Pensions CIV Sectoral Joint Committee

Background and Progress Update

Item no: 6

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Summary This report provides the committee with an update on progress towards establishing a Collective Investment Vehicle for those London boroughs that wish to participate in such arrangements.

Recommendations The committee is recommended to consider and note the contents of this report.

Progress report and proposed next steps towards a London LGPS CIV

Introduction

1. The question of whether and if so how the Local Government Pension Schemes (LGPS) across London might work more closely together has been the subject of a number of reports to London Councils' Leaders' Committee and Executive since March 2012 (see 'Background Papers' below for a complete list of all reports). To provide leadership and direction to this consideration Leaders' Committee resolved to establish a Pensions Working Group (PWG) comprised of the then three London Councils' Party Group Leaders (Mayor Jules Pipe and Cllrs. Teresa O'Neill and Ruth Dombey) and three representatives from the Society of London Treasurers, supported by the then Director of Fair Funding, Performance & Procurement.

2. In response to a Pensions Working Group (PWG) update to its December 2013 meeting, Leaders' Committee resolved that London Councils should establish a designated fund with contributions from those boroughs interested in further exploration of proposals for the establishment of a London LGPS Collective Investment Vehicle (CIV) and that the funds collected should be used to pay for the professional costs associated with that exploration.

3. Since that meeting 30 London local authorities have become active participants in the CIV programme and have each contributed £25,000 to the designated fund. Three boroughs have decided not to participate at this time.

4. The fund is being used to commission specialist expert professional advice associated with the development of the proposed CIV. At this point £470,000 of the fund has been committed to cover the costs of expert advisors (Eversheds, Deloitte, Northern Trust (on a short contract leading to the February 2014 report to Leaders' Committee), and Mercer), and the engagement of a Programme Manager on a one year fixed-term contract.

5. At its February 2014 meeting, Leaders' Committee considered a report from the PWG, which presented a more detailed business case and proposals in respect of establishing a CIV with the underlying structure of a UK Authorised Contractual Scheme (ACS).

6. Leaders' Committee agreed the recommendations of the PWG, and resolved to endorse and recommend to each local authority which decides to participate that, in addition to matters connected to the establishment of an ACS operating company, a representative

body, in the form of a new Sectoral Joint Committee (the "Pensions CIV Joint Committee" (PCJC)), be established (pursuant to the existing London Councils Governing Agreement, dated 13 December 2001 (as amended)). That committee has now been formed and is meeting today for the first time.

7. This report provides an update to the PCJC on progress since the February meeting of Leaders' Committee and sets out plans leading towards the eventual launch of the CIV.

Borough engagement

8. The February 2014 report asked that Leaders' Committee endorse and recommend to each local authority which decides to participate, that they make decisions based on a number of recommendations that would be necessary to the establishment of the CIV. Since then 30 boroughs have given formal notification (in the form of a letter to London Councils' Chief Executive) that such resolutions have been made. Three have decided that they will not be participating at this time.

Programme Structure

9. With such weight of support being demonstrated by the boroughs the initial exploratory project has quickly moved to being an implementation programme. Within the programme there are three projects:

    i. **Establishing the company that will be the ACS Operator with all the underlying systems, processes and policies required of an organisation that will conduct business and employ staff**, which includes all the areas associated with setting up a new company from the ground up including (as examples) incorporating the company as a company limited by shares (London LGPS CIV Ltd. has been incorporated and each participating borough holds a £1 share), agreeing a licence to occupy with London Councils (it is proposed that the company will be accommodated within 59½ Southwark Street), and setting up finance, HR and IT systems and policies;

    ii. **Establishing the company as a financial services organisation regulated by the Financial Conduct Authority (FCA)**, which includes defining the company's operating model, writing policies and procedures, completing a significant amount of paperwork to support the authorisation application to the FCA, and procuring relationships with key partners such as the Asset Servicer (covering custodian, depository and fund administration);

    iii. **Establishing the fund structure for launch**, which includes analysing the current pattern of investments across the boroughs, engaging with the

Investment Managers (IMs) to gather detailed data about assets under management, mandate types and fee structures, discussing with the IMs which mandates may be suitable to transition to the CIV, putting the proposed structure to each borough for consideration by their relevant committee and, later, agreeing a transition strategy for launch.

10. To support the delivery of this programme a Technical Sub-Group (TSG) was set up at the beginning of 2014. This is an officer group, constituted of the core programme team of two officers from London Councils and a number of LGPS experts from across the boroughs, under the leadership of the Director of Finance from LB Wandsworth. The input from these borough colleagues has been vital to the progress made so far.

Governance and structures

11. The CIV is being developed for and on behalf of the London boroughs and the City of London, and each will participate on an entirely voluntary basis. As such, considerable attention is being given to ensuring that the proposed governance and operational structures of the CIV reflect the wishes and needs of the boroughs, both on day one and into the future.

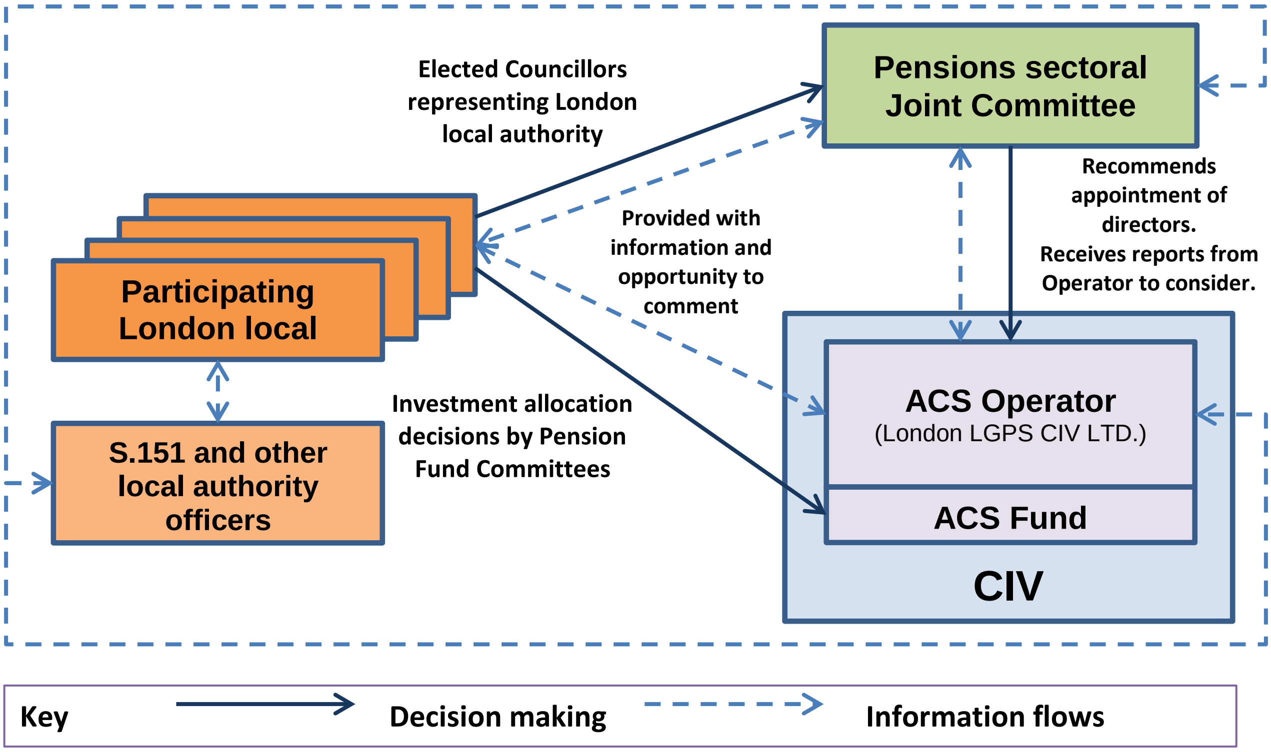
12. It is noteworthy that from advice to date the governance and structures described below are considered to give sufficient ownership and control for the participating boroughs such that there is no requirement for a borough to procure either the services of the Operator nor entry in the Fund (procurement professionals would recognise the arrangements are “Teckal compliant”). Some initial thought has been given to the possibility that the CIV might be open to investments from other LGPS funds (Administering Authorities from outside of London). This is something that members will be asked to decide upon at a later stage, but the question does have some bearing on the relationship between participating London LGPS funds and the CIV which could lead to the Teckal rules being breeched, this is explored in more detail in the ‘Relationship between the London boroughs, the CIV and other LGPS funds’ section below.

13. Figure 1 below illustrates the overarching governance structure that is being established. A key element of that structure is the Pensions CIV Joint Committee. The committee will act as a representative body comprised of elected members from those local authorities that resolve to participate in the arrangements. At its March 2014 meeting, Leaders’ Committee agreed, in principle, the Pensions CIV Joint Committee terms of reference, which are the subject of a separate report to today’s meeting (see agenda item 5).

14. The CIV will be a Financial Conduct Authority (FCA) regulated UK domiciled Authorised Contractual Scheme (ACS). The ACS structure has been adopted because it brings with it significant international tax advantages and a high degree of data transparency. There are primarily two separate regulated elements to the structure, which are an ACS Operator and the ACS Fund.

15. The ACS Operator is a limited liability company (London LGPS CIV Ltd.), which is wholly owned by the 30 participating boroughs. At this stage it has interim directors, as proposed in the February report to Leaders' Committee, with final directors to be recruited and appointed ahead of the company being authorised and operational. The interim directors are Mayor Jules Pipe, Cllrs. Teresa O'Neill and Ruth Dombey, Mr Chris Buss (Treasurer, LB Wandsworth), Mr Ian Williams (Treasurer, LB Hackney), Mr Peter Kane (Chamberlain, City of London) and Mr John O'Brien (CEO, London Councils).

Figure 1



16. Detailed work is about to begin of define the company's operating model. Deloitte LLP have been selected through a procurement process to give expert advice to this work and to assist in taking the company through to authorisation and launch.

17. It is anticipated that, initially, the Operator will be based on a model that has as many roles and functions outsourced as possible – accepting that the FCA will have strong views in this area so total outsourcing is unlikely to be acceptable. As such it will have a

limited number of directly employed staff, with most functions being provided through outsourced partners. Over time, it is likely that a number of the outsourced functions could be brought in-house, but this will depend on establishing the necessary level of skills, knowledge and expertise, either through recruitment or training.

18. Procuring the outsourced partners is a complex and time consuming exercise and the Technical Sub-Group (TSG, set up to support the PWG) has begun the process of drawing up specifications and engaging with the market. It is hoped to have the first key partner, the Asset Servicer, in place by the end of 2014.

19. For expediency it was agreed that the London LGPS CIV Ltd. would adopt 'model' Articles of Association for its initial incorporation and that these would be revised to reflect the final governance structures and operating model as the detail became clearer. Over recent weeks Eversheds has been working on a draft 'Head of Terms' (HoT) document to inform the revision of the Articles and the drafting of a Shareholder Agreement. It is proposed that the draft HoT will be circulated to officers in participating boroughs for consideration and comment before bringing a final draft to the company's Board of Directors and this committee for formal agreement.

Structuring the ACS fund

20. Final decisions about the initial fund structure will be taken later following consultation with the participating boroughs and the Investment Management industry. However, it is thought that a pragmatic starting point is to analyse which Investment Managers (IM) boroughs are currently invested through, to look for commonality (i.e. more than one borough invested with the same IM in a largely similar mandate), and to discuss with boroughs and IMs which mandates would be most appropriate to transition to the ACS fund for launch. Each mandate would become a separate, ring-fenced, sub-fund within the overall ACS fund. Boroughs will be able to move from one sub-fund to another relatively easily, but ring-fencing will prevent cross contamination between sub-funds.

21. The strategy being proposed for launch does, however, raise the question of whether the CIV can enter into contracts with IMs without the need for procurement (were procurement rules to apply there would be a significant risk that current borough-Investment Manager relationships may not be replicated on the ACS fund). Because of the critical nature of this issue to the overall strategy the advice of counsel has been sought.

22. Counsel's initial advice suggests that Regulation 6(2)(h) of the Public Contracts Regulations (as amended) can be relied upon to take these contracts outside of the EU

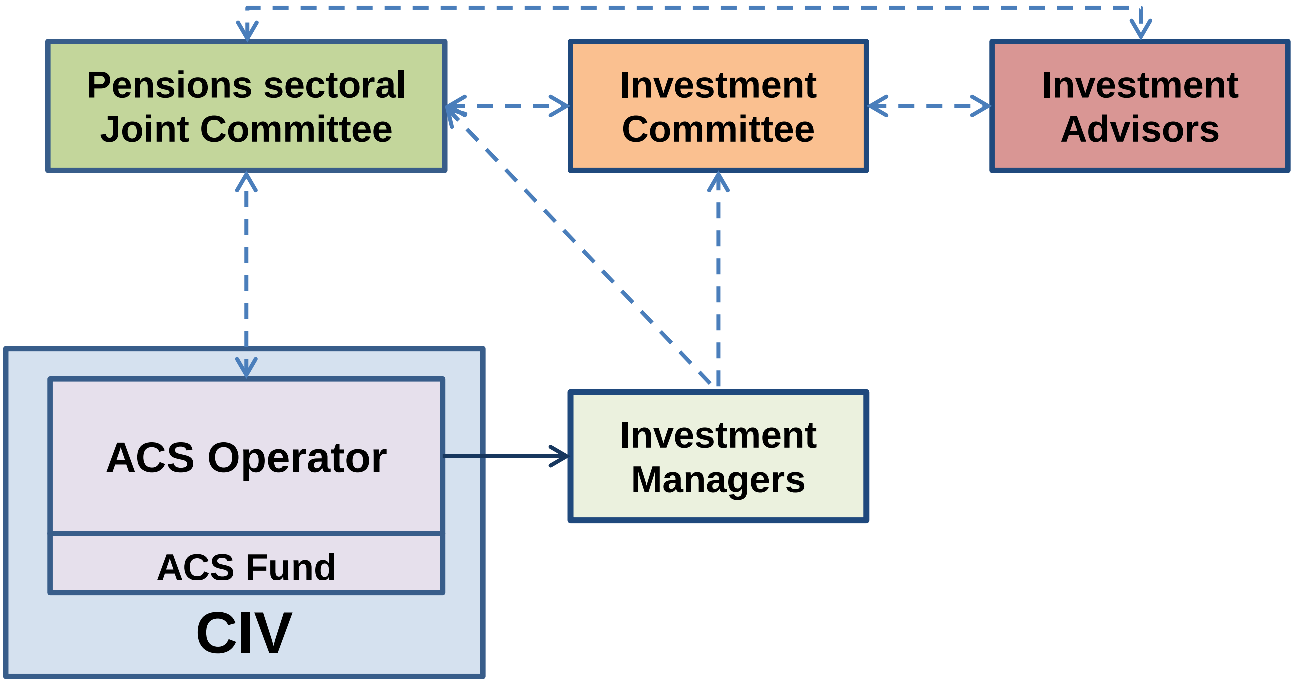
procurement regime. However, because this advice is so important to the CIV's proposed launch strategy it is intended to return to Counsel for clarification of a few points before circulating the final advice around the boroughs.

23. It is worth noting that, beyond the launch phase, the intention of the CIV company would be to normally carry out competitive procurements for the contracts which it concludes in the same way as currently seen across the boroughs.

24. Over time the fund will evolve and develop, with the potential for some mandates to be removed and others to be brought on. The Operator will not be regulated to give investment advice to the boroughs (at least not initially), and so thought is being given to the governance structures that might inform decision making of the boroughs and ensure that the boroughs' needs and wishes are reflected in the fund going forward.

25. Figure 2 illustrates current thinking in this area; it shows that an investment committee might be formed, with a number of LGPS experts drawn from across the boroughs, and potentially some independent experts. This committee would meet to consider how the ACS fund is performing and how it might be developed. Those considerations would be informed by input from a panel of procured investment consultants/advisors. Reports and recommendations would flow from the Investment Committee to the PCJC (similar to the way borough officers and investment advisors support borough pension committees). The PCJC would consider the recommendations made by the Investment Committee and feed its recommendations to the Operator. The Operator will act on the recommendations of the Joint Committee, subject to the necessary due diligence checks and so on that it will be required to carry out as the regulated body with responsibility for the good management of the ACS fund.

Figure 2



26. This is not an entirely settled structure and its final form will depend on the wishes of the boroughs, the final directors of the ACS Operator being content, and what is acceptable to the FCA from a regulatory perspective.

Relationship between the London boroughs, the CIV and other LGPS funds

27. A number of LGPS funds outside of London have shown an interest in what the boroughs are seeking to achieve. This has included both, looking at the governance and structures being proposed as a source of learning and information, as well as asking if the CIV will be open to investors beyond just the London boroughs.

28. On the point of the ACS fund being open to other investors, it is a requirement of the legislation underpinning an ACS fund that it must be open to all qualified investors (it will be what is known as a Qualified Investor Scheme (QIS)). Clearly the Operator will need to manage this as it is not the intention that it should take on, for instance, investors from the private sector. However, it could be that the boroughs might wish the CIV to accept investments from other LGPS funds, and this may well be attractive in terms of the benefits to be derived from additional scale.

29. Should the boroughs wish to have the ACS fund open to the wider LGPS in the future, there are some issues to be worked through to ensure that this can be achieved without undermining the ability of the boroughs to use the CIV without having to procure its products (investment opportunities) or the services of the Operator.

30. Because of the potentially critical nature of this issue it has been raised with Counsel as part of the advice noted above. In essence, Counsel has been asked to confirm that the boroughs' relationship with the company is exempt from procurement, and whether opening the CIV to investments from other LGPS funds would undermine that position and lead to the boroughs having to procure the services of the company.

31. In brief Counsel has confirmed that he is of the view that there are two possible arguments that might be used to argue that the relationship between the boroughs and the CIV is procurement exempt. These are either (1) the application of the Teckal Exemption (which can apply where a contracting authority (in this case a London borough or the City of London) contracts with a legally distinct entity (usually this will be a company that the authority has set up, either on its own or in concert with others), to provide services) or (2) that Regulation 6(2)(h) of the Public Contracts Regulations 2006 (as amended) provides an appropriate exemption to the application of the Regulations.

32. The Teckal exemption is based on a set of rules which includes that 80% of the company's turnover must derive from its 'parent' authorities. In the context of allowing other LGPS funds to invest in the CIV this presents a potential problem if significant investments, and therefore fees, were to be generated by investments from other parts of the LGPS (i.e. non-London authorities). It may still be possible to establish the company as a Teckal body but it will be less straightforward.

33. The second argument, is that "contracts" between the London boroughs (who are members of London LGPS CIV Ltd) and the CIV itself and any associated contracts with third party suppliers to which the boroughs may become signatories (e.g. Asset Servicer) do not need to be procured, as such arrangements are excluded from the application of the Regulations by virtue of Regulation 6(2)(h). The specific exemption provides that the Regulations do not apply to the seeking of offers for *"financial services in connection with the issue, purchase, sale, or transfer of securities or other financial instruments in particular transactions by the contracting authorities to raise money or capital."*

34. Counsel has confirmed that in his opinion this exclusion does apply and therefore the boroughs do not need to procure the services of the CIV. In effect this means that at the outset the boroughs can rely on either the Teckal exemption or Regulation 6(2)(h) to use the CIV without procurement.

35. Relying on Regulation 6(2)(h) counsel also advises that any LGPS fund can chose to invest through the CIV without the need for procurement even though they are not a

participating member of the CIV. If the reliance is placed on Regulation 6(2)(h) rather than Teckal the “80%” rule is no longer an issue.

36. As noted above, because this issue is so critical to the overall strategy for the CIV, the programme’s legal advisers have been asked to go back to Counsel with some points needing clarification. Once this clarification has been received a note will be circulated to the boroughs.

Budget

37. Since the report to Leaders’ Committee in December 2013, and the subsequent report in February 2014, 30 boroughs have agreed to participate in the CIV and have each contributed £25,000 to a dedicated fund held by London Councils which was initially for the purposes of “…exploring the proposal…”. As noted above the initial exploratory project has swiftly moved to being an implementation programme. The February report provided an estimated budget, based on what was known at the time, that proposed an implementation cost in the region of £1.5 million.

38. Attached at Annex A is an updated budget showing expenditure committed to date and anticipated expenditure through to launch. From Annex Ait can be seen that the total estimated expenditure to launch is now £1,713,831.

39. At its inaugural meeting of 14 October 2014 the board of London LGPS CIV Ltd. were presented with this budget overview and were recommended to write to the Treasurer of each participating borough proposing that each borough make an additional contribution of £25,000 now and a further contribution of the same amount at the beginning of the next financial year.

40. The board agreed to the recommendation and letters have now been sent, and invoices will be raised shortly for the first amount, although it should be noted that one borough has indicated that an invoice should not be sent until after this meeting and subject to a final decision by members of the borough’s pension committee.

41. The committee will wish to note that there will be an anticipated underspend at launch of £516,169 which will contribute towards the first year’s operating expenses as the CIV becomes established and the ‘business as usual’ (BAU) budget and fee structure comes into play.

42. A BAU budget is being worked on by the TSG, but this is heavily reliant on the final definition of the company’s operating model and as such it will be brought to the committee at a later meeting.

Timeline

43. The TSG has been working hard during 2014 to make swift progress, a significant amount has been achieved, but there is a lot of ground still to cover. As things stand it looks likely that the CIV will launch in the summer of 2015, but key to this will be defining the company's operating model and taking this to the FCA for authorisation – the FCA can take up to six months to consider an application for authorisation, although it is hoped that they might be able to process this application more swiftly.

Government Consultation

44. Government Ministers have shown significant interest in the LGPS over the last two years and have been particularly keen to consider options for reform that might deliver cost savings and efficiencies.

45. On 2 May 2014 the Government released a consultation titled Local Government Pensions Scheme: Opportunities for collaboration, cost savings and efficiencies, which drew on an earlier call for evidence on the future structure of the LGPS, which ran through the summer of 2013, and supplementary cost-benefit analysis of proposals for reform that the Government commissioned from Hymans Robertson LLP.

46. The package of proposals set out in consultation included:

- Establishing common investment vehicles to provide funds with a mechanism to access economies of scale, helping them to invest more efficiently in listed and alternative assets and to reduce investment costs;

- Significantly reducing investment fees and other costs of investment by using passive management for listed assets, since the aggregate fund performance has been shown to replicate the market;

- Keeping asset allocation with the local fund authorities, and making available more transparent and comparable data to help identify the true cost of investment and drive further efficiencies in the Scheme;

- A proposal not to pursue fund mergers at this time.

47. The Government posed five questions in the consultation, which were:

Q1. Do you agree that common investment vehicles would allow funds to achieve economies of scale and deliver savings for listed and alternative investments? Please explain and evidence your view.

Q2. Do you agree with the proposal to keep decisions about asset allocation with the local fund authorities?

Q3. How many common investment vehicles should be established and which asset classes do you think should be separately represented in each of the listed asset and alternative asset common investment vehicles?

Q4. What type of common investment vehicle do you believe would offer the most beneficial structure? What governance arrangements should be established?

Q5. In light of the evidence on the relative costs and benefits of active and passive management, including Hymans Robertson's evidence on aggregate performance, which of the options set out above offers best value for taxpayers, Scheme members and employers?

48. The consultation closed on 11 July 2014, and by agreement of Leaders' Committee London Councils submitted a response on behalf of its members which in summary said:

- London Councils endorses the Government's decision not to pursue fund mergers at this time.
- London Councils believes that Collective Investment Vehicles (CIVs) can offer significant savings and the opportunity for improved investment returns through economies of scale and access to alternative investments.
- London Councils strongly endorses the proposal to keep asset allocation decisions with the local fund authorities.
- London Councils has no firm view on the number of CIVs that should be set up, but does believe that a single CIV for the entire LGPS would generate dis- economies of scale and potential disruption to the investment market.
- London Councils believes that an FCA regulated ACS is the most suitable form of CIV for the London boroughs, and proposes a governance structure that allows the boroughs strong oversight and control within the regulatory framework.
- London Councils believes that passive management should not be enforced at any level and that individual fund authorities should have the ability to use active management as part of their investment strategies. London Councils also believes that the London CIV could enhance governance and could act as a catalyst to deliver the benefits of active management for individual pension funds.

49. London Councils’ officers have continued to engage closely with their counterparts in Government and, while ultimate decisions are still to be made by Ministers, there has been no indication that the Government thinks the boroughs should stop their plans to establish a CIV. Indeed, the fact that the Government’s consultation clearly shows that Ministers have developed their thinking away from LGPS fund mergers (although not to the point of abandoning the potential for mergers altogether), towards encouraging the development of CIVs, and that the Local Government Minister has met with Mayor Jules Pipe and Cllr Teresa O’Neill since the consultation, could both be taken as positive signs of encouragement.

Conclusion

50. Significant progress has been made towards establishing a CIV for those London boroughs that wish to participate in the arrangements. This report has provided an update on the key aspects of that progress to date. There is still significant ground to be covered across the three projects underpinning the programme, further reports will come to future meetings of the committee to ensure that members are kept fully informed and have regular opportunities to comment on and steer implementation over the coming months.

Recommendations

51. The committee is recommended to consider and note the contents of this report.

Legal implications

52. These are captured in the body of the report.

Financial implications

53. This report outlines progress on a range of issues, primarily financial and governance processes, required to successfully establish the London LGPS CIV. These will continue to be developed as the requirements of the company become clearer and the operating model is firmed up. Annex A details the current budget plan in respect of preparatory costs and highlights the contributions from participating boroughs to cover all anticipated commitments up until launch.

Equalities implications

54. There are no equalities implications for London Councils

Attachments

Annex A Budget Overview

Background papers

13 March 2012, Leaders' Committee report:
http://www.londoncouncils.gov.uk/committees/agenda.htm?pk_agenda_items=4796

13 November 2012, Leaders' Committee report:
http://www.londoncouncils.gov.uk/committees/agenda.htm?pk_agenda_items=5072

11 December 2012, Leaders' Committee report:
http://www.londoncouncils.gov.uk/committees/agenda.htm?pk_agenda_items=5109

14 May 2013, Leaders' Committee report:
http://www.londoncouncils.gov.uk/committees/agenda.htm?pk_agenda_items=5252

19 September 2013, Executive report:
http://www.londoncouncils.gov.uk/committees/agenda.htm?pk_agenda_items=5353

26 November 2013, Executive report:
http://www.londoncouncils.gov.uk/committees/agenda.htm?pk_agenda_items=5490

10 December 2013, Leaders' Committee report
http://www.londoncouncils.gov.uk/committees/agenda.htm?pk_agenda_items=5495

11 February 2014, Leaders' Committee report
http://www.londoncouncils.gov.uk/committees/agenda.htm?pk_agenda_items=5562

11 March 2014, Leaders' Committee report
http://www.londoncouncils.gov.uk/committees/agenda.htm?pk_agenda_items=5598

15 July 2014, Leaders' Committee Report
http://www.londoncouncils.gov.uk/committees/agenda.htm?pk_agenda_items=5668

Annex A

Budget Overview			
		£	£
Expenditure committed to date			
Deloitte - initial consultancy		-£150,000	
Eversheds		-£170,000	
Northern Trust		-£22,080	
Eversheds - procurement advice (inc. Counsel)		-£15,890	
Project Manager (to May 2015)		-£70,000	
Mercer		-£49,950	
Office equipment		-£911	
			-£478,831
Income to date			
Borough contributions		£750,000	
(30 boros x £25k)			£750,000
	Balance		£271,169
Estimated expenditure to Mar 2015			
Tax advice consultancy		-£144,000	
ACS set up costs		-£320,000	
Legal costs		-£160,000	
Transition consultant		-£20,000	
Recruitment and employment costs of			
CEO / CIO / COO and non-exec board members		-£190,000	
			-£834,000
Additional income from boroughs now		£750,000	
(30 boros x **£25k**)			£750,000
	Balance		£187,169
Estimated expenditure Apr 2015 - launch			
Tax advice through to launch		-£36,000	
ACS set up		-£100,000	
Legal costs		-£40,000	
Transition consultant		-£80,000	
Anticipated employment costs of CEO / CIO / COO			
and non-exec board members to launch		-£165,000	
			-£421,000
Additional income from boroughs Apr 2016		£750,000	
(30 boros x **£25k**)			£750,000
	Balance		£516,169
Total estimated expenditure to launch			-£1,733,831