

Regulations expressly permitting LGPS investment in derivatives come into force on 1 November 2016

Following on from our [briefing](#) published last week, the new Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 have now been laid before Parliament and will come into force on 1 November 2016. These regulations will revoke and replace the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009.

The Government's response to its consultation on the new regulations was also published this week.

This briefing takes a closer look at the new regulations, now they have been finalised. It focuses, in particular, on the points likely to be of interest to those in the investment banking sector looking to transact with administering authorities of Local Government Pension Scheme (LGPS) funds (including the extended capacity to use derivatives).

The final form regulations

The final regulations do not differ significantly from the draft published for consultation last year.

The main change is an extension to the deadline for LGPS funds to publish their investment strategy statements (a requirement of the new regulations and discussed further below); which has been moved from 1 October 2016 to 1 April 2017. The period during which existing statements of investment principles under the 2009 regulations can remain in

force until the new statements are published is similarly extended.

Derivatives

The new regulations expressly define "investment" to include a contract entered into in the course of dealing in financial futures, trade options or derivatives.

As reported previously, this is likely to be of particular interest to those in the investment banking sector as by expressly permitting investment in derivatives, the new regulations will open up the derivatives market to LGPS funds; which have previously had only limited ability to make use of these products as part of their

Points of Interest

- Extended capacity for LGPS funds to invest in derivatives
- New ability for Secretary of State to intervene in LGPS investment decisions
- Potentially more limited capacity for LGPS funds to enter into stock lending arrangements directly
- Increased investment via asset pooling could prove helpful where concerns over capacity

investment strategies.

Guidance was also published last week (designed to help LGPS funds with the preparation of their investment strategy statements). Currently, this guidance does not contain anything specific about the use of derivatives; instead it gives general guidance on matters such as diversification of investments and the suitability of particular investments.

In particular, it states that the guidance's purpose is not to prescribe specific asset classes over which LGPS fund assets must be diversified, and what constitutes a suitable investment is a matter for individual LGPS administering authorities to assess taking into account factors such as risk appetite, funding strategy and performance benchmarks. (It is likely that this guidance will be updated over time).

Secretary of State intervention

One aspect of the 2016 regulations which has attracted a lot of attention is the new ability for the Secretary of State to intervene in investment decisions made by LGPS administering authorities.

The 2016 regulations require LGPS administering authorities to formulate an investment strategy, which must be in accordance with guidance issued from time to time by the Secretary of State. As mentioned above, LGPS authorities are then required to publish an investment strategy statement (the first statements must be published by 1 April

2017).¹

As part of the new framework, the regulations empower the Secretary of State to make a direction if satisfied that the LGPS authority is failing to act in accordance with the Secretary of State's guidance.

The scope of the Secretary of State's powers in this respect is broadly drawn under the 2016 regulations. They provide that a direction can require any of the following:

- the LGPS authority to make changes to its investment strategy as the Secretary of State considers appropriate, within a specified timeframe;
- the LGPS authority to invest in such assets and in such manner as the Secretary of State specifies;
- the investment functions of the LGPS authority to be transferred to the Secretary of State or a person nominated by the Secretary of State for such period considered appropriate;
- the LGPS authority to comply with any instructions in relation to the exercise of its investment functions where such functions have been transferred.

Before making a decision to issue such a direction, the Secretary of State must consult the relevant LGPS authority. In its consultation response, the Government notes that this safeguard is designed to ensure the power is used

¹ Investment strategy statements must be reviewed and if, necessary, revised at least every three years.

appropriately, proportionately and only where justified by the evidence.

At this stage, it is impossible to predict how the Secretary of State may choose to exercise these powers in practice. Our view is that the Secretary of State could not require existing contracts to be unwound, but banks and other financial counterparties may want to build in additional representations and events of default / termination events to investment contracts in order to protect against this potential risk when contracting with an LGPS administering authority.

At the same time, it is possible that LGPS authorities may seek to incorporate greater flexibility to enable them to terminate contracts in the event they cease to be compatible with the Secretary of State's investment guidance.

Stock lending arrangements

Unlike the 2009 regulations, the 2016 regulations no longer expressly refer to stock lending arrangements as a permitted investment.

It would appear from the original consultation paper that this removal was not intended to prohibit the use of such arrangements. The consultation response published this week does not comment on this specifically, but reiterates the policy intent behind the 2016 regulations to deregulate the investment functions of LGPS administering authorities – imposing a prohibition on using such arrangements would appear to run counter to this new

deregulatory approach.

Notwithstanding this, on its face, the wording of the 2016 regulations may make it more difficult for LGPS funds to get comfortable entering into stock lending arrangements. However, it is possible this may be less of a concern given the changes on pooling (see below).

LGPS asset pooling

At the Summer Budget 2015, the Government announced its intention to invite the LGPS administering authorities to make proposals for pooling LGPS investments, with the intention of delivering reduced costs while maintaining overall investment performance. At the same time, the Government indicated an intention to legislate to *require* any LGPS authorities who failed to develop sufficiently ambitious proposals to pool their assets with others. This approach is reflected in the new regulations and related guidance.

Investment via asset pooling could prove helpful where there are concerns over the capacity of an LGPS administering authority to enter into particular contracts /

investments (such as the uncertainty over stock lending arrangements discussed above).

This is because certain vehicles (and this will depend on the specific type of pooling vehicle used) are treated as standalone entities for capacity purposes, meaning that, as long as the operator of the pooling vehicle is permitted to enter into particular types of contract / investment, there is no need for a counterparty contracting with that operator to look behind this and confirm the capacity of the pooling vehicle's participants to enter into those underlying contracts. (Capacity for the participant (i.e. LGPS authority) to invest in the pooling vehicle alone should be sufficient).

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