NORTHUMBERLAND COUNTY COUNCIL PENSION FUND
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UK public sector pensions speedbrief: The new LGPS investment regulations and investment strategy statement guidance

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The Department for Communities and Local Government ("**DCLG**") recently issued the **final version** of the new Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 (the "**Regulations**"). Under the Regulations, which will provide LGPS administering authorities with increased investment freedom, each administering authority must prepare an "investment strategy statement".

Alongside the Regulations, DCLG has also issued **guidance** intended to assist administering authorities in preparing and maintaining their statements, which must be in place no later than 1 April 2017.

Background

DCLG consulted on changes to the current Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 (the "**2009 Regulations**") in November 2015. The 2009 Regulations have long been criticised as being overly rigid and prescriptive. The new Regulations and DCLG's accompanying guidance aim to define the scope of the administering authority's duties and powers in relation to investment, and (more controversially) to introduce new supervisory and intervention powers for DCLG.

The Regulations

The final version of the Regulations is largely identical to the consultation draft, indicating that DCLG was in the main unmoved by the 23,516 responses received to the consultation.

In marked contrast to the 2009 Regulations, the Regulations do not set prescribed limits upon the type of investments which LGPS funds may hold or the weighting of different asset classes within the investment portfolio. Regulation 3 expressly confirms that derivatives count as "investments" under the Regulations.

Under Regulation 7, each administering authority will be required to formulate an "investment strategy statement", in place of the current requirement to prepare a statement of investment principles. As the name suggests, the statement is essentially an outline of the administering authority's approach to investing. Certain parameters are set out in the Regulations – for instance, the statement must include a requirement to invest in a "wide variety" of investments, and must set out the authority's approach to matters such as risk, pooling of investments, ESG (environmental, social and corporate governance) considerations and the exercise of voting rights.

The statement must comply with DCLG's guidance, and the authority must take "proper advice" before preparing it. The first statement must be published by 1 April 2017 and there is an ongoing requirement to review and revise the statement at least every three years.

The most hotly-contested provision in the consultation process was Regulation 8, which allows the Secretary of State to intervene **directly** in the investment management of a LGPS fund in the event that an administering authority fails to act in accordance with

DCLG's guidance. Under Regulation 8, the Secretary of State may direct the authority to:

1. make specified changes to its investment strategy statement;
2. invest some or all of the fund's assets in a specified manner;
3. permit the Secretary of State (or a nominee) to exercise the authority's investment functions for a specific period or as long as is considered appropriate; and/or
4. comply with instructions issued by the Secretary of State / nominee in relation to the exercise of its investment functions.

Directions under Regulation 8 may only be issued after consultation with the administering authority and after consideration of all reasonably available evidence regarding the authority's actual or proposed exercise of its investment functions.

The guidance

The guidance deals with the various requirements of Regulation 7 regarding the content of investment strategy statements (as outlined above).

Perhaps the most eye-catching extract from the guidance is confirmation of the Government's previously announced stance that the use by administering authorities of investment policies to pursue boycotts, divestment and sanctions against foreign nations and UK defence industries is inappropriate, except where formal embargoes, restrictions or legal sanctions have been imposed by the UK Government.

Instead, the pursuit of financial return must be the priority. Whilst the guidance does not rule out making "*investments that deliver social impact*", these must pose "*no risk of significant financial detriment to the fund*", and to the extent that such investments would produce a lower return, administering authorities must consider whether the scheme members would share the concern for social impact.

The guidance also seeks to strengthen the current requirements regarding use of voting rights, with administering authorities being strongly encouraged to "*engage with companies on matters such as strategy, performance, risk, capital structure and corporate governance, including culture and remuneration*". The latter point suggests that excessive remuneration and benefits packages are unlikely to conform to the guidance.

Concerns that the Government would include in the guidance an explicit requirement to invest in infrastructure have not been borne out. However, there remain a number of specific requirements regarding pooling, some of which sit somewhat awkwardly within the concept of an investment strategy statement as a summary of the fund's chosen approach to investment. For instance, the guidance requires the statement to provide that the administering authority will make certain notifications to the Scheme Advisory Board and to the DCLG, and issue annual reports to the Scheme Advisory Board on the progress of asset transfers into pools. These requirements may have been better placed within the Regulations, rather than being introduced within the guidance.

Comment

It is interesting that the Government chose to make so few changes to the final Regulations, given the numerous responses to the consultation exercise. 98% (over 23,000) of the responses came from members of the public, and a separate e-petition requesting a Parliamentary debate on the new powers for DCLG contained in the Regulations gathered 105,771 signatures (the date for the debate has yet to be confirmed).

No doubt the clear warning that LGPS investments should not pursue a political/social agenda at odds with central Government foreign policy is, and will remain, controversial. The consultation exercise resulted in a large number of comments on this area, despite it not being an explicit part of the consultation. However, the Government has opted to adhere firmly to its announced policy position.

Two-thirds of responses which commented on the intervention power disagreed with the scope of Regulation 8, with a sizeable proportion arguing that the power is too broad. It is certainly true that the provision marks a new development in the LGPS investment sphere, and has the potential to undermine the new freedoms granted to administering authorities. The Government's justification is that the removal of the old, highly-restrictive regime requires new "*checks and balances*" to be introduced, to safeguard the large sums of public money involved. However, it remains to be seen just how much appetite there will be from Whitehall to intervene in anything other than the most clear-cut of cases, given the evident public sensitivities on this topic.

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