ease of reference.

2.2 Scope

We were engaged under the Award Letter to undertake a preliminary piece of work with focus only on a limited range of specific issues, namely:-

- A technical analysis of possible design options for CIVs, focusing in particular on legal, tax and regulatory issues in relation to listed assets;
- Presentation of options for operational structures for the preferred CIV model; and
- The governance arrangements for such model(s) with emphasis on achieving an effective governance framework with LGPS Fund representation.

Specifically excluded from the scope of our work were:-

- Consideration of the ownership structure of CIVs and whether participation would be voluntary;
- Analysis of any aspect of transition of assets to a CIV;
- Comparison of different investment models (for example passive or active) for asset classes;
- Consideration of costs of ongoing ownership; and
- Any analysis of the implications of the IORP Directive ("IORP") applying to the LGPS, given that you had told us that Central Government would be considering this issue separately.

In preparing this Report, we have relied on legal advice provided to us by our sub-contractor Squire Patton Boggs (UK) LLP ("SPB"). Neither PwC not SPB accepts liability to any third parties in respect of any legal opinions expressed in this Report. Third parties are advised to take independent legal advice in respect of any legal matters arising out of this Report.

This document has been prepared only for the Cabinet Office and DCLG and solely for the purpose and on the terms agreed with the Cabinet Office and DCLG in our agreement dated 4 December 2014. We accept no liability (including for negligence) to anyone else in connection with this Report, and it may not be provided to anyone else without our prior agreement.

The analysis in this Report is based on the law and our understanding of the prevailing interpretation and practice of the relevant authorities as at 22 December 2014.

3. Technical analysis of the investment vehicle

3.1 Selection of Entity Structure

In selecting the most appropriate entity structure for a CIV for a group of participating LGPS Funds we considered the following possible forms:-

- authorised unit trust ("AUT");
- open-ended investment company ("OEIC");
- limited partnership ("LP");
- authorised contractual scheme ("ACS") – which can take the form of a limited partnership or a co-ownership scheme; and
- unit-linked life assurance fund.

These were the vehicles identified in the Hymans Robertson report of December 2013 (LGPS structure analysis) (the "December 2013 Report"). The selection of these vehicles was made partly on the basis of the current LGPS Investment Regulations (which expressly reference four of the five vehicles) and partly to recognise the introduction of the ACS as an alternative CIV even though the LGPS Investment Regulations are silent on the ACS. We have set out brief comparative information below to show how the choice of entity structure for the CIV was reached.

3.1.1 AUT

AUTs are established under section 242 of the Financial Services and Markets Act, 2000 ("FSMA"). These are schemes established by trust deed between the authorised fund manager ("AFM") and the trustee. They are regulated by the Financial Conduct Authority ("FCA") and must be authorised before they can be launched to investors. The AFM is considered the operator of the AUT and takes on all regulatory responsibility for the scheme; this includes ensuring it is investing in accordance with its investment powers and investment policies. The trustee is responsible for keeping the AUT's investments in safekeeping and is responsible for overseeing the AFM, ensuring it is acting in accordance with the FCA's rules.

An AUT may have an unlimited number of sub-funds which may have investment strategies and objectives independent of each other. However, such sub-funds do not have the same legal separation as exists for segregated sub-funds of an OEIC or ACS.

An AUT is a tax opaque entity. AUTs are exempt from UK tax on capital gains and subject to a 20% tax on income. However, as UK and foreign dividends are exempt from tax and relief is available for expenses (e.g. management, depositary/trustee, authorisations and audit fees in the case of equity funds), such funds typically pay minimal UK Corporation Tax. AUTs have access to many of the UK's tax treaties in their own right.

3.1.2 OEIC

OEICs are created under the OEIC Regulations. An OEIC is established as a body corporate in its own right. One of the directors must be the authorised corporate director ("ACD") which is responsible for the regulatory oversight and operator role of the OEIC. OEICs are regulated by the FCA and must be authorised before they can be launched to investors. The ACD takes on a similar role to the AFM in an AUT. The OEIC must have a depositary, which has similar responsibilities (of safekeeping and oversight over the ACD) to the trustee of an AUT.

As with an AUT, an OEIC may have an unlimited number of sub-funds, each of which may have investment strategies and objectives independent of each other. As for an AUT, an OEIC is a tax opaque entity. OEICs are taxed in broadly the same way as AUTs.

3.1.3 LP

LPs are unregulated schemes, although any LP would need an entity authorised by the FCA to operate it. Assuming the LP would be an alternative investment fund ("AIF") under the alternative investment fund managers directive ("AIFMD"), the Operator would require authorisation as an alternative investment fund manager (AIFM). An LP is set up between a general partner and the investors, who become limited partners in the scheme under a partnership deed meeting the requirements of the Limited Partnerships Act 1907.

An LP can only be a standalone scheme, meaning it is necessary either to mix all investments and investment strategies within the same LP, or to set up several LPs to handle different investment strategies (for example, one LP for UK equities, one LP for Europe ex-UK equities and so on). It cannot therefore accommodate an umbrella structure in the same way as an AUT, OEIC or ACS.

An LP is a tax transparent entity; this means that all income and gains from underlying investments would be treated as arising directly to investors. No UK corporation tax would be payable at the vehicle level

3.1.4 ACS

ACS were introduced as a potential form of investment vehicle in 2013. They can take two different forms, these being a limited partnership (a regulated version of the structure described in 3.1.3) and a co-ownership scheme established by a contractual deed between the ACS operator and the trustee. The ACS operator and trustee have similar roles to the AFM and trustee of an AUT. Both types of ACS are regulated by the FCA and must be authorised before they can be introduced to investors.

The co-ownership ACS may be created as an umbrella scheme with an unlimited number of sub-funds which may have investment strategies and objectives independent of each other. As with an unregulated LP, a limited partnership ACS can only be a standalone scheme meaning it would be necessary either to mix all investments, and investment strategies, within the same LP or set up several LPs to handle different investment strategies (for example, one LP for UK equities, one LP for Europe ex-UK equities and so on).

The tax treatment of the LP version of the structure should follow that of the LP described above. The co-ownership scheme has been designed with the objective of being tax transparent to income, but tax opaque for capital gains This ACS should be exempt from UK corporation tax on capital gains in the same way as UK AUTs and OEICs.

3.1.5 Unit-linked fund

A unit-linked life fund is solely owned by the establishing insurance company. Unlike the other structures described here a unit-linked fund sits outside the UK definition of a Collective Investment Scheme ("CIS") in section 235 FSMA. The fund sits on the balance sheet of the insurance company rather than having a depositary/trustee responsible for the assets. Investors also own no part of the underlying investments; instead they have contractual rights as policyholders.

Sub-sections of a life company's fund can be created but because the life company owns the assets, this sectionalisation is really an accounting tool rather than a way of creating an effective legal separation of assets.

3.1.6 Rationale for selection of a co-ownership ACS

As a result of our analysis, briefly summarised above, we have determined the most suitable CIV legal structure for the LGPS Funds to be a co-ownership ACS.

Firstly, we considered that a regulated entity with the protective restrictions placed over it would be more appropriate than an unregulated structure given the nature of the assets and interests within it. This

discounted the unauthorised LP as an appropriate entity. There was also the additional complexity of requiring a potentially large number of similar entities to cover different investment strategies resulting in more inefficiencies and higher costs. The tax position of the LP is similar to and no more advantageous than the ACS.

Secondly, we discounted the unit linked fund as it would not afford the participating LGPS Funds the right of ownership over the underlying assets themselves and has an inferior tax position in some respects. We believe this would be an unattractive proposition.

The regulatory rules under which AUT, OEIC and ACS operate are largely the same and often driven by scheme type rather than legal structure (section 3.2 has more information on scheme type). Of the three, we concluded that the ACS is the preferred choice because it is likely to offer the most tax efficient solution for the LGPS Funds as a result of its tax transparency. The tax treatment of a co-ownership ACS is discussed in more detail in section 3.4.

Of the two forms of ACS, we consider the co-ownership vehicle, set up under contract, to be favourable to a limited partnership ACS in this case. This is primarily because the limited partnership scheme would require a number of investment schemes to be established as it cannot operate as an umbrella scheme. This would almost certainly increase both establishment and ongoing costs. The co-ownership ACS, on the other hand, may operate a number of sub-funds under one investment structure and thereby offers simplicity and efficiency of structure. Additionally, the structure provides the LGPS Funds with an ownership interest directly related to the scheme assets in that the LGPS Funds will hold units in the ACS and will be beneficial owners of the ACS assets as tenants in common.

3.2 Choice of scheme type

With the structure of the entity being a co-ownership ACS the investment scheme may be established as:

- an undertaking for collective investment in transferable securities ("UCITS");
- a non-UCITS retail scheme ("NURS"); or
- a qualified investor scheme ("QIS").

Whilst a scheme can have an unlimited number of sub-funds these must all be the same as the scheme type – for example, a UCITS ACS could only have sub-funds meeting the UCITS requirements.

3.2.1 Rationale for choosing a QIS

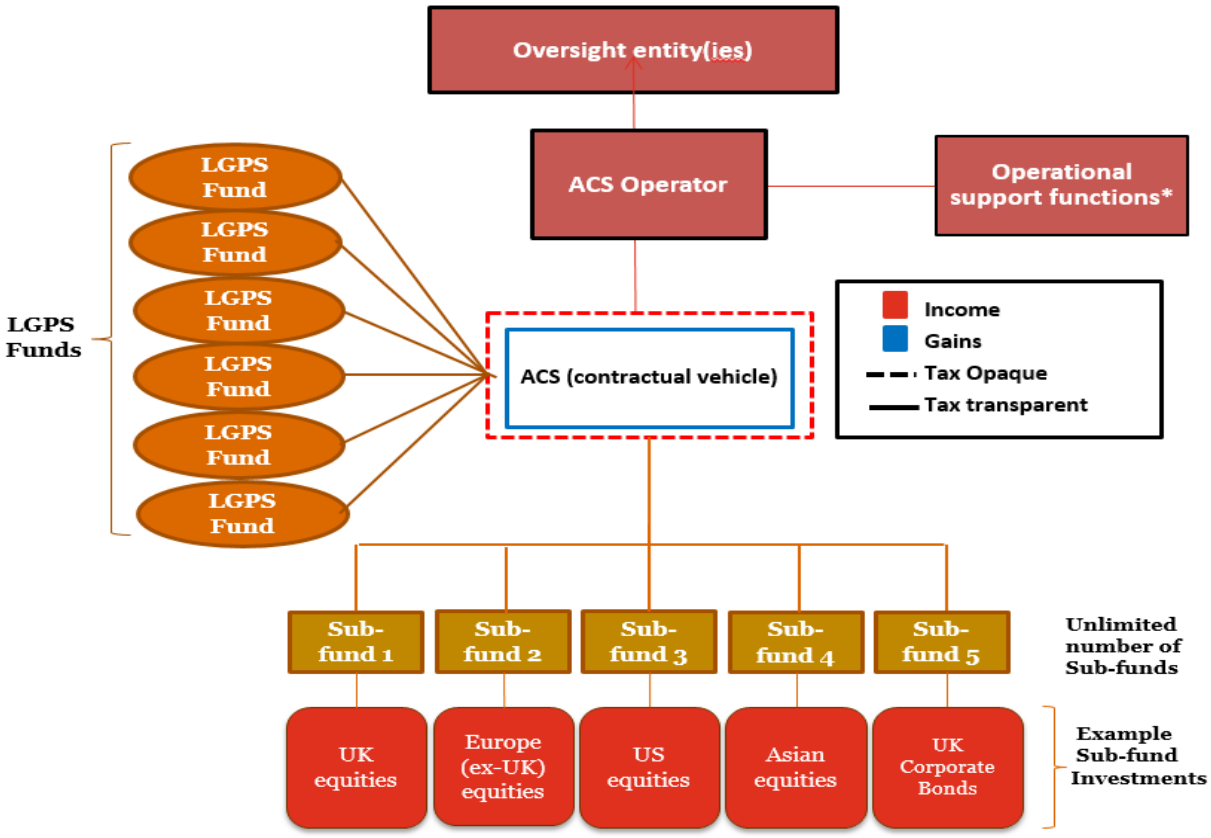
Given the objectives of the proposed structure, we believe a QIS to be the most suitable scheme type for the new ACS. A QIS has very wide powers regarding the types of assets in which it can invest (which includes all specified investments in the Financial Services and markets Act (Regulated Activities) Order ("RAO") and can hold any concentration of assets as long as this fits with its investment policy and investment strategy. It therefore offers a wide range of investment freedoms and may track an index both actively or passively through other tracker funds. Index-tracking is possible through both UCITS and NURS but these introduce more regulatory requirements and more restrictive investment powers which also require careful monitoring.

Further, establishing the ACS as a QIS provides a vehicle which can invest in a wide range of alternative assets and thereby may enable use of one type of CIV structure for all investment types.

Appendix 2 sets out a comparative table of the three scheme types and description of the UCITS and NURS schemes.

3.3 Authorised Contractual Scheme (ACS) Analysis

3.3.1 Background to an ACS



*the operational support functions are detailed in the diagram included in section 4.

The FCA's rules for the authorisation of an ACS came into force on 1 July 2013. The main regulations are set out in Statutory Instrument (SI) 2013/1388 Collective Investment in Transferable Securities (Contractual Scheme) Regulations 2013.

The ACS will be operated by the Operator, which will be either an AIFM or a UCITS Management Company depending on whether the scheme is a NURS/QIS (AIFM) or UCITS (UCITS Management Company). As set out in more detail in section 4 of the Report, an oversight entity(ies) would oversee the Operator, though the Operator itself is responsible for all regulatory requirements relating to itself and the ACS.

The co-ownership ACS and the Operator will both need to be authorised by the FCA before they can begin to provide services (see section 3.5). The ACS may have an unlimited number of sub-funds to meet the investment needs and asset allocations of the LGPS Funds. As set out in section 3.6 each sub-fund is protected by FSMA from meeting the losses of any of the other sub-funds. Each LGPS Fund is also protected from a requirement to make good any losses in a sub-fund in which it owns units, over and above the capital already invested.

Each sub-fund of the ACS may have its own investment objective (e.g. seeking capital or income return over particular time periods) and invest in its own assets. Further, each sub-fund may have a different (or a

number of) investment managers appointed. This means that specific investment manager(s) selected for cost efficiency, performance record or expertise in a particular investment form, or asset class may be appointed by the Operator.

3.3.2 What is tax transparent pooling and what are its benefits?

When HM Treasury established the ACS, it intended that it would work, in tax terms, in broadly the same way as competing existing equivalent vehicles do e.g. the Luxembourg Fonds Commun de Placement ("FCP") and the Irish Common Contractual Fund ("CCF"). This involved drafting the legislation to try to ensure foreign tax authorities would regard the vehicle as transparent for income tax purposes, as well as deeming the units to be treated as shares for UK capital gains tax purposes only.

Investment pooling is the term used to describe the aggregation of different investors' assets into a common fund vehicle. It offers investors the opportunity to diversify their portfolio and spread portfolio risk, and to achieve centralised administration, enhanced governance and risk management, and cost savings from economies of scale. Pooling can take place through a vehicle which is opaque for tax purposes, or one which is regarded as tax transparent.

The pooling of assets in a fund which is transparent for tax purposes means that income and gains from investments made by the fund accrue to each investor in proportion to its holding in the fund, without changing their character, source and timing. In other words, the fund is "looked through", and investors are treated for tax purposes as if they held their proportionate share of the underlying investments directly.

The benefit of this is that investors should be able to access the treaty benefits of their home jurisdiction, provided that both the jurisdiction of the investor and investment view the fund as tax transparent. Where viewed as tax transparent, this will allow investors to take full advantage of the relevant double tax agreement as if they had invested directly, while achieving the administrative benefits and scale efficiencies of pooling.

Where the pooling vehicle is regarded as tax transparent, withholding tax rates are applied based on the double taxation treaties concluded between the country of the investor and the country of the underlying investments. This allows investors such as pension funds, which are often eligible for a reduced withholding tax rate, to benefit from that rate as if they held the investments directly. The difference between withholding tax rates for pension funds investing in US equities through a tax transparent and non-tax transparent vehicle can be up to 30% and points to the clear advantage of a tax transparent pooling vehicle in such a case.

In addition, it is usually preferable that the master fund in the master/feeder structure introduced by the UCITS IV Directive is tax transparent, in order to be attractive to feeder funds in different jurisdictions with different tax profiles.

An example of an ACS pooling arrangement can be seen on the diagram in section 3.3.1 above.

3.4 Tax treatment of a contractual ACS

3.4.1 UK tax at the fund level

Income

A contractual ACS does not have its own legal personality and as such, is not within the charge to direct UK tax (ACS are specifically excluded from the definition of a company for the purposes of the Corporation Tax Acts by CTA2010/S2212(1)). Consequently, the LGPS Funds, as participants in an ACS, would be liable to tax on their proportionate share of the net income of each sub-fund in which they invest. However, one would anticipate that the LGPS Funds would be exempt from UK tax on any net income allocation by virtue of their status as UK registered pension schemes.

Capital gains

Capital gains are not treated as arising on a participant's share of assets held in a sub-fund, but instead, a unit in an ACS is treated as if it were an asset purely for the purposes of tax on capital gains. Investors in an ACS are therefore subject to capital gains made on their interest in an ACS and not on movements in the underlying assets of an ACS. As such, for the purposes of UK tax on chargeable gains only, the ACS units are deemed to be shares in a company with the result that UK unit holders will not be liable to tax on chargeable gains realised by each sub-fund.[1] UK unit holders may instead be liable to tax on chargeable gains arising from the redemption, transfer or other disposal of ACS units depending on their own UK tax status. In particular, as the LGPS Funds are registered pension schemes, they would not be expected to be subject to capital gains tax on disposal or redemption of ACS units.

Switches between units in one sub-fund of an ACS to units in another sub-fund should generally be treated as a disposal for this purpose, but conversions of units between classes within a sub-fund should not.

3.4.2 Foreign tax considerations

On the international tax front, the ACS has been designed in such a way that it should generally qualify for tax transparent treatment in overseas jurisdictions, although ultimately this will be a matter for local fiscal authorities to determine.

We expect ACS to be regarded as tax transparent in at least all the jurisdictions that accept the tax transparency of Luxembourg FCPs, as they have been designed with many similar key features. As a result investors in them will qualify for double tax convention-reduced rates of withholding tax on their underlying investments.

Whilst HMRC initially indicated its intention to write to its foreign counterparts to explain the new ACS scheme and to follow this up with informal contacts to seek views on whether these overseas jurisdictions would treat UK co-ownership schemes as tax transparent, at the time of writing, no such correspondence has been issued.

In the event it is decided to proceed with the ACS, it would be necessary to obtain confirmation from the tax authorities in the relevant tax jurisdictions that they would in fact regard the ACS as tax transparent. The UK tax authorities would support any such approach.

Where practical and appropriate, we anticipate that investment managers for an ACS ("ACS providers") would seek to achieve reduced rates of withholding tax on foreign source income at source. To facilitate this, we anticipate that ACS providers will require each unit holder to supply the appropriate tax information forms for particular income types. If it is not practical or possible for any reason to claim relief at source, then the unit holders may in certain circumstances be able to make their own tax reclaims.

Tax transparency is considered to be a desirable characteristic of an investment vehicle, as generally pension schemes can access much more preferential rates of withholding taxes in accordance with the UK's global tax treaty network. For example, the rate of withholding tax on US securities is 30%. This can be reduced to 15% for UK AUTs and OEICs. UK pension schemes, as LGPS Funds, access a tax treaty rate of 0%.

[1] The new s103D TCGA brings ACS units into s99B, which provides for units to be treated as shares in a company for chargeable gains purposes.

3.4.3 ACS Establishment: seeding arrangements

3.4.3.1 UK tax matters

Capital gains taxes

As a result of a legislative exemption, it will be possible to seed an ACS with existing assets without triggering a UK capital gains tax charge in the hands of the contributor.

Stamp taxes

a) Stamp Duty Reserve Tax ("SDRT")

Transfers of securities to a co-ownership scheme in consideration for an issue of units in it (i.e. an in specie seeding) are exempt from SDRT and stamp duty. Further, transfers of securities between sub-funds in an umbrella co-ownership scheme, are also exempt (this relief was granted to match the position in Luxembourg FCPs and Irish CCFs). There is also an exemption for the transfer of units in a co-ownership scheme.

b) Stamp Duty Land Tax ("SDLT")

If the participating Funds were to consider seeding property into the ACS, then they should currently be able to do so without triggering an SDLT charge. However, it should be noted that as part of the recent budget announcements, HMRC is considering introducing some anti-avoidance tax legislation in this area. What this may look like is the subject of ongoing consultation and consideration.

3.4.3.2 Foreign tax considerations

The mitigation of potential overseas capital gains taxes and potential overseas transaction taxes should be carefully considered on a jurisdiction by jurisdiction basis in order to minimise potential transaction costs.

3.4.4 Exit arrangements

3.4.4.1 UK tax matters

Liquidations

Capital gains tax would be payable on redemption of the units, which would be treated as a disposal of a share for capital gains tax purposes. However, pensions funds are exempt from UK capital gains taxes, so no such tax should become payable.

In specie redemptions

The investment managers may, in redeeming ACS units, decide to pay out in a form other than cash. No capital gains tax should arise in the ACS on the in-specie redemption. Where this is done, it would be treated as a disposal of the ACS units by the investor and an acquisition of the in-specie assets received at fair value.

Stamp tax considerations

If an ACS is wound up and its assets are distributed in specie to investors, this should not trigger an SDRT charge. No comment is provided on SDLT at this stage.

VAT considerations

The VAT treatment of the ACS is attractively simple. The supply of management services to tax transparent funds such as the ACS is VAT exempt[2], just as it is with OEICs and AUT.

3.4.4.2 Foreign tax considerations

The mitigation of potential overseas capital gains taxes and potential overseas transaction taxes should be carefully considered on a jurisdiction by jurisdiction basis in order to minimise potential transaction costs.

3.4.5 The QIS tax regulations

As mentioned previously, a QIS scheme is a type of AIF which can accept more 'sophisticated' investors, but is still subject to regulation by the FCA. The reason that a QIS structure is put forward is that a QIS has wider investment and borrowing powers than other AIFs, but is subject to lighter regulation as it is only open to 'qualified investors'.

Investors in a QIS may be corporates and other institutional investors (such as pension funds and charities) or sophisticated individual investors who regularly invest significant sums and can be expected to understand the risks associated with a wide range of investments.

Some established anti-avoidance tax legislation included in the QIS tax regulations (Regulation 14B SI2006/964) requires that an ACS should be "widely marketed" in order to avoid becoming subject to direct UK corporation tax.

However, since a contractual ACS is outside of the scope of direct UK tax (see 3.4.1) this potential piece of anti-avoidance legislation should not be in point.

3.5 Regulatory considerations

3.5.1 The ACS investment fund

An ACS will need to be authorised by the FCA before it can be launched and made available to participating LGPS Funds. An application will need to be submitted to the FCA's Fund Authorisation and Supervision team ("FAS") seeking authorisation. It will also be supervised on an ongoing basis by FAS. This application is similar for UCITS, NURS and QIS but there are some nuances as shown in the following table.

[2] SI 2013/1401 amends item 9 and Note 6 of Group 5 of Schedule 9 to the Value Added Tax Act 1994 (c.23) to insert ACS into the list of schemes and/or undertakings the management of which are exempt from VAT

	UCITS	NURS	QIS
Application form	Form 261C	Form 261C and submit a new fund under management application (AIFMD requirement)	Form 261C and submit a new fund under management application (AIFMD requirement)
Supporting documents	• draft prospectus • draft contractual scheme deed (with solicitor's certificate) • model portfolio for each sub-fund • draft KIID	Same as UCITS (though KIID optional)	Same as UCITS (though KIID not required)
Timeline	2 months (set by UCITS Directive) though FCA aims to approve 90% of applications within 6 weeks	6 months (under FSMA) though FCA aims to approve within 3 months (2 months from 1 April 2015)	6 months (under FSMA) though FCA aims to approve within 2 months (1 month from 1 April 2015)
Application fee	£2,400 for an umbrella scheme with sub-funds	£3,000 for an umbrella scheme with sub-funds	£4,800 for an umbrella scheme with sub-funds

In a typical case the FCA will nominate a dedicated case officer who will be responsible for reviewing the submitted application and working with the Operator (or typically the Operator's representative) to amend any parts of the application and documentation until they believe it meets the regulatory requirements. Once the case officer's work on the application is complete, it is passed to the team leader who will give overall approval to the application. At this point it will become an authorised scheme and will be listed on the FCA's financial services register.

The FCA may agree that the ACS application may be submitted alongside a new Operator application (if such an application needs to be submitted), though the FCA will not be able to authorise the ACS until the Operator itself has been authorised.

Once the ACS is authorised FAS will be responsible for supervising it and ensuring it operates within the regulatory requirements (for which the depositary and Operator are also responsible). In terms of supervision the ACS may be included in wider thematic reviews or more targeted "deep dives" undertaken by the FAS team. Whilst the FCA's FAS team will be supervising how the ACS acts, the onus will be on the Operator of the ACS to demonstrate how it is compliant.

An ACS Operator will also be responsible for submitting new applications to the FCA to notify a change to the scheme which requires investor notification. This could be (for example) a change in fees, change to the investment objective or strategy of a sub-fund, or change to one of the key players involved in the ACS and its sub-funds, as well as the launch of a new sub-fund.

3.5.2 The Operator

We set out the options regarding entity choice for the Operator of an ACS in section 5. This section 3.5.2 assumes that the decision is taken to establish a new Operator vehicle as a standalone. The Operator will need to be authorised by the FCA because it will be undertaking regulated activities as driven by the RAO. Specifically these are the activities of managing authorised AIFs because a QIS ACS will meet the requirements of being an AIF under the AIFMD. This permission would allow the Operator to carry out all activities connected with being an AIFM, including providing risk management, investment management, administration services, etc. Even if it delegates the investment management activity the Operator will still be responsible, from a regulatory perspective. The Operator will not be an investment firm under the

Markets in Financial Instruments Directive ("MiFID") because the operators of ACS and similar schemes are exempted from MiFID (Article 3).

A new Operator will need to be authorised first by the FCA before it can launch the ACS. An Operator will also be subject to ongoing supervision by the FCA once authorised.

Under FSMA the FCA has up to six months to determine complete applications seeking authorisation for a new entity (and up to 12 months to determine incomplete applications). There is no guidance on what constitutes a complete/incomplete application. Typically in our experience most applications will be treated as being incomplete on first submission as the FCA will raise further questions about part of the application. However, it typically takes no more than six months for an application to be authorised.

The application pack to be submitted to the FCA to seek authorisation as a new AIFM is very detailed and comprehensive. It will be necessary to provide detail around the business plan of the Operator (including committees that will be established around risk management, investment and remuneration), proposed fee structures, individuals who will play a key role in running the business, the types of funds it will be operating and any other relevant information on compliance and governance within the Operator.

Key individuals within an Operator will also require approval by the FCA under its approved persons regime for controlled functions ("CF"). These may include:

- Directors (who will hold CF1)
- Non-executive directors (who will hold CF2)
- Chief executive officer (who will hold CF3)
- Head of compliance (who will hold CF10)
- CASS oversight function (who will hold CF10A)
- Money laundering reporting office (who will hold CF11)
- Investment managers (who will hold CF30)

An Operator must assess each individual as being competent to hold their role before the application is submitted to the FCA. The FCA will then approve these individuals if it believes they are fit and proper, meeting its tests in the FIT (The Fit and Proper Test for Approved Persons) and APER (Statements of Principle and Code of Practice for Approved Persons) sourcebooks. Once approved these individuals may then be held to account if the Operator fails to meet its regulatory requirements in any specific area.

Further, an Operator must submit, or have available for submission, the policies and procedures it will use in relation to compliance (including a compliance monitoring programme), conflicts of interest, remuneration and business continuity. The FCA may also require information concerning any proposed outsource arrangements and those remaining in-house which it will carry out itself. It will not expect the Operator to be a "shell" or letterbox entity – it should carry out some business activities within the Operator as well as outsourcing to other specialist providers. As an AIFM this may mean that it performs risk management activities since investment management will likely be outsourced to specialist providers. Third parties may be contracted to assist in risk management provided they are working within the Operator rather than acting as a delegate of the AIFM. We have seen a number of firms operate under this structure when implementing AIFMD into their business over the last year.

Lastly, authorised firms must meet regulatory capital requirements. For the Operator these are driven by the UCITS Directive (if the ACS is set up as a UCITS scheme) or the AIFMD (if the ACS is set up as a NURS or QIS). Under the UCITS Directive the capital requirements will be:

- EUR125,000 + 0.02% of assets under management over EUR250,000,000; or
- one quarter of fixed operating costs (whichever is higher).

For an AIFM the capital requirement calculation is the same, but is capped at a maximum of EUR10,000,000[3]. Additionally, the AIFM must hold either professional indemnity insurance or additional regulatory capital (0.01% of assets under management) to account for professional liability risks that the Operator faces – for example, for loss of documents or an error by an individual within the Operator.

Once authorised, the Operator will be supervised by the FCA in accordance with its assessment of the correct supervisory level to be applied. The FCA will supervise the Operator both from a prudential and a conduct perspective. Depending on the level of supervision considered appropriate, the Operator may have a relationship supervisor appointed who is responsible for the regulatory supervision of the Operator. In this situation it is likely to have more frequent contact with the FCA and be monitored more closely to ensure it is operating within the FCA's rules and expectations.

If no direct supervisor is allocated then the Operator may well have more infrequent contact with the FCA – though could still be included in any thematic reviews or ongoing supervision work that reviews specific parts of the business and how it operates on a daily basis.

3.6 Legal considerations

3.6.1 ACS Structure

Under the ACS Regulations, there are certain pre-requisites about the structure of an ACS which need to be observed. As mentioned above, an ACS can take two forms: a "co-ownership scheme" or a "partnership scheme". Principally because of the fact that a limited partnership cannot have an umbrella structure (but would require multiple partnerships to offer LGPS Funds sub-funds for investment) and restrictions over the extent to which limited partners can become involved in any form of management of a limited partnership, we have disregarded the second of these structures.

A co-ownership scheme is defined under Section 235A FSMA as a CIS which satisfies certain conditions:

- the arrangements are contractual;
- they are set out in a deed between the operator and the depositary which itself contains certain prescribed provisions (see below);
- the scheme itself does not constitute a body corporate, partnership or limited partnership;
- the property subject to the scheme is held by or to the order of a depositary; and
- the property is owned beneficially by the participants as tenants in common.

What this means is that the ACS itself has no legal personality (if it were to be a separate person, that would undermine its tax transparency). Instead, the legal owner of the property is the depositary (i.e. a custodian in more common parlance), where the participants (or investors) are the beneficial owners of the underlying property. Here those participants would be the LGPS Funds.

The legislation requires the operator to act as the manager of the ACS. Because the scheme is a CIS within the meaning of Section 235 FSMA, that person must be authorised to operate (as well as establish and wind up) an ACS. Note that this activity of management is not the same as the separate authorised activity of managing investments under the RAO.

By virtue of section 261D FSMA, the operator and depositary must be:

- independent of each other;
- each "a body corporate incorporated in the United Kingdom or another EEA State";
- each have a place of business in the UK or another EEA State, and
- each a "fit and proper person".

[3] These amounts are expressed in Euro because they are provided for in European directives but they can be held by the entity in the GBP equivalent of this amount.

The last requirement refers to a general prudential requirement under FSMA for authorised persons, the test for which is set out in detail under the FIT under the High Level Standards part of the FCA Handbook. The detailed operational rules of an ACS are set out in the FCA's Collective investment schemes sourcebook ("COLL").

These financial services regulatory requirements will have a bearing on the optimum choice of the ACS Operator; on this subject see section 5 below.

3.6.2 LGPS investor status

As explained above, LGPS Funds which are invested through an ACS would retain beneficial ownership of the underlying property which was held subject to the scheme. However, as the LGPS Funds would hold property as tenants in common, no individual LGPS Fund would be able to claim that it owned any particular assets. This would not be a practical problem in respect of listed assets, which would, by definition, all have the same characteristics, but it would be an issue in relation to certain alternative investments, which are not divisible in the same way. Real estate in particular is a good example of where this would be a practical problem.

This issue of legal ownership of an ACS' underlying assets may also impact the ability of an ACS to provide a liability driven investment ("LDI") sub-fund. The reason for this is that bank counterparties to derivatives transactions which an LDI sub-fund would use would require there to be a clear and unfettered right of ownership over assets posted as collateral in respect of such transactions. Unlike some other forms of pooled arrangement where the bank's counterparty (such as a life company, unit trust or OEIC) has sole legal title to the collateral assets, this would not be true of an ACS (or, for that matter, a limited partnership). It is outside the scope of this Report to design a solution to this problem, but it may mean that the relatively small number of existing LDI strategies that have been adopted by LGPS Funds to date would have to remain outside any collective vehicle. We understand that one LGPS Fund, Berkshire Pension Fund, has entered into a longevity swap arrangement with Swiss Re. Given the bespoke nature of this arrangement we have not considered whether it is possible to transition this to an ACS.

The ACS Regulations make provision for the unitisation of the interests of participants. Participating LGPS Funds would have their rights set out in relation to the issue and redemption of units in the deed establishing the ACS. The ACS Regulations are permissive in either allowing the deed to prohibit the transfer of units or to allow for units to be transferred only if specified conditions are met. They also permit different policies to be adopted in relation to different sub-funds so that, as with other forms of collective investment scheme, different rights (and therefore different pricing- see below) can be established in relation to different sub-funds.

The ACS Regulations contain unit pricing rules in Section 261E (reflected in COLL 6.3). These provisions include the fact that units may not be issued to anyone other than a professional investor, a large investor or a person who already holds units in the scheme. (See above, section 3.1).

The rights of unit holders are not prescribed in any detail by legislation or by COLL, although COLL 4.4 sets out numerous requirements for the conduct of investor relations. Given the importance of establishing appropriate governance arrangements for the proposed ACS (see section 4 below), the following are the most relevant provisions.

In the case of an ACS, it is the depositary which has the power to convene a general meeting of unit holders, although as with a corporate entity, the unit holders may also request a general meeting (COLL 4.4.2). There is no de minimis limit on the number of units that must be represented by unit holders calling for such a meeting, hence this can be prescribed in the ACS deed.

COLL 4.4.10 also allows unit holders in the ACS to appoint proxies. Through this mechanism, oversight entities could be appointed as proxy for the participating LGPS Funds, to avoid the logistical problem of a large number of separate votes on any poll of unit holders i.e. corresponding to the participating LGPS Funds.

However, there are restrictions on what unit holders can and cannot do. In keeping with the more stringent provisions which apply to limited partnerships, it is a statutory function of the operator alone to:

- acquire, manage and dispose of properties subject to the scheme; and
- enter into contracts which are binding on participants for the purposes of, or in connection with, the acquisition, management or disposal of property subject to the scheme.

Any contracts which are entered into in respect of the statutory function of the operator are referred to as "authorised contracts" under Section 261M of FSMA. The operator has consequential obligations to:

- exercise rights under an authorised contract;
- bring and defend proceedings for the resolution of any matter relating to an authorised contract; and
- take action in relation to the enforcement of any judgment given in such proceedings. (Section 261M(3)).

The fact that the unit holders in the ACS may not themselves do any of these things does not affect their rights against the operator, who effectively acts as their agent.

3.6.3 Liability of unit holders, operator and depositary

As in a limited partnership, unit holders in an ACS are expressly provided with limited liability by virtue of Section 261D of FSMA, which states that "the participants in a relevant scheme are not liable for the debts of the relevant scheme beyond the amount of the property subject to the relevant scheme which is available to the operator to meet the debts". Unlike a limited partnership, however, there is no reference to the loss of this limited liability if the participants were to become involved in management on a day to day basis of the affairs of the ACS.

In keeping with provisions which are made under the AIFMD, Section 261T FSMA states that any provision in an ACS deed is void if it would have the effect of exempting the operator or the depositary from any liability "for failure to exercise due care and diligence in the discharge of its functions in respect of the scheme". To that extent, liability is therefore strict on the part of both the operator and the depositary.

The segregation of liability in relation to sub-funds under an umbrella ACS is provided for by Section 261P FSMA, which states that the "property subject to a sub-scheme of an umbrella co-ownership scheme must not be used to discharge any liabilities of, or meet any claims against, any person other than the participants in that sub-scheme". This would achieve the goal of ensuring that there was no unintended cross-subsidisation of liabilities between sub-funds (and therefore between different participating LGPS Funds).

4. Governance

4.1 Separating operator and oversight functions

We set out here one approach to separating the operational and oversight functions in a practical way. This is by no means the only way of achieving this separation, so it is described only to provide an example of an approach which is consistent with the legal requirements. Other approaches would also be possible.

The Operator would be responsible for delivering investment returns within an ACS structure. To this end, its key functions would be to establish sub-funds, and to appoint, manage and dismiss investment managers to operate the sub-funds. It would also need to engage with the participating LGPS Funds through its own customer function and the administrator and could provide performance statistics on the sub-funds. It would be authorised by the FCA. Roles are described more fully below.

Oversight could then be by a separate entity or entities, essentially non-executive in nature, which would be accountable to the participating LGPS Funds for the performance of the Operator. The functions of any oversight entities would be carefully defined so that they were not effectively operating the ACS, since this would involve carrying on a regulated activity and require it or them to be authorised by the FCA.

4.1.1 Benefits of separating the operator and oversight functions

The primary benefits of the separation of the operator and oversight functions are:

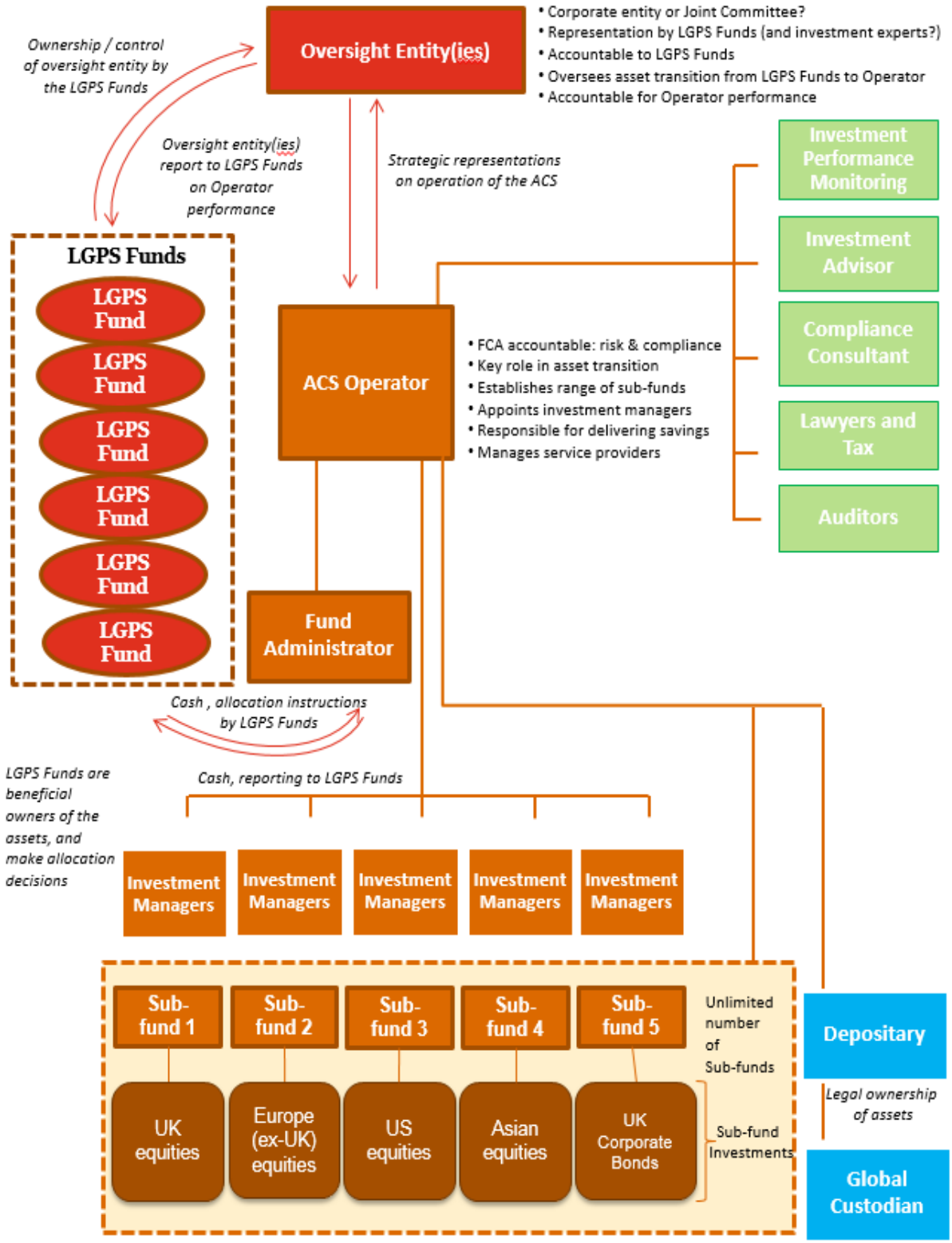
- As unregulated bodies, oversight entities could bring a wide range of experience and perspectives to the oversight role. The oversight entities would provide appropriate and efficient mechanisms to challenge the Operator. This would supplement the regulatory oversight of Operators by the FCA.

- The participating LGPS Funds can be properly represented, channelling their voices through their agreed oversight entities. Representation might work in various ways, reflecting the greater constraints of working efficiently if there are higher numbers of participating LGPS Funds working with a given Operator.

- The participating LGPS Funds would have a keen interest in the performance of the sub-funds but not direct authority over their management.

- Separation enables the appointment of strong investment teams at Operators, which would be FCA regulated. The best professionals employed here should be able to focus on meeting the challenge of delivering investment savings and long term investment performance, at scale, in each asset class that it offers.

- The ability, if it were to be set up as a new body, to build a bespoke Operator that could be designed to meet the precise investment needs of the participating Funds


Oversight Entity(ies)
• Corporate entity or Joint Committee?
• Representation by LGPS Funds (and investment experts?)
• Accountable to LGPS Funds
• Oversees asset transition from LGPS Funds to Operator
• Accountable for Operator performance
Ownership / control of oversight entity by the LGPS Funds
Oversight entity(ies) report to LGPS Funds on Operator performance
Strategic representations on operation of the ACS
Investment Performance Monitoring
Investment Advisor
Compliance Consultant
Lawyers and Tax
Auditors
LGPS Funds
LGPS Fund
LGPS Fund
LGPS Fund
LGPS Fund
LGPS Fund
LGPS Fund
ACS Operator
• FCA accountable: risk & compliance
• Key role in asset transition
• Establishes range of sub-funds
• Appoints investment managers
• Responsible for delivering savings
• Manages service providers
Fund Administrator
Cash , allocation instructions by LGPS Funds
LGPS Funds are beneficial owners of the assets, and make allocation decisions
Cash, reporting to LGPS Funds
Investment Managers
Investment Managers
Investment Managers
Investment Managers
Investment Managers
Sub-fund 1
Sub-fund 2
Sub-fund 3
Sub-fund 4
Sub-fund 5
Unlimited number of Sub-funds
UK equities
Europe (ex-UK) equities
US equities
Asian equities
UK Corporate Bonds
Sub-fund Investments
Depositary
Legal ownership of assets
Global Custodian

4.2 Oversight entities

An oversight entity could take several different forms. It might be a Joint Committee or a corporate entity or a group constituted in some other way to suit the needs and objectives of the participating LGPS Funds. It might be a single entity or a combination of several entities.

For simplicity, an entity rather than entities is described below. This should be taken to include a combination of entities to suit participating LGPS Funds' specific requirements of a given CIV.

4.2.1 Roles and responsibilities of oversight entities

- During the set up phase* of an ACS, if a private sector provider is to be procured to deliver the Operator function, the oversight entity could appoint the provider;
- During the transition phase to the ACS, the oversight entity would be accountable to the participating LGPS Funds for the execution of transition plans;
- During the operate phase, the oversight entity could collate and evaluate participating LGPS Fund requests for additional investment sub-funds;
- The oversight entity could be the forum for aggregation of regular Operator and sub-fund information, performance and other analysis, preparing this for dissemination to the participating LGPS Funds;
- The oversight entity could ensure that participating LGPS Funds had sufficient information on sub-Funds to enable the LGPS Funds to make informed decisions about asset allocation, subject to proper advisory processes;
- Oversight entities could carry out performance bench-marking between different ACSs / other pooled arrangements and best practice sharing; and
- Oversight entities could make recommendations on behalf of participating LGPS Funds to the Operator in relation to the operation of the ACS.

*These observations assume that the phases of establishing an ACS would be broadly as follows:

4.2.2 Composition of an oversight entity

One practical structure for an oversight entity might involve one member from each participating LGPS Fund, perhaps the Chair of a Pensions Committee or a Head of Fund. There may be value in different Funds nominating people with different roles, to achieve a mixture of expertise on the oversight entity.

There might also be appointments with investment industry expertise.

Individuals involved in oversight entities would not require FCA authorisation for this role.

4.2.3 Representation by participating LGPS Funds.

Participating LGPS Funds for a given CIV may vary in size and representation might, to some extent, reflect asset value (or membership numbers, if broadly the same thing) if the variation was very significant. It would however be essential to ensure that the smallest LGPS Funds are fully represented.

Other factors to consider include: -

- **Capturing knowledge.** A number of LGPS Funds have been managed internally with success (source: State Street Investment Analytics, September 2013 report). The London Borough LGPS Funds have been establishing a CIV on a voluntary basis. There are proposals between geographically separate LGPS Funds to work together, such as between the LPFA and Lancashire. Frameworks and shared procurements are in use. The knowledge underpinning these situations should be captured by any oversight entity.

- **Political balance.** The existing Pension Committees of the LGPS Funds reflect the political composition of local councils (as required by wider local government law: Local Government and Housing Act 1989 s15). There may be a wish to have balanced representation by major political parties in some oversight entities, although within a separate corporate vehicle this would not be required. Similarly, there may be a place for union representation, but again this would not be required.

- **Operational and investment expertise.** It may be helpful if some of an oversight entity's members were to have direct investment experience, gained either within or outside the LGPS and a mix of experience might be considered the most desirable.

- **Continuity of membership**. A long term view of investment issues has often been identified as a basis for investment success. The impact on continuity should be considered when rights to appoint and remove members were decided.

- **Infrastructure investment.** Our scope in this report is limited to ACSs for listed investments. If CIVs include unlisted investments, such as infrastructure or private equity, membership of oversight entities should reflect this.

An oversight entity's individual members could be in a visible and responsible role. There may be an analogy between their position and those of existing members of LGPS Funds' pension committees, but the scale of an ACS could be substantially larger, and there will be a high degree of public scrutiny.

It may be important that the individual members of an oversight entity are not delegates of any statutory functions of the participating LGPS Funds, since that could cut across the decision that asset allocation should remain local.

4.2.4 Legal structure

There are no particular restrictions on the form an oversight entity can take, since we do not believe their functions would amount to a "commercial purpose" within section 4 of the Localism Act 2011 (which requires local authorities engaged in such purposes to act through a company).

One possibility is that an oversight entity is established as a company limited by guarantee in relation to which each of the participating LGPS Funds would undertake responsibility for a nominal amount (usually £1) of the oversight entity's debts, should any arise on its winding-up. This structure has the benefit of providing participating LGPS Funds with limited liability in relation to the oversight entity and the ability to establish a bespoke governance process within a distinct and separate corporate structure.

Alternatively, an oversight entity could be structured as a joint committee under section 102 of the Local Government Act 1972. Although the political balance requirements apply to pensions committees by virtue of Section 15 of the Local Government and Housing Act 1989 and schedule 1, para 1(e), (detailed in Appendix 3, section 3.2 of this Report) the delegation of functions to a joint committee deems the political balance requirement to be satisfied already for each participating authority.

4.3 The Operator

4.3.1 Roles and Responsibilities of the Operator

The Operator of an ACS would: -

- set up and manage service providers (depositary, administrator, investment managers etc.);
- set up the agreed initial range of sub-funds;
- during the transition phase, manage one side of the transition of assets from participating LGPS Funds to the Operator;
- carry out the ongoing management of the ACS;
- be accountable to the FCA and to oversight entities, and through them, to the participating LGPS Funds;
- manage relationships with participating LGPS Funds as customers;
- set up new sub-funds itself or through appointed third parties;
- oversee investment management performance; and
- provide information analysis and reporting.

The Operator would also make many of the key decisions, notably around:

- appointment and removal of investment managers;
- management;
- risk and compliance; and
- legal rights to bring / defend proceedings.

4.3.2 Board Composition

The composition of an Operator's board is likely to depend on the operational structure adopted for the Operator. These structures are described in more detail in section 5.

Option A: Set up – the board will be designed and appointed by the participating LGPS Funds.

Option B: Appoint – the commercial provider may have an existing board in place for the Operator.

4.3.3 Operator legal structure

This will depend on the set up option taken forward (set up or appoint). See section 5 for a discussion.

4.4 Administrative interactions between the LGPS Funds and the Operator

Day to day interaction between the participating LGPS Funds and the Operator would be through the Administrator, which would be responsible for cash transactions to and from the LGPS Funds. The LGPS Funds would instruct the Administrator as to asset allocations between sub-funds, and the Administrator would report holdings and other information to the LGPS Funds.

A detailed model of Operator / participating LGPS Funds interactions would be required in each case.

It is, however, possible to start identifying opportunities that an ACS may offer to improve LGPS Fund operation, governance and transparency. Examples may include:

- If the ACS Administrator engaged by the Operator were able to report several separate holdings in each ACS sub-fund to each participating LGPS Fund, it would provide a simple mechanism to enable individual LGPS Funds to offer different investment strategies to different employers or groups of employers.

- Any performance monitoring service engaged by the Operator could be charged with delivering clear information about the initial and changing characteristics of each sub-fund to reduce participating LGPS Funds' investment advisor costs and minimise reporting duplication.

- The performance monitoring service may be charged with delivering combined analysis on each LGPS Fund performance within the ACS, to permit clear differentiation between sub-fund performance effects and asset allocation performance effects.

As explained in section 3.6.2, certain investment functions must be carried out by the Operator. Notably, there will be restrictions on rights of the LGPS Funds as investors regarding "authorised contracts" (i.e. contracts relating to acquisition, management and disposal of ACS property). The LGPS Funds would not be able to bring or defend proceedings or take action to enforce a judgment. All of these functions must be carried out by the manager or depositary appointed by the Operator.

4.4.1 Management by LGPS Funds of their investments in a CIV

The process of establishing pooled funds / CIVs / ACSs by groups of LGPS Funds is outside the scope of this report. However, during the establishment and then in operation, it will be essential that participating LGPS Funds anticipate and then understand how new arrangements will impact the way they operate.

We understand that the overall investment performance of each of participating LGPS Fund would typically remain the responsibility of its local pension committee and of great importance to its local pensions advisory board.

It is widely understood that overall investment performance of any major pension fund is driven much more by allocation decisions between classes of asset than by the performance of individual investment managers within each asset class. It would be important to ensure that this position is not undermined for participating LGPS Funds by poor performance of individual sub-funds in their CIV.

The performance of the sub-funds run by the Operator would typically be judged against investment industry benchmarks for the specific relevant asset classes. These performances would be elements of, but distinct from the overall investment performance of each of the participating LGPS Funds, since they would each retain the authority to make asset allocation decisions.

The practical work required by LGPS Funds to manage investments at the local level would be reduced by the introduction of the CIV. This should allow more efficient use of officer, committee and pension board time.

The broad nature of the work that may be required by each participating LGPS Fund could include the following:

- Facilitating the transition of assets into its CIV in line with any revised investment regulations and processes to be established.

- Finding a route to permit gilts to be retained as collateral against existing or envisaged derivative contracts for an LDI sub-fund.

- Reviewing the extent of any investments which would not be held within the CIV.

- Establishing and maintaining understanding about the risk, return, income generation and liquidity characteristics of each of the sub-funds in which the LGPS Fund wishes to remain invested or make new investment.

- Transitioning to a revised investment strategy that recognised the characteristics of:

    - that individual LGPS Fund, typically including liability profile, deficit, employer covenants, and affordability of contributions and trends in contributions;

    - the sub-funds to be held; and

    - any separately held illiquid assets and derivative contracts.

- Documenting the revised investment strategy in the individual LGPS Fund's Statement of Investment Principles.

Once through transition, there should be reduced requirements for investment advice to the LGPS Funds, in particular removing processes to directly appoint and monitor investment managers for listed assets. There would remain a need for investment advice to inform the decisions and actions identified above.

5. Operational structure

There are two main potential delivery models for the Operator of a CIV: build / set up or buy / rent. Each of these options is set out below with an analysis of the criteria for decision-making. This is not intended as an exhaustive list: participating LGPS Funds in a CIV will have further criteria to be factored into the decision-making process.

Buying / renting an Operator could include the use of a fiduciary investment service.

Given that setting up / building an Operator is more time consuming, this may be an option that CIVs plan to move to, having started by buying / renting the Operator service.

5.1 Operational structure options

5.1.1 Option A: set up Operator

- Cost: this may be the more expensive delivery model to implement. It may involve IT, with systems procurement, design and build. An Operator built from scratch requires all processes and policies to be developed during a set up period in order to prepare for FCA authorisation. There may be recruitment costs for a new team unless roles could be filled by alternative resourcing models e.g. secondments / transfers from participating LGPS where existing staff matched requirements in the new operator. Further costs include procurement of the depositary/global custodian, administrator and transfer agent as well as programme management throughout the lifecycle of the set up project.

- Capital requirement: the participating Funds would need to provide this.

- Implementation timeframe: this is estimated at up to 18 months to FCA authorisation for the ACS and operator. This assumes a 12 month set-up period followed by a 6 month FCA authorisation process. There is now some experience of setting up Operators for LGPS CIVs, which may help reduce the 12 month projected timeframe for set-up, but the challenge involved in establishing Operator processes clearly enough for an FCA application should not be underestimated.

- Onward procurement (depositary, administrator, investment managers): in this model, Public Contracts Regulations 2006 ("PCR")[4] are likely to apply in full as an administering authority owned Operator will be considered a contracting authority. As such, the OJEU procurement process must be followed. The exemption in Regulation 6 (2)(h)[5], considered in Appendix 3, only applies to public bodies who are investors so will not apply. It will not be possible for the Operator to access existing LGPS framework agreements for the appointment of investment consultants, auditors, legal advisors or custody services on behalf of all LGPS Funds since the terms of those frameworks are clear that they are open only to LGPS Funds (or rather their administering authorities) and, in the case of the custody framework, certain other designated public bodies such as the Pensions Protection Fund. As such they would not be accessible to the Operator of an ACS, which by definition would be a new body and which was not in existence at the time when the various frameworks were procured.

- Value for Money: All procurement is subject to public sector value for money ("VFM") tests.

- Staff: Some new recruits would come from the asset management industry in order to meet FCA requirements. This creates an issue for new Operators in that they would be seeking to attract a talent pool into the public sector at potentially lower levels of pay than offered by their home industry.

[4] Now Public Contracts Regulations 2015 ("PCR2015")
[5] Now PCR2015, Regulation 10(1)(e)(i)

- Managing investment managers: The participating LGPS Funds will have oversight of manager performance through their oversight entity(ies).

- Engagement by LGPS Funds: this model may create higher engagement with participating LGPS Funds by involving existing investment teams through secondments or transfers. Operators could develop a regional presence reflecting the broad location of the participating Funds. Operators could also set up a customer/stakeholder team to manage relationships with individual LGPS Fund and provide regular reporting to them. Any operational service issues and improvements could be handled through this communication route.

5.1.2 Option B: appoint operator

- This may be the lower cost delivery option. Establishment costs would involve a detailed operating model design to develop requirements for the ITT for the Operator. There would also be costs for procurement and programme management. The Operator would normally procure the depositary/custodian, administrator and transfer agent. Systems would typically be provided by the Operator, included within its charging structure.
- Participating Funds would normally assume that their Operator's costs will be passed back to them in set up fees and ongoing contractual payments. The scale of these costs would depend on many factors including the extent to which the Operator could reuse existing systems, configurations required, number of sub-Funds, and total assets under management. Negotiations may be appropriate to smooth costs over the projected life of the contract etc.
- Capital requirement: The appointed Operator would normally provide the capital required for FCA authorisation within its fee structure.
- Implementation timeframe: appointing the operator is the fastest implementation route for the ACS as the operator will have existing systems, people, processes and policies which can be tailored to fit the purpose of the LGPS ACS. We estimate 9 months to FCA authorisation including development of a high-level operating model in parallel with a consultation process and regulatory changes, followed by immediate launch of a procurement process to select the Operator. The FCA authorisation process for the ACS could start soon after the Operator is appointed. The Operator itself may have already achieved ACS authorisation.

- Onward procurement (depositary, administrator, investment managers): in this model, PCR should not apply to the procurement of the depositary/global custodian, administrator, transfer agent, investment managers if they are appointed by the Operator.

- Value for Money: to ensure that the Operator works to the VFM test, contractual terms could be set by the oversight entities to include the VFM test. These could also be passed on to sub-contractors.

- Staff: Existing teams with FCA authorisation would be used to staff the Operator so FCA approval may be quicker. Staff in the asset management sector would be able to leverage existing relationships with service providers and investment managers, creating potential for a smoother start-up phase.

- Managing investment managers: there is a requirement that the Operator and depositary of an ACS are independent of each other (section 261D(4)FSMA). There is no express prohibition on an ACS operator connected investment managers to manage the underlying assets (indeed some of the several ACS that we anticipate will be marketed use precisely this model.

- Concerns about the avoidance of conflicts of interest between the operator and the manager(s) would have to be addressed in the way in which the ACS operator was initially procured itself, for instance by specifying that all onward procurements would be made on arm's length terms. FCA rules would to some event mitigate the risk of conflicts of interest that apply to all authorised firms.

- Engagement by LGPS Funds: this model may have a lower potential for engagement with LGPS Funds as there is less capacity for existing investment teams to join the Operator delivery team.

5.1.3 Prioritising selection criteria

Ultimately, the choice of delivery model for any given CIV will depend on the priority given to the criteria above and others developed internally by participating LGPS Funds.

Appointing an Operator may be the faster and the lower cost route to setting up a CIV. However, its success will rely on a successful commercial negotiation of contracts on set up, partnership working and rigorous change management during the life of the deal in order to avoid excessive costs for unforeseen events in the medium- to long-term. Planning for later transition to a build model may also be important.

5.2 Operational set-up

The key processes that participating LGPS Funds will need to undertake to build / set up or buy / rent an Operator are likely to be:

	Build / Set up	Buy / Rent
Legal Structure		
Operator & oversight entities – corporate structure, set up & governance	√	√
ACS scheme deed	√	√
Design		
High-level operating model design	√	√
Detailed operating model design	√	√
Business process design	√	
Organisational design	√	
Governance, risk & compliance design	√	
Build		
IT systems		
- Risk	√	
- Portfolio Management	√	
- Finance & HR	√	
- CRM	√	
- MI & reporting	√	
Non IT - **Programme Management**	√	√

- **Procurement**
  ○ **Administrator**
  ○ **Depositary/global custodian**
  ○ **Transfer agent**
	√	

Recruitment	√	
FCA authorisation		
- **ACS**	√	√
- **Operator**	√	

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Appendix 1

Glossary

ACD	Authorised corporate director
ACS	Authorised Contractual Scheme
ACS Regulations	Collective Investment in Transferable Securities (Contractual Scheme) Regulations 2013 (SI 2013/1388)
AFM	Authorised fund manager
AIF	Alternative investment fund
AIFM	Alternative investment fund manager meeting the requirements of the AIFMD
AIFMD	Alternative Investment Fund Managers Directive (Directive 2011/61/EU)
APER	Statements of Principle and Code of Practice for Approved Persons
AUT	Authorised Unit Trust
Award Letter	Agreement entered into between Cabinet Office and PwC, signed and dated 4th December 2014, instructing PwC in relation to the production of this report.
CCF	Common Contractual Fund – an Irish fund type
CCO	Chief Compliance Officer
CEO	Chief Executive Officer
CF	Controlled Functions as described by the FCA: http://www.fca.org.uk/firms/being-regulated/approved/approved-persons/functions
CFO	Chief Financial Officer
CIO	Chief Investment Officer
CIS	Collective Investment Scheme
CIV	Collective Investment Vehicle
COLL	FCA's Collective Investment Schemes sourcebook
Consultation	"Local Government Pension Scheme: Opportunity for collaboration, cost savings and efficiencies" https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/307923/Consultation_LGPS_structural_reform.pdf
COO	Chief Operating Officer
CRM	Customer Relationship Management
DCLG	Department for Communities and Local Government

December 2013 Report	Hymans Robertson report of December 2013 (*LGPS structure analysis)*
EEA	European Economic Area
EUR	Euro currency
FAS	FCA's Fund Authorisation and Supervision team
FCA	Financial Conduct Authority
FCP	Fonds Commun de Placement – a Luxembourg fund type
FIT	Fit and Proper Test for Approved Persons
FSMA	Financial Services and Markets Act 2000, as amended
FTSE	Financial Times Stock Exchange
GBP	Pounds Sterling currency
HMRC	Her Majesty's Revenue & Customs
HMT	Her Majesty's Treasury
HR	Human Resources
IORP	Institutions for Occupational Retirement Provision Directive (Directive 2003/41/EC)
IT	Information Technology
ITT	Invitation to tender
KIID	Key Investor Information Document
LDI	Liability driven investments
LGA	Local Government Act 1972
LGHA	Local Government and Housing Act 1989
LGPIHA	Local Government and Public Involvement in Health Act 2007
LGPS	Local Government Pension Scheme in England and Wales
LGPS Funds	The existing 89 Funds of the LGPS; participating LGPS Funds refers to those LGPS Funds that participate in a given CIV or ACS
LP	Limited Partnership
LPFA	London Pensions Fund Authority
MI	Management Information
MiFID	Markets in Financial Instruments Directive (Directive 2004/39/EC)
NED	Non-Executive Director
NURS	Non-UCITS Retail Scheme
OBC	Outline Business Case
Oversight entities	Entities established by participating LPGS Funds to oversee and monitor pooled vehicles / CIVs / ACSs. Oversight entities may take a range of forms.

OEIC	Open-ended investment company
OEIC Regulations	Open-ended Investment Company Regulations 2001
OJEU	Official Journal of the European Union
OTC	Over the counter, i.e. OTC Derivative
PCR	Public Contracts Regulation 2006
PSPA	Public Service Pensions Act 2013
PwC	PricewaterhouseCoopers LLP
QIS	Qualified Investor Scheme
RAO	The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, as amended
Report	This report on the design of the structure and governance of efficient and effective CIVs for LGPS Funds
S&P	Standard and Poor's
SAB	Scheme Advisory Board
SDLT	Stamp Duty Land Tax
SDRT	Stamp Duty Reserve Tax
SPB	Squire Patton Boggs (UK) LLP
UCITS	Undertaking for Collective Investment in Transferable Securities as defined in the UCITS Directive (Directive 2001/107/EC and 2001/108/EC)
UCITS Management Company	Fund management company meeting the requirements of the UCITS Directive (Directive 2001/107/EC and 2001/108/EC)
UK	United Kingdom
VAT	Value added tax
VFM	Value for money

Appendix 2

1. UCITS schemes

A UCITS scheme is one which meets the requirements set out in the UCITS Directive. It can broadly invest in transferable securities (such as shares and bonds), other collective investment schemes, deposits, derivatives and money market instruments. It cannot invest in other alternative assets such as commodities or real property, although it may gain exposure to these asset classes indirectly. One of the key requirements of a UCITS scheme is that it raises money from the public. Funds can, however, set their own minimum investment limits which might prevent most investors from investing into the fund. In fact, an ACS must impose minimum investment limits of £1m to keep small retail investors from accessing the scheme. Given the basic requirement for the UCITS to be widely available and the need to set additional investment conditions to artificially restrict the investor base, the UCITS is considered unattractive.

It is also a key requirement of the UCITS Directive (and implemented in the FCA rules in COLL) that a UCITS scheme cannot be converted into a NURS or a QIS (COLL 3.2.8R).

The UCITS rules are prescriptive concerning funds that seek actively to replicate an index (by investing in the underlying components of an index). The rules allow some of the specific UCITS spread rules to be amended so that a UCITS can invest up to 20% of its scheme property into a single entity because that reflects the entity's relationship to the index. This can be increased to 35% of property in exceptional circumstances (note this would apply at each sub-fund level rather than across the ACS as a whole).

2 NURS

Similarly to the QIS, the NURS falls within the definition of an AIF under the AIFMD.

A NURS is a UK-specific scheme type. It can invest in broadly the same types of assets as a UCITS but can also invest in gold (up to 10% of scheme property) and real property. It also has more relaxed concentration and spread limits than a UCITS scheme. The NURS rules for directly tracking an index are similar to those of a UCITS, though the rules are more flexible on the types of index a NURS can track. Both a UCITS and NURS would be able to track a normal equity index like FTSE 100/250, S&P 500 etc.

3. Comparison between the UCITS, NURs and QIS schemes

Investment classes	UCITS restrictions (assumed the scheme is not a feeder fund)	NURS restrictions (assumed the scheme is not a feeder fund)	QIS restrictions
Spread requirements	Must ensure that the fund delivers a spread of risk in line with its objective and policy within six months of launch	Must ensure that the fund delivers a spread of risk in line with its objective and policy within 12 months of launch/end of initial offer period (except spread rules for immovable property, which apply after 24 months)	Must take reasonable steps to provide a spread of risk in line with the fund's investment objective and policy
Eligible assets	Transferable securities (including shares and bonds), regulated collective investment schemes, warrants, investment trusts, deposits, derivatives and money market instruments	Same as UCITS but can also invest in unregulated collective investment schemes, gold and immovable property	Any specified investment listed in the RAO as well as precious metals and immovable property
Concentration rules	Alongside the general investment limits UCITS must also not acquire more than 10% of a body corporate's shares, no more than 25% of the units in a collective investment scheme and no more than 10% of money market instruments form a single issuer	NURS do not have concentration rules but do have the detailed spread rules that they must adhere to	No specific concentration rules

Index-tracking specific rules	Specific spread rules for funds replicating an index that go over and above the ordinary spread and concentration rules. These allow a fund to invest up to 35% in one other entity where this is justified by exceptional market conditions. Rules also contain specific requirements about identifying eligible indices	Same spread rules as for UCITS schemes apply – only difference relates to eligible indices (rules more flexible than UCITS requirements)	No specific spread rules for tracking indices
Regulated collective investment schemes (those authorised in the UK or passported from EU Member States) – other than QIS	Can invest up to 100% of scheme property in other collective investment schemes ("second schemes") – up to a maximum of 20% of scheme property in each second scheme. The second schemes themselves must only invest in UCITS eligible assets (e.g. a UCITS can invest in NURS as long as that NURS does not invest in gold or property) and must restrict their own investment into second schemes to a maximum of 10% of their scheme property. UCITS can only invest up to 30% of their scheme property in eligible schemes that are non-UCITS.	Can invest up to 100% of scheme property in second schemes – up to a maximum of 35% of scheme property in each second scheme. The second schemes themselves must restrict their own investment in second schemes to 15% of their scheme property. The second scheme must be a UCITS, NURS or fund from outside the UK with the same/more restrictive investment powers as a NURS.	Can invest up to 100% of scheme property in other regulated collective investment schemes
Unregulated collective investment schemes (e.g. hedge funds) and QIS	UCITS cannot invest in unregulated schemes.	Can invest up to 20% in unregulated schemes (e.g. hedge funds) – although this limit must be aggregated with any investment in transferable securities that are not approved securities.	Can invest up to 100% of scheme property in unregulated schemes as long as the authorised fund manager has first performed due diligence on the second scheme

Closed-ended funds	Can invest in closed-ended funds – as long as these investments are considered eligible transferable securities – cannot invest in them as collective investment schemes (for example the UCITS can invest up to 100% in investment trusts – subject to the usual spread limits).	Can invest in closed-ended funds as transferable securities or collective investment schemes (whichever criteria they meet). If not considered as approved transferable securities then investment limited to 20% of scheme property.	No specific restrictions for investing in closed-ended funds
Approved transferable securities (e.g. shares and bonds)	Can invest up to 100% (limited to max of 10% of scheme property invested in any single group of companies) in "approved securities" (simply put, these are securities listed on eligible markets).	Can invest up to 100% of scheme property in approved transferable securities (limited to maximum of 10% in scheme property invested in the securities of a single body (except for regulated covered bonds, where this is increased to 25% of scheme property).	No restrictions
Transferable securities that are not "approved" (sometimes known as the "trash bucket")	Can invest up to 10% in securities that are not "approved securities".	Can invest up to 20% in securities that are not "approved securities" – aggregated with the 20% investment limit in unregulated schemes.	No restrictions
Derivatives	Can be used for efficient portfolio management and investment purposes.	Can be used for efficient portfolio management and investment purposes.	Can be used for efficient portfolio management and investment purposes
Gold	Cannot invest in gold – though can get exposure to commodities through exchange-traded commodities or the securities of commodities companies.	Up to 10% of scheme property can be invested in gold – cannot invest directly in other precious metals	Up to 100% of scheme property can be invested in all precious metals

Immovables (e.g. property)	Cannot invest in direct property – though can invest in the securities of property companies and in real estate investment trusts (REITs).	Can invest directly in property.	Can invest directly in property
Securities lending	Up to 100% of scheme property can be part of securities lending transactions – subject to collateral requirements.	Up to 100% of scheme property can be part of securities lending transactions – subject to collateral requirements.	Up to 100% of scheme property can be part of securities lending transactions – subject to collateral requirements
Borrowing	Up to 10% of scheme property – on temporary basis.	Up to 10% of scheme property.	No limits

Appendix 3

Legal issues: investment regulations, procurement law and the establishment and ownership of oversight entities

1. High-level legal considerations

- ACS structure can be used by LGPS Funds, but the LGPS Investment Regulations may need to be amended, in particular the limits on investments in partnerships, in certain types of collective investment schemes and certain categories of defined investments.[6]Procurement rules would ordinarily apply to the contract with the ACS operator but under the exemption for investment in financial services in PCR 6(2)(h) [7]may be avoided.
- The oversight entity could take the form of a company (limited by guarantee) or a joint committee structure.
- Functions can be delegated to the oversight entity but if asset allocation is to remain with LGPS Funds, delegation may be limited.

2. Status of ACS under the LGPS Investment Regulations

The power of investment which is applicable to LGPS funds is vested solely in the administering authority by virtue of Regulation 11(3) of the LGPS Investment Regulations: "*The authority must invest, in accordance with its investment policy, any fund money that is not needed immediately to make payments from the fund*". Regulation 11(4) goes on to say that the authority may vary its investments (only subject to the limits which are imposed by virtue of Regulation 14 and Schedule 1). As such, no other party (including the Secretary of State for DCLG as the responsible authority for the LGPS) has the power to direct how investments may be made.

Because it is intended that asset allocation decisions will be reserved expressly to the LGPS Funds, as currently, it might be thought that Regulation 11(3) need not be amended with the current proposal. However, if the exercise of the power of investment is to be limited by reference, for listed assets at least, to a newly created ACS, any statutory prohibition on holding listed assets through any other means would require an amendment to the Investment Regulations. This would be necessary to pre-empt the separate statutory provision in section 2 of the Localism Act 2011 (the general power of competence) which establishes that local authorities have the power to do anything an individual can do, subject to any contrary statutory provision.

It is also relevant to note that LGPS Funds must exercise their investment powers in a fiduciary way (subject only to the current diversification limits on LGPS Funds in Regulation 14 and Schedule 1). This view was endorsed by the recent Law Commission Report on the duties of Investment Intermediaries. Any new direction as to how LGPS Funds should exercise their fiduciary responsibilities with regard to investments would have to take that factor into account.

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[6] As instructed by the Cabinet Office and DCLG, this report does not cover the potential implications of article 18 of the IORP Directive, which may impact on the ability of DCLG to mandate participation in the ACS.

[7] Now PCR 2015 Regulation 10(1)(e)(i)

The LGPS Investment Regulations are silent on the characterisation of the ACS, for the simple reason that the ACS is a newly created legal vehicle, with Regulations dating from 2013. Apart from a minor change in 2013 (made under SI 2013/410) which updated the LGPS Investment Regulations to increase the limit on investments in partnerships from 15 to 30%, the Regulations have not been amended since 2009 and so this is not surprising.

There are other provisions which relate to diversification by reference to different legal structures in the Regulations. These include certain types of collective investment schemes (unit trusts and OEICs) and insurance policies if managed by the same body in Schedule 1 which apply a maximum limit of 35%. Given this background, it is anomalous that the creation of a major new collective investment scheme vehicle, such as the ACS, currently is not reflected in the Regulations.

On this subject of diversification, attention is drawn to Appendix 6A of the December 2013 Report for DCLG and Cabinet Office (pages 73 to 75). In that earlier analysis, SPB noted that it may be possible for an ACS to be regarded for the purposes of the current LGPS Investment Regulations as falling outside those Regulations entirely.

There is, however, a contrary argument that an ACS might still be subject to the 10% single holding limit which applies under Schedule 1, paragraph 6.

If it were to be decided to create an ACS to hold all listed assets, this question would need to be resolved. However, it may be possible to address the question in a different way if, as seems inevitable for the reasons outlined above, the LGPS investment regulations would need to be revised in order to mandate the use of the ACS in any event.

The 10% single holding limit is defined by reference to certain categories of defined investments, i.e.

"*(a) securities of, or in loans to or deposits with, any one body;*

(b) units or other shares of the investment subject to the trust of any one unit trust scheme; or

(c) in transactions involving any one piece of land or other property".

There are some exemptions to this restriction which do not apply if the investment is made by an investment manager appointed by the LGPS Fund under Regulation 8 (which would not be the case in the present context as the ACS operator would not itself fulfil that function) or where the relevant single holding is in "*units or other shares [sic] of the investments subject to the trusts of a unit trust scheme*" which is again not relevant because an ACS is clearly not a unit trust scheme, at least for the purposes of FSMA. Hence, the exemption from the 10% restriction under item 6 above does not seem to be available.

In order therefore for the single holding limit to apply to an ACS, one of the three limbs of the definition must be satisfied. We have already noted that an ACS is not a unit trust scheme, so the second part of the definition does not need further discussion.

Since we have also noted that, for the purposes of this report, the proposed ACS would be used to hold listed assets only, the third limb which relates to real estate may also be ignored. That leaves the third part of the defined term which refers to single holdings by reference to securities, loans and deposits. It is not obvious that an ACS itself, since it is merely a contractual arrangement whose purpose is to hold underlying property in common, issues securities (the legislation refers instead to units); still less could an ACS be said to be a lender or deposit taker.

As a preliminary view, therefore and leaving aside alternative assets such as real estate, we would suggest that the limit on single holdings must apply (if it applies at all) either to the underlying securities or loans (if that term can be construed to include traded debt instruments) which are the property of the ACS as a whole or to a sub-fund which holds such securities or loans.

This interpretation would lead to an anomalous advantage where another form of tax transparent vehicle (the limited partnership) is subject to a separate and clearly identifiable limit (defined by reference to partnership interests generally) of 30% should be noted.

SPB recommends that the legislative ambiguities in this area are such that the Government should clarify, via reform of the LGPS Investment Regulations, what its intentions are if LGPS Funds are to be encouraged to use ACS for pooling of investments.

2. Public procurement considerations

Public procurement law will need to be taken into consideration at two levels: first, regarding the relationship between the LGPS Funds and the Operator; and second, regarding the contracts entered into by the Operator with third parties ("onward procurement"). We have considered the former in Section 4.1.3 and the latter in Section 5. We have assumed that for reasons of timing and cost efficiency, the optimum structure will be one where procurement obligations are minimised. That objective may not necessarily be consistent with other policy objectives.

Any agreement between the LGPS Funds and the Operator will be a public services contract for the purposes of the PCR. The LGPS Funds are contracting authorities within the meaning of the PCR and will enter into a contract in writing for consideration under which the Operator will be engaged to provide services. This principle applies regardless of who owns or establishes the Operator. It is also assumed that the value of the contract will exceed the applicable thresholds above which the PCR requirements apply in full.

As described in Section 5, the Operator could be either: (i) a body set up by participating LGPS Funds or (ii) an appointed private body. The nature of the Operator will impact upon the procurement requirements applicable to the contract between the LGPS Funds and the Operator (as well as onward procurement). In broad terms, there is greater scope to avoid the full application of the PCR if the Operator is set up the LGPS Funds rather than appointed by the LGPS Funds.

There is no general exemption to the PCR for contracts entered into between public authorities. It is also not relevant for these purposes whether the Operator seeks to make a profit or merely cover its own costs. However, there are grounds to argue that a contract between the LGPS Funds and an Operator that they set up is not one that has to be competitively procured. There is an exception to the normal application of procurement rules in cases where contracting authorities award contracts to "in-house" providers.[8] The so-called *Teckal* exemption applies where[9]:

i. a contracting authority exercises a similar level of control over the provider to that which it exercises over its own departments, and
ii. the provider carries out the *essential* part of its activities with the authority that controls it.

The first limb of the Teckal test, which assesses the control of the provider, would be more easily satisfied if the LGPS itself set up the Operator. In the alternative, whereby the Operator was established before being awarded a contract by the LGPS, it is less clear whether this criterion would be satisfied. In principle, for the exemption to apply, the contracting authority itself must exercise control over the service provider.

As regards the second limb of the test, The draft PCR 2015 specify that more than 80% of the activities of the service provider must be carried out in the performance of tasks entrusted to it by the controlling contracting authority to satisfy the second limb of the exemption. We assume that this criterion would be satisfied by the Operator as it will not provide services to third parties. The exemption does not apply if there is private capital participation in the provider. Therefore, the LGPS Funds will *not* be able to rely on the *Teckal* exemption if the Operator is privately appointed and is unlikely to apply if the Operator is established as a public venture. In this regard, the draft PCR 2015 state that there must be "no direct private capital participation in the controlled legal person with the exception of non-controlling and non-blocking forms of private capital participation required by national legislative provisions … which do not exert a decisive influence on the controlled legal person".

In addition to the possible exemption under *Teckal*, the contract between the LGPS Funds and the Operator may, however, also be excluded from the PCR by virtue of Regulation 6 (2) (h). This exemption, if applicable, could be used whether the Operator is set up or appointed, or takes the form of a JV. Regulation 6 (2) (h) exempts the award of contracts "*for financial services in connection with the issue, purchase, sale*

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8 The public procurement rules also do not apply where two or more public authorities cooperate amongst themselves to deliver a service, provided that certain detailed conditions are satisfied (in light of Case C-480/06 *Commission v Federal Republic of Germany*). Based on our current understanding and subject to a more detailed review, it does not appear likely that this exemption will apply to the relationship between the LGPS Funds and the Operator.

9 See Case C-107/98 *Teckal Srl v Comune de Viano and Azienda Gas-Acqua Consorziale (AGAC) di Reggio Emilia* [1999] ECR I-8121.

or transfer of securities or other financial instruments in particular transactions by the contracting authorities to raise money or capital."

To determine whether the exemption in Regulation 6 (2) (h) will apply to the contract with the Operator requires further analysis of the proposed ACS. However, there are at least *prima facie* arguments that it will, provided in particular that the main object of its contract consists of "financial services" and that these services are "in connection with transactions in "securities", within the meaning of that Regulation. "Securities" are widely defined in the Regulation and it is reasonable to assume that the majority of the underlying listed assets that will be held in the funds controlled by the Operator would fall within this category. Further assessment would be required to determine whether other assets, in particular unlisted assets, could be classed as securities and whether this may impact upon the application of Regulation 6 (2) (h).

It should also be noted that the wording of the exemption has been altered in the PCR 2015 as follows, in draft Regulation 10(1)(e) : "*financial services in connection with the issue, sale, purchase or transfer of securities or other financial instruments within the meaning of Directive 2004/39/EC of the European Parliament of the Council, central bank services and operations conducted with the European Financial Stability Facility and the European Stability Mechanism*". This does not alter our analysis.

If Regulation 6 (2) (h) applies to the contract with the Operator, it will not be subject to the full requirements of the PCR irrespective of the nature of its establishment (i.e., whether set up, appointed or a JV). If Regulation 6 (2) (h) does not apply (and, in the case of a set up Operator, the *Teckal* exemption does not apply), the contract with the Operator will require a competitive procurement process through the OJEU.

3. Oversight Board: establishment and ownership

As section 4.2 explains, we have proposed that separate oversight entities are established in order to act as an interface with ACS operators. Certain key questions, therefore, arise in relation to the oversight entities, which are as follows:

1. What legal structure can these body take?
2. Are there any different consequences arising from the choice of a legal structure?
3. Is there any restriction on who may be a shareholder in the oversight entity?
4. Are there any restrictions on the appointment of directors to the oversight entity?
5. Are there any restrictions on the functions that may be delegated to the oversight entity from the LGPS Funds?
6. Can the oversight entity procure the appointment of the ACS operator and any other parties?

1 Legal Structure of the oversight entities

Given that the oversight entities' operating functions are at this stage not finalised, there is no express restriction on the legal form which an oversight entity could take. However, the central prerequisite that we have set out in this report is that it must provide a means of representation for the participating LGPS Funds in relation to a ACS operator. As such, the legal structure needs to be pre-determined in such a way as to prevent the oversight entity from having an impractical operating structure, but one that is sufficiently robust to answer any criticisms from third parties (bearing in mind that as a public body, whoever owns it, it will be subject to the Freedom of Information Act 2000).

It is important to remember that an oversight entity cannot exercise certain functions itself, since it is neither a "participant" in the ACS (i.e. a unitholder), nor would it be desirable for it to have an executive function within the ACS operator which requires it to be authorised in any way by the FCA. Its functions therefore are circumscribed by having an advisory role on behalf of the participating LGPS Funds and monitoring in respect of the ACS operator.

Under local government law, the oversight entity could take the structure of a joint committee or a corporate body, which in turn could be a company limited by shares or guarantee or an unlimited company.

2 What are the consequences stemming from the choice of legal structure for the oversight entity?

The current statutory position is set out under the LGHA with regard to both committee functions and companies in which local authorities have interests. Part I of the LGHA and specifically section 15 provides that there must be a political balance on committees which are subject to that part of the Act. This provision applies (by virtue of Schedule 1 paragraph 2(1)(e)) to a pensions committee established in accordance with regulations made under Section 7 of the Superannuation Act 1972 which falls within the scope of Section 15 and therefore is bound to have political balance. The position of joint committees is complicated. Paragraph 2(1)(h) to Schedule 1 extends the requirement of political balance to joint committees but only if they do not fall within the preceding sub-paragraphs (ie including sub-paragraph (e)). The Local Authorities (Arrangements for the Discharge of Functions (England) Regulations 2000, Regulation 12(1) confirms that where a joint committee is appointed under section 101(5) of the LGA "the political balance requirements shall not apply". The equivalent Welsh regulations are the Local Authorities (Executive Arrangements) (Discharge of Functions) (Wales) Regulations 2002, Regulation 12(1).

By contrast, Part V of the LGHA, which defines companies which are "controlled" or is subject to the influence of local authorities, are subject to the requirements of Section 70 of the Act. Section 70 merely provides that the Secretary of State may, by order (i.e. secondary legislation) "make provision regulating, forbidding or requiring the taking of certain actions or courses of action" (Section 70(1)). There are some other consequential provisions in Section 70 which relate to accountability for expenditure and financial transactions entered into by companies which are under the control or subject to the influence of local authorities, but these are no more than one would imagine would apply under local authority legislation generally.

Part V of the LGHA is due to be repealed and replaced by Part 12 of the Local Government and Public Involvement In Health Act 2007 ("LGPIHA"). Section 214 contains similar powers to the current Section 70, although the main drafting change is to refer to "entities" as opposed to companies which are controlled etc. by local authorities. The only other difference between the two statutes is that under the LGHA the Secretary of State is empowered to make an order which applies to all local authorities, particular local authorities or particular descriptions of local authority (Section 70(6)), whereas under the LGPIHA, there is a distinction now made between the Secretary of State's powers in respect of English local authorities and Welsh local authorities.

Finally, Section 73 of the LGHA allows for the provisions of Part V to apply to authorities acting jointly and by committees as if the powers were applicable to a single local authority.

Note that the above statutory provisions only apply to local authorities. Some administering authorities (the LPFA, Environment Agency and South Yorkshire Pensions Authority) are not local authorities so other constitutional provisions may apply.

3 Is there any restriction on who may be a shareholder in the oversight entity?

There is no restriction on either an LGPS Fund (i.e. its administering authority) becoming a shareholder in a corporate entity, especially in light of the Localism Act 2011 and the general power of competence under Section 2. This is somewhat at odds with the provisions of Section 71(2) of the LGHA, which reserves to the Secretary of State the power to "approve" the subscription for a shareholding in a company or the ability of a local authority to become a member of company limited by guarantee. That section also gives the Secretary of State the power to prevent the power of appointment of directors of companies, the power to nominate any person to become a member of a company and the power to permit any officer of the authority in the course of his employment to become or remain a member or director of the company. It appears, however, that this power, although expressed positively, is actually a power of veto and the only instances where it has been used have been in relation to transport companies.

Under Section 3(2)(a) of the Public Service Pensions Act 2013 ("PSPA") there is a general power given to the "responsible authority" (i.e. the DCLG in the case of the LGPS) to make such regulations which are "consequential, supplementary, incidental or transitional" in relation to the LGPS as the responsible authority "considers appropriate". Schedule 3 sets out the scope of scheme regulations in respect of "supplementary matters". There is an extensive list of provisions which are now to be found in the Local Government Pension Scheme Regulations 2013 (SI 2013/2356).

4 Are there any restrictions on the appointment of directors to an oversight entity?

See above re section 70 of LGHA; in reality there are no relevant legal restrictions from an LGPS Funds perspective.

5 Are there any restrictions on the functions that may be delegated to an oversight entity from the LGPS funds?

It is not intended that decisions about asset allocation, which are currently reserved to the LGPS funds under the LGPS Investment Regulations, would be delegated to any other party since it is important that local accountability is preserved. However, the possibility of using the oversight entity to carry out performance measurement and scrutiny of the ACS operator and any parties appointed by the Operator may arguably entail some delegation of a function that is ancillary to the power of investment (see comments in 3 above regarding paragraph 13 of Schedule 1 to PSPA). Notwithstanding this balance, there are no applicable restrictions which would prevent the functions of the LGPS funds from being delegated to the oversight entity. Certain other functions as set out in the Local Authorities (Alternative Arrangements) (England) Regulations 2001 and the equivalent Welsh regulations contain detailed provisions about non-delegable functions, but these are not relevant.

This ties into the use of cost sharing structures which take advantage of the Teckal exemption from procurement legislation set out in Point 2 above, whereby one body discharges the functions of another contracting authority.

6 Can the oversight entity procure the appointment of the ACS operator?

On the assumption that the LGPS funds would either own or establish the oversight entity, the oversight entity would likely qualify as a contracting authority for the purposes of the procurement legislation. It could procure on behalf of the participating LGPS funds the appointment of the ACS operator, subject to the normal OJEU procedure. On this subject, please see Point 2 and the analysis of the exemption under regulation 6(2)(h)[10] of the PCR.

[10] Now PCR2015 Regulation 10(1)(e)(i)