PENSIONS AND
LIFETIME SAVINGS
ASSOCIATION

Viewpoint:

LOCAL AUTHORITY POOLING FOCUS

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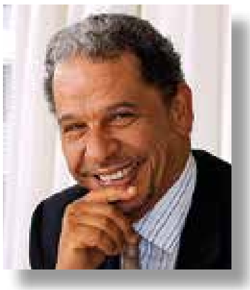


LISTED SECURITIES: ACS OWNERSHIP RIGHTS

Mark Solomon explores the litigation obstacles that can arise when ownership rights are vested in authorised contractual schemes.

LGPS FUNDS, TOGETHER WITH PUBLIC PENSION FUNDS AROUND THE WORLD, INCREASINGLY HAVE BEEN LEADING SECURITIES FRAUD LAWSUITS IN A VARIETY OF JURISDICTIONS AS REPRESENTATIVE PLAINTIFFS AND CLAIMANTS.

The cases involved generate billions of dollars in recoveries for investors every year and, where possible, governance reforms designed to reduce recidivism. But by pooling their ownership of listed securities via an authorised contractual scheme (ACS) without retaining the right to seek legal redress when they have been defrauded, LGPS funds could lose their ability to participate actively in future cases. That may be of less concern if the ACS operator is owned by the participant funds and all of the various ACS constituents are in and remain in sufficient agreement. Indeed, in those agreeable circumstances, the leverage in litigation of participating LGPS funds will increase dramatically. However, where the operator is rented or where the various parties fail to agree or fall out, powerful rights could be lost to the funds and left unexercised.

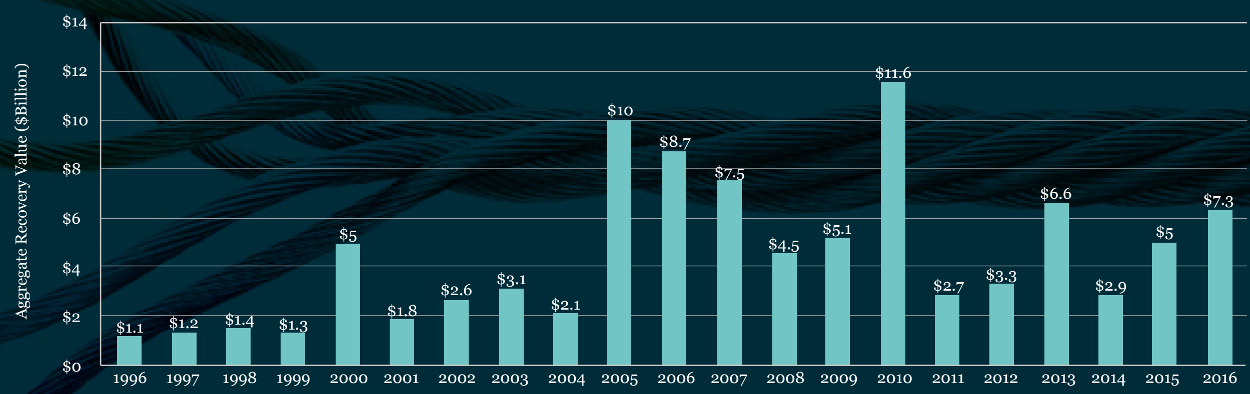
RESPONSIBLE OWNERSHIP

Over the last two decades, pension fund investors in publicly-traded securities, including LGPS funds, have answered the clarion call to be responsible owners of otherwise 'ownerless' public companies in various ways, including by:

- Signing up to and following the prescriptions of stewardship codes and responsible investing initiatives;
- Exercising their voting rights;
- Engaging directly or via their chosen managers with the companies in which they invest; and
- Exercising their litigation rights, including seeking monetary redress and governance reforms via legal action when defrauded or otherwise harmed by redressable financial misconduct.

Even if some of the perceived benefits of the drive to responsible ownership can be debated, what cannot be is the fact that close to $100 billion has been recovered for defrauded securities investors over the last 20 years. Governance reforms are also being insisted upon with increasing frequency, all largely as a result of pension funds exercising their legal rights in various jurisdictions in which they entrust their money.

UNITED STATES SECURITIES FRAUD RECOVERIES ($ BILLIONS)
JANUARY 1996 TO DECEMBER 2016



COURTS MAY DECLINE TO RECOGNISE CLAIMS ASSERTED BY ONE FUND OR A SUBSET OF CONSTITUENT FUNDS THAT ALL COLLECTIVELY OWN A SECURITY IN AN ACS

Pension funds have been able readily to lead class action efforts to secure such compensation – and governance reforms along the way – because significant amounts of their securities portfolios are segregated rather than pooled and because many fund members and officers are convinced that the responsible exercise of ownership rights is the right thing to do. The funds have been able to pursue such cases at no out-of-pocket cost to themselves because the proceedings usually are prosecuted and funded on a contingent 'no win, no fee' basis. They have won governance reforms such as shareholder-nominated directors, auditor rotation, limitations on options grants, separation of CEO and chairman, ethics monitoring, whistleblower hotlines and other bespoke governance enhancements as a result of the leverage that can be brought to bear when concluding meritorious cases.

The problem facing more proactive owners with the collective pooling of ownership is with the nature of an ACS itself:

- Typically only a complete owner of a security, and not a fractional owner, will have legal standing to assert any related claim; and
- ACS rules provide that only the ACS operator can exert day-to-day control over property in the ACS.

This in part explains why pooled funds are rarely at the vanguard of securities litigation recovery efforts. Their participants often are uncoordinated or prevented from doing so, and most managers and operators have yet to pick up the mantle.

Only if the fractionalised ownership obstacle is overcome and funds are also assured that they are acting within their authority, will there remain a path by which LGPS funds who choose the ACS route may still actively participate in anti-fraud cases for themselves and for other similarly damaged investors.

WHO OWNS WHAT MATTERS

Unsurprisingly, it has been the real owners of publicly-traded companies who, when defrauded by them, have led the charge for financial redress in courts across the world, and particularly in the United States. It stands to reason that the owner who suffers a loss owing to purchasing securities at fraudulently inflated prices is more likely to assert a claim than a manager whose function is to select the securities for the owner and who may be or feel conflicted in myriad ways. And, in any event, it may be that the jurisdiction in which the claim is asserted requires that the claim be brought by the asset owner and not by the manager, unless the claim is sufficiently assigned.

Who, then, is the 'owner' of listed securities purchased by an ACS? While the regulations say that the constituent LGPS funds will be the owners as 'tenants in common' of the assets held by the ACS and the funds own units in the ACS, legal title to the underlying securities is held by or to the order of the depositary.

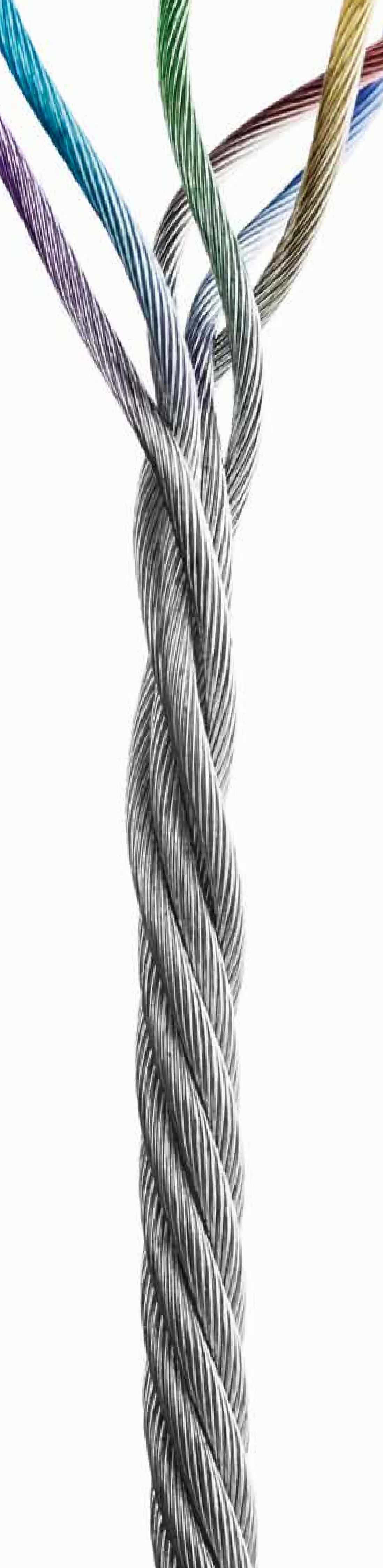
This confusion allows for the distinct possibility that LGPS funds, which in the past would have had no problem asserting their claims in court as segregated owners of securities with sufficient legal standing, may find themselves disabled from taking action. Courts may decline to recognise claims asserted by just one fund or a subset of constituent funds that all collectively own a security in an ACS, leaving it either to the non-owner operator to convince the courts of its standing (should it be motivated to do so) or perhaps to the manager of some sub-fund in which the loss manifested itself.

To date, depositaries have not displayed any appetite for asserting such claims, not withstanding their possession of legal title or their status as trustees. The reality is that the more distance (and more fees) between beneficial asset ownership and asset management, the less aggressive the assertion of ownership rights is likely to be.

Even if the fractionalised ownership obstacle associated with ACS arrangements is overcome, LGPS participants still will be faced with the fact that they cannot exercise day-to-day control over the acquisition, holding, management or disposal of property in the ACS – only the operator can do so. The operator, however, is called upon by the rules to instruct the depositary as to how rights attaching to the ownership of property are to be exercised. How then can LGPS participants ensure that any erstwhile ownership rights over any listed securities are being exercised appropriately?

DIRECTIONS AND BOARD OVERSIGHT

ACS participants can issue directions to the operator so long as they do not amount to the exertion of non FCA approved day-to-day control. Directions can be envisaged which mandate fraud monitoring; require the appropriate consideration by the operator or depositary of the exercise of litigation rights; and enable oversight and recommendations concerning litigation decisions by establishing an oversight board comprised of the participant funds. To ensure a court recognises the legal standing of the non-owner operator, in circumstances where it will, but the depositary declines to act, such directions could also anticipate the assignment of any right to sue in chosen situations. Assignments of litigation rights are recognised in most jurisdictions and can provide sufficient authority and legal standing for the assignee to pursue the claims as if the assignee were the legal or beneficial owner.



Close to $100bn

has been recovered for defrauded securities investors over the last 20 years

RESERVING THE RIGHT TO SUE

The ‘property’ over which the ACS operator has day-to-day control and with respect to which the depositary notionally is directed by the operator concerning the exercise of “ownership” rights arguably includes the ‘chose in action’ which is the right to sue. The ‘right’ is itself an asset. Accordingly, if that right enters the ACS then it may be that only the operator or depositary can exercise it, albeit with a level of oversight by participant funds. Measures that LGPS funds may wish to consider taking in order to retain control over rights attaching to ‘legacy’ securities they already own but are transferring to the pool include explicitly reserving such rights so that they do not enter the pool in the first place (even if any proceeds derived from their exercise are to be transferred to the pool).

As for the exercise of rights attaching to non-legacy securities purchased in the ACS, unless agreements that pass FCA muster can be crafted prior to their purchases that ensure such rights are to be held outside the ACS by the participants or their nominee, LGPS funds may find themselves disabled from exercising any of the ownership rights that attach to them.

CONCLUSION

The ACS was not designed in order to promote active and responsible ownership. Nor was it designed with LGPS pools in mind. It was designed as a tax-transparent, collectivised investment vehicle to attract mulitple cross-border investors to the UK from Europe and around the world.

LGPS funds seeking whatever they perceive to be the benefits of collectivised investing in an ACS, while also preserving the accountability to them of the companies in which they invest, must consider carefully with their advisers how they can best fashion their ACS arrangements and still meet FCA approval. At stake is ensuring that at least one of the ACS entities – a participant fund, the operator, or even the depositary – continues the exercise and vindication of important hard-won shareholder rights when the participant LGPS funds are victimised by securities fraud.

Mark Solomon is a founding partner of Robbins Geller Rudman & Dowd and leads its international litigation practice.

POOLED FUNDS ARE RARELY AT THE VANGUARD OF SECURITIES LITIGATION RECOVERY EFFORTS

PENSIONS AND LIFETIME SAVINGS ACADEMY

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- demonstrate an awareness of the role and purpose of the Scheme Advisory Board (SAB) and Local Pension Boards
- identify what constitutes good governance in the LGPS
- to describe key issues which are currently affecting the LGPS
- recognise how matters which affect defined benefit schemes, in general, impact upon the LGPS

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19 Sepember

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THE PRACTICAL CHALLENGES OF LGPS PROPERTY POOLING

A detailed strategic vision is needed to achieve the most effective transition into direct property portfolios. **Matt Day** reports.

WITH AN ESTIMATED £13 BILLION OF LOCAL GOVERNMENT PENSION SCHEME (LGPS) ASSETS INVESTED IN PROPERTY, THIS ASSET CLASS OFFERS SIGNIFICANT POTENTIAL COST SAVINGS FROM POOLING. IN PARTICULAR, THE PROJECT POOL REPORT SUGGESTED THAT ECONOMIES OF SCALE COULD BE ACHIEVED BY MOVING FROM INDIRECT PROPERTY FUNDS TO DIRECTLY HELD PROPERTY, THEREBY REMOVING AN ADDITIONAL LAYER OF FEES WITHIN FUND AND MULTI-MANAGER STRUCTURES.

There seems to have been relatively little consideration given to how the various pools might move from a disparate collection of property funds to direct property portfolios.

The complexity and illiquidity of property will require a detailed strategic vision, along with time and experience to manage the transitions. Given the considerable costs and ongoing savings at stake, the advantages to those pools which plan carefully will be considerable.

It looks like there will be eight pools with total assets ranging from around £13 billion to £36 billion. Given a fresh start each would undoubtedly have sufficient scale to form a direct property portfolio. These would be complemented by indirect holdings or joint ventures to access specialist sectors where individual property values make diversification difficult, such as central London offices, major shopping centres and overseas markets.

But of course the pools are not starting from scratch. Many existing local government schemes already have between £100 million and £200 million allocated to property. So it is no surprise that indirect portfolios have been the route of choice for many schemes, given the transaction cost savings and vastly superior diversification that can be achieved compared to direct investment.

THE LONDON CIV PROPERTY HOLDINGS

We estimate that indirect funds account for between 55-60 per cent of the LGPS property allocation, although this is not consistent across all eight pools. The Northern pool and the LPP hold very few indirect holdings, while Access, Brunel and the London CIV have combined property exposure made up almost entirely from a collection of indirect holdings.

We analysed the property holdings of each pool, and it became clear to us the importance of developing sophisticated strategies to ensure the objectives are met without transition costs becoming prohibitive. One example was the London CIV, where our research found that 29 of the 33 individual LGPS participants hold indirect property, with just one having some direct property and four having no exposure to property. In 2015 the total invested in property amounted to £2.1 billion across 69 various underlying property funds or fund-of-funds.

In table 1 we illustrate the breakdown by fund category.

TABLE 1: PROPERTY HOLDINGS OF LONDON CIV

Type	Estimated value	Proportion of known assets
UK core balanced funds	£896m	50%
UK esoteric funds	£487m	27%
UK fund-of-funds	£130m	7%
UK direct property	£142m	8%
European	£115m	6%
Global	£27m	2%
Unknown	£316m	-
Total	**£2,113m**	

Source: Kames Capital, based on Freedom of Information Request as at 31 December 2014, 31 March 2015 and 30 June 2015.

This example gives some insight into the transition challenges, with only the core balanced funds offering reasonable liquidity. Even here, this liquidity may be non-existent should all the pools attempt to transition at a similar time.

The other indirect holdings are typically closed-ended and are likely to be held on a passive basis until money is returned by the manager. In these instances strong monitoring and governance is still required to ensure liquidity is achieved on the best possible terms.

We estimate that to achieve the objectives of Project POOL and move from indirect to direct property, the full round-trip cost to the London CIV would be around £165 million.

While the costs of dealing in indirect funds can be mitigated through secondary market transactions, where units are sold at a mutually agreed price between buyer and seller, there is unlikely to be sufficient demand to satisfy the huge amount of indirect property currently held by LGPS.

If the London CIV continues to adopt an outsourced management approach then we estimate that the Total Expense Ratio (TER) on a segregated direct portfolio will be around 0.25 per cent. Assuming a 1 per cent blended TER on funds currently held, it will take more than 10 years before this cost is offset.

An internally managed approach may reduce this through even lower ongoing costs, although establishing a direct property investment and management team with relevant experience would undoubtedly require time and expertise.

FIVE TRANSITION MANAGEMENT QUESTIONS EVERY LGPS POOL SHOULD ASK

1. Should the holdings be pooled first and then transitioned?
2. If so, should there be just one 'bucket' for indirect property or should there be solutions-driven buckets to provide LGPS with scope to invest in a variety of property strategies such as diversified beta, inflation-linked, growth or high income?
3. Is there a better way to transition than simply executing a costly sale and reinvestment?
4. Who is going to manage the transition, given the specialist skill-set required to ensure that the transition happens efficiently and professionally, with the expert due diligence that is required to assess each holding?
5. Which holdings could still give access to a specialist market where a generalist direct manager will not have a sufficient skill-set?

FINDING A SOLUTION

For pension funds property is a versatile asset class that can support a range of different investment objectives, including:

DIVERSIFICATION
The decision to invest in property is primarily driven by asset allocation considerations. By adding property to a multi-asset portfolio a scheme can improve the risk-adjusted return of its whole portfolio.

DE-RISKING
A property portfolio can be tailored to assist pension schemes in de-risking strategies by targeting assets that should deliver a consistent real return, where rents are linked to inflation, with secure income.

GROWTH
Pension schemes seeking growth or higher-return targets can tailor a property portfolio to meet these objectives through methods such as utilising financial leverage or targeting refurbishment and development opportunities, and value-add strategies.

There is an opportunity for all existing property holdings (both indirect and direct) to be allocated to three distinct collective investment vehicles, mandated to achieve these high-level strategic aims. Each LGPS would receive a pro-rata share determined by the value of units transferred in-specie into the funds and in time be able to establish exposure that aligns with their strategic objectives.

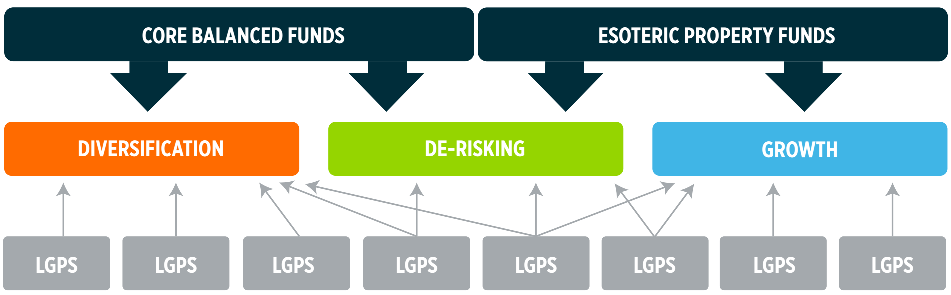
The process, which we illustrate in the diagram below, involves:

- Re-organising existing property into three distinct 'buckets', each providing a different solution (diversification, de-risking or growth)
- LGPS receives pro-rata share determined by value of units transferred in-specie into the funds
- Each LGPS retains control over strategic allocation.

This solution would avoid a costly 'fire-sale' transition to direct property and allow the managed long-term movement to direct property within funds.

We believe that structuring the three CIVs would incur minimal initial set-up costs. However, given the varied holding structures of indirect property, the structure of the CIVs would need carefully consideration to ensure their suitability.

Matt Day is a Fund Manager, Indirect Property, at Kames Capital.



Kames Capital is currently in the latter stages of launching a fund-of-funds and has devised an appropriate structure to allow investors to in-specie the widest possible variety of indirect property funds. We would be happy to discuss this or any other aspect of this article with any LGPS or pool that wishes to discuss the practical transition of their property allocation.

ECONOMIES OF SCALE COULD BE ACHIEVED BY MOVING FROM INDIRECT PROPERTY FUNDS TO DIRECTLY HELD PROPERTY

POOLS: WHAT ARE THEY GOOD FOR?

Mark Packham, finds plenty of reasons to be positive about LGPS asset pools.

A FANTASTIC EFFORT IS BEING DEDICATED TO THE NEW ASSET POOLS TO GET THEM OPERATIONAL WITHIN TIGHT DEADLINES. BUT, IF WE PAUSE FOR A MOMENT AND TAKE A 10-YEAR PREVIEW, WHAT DO WE EXPECT THEM TO BE GOOD FOR BY 2027? WHAT WILL BE THE JUDGEMENTS OF FUTURE COMMENTATORS, AND WHAT VISION AND ACTIONS ARE NEEDED NOW TO ACHIEVE SUCCESS?

FOR INVESTMENT PERFORMANCE

Performance will be crucial. Pools must demonstrate successful investment performance, and less successful pools may face calls for consolidation within 10 years. Successful performance is highly feasible: there is good evidence that scale, and especially the quality of governance that goes with it, can deliver. The LGPS has moved from debating this assertion to putting in place the structures, processes and people to deliver it.

Drilling down, pools will deliver performance asset class by asset class. Central government is determined that performance measurement will be rigorous. There will be no hiding place from three comparisons:

- **First, on external manager fees:** will combined buying power deliver anticipated fee reductions?
- **Second, on underlying performance:** how will internally managed assets perform, and will external investment managers that offer acceptable fee structures deliver high performance?
- **And third, with passive management:** some groups of LGPS funds have already procured passive asset management very cost-effectively. Active management in the relevant asset classes, whether internal or external, will face a clear comparator.

The LGPS funds, each being a client of a pool, will have retained strategic responsibility for delivering overall performance using only that pool's offerings. For this to work, each pool and its client funds will have to align pool investment offerings to fund strategies, showing the courage to implement sensible adjustments at the start. The various parties will have to understand each other's language around benchmarks and risks. Pools should be comfortable to drive this, offering the funds enough but not too many options. Pools will also feel a duty of care to ensure that funds choose a strategic balance of investments that should deliver robust returns without undue exposure to market risks.

To come good, pools will have to demonstrate long-term investment thinking: low turnover, investing for real value, beating inflation year after year. These attributes will be particularly relevant to less liquid investments such as private markets and infrastructure.

FOR STABLE CONTRIBUTIONS

Pools will become a vast storeroom of real-time digital knowledge. This will start with granular information on assets, enabling full risk analysis of assets, but will strong pools stop there? The storeroom could be expanded to include an overview of liabilities.

This is where it gets interesting. Pools should be able to address a question that's never far below the surface: what are the liabilities we are holding assets to cover? A fixed actuarial methodology to measure the liabilities, if followed to the letter, can create unnecessary contribution fluctuations. Indeed, it can be worse: gilt-based actuarial methodologies can generate inappropriate investment decisions for LGPS funds.

Provided any new approach is underpinned by the right governance, a digital warehouse may enable pools to offer funds a new paradigm. Armed by pools with centralised information on liabilities, delivered using the right software, funds would be able to ask their own actuarial advisors to identify contribution trends in advance. Second opinions could easily be obtained. This could help both taxpayer-backed employers, including local authorities that are not administering authorities, and deliver greater clarity for other groups of employers, with proper recognition of the limits of their security positions.

FOR SCALE AND EFFICIENCY

The number of LGPS employers just keeps growing. When PwC has interviewed stakeholders, many have reflected on the benefits of geographic proximity between LGPS administration and employers.
If a wider efficiency agenda is pressed forward over the next decade, there may be opportunities for pools to take a role in co-ordinating administrative efficiency without losing local contact.

Returning to investment, there are many billions of assets funded public sector schemes outside the LGPS. By 2027, why shouldn't successful pools be managing their assets?

TO COME GOOD, POOLS WILL HAVE TO DEMONSTRATE LONG-TERM INVESTMENT THINKING: LOW TURNOVER, INVESTING FOR REAL VALUE, BEATING INFLATION YEAR AFTER YEAR

FOR GOVERNANCE AND PROFESSIONALISM

FCA oversight will itself ensure professional staffing and structuring at the new investment companies. Study the delivery of the FCA's control functions, drilling down to identified individuals, if you wish to understand the accountability that central government has built in by requiring FCA authorisation. Funds that are building pools are climbing a steep learning curve and will reap the benefits of their new insight and ownership.

Balances of power between pools and the LGPS funds are now being established by extensive legal documentation, and only time will try and test this. But governance arrangements are not just the words to define structures and processes: strong pool governance will demand the right people, the right mixture of leadership, professional scepticism, experience and innovation.

£1,300 billion

The UK's total unfunded liability to be paid off as we go.

But oversight will not be only by the FCA. Pool oversight boards will provide a seat at the table for each administering authority and, at some pools, for member representatives. The boards will take a high-level view and, critically, shareholder agreements are reserving votes on key matters to individual authorities. Local control will not be lost: decisions will be shared, better informed and more effective as a result.

One trend will emerge early. Oversight boards will find themselves handling several issues now handled by local pension committees. If this leaves a sense of imposed decisions, there will be conflict and accusations of mission creep. But effective collaboration will generate better judgements at local level.

If consolidation goes further and reduces the number of people involved, pools may help answer the criticism that 1,500 is too many people, across the UK, to be involved in LGPS governance. Realistically, power is likely to move gradually from funds to pools, even if this transfer is tempered by the need to prove that new approaches are delivering.

FOR MEMBERS AND TAXPAYERS

Deficits have been with us forever. Across England and Wales they totalled £47 billion in 2013. But no sooner had we seen predictions that they'd be £100 billion by the end of 2016, we are looking at a 2016 total that's only £35 billion.

PwC calculations indicate that the total LGPS deficit would be less than £10 billion – almost breakeven – if the LGPS used assumptions corresponding to those used for the NHS, the Armed Forces, teachers and civil servants. The UK has a total unfunded liability of £1,300 billion, to be paid as we go. By contrast, we now have a good news story in the LGPS.

The pools will be in a strong position to build on this over the next 10 years. Maintenance of healthy funding is about intergenerational equity: if the LGPS holds sufficient assets, the next generation of taxpayers will not have to meet local pensions as they go.

The corresponding challenge for pools is about where to invest this money they have on trust for future pensioners. Infrastructure: which investments will deliver both social value and the necessary long-term returns? Responsible investment: how will pools support the transition pathway to a low-carbon economy while gaining the necessary financial returns?

There are important questions ahead. Bold approaches by pools, taking all their stakeholders with them, will deliver success well before 2027.

Mark Packham is head of PricewaterhouseCoopers' public sector pensions team.

SUCCESSFUL PERFORMANCE IS HIGHLY FEASIBLE: THERE IS GOOD EVIDENCE THAT SCALE, AND ESPECIALLY THE QUALITY OF GOVERNANCE THAT GOES WITH IT, CAN DELIVER