Briefing note October 2016

New regulations impact LGPS investment in stock-lending and derivatives

The new *Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016* will come into force on 1 November 2016; revoking the 2009 investment regulations currently in place.

The new regulations make some significant changes to the investment regime for Local Government Pension Scheme (LGPS) funds.

Of interest to those operating in the securities-lending market is the fact that the new regulations (unlike the 2009 regulations) no longer expressly refer to "stock lending arrangements" (see note below) as a permitted investment for LGPS funds.

It would appear from the Government's consultation on the new regulations that this change was not intended to prohibit the use of stock lending arrangements by LGPS funds, but it is possible the omission from the 2016 regulations could cause concern for LGPS funds over their capacity to enter into such arrangements once the regulations come into force.

The Government's current drive on LGPS asset pooling may, however, prove helpful here. Certain types of pooled vehicle are treated as standalone entities for capacity purposes, meaning that, as long as the operator of the pooled vehicle is permitted to enter into the particular contract / investment, there is no need to look behind this and confirm the capacity of the vehicle's participants (for example, an LGPS fund) to enter into those underlying contracts. Investment via a pooled vehicle could therefore prove useful where there are concerns over LGPS funds' capacity to invest in particular arrangements directly (as capacity to invest in the pooled vehicle itself may well be sufficient).

In contrast to the potentially more restrictive capacity for LGPS funds to enter into stock lending arrangements is the expanded scope to use derivatives; with the new regulations expressly defining "investment" to include a contract entered into in the course of dealing in financial futures, trade options or derivatives (previously LGPS funds had only limited ability to make use of derivatives).

A final point of significance to be aware of in relation to the 2016 regulations is the new ability for the Secretary of State to intervene in investment decisions made by LGPS fund administering authorities.

The scope of this power is broadly drawn under the new regulations. At this stage, it is impossible to predict how the power may be exercised 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 fund. At the same time it is possible LGPS authorities may seek greater flexibility to enable them to terminate contracts in the event they cease to be compatible with the Secretary of State's investment guidance (with which LGPS funds' investment strategy statements must be formulated in accordance).

Note: The 2009 regulations (which will be revoked by the new 2016 regulations) specify a "stock lending arrangement" as an investment eligible for use by an LGPS fund if certain conditions in the FCA's collective investment scheme sourcebook are satisfied. A "stock lending arrangement" for these purposes is defined as "an arrangement such as is mentioned in section 263B of the Taxation of Chargeable Gains Act 1992."

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