

**Report for: Pension Fund  
Committee**

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<b>Date of Meeting:</b>	24 November 2021
<b>Subject:</b>	London Collective Investment Vehicle - Amendments to Shareholder Agreement and Articles of Association
<b>Responsible Officer:</b>	Dawn Calvert – Director of Finance and Assurance
<b>Exempt:</b>	No
<b>Wards affected:</b>	Not applicable
<b>Enclosures:</b>	None

## **Section 1 – Summary and Recommendations**

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This report seeks agreement to changes to the Articles and Shareholder Agreement for London CIV following notification by the Financial Conduct Authority (FCA) that the current capital does not meet the definition of regulatory capital used by the FCA. This does not require London CIV to raise further capital or for boroughs to contribute further capital. It is rather a case of amending the key constitutional documents to ensure that existing capital falls within the definition set out in regulations.

### **Recommendations:**

The Committee is recommended to

1. approve the changes set out in the report to the London CIV's Articles of Association and Shareholder Agreement in principle; and
2. authorise the Director of Finance and Assurance to sign the amended Articles of Association and Shareholder Agreement.

## **Section 2 – Report**

1. The London CIV is a company owned by the 31 London borough pension funds and the City of London pension fund. London CIV's ability to deliver its original goal of collective investment on behalf of these funds, thus reducing the cost of investment management and improving risk adjusted returns will impact the financial performance of the pension fund and keep employer contributions low which will ensure the Council's contributions are stable and represent good value.
2. The London CIV was established in 2014 with the purpose of lowering investment costs and delivering better investment returns for local authority pension funds in London. The London CIV aimed to achieve these goals by appointing investment managers to its platform, which would be accessible to participating pension funds. The London CIV would be responsible for selection, performance and investment management whilst individual pension funds would retain authority over strategic asset allocation amongst different asset classes.
3. Since its inception, the London CIV has grown substantially, achieving oversight of assets valued at £24bn, which represents around 53% of the total investment assets across London borough pension funds. At the same time, the context in which the London CIV operates has changed: although London CIV was originally set up on a voluntary basis, the Government subsequently determined that pooling should be mandatory across England and Wales. London Borough of Harrow is a shareholder in LCIV and its Pension Fund currently has £380m invested in London CIV funds.

### **PROPOSAL AND REASONS**

4. As a Financial Conduct Authority ('FCA') regulated firm, London CIV must hold capital that meets the FCA definition of regulatory capital. The original London CIV regulatory capital requirements were set out in the application to the FCA in 2015. The application was prepared by Deloitte (as advisers) and the legal agreements drafted by Eversheds in consultation with Deloitte. The application was approved by London CIV's then interim board and then by the FCA which led to London CIV becoming authorised and regulated by the FCA on 15 October 2015.
5. During the course of reviewing the London CIV application for additional regulatory permissions this year, the FCA raised questions about the original capital structure. The FCA have indicated that the A and B shares as described in the Articles of Association and Shareholder Agreement do not meet their definition of regulatory capital.
6. In particular, the way the documents describe the mechanism to buy back (redeem) the B shares in the unlikely event that a shareholder wished to exit London CIV do not meet the permanent capital requirement.

7. Furthermore, the redemption characteristic means that under accounting standard FRS102 the shares have been classified as debt rather than equity in the accounts since 2016
8. It is important to remember in all of this that there is no need to provide additional capital. What is required is to make sure that the legal description of the existing A and B shares meet the test of regulatory capital.
9. The minimum level of regulatory capital is determined by an FCA formula and is not a static figure. The current calculation is based on assets under management (AUM) so that the higher the level of AUM the higher the level of regulatory capital required
10. The London CIV has £4.95m of B shares which is used to provide the regulatory capital. The number of B shares issued was set in 2015 and was based on the expected level of assets after a number of years of operation as the intention was to avoid having to raise new capital from shareholders each year.
11. The FCA have indicated their desire to work with London CIV to resolve this position.
12. The London CIV have asked Linklaters who have considerable expertise in these matters to review the documents Eversheds originally prepared. This means they have been the subject of thorough scrutiny. The London CIV's external auditors have also reviewed the revised documents and the London CIV are now confident that they will be supportive of a treatment of the shares as equity if the changes are implemented.
13. Agreement by 75% of shareholders to a written resolution is required. The Shareholders Agreement also requires that all shareholders must agree to a change to the Articles of Association and any change to the rights attached to shares.
14. The required changes can be summarised as follows:
  - The changes seek to address the issues raised by the FCA and their view that the B shares do not meet the definition of regulatory capital. The changes achieve this by removing reference to the redeemability of A and B shares in the documents.
  - These changes will result in the A and B shares being treated as equity not debt as confirmed by Deloitte
  - The revised documents still allow shareholders to ask the company to buy back shares but do not give the company an obligation to do so.
  - The documents emphasise shareholders rights to agree between themselves to buy/sell shares in order to facilitate a shareholder exit.

15. The following changes are proposed to the Company's Articles of Association:

- An amendment to the text of the definition of "B Shares" to make it clear that they are ordinary shares and a change to characterise them as not redeemable.
- Removal of the definition of "Withdrawal Date" and the deletion of articles 27.4 to 27.7, 34 and 35, which previously provided for Shares to be redeemed by or transferred to the Company. The terms relating to a Shareholder wishing to cease to hold shares is now dealt with in the Shareholders' Agreement as described in paragraphs 3.5 and 3.6 below.
- An amendment to article 28.1 to delete a reference to purchases by the Company of its own shares (because the relevant provisions have been deleted as described in paragraph 2.2). Additional wording has been included to make clear the existing position that any purchase by the Company of its own shares will require the prior approval of the FCA. Similar amendments have also been made to article 33.1 which refers to purchases of its own shares by the Company.
- Amendments have been made to article 35.1 to refer to the registration of transfers of Shares to existing Shareholders in connection with the shareholder transfer mechanisms introduced in the Shareholders' Agreement as described in paragraph 3.6 below and article 33.1 which dealt with similar ground has been deleted.
- Article 43 has been amended to remove references to a redemption of purchase by the Company of its shares and to provide that surplus assets on a liquidation of the Company will be distributed proportionately to the holders of A Shares and B Shares. Previously, all surplus assets were to be distributed in respect of the A Shares only but this is not consistent with regulatory capital requirements which require shares counted for regulatory capital to be entitled to distribution of surplus assets on a liquidation of the firm.

16. The following changes are proposed to the Shareholders' Agreement:

- A change to the text of the definition of "B Shares" to make it clear that they are ordinary shares and a change to characterise them as not redeemable.
- A change to clause 1.2 to make clear that references to legislation include any replacement legislation introduced as a result of Brexit.
- Deletion of clause 3.2.3 which provided for an Exiting Shareholder's Shares to be redeemed by the Company and setting out a mechanism under which replacement regulatory capital would be raised from the remaining shareholders. The terms relating to a Shareholder wishing to cease to hold shares is now dealt with as described in paragraphs 3.5 and 3.6 below.

- Paragraphs 3.5.1 and 3.5.3 deal with the position where a Shareholder fails to provide any additional regulatory capital required from the Shareholders and the shortfall is made up by the other Shareholders. Previously, these clauses provided that if the defaulting shareholder subsequently provided the relevant capital contribution (or was entitled to dividends or other distributions) these would be applied in redeeming the additional shares acquired by the non-defaulting Shareholders in the defaulting Shareholder's place. These redemption provisions have been replaced by provisions under which the additional shares acquired by the non-defaulting Shareholders will be transferred to the previously defaulting Shareholder against payment of the relevant purchase price to the non-defaulting Shareholders.
- New clause 3A has been introduced to make clear that the Company has the statutory power to purchase its own shares in accordance with the Companies Act and provided that it has obtained regulatory approval from the FCA. This clause allows a Shareholder to notify the Company that it wishes to sell its Shares and request the Company to consider whether it wishes to purchase the Shares.
- Under new clause 3B, the Shareholders will seek to meet, discuss and agree whether the remaining Shareholders or any of them are willing to purchase any Shares if the Board notifies a Shareholder that wishes to sell its Shares that the Company does not propose to buy them under new clause 3A. The Company will facilitate discussions between Shareholders in relation to this and will register any resulting transfers of Shares between Shareholders.
- Clause 8.1, which previously prohibited any transfer of Shares except in the case of the Company purchasing its own shares has been amended. This is because there are no longer any provisions in the Articles of Association or the Shareholders' Agreement under which the Company agrees to buy its own shares (because this is incompatible with regulatory capital requirements) and the provision now refers to registration of transfers of Shares in accordance with the Shareholders' Agreement (in order to capture transfers between Shareholders as described in paragraph 3.6) or as otherwise approved by the Board.
- Clauses 8.3 and 9.3 previously provided, respectively, for (i) the Company to purchase a Shareholder's additional A Shares if two Shareholders combine and (ii) the Company to compulsorily purchase a defaulting Shareholder's A Share. These references to the Company purchasing its own shares are not consistent with regulatory capital requirements and these provisions have therefore been amended to provide that the relevant Shareholder will not exercise or seek to exercise any voting or other rights attaching to the A Shares which would previously have been repurchased. As well as being consistent with

regulatory capital requirements, this approach will be administratively much simpler for the Company.

- An amendment to paragraph 9 of Schedule 2 (A List Reserved Matters) to remove references to deleted provisions of the Articles of Association that previously referred to the Company purchasing its own shares.

## **OPTIONS APPRAISAL**

17. If changes to the regulatory capital are not amended then the FCA could lose confidence in the London CIV's ability to make these changes. The FCA could withdraw the London CIV's "licence to operate". This is not an option as the London CIV manage £24bn of London Pension Fund's LGPS assets for a large number of beneficiaries and require ongoing FCA authorisation to operate.

## **Legal Implications**

### Overview

18. London LGPS CIV Limited ("London CIV" ) was established by the London Local Authorities in 2014 as a collective venture to facilitate the pooling of Local Government Pension Scheme (LGPS) fund assets. It was authorised by the Financial Conduct Authority (FCA) in 2015. It was initially a voluntary arrangement however the government mandated LGPS pooling in 2015 and there are now 8 LGPS pools.
19. Following the merger of the Wandsworth and Richmond pension funds by statutory instrument there are now 32 shareholders. The Company is governed by the Companies Act, Articles of Association ("AA") and a contractual Shareholder Agreement ("SHA") which retains certain matters for decision by shareholders and rules and regulations of the Financial Conduct Authority ("FCA"). The SHA is a contractual document which complements the Companies Act and AA, in particular by setting out governance arrangements specific to London CIV as a collective LGPS pooling venture. These include a mechanism in the (unlikely) eventuality that a local authority might decide to leave the pool to join another pool. The AA and SHA were first agreed in 2015 and some amendments have been made since that time to update the governance framework and to change the description of the business purpose of the company so that it has more flexibility in the range of services and products it provides.
20. The original decision to participate as shareholders in the London CIV (which was a new company) was, on legal advice, taken by the Council on 13 November 2014. However, this is a straightforward decision about a relatively minor amendment to the AA and SHA which comes within the terms of reference of the Pension Fund Committee.

21. The decision is necessary as a matter of urgency to meet regulatory requirements to ensure London CIV continues to meet its “licence to operate” requirements. It relates to ensuring that the characteristics of the share capital meet the definition of equity rather than debt and requirements to meet the tests for regulatory capital. It is our understanding that most local authorities will therefore be able to deal with the matter under delegated authority or urgency procedures, although this is of course a matter for each local authority. Each shareholder holds one A share which is a voting share and 150,000 B shares which contribute regulatory capital, with the exception of London Borough of Wandsworth which holds two lots of B shares and a second non-voting A share following the merger of the Wandsworth and Richmond pension funds.
22. London CIV is authorised and regulated by the FCA as an alternative investment fund manager (“AIFM”). As such it is required to hold regulatory capital. The share capital must meet certain technical requirements to count as regulatory capital. London CIV must also have an adequate level of regulatory capital and the minimum level is calculated using a designated formula. It is an absolute requirement that London CIV holds capital that meets the technical requirements and sufficient regulatory capital to retain FCA authorisation to perform its functions. The FCA requires the company to amend its AA and SHA to amend the characteristics of the “B” shares to meet the technical requirements for them to be counted as regulatory capital. The FCA’s concerns have arisen because the shares are redeemable and classified as debt in the accounts. LCIV’s external auditors have also confirmed that the proposed changes will also result in the re-classification as equity rather than debt on the company balance sheet.
23. It is not a change to the amount of regulatory capital that the Company is required to hold; there is no requirement to increase the capital held by the Company so no requirement for the boroughs to increase their holdings of “B” shares as a consequence of these changes. This change of itself does not increase the likelihood of a future requirement to increase regulatory capital.
24. The changes do not affect or impact any of the investment funds operated by the Company or the investors in those funds.
25. No other document or agreements require amendments.

#### The changes

26. The basic change is removing references to the “B” shares being redeemable. The key issue that then arises for boroughs is whether there remains a mechanism whereby shareholders can exit the pool and London CIV as a company and to request the company to purchase their shares. In practice if this happens it will be a very carefully considered decision since LGPS funds will be invested in pooled investment funds operated by London CIV and will need to be transitioned elsewhere and

it will also be necessary to settle any liabilities. So, this will be a carefully planned change and considered decision. Given that pooling is mandated by government it will also be necessary for the local authority to join another pool. In these circumstances the changes to the AA and SHA have been made such that it will still be possible for shareholders to request the company to purchase shares following Companies Act procedures.

27. At present the “B” shares will be purchased by the company at par, subject to any liabilities also being met, at the end of a defined period (on a minimum of twelve months’ notice) on the request of a shareholder to the company if a number of gating provisions are met. The gating provisions are:

- that the company has sufficient regulatory capital either because it holds it already or because it raises regulatory capital from the remaining shareholders to match that of the exiting shareholder, and,
- the FCA consent to the “B” shares being purchased by the company.

Although there is no guarantee that any “B” shares would be bought back, the Shareholders’ Agreement sets out detailed provisions on how London CIV can request additional regulatory capital from the shareholders to fund a shareholder’s exit and what happens if one or more shareholders do not contribute.

28. Under the proposed amendments, shareholders are still able to request the company to purchase their “B” shares at par, subject to any liabilities also being met. London CIV is still able to purchase the shares provided certain conditions are met which are contained in the FCA capital requirements and which are reflected in the current gating provisions set out above.

The “B” shares are not redeemable and it is in the Company’s discretion whether to purchase the “B” shares. A shareholder still has the right to request a purchase of its shares, and the Company may purchase a shareholder’s shares but there is no formal obligation for the Company to purchase shares, no time limit by when “B” shares would be purchased and the documents do not contain provisions on how the Company would raise replacement capital.

However, just as now, provided the Company has sufficient regulatory capital and the FCA consents the Company can purchase “B” shares on the request of a shareholder.

29. In order to increase options in case a shareholder wishes to leave and the Company does not agree to buy back the shareholder’s shares, the amendments also build in a mechanism for the shareholders to meet and seek to reach agreement amongst themselves to buy the “B” shares, with London CIV facilitating those discussions between transfers and agreeing to register any resulting transfers of shares between shareholders.

30. The position on liabilities for an exiting shareholder remains the same.
31. The “B” shares remain the regulatory capital of the company designed to be permanent capital. Shareholders still have the right to request that the company purchases their shares at par and provided the company would have sufficient regulatory capital and the FCA agrees, then the company is able to purchase the shares.

## **Financial Implications**

32. There are no direct financial implications arising directly from this report. London CIV has incurred costs in relation to legal and accounting advice which are estimated to cost around £100,000. However, London CIV has confirmed that this can be accommodated within its existing budget provision in the current year.
33. The financial health of the Pension Fund directly affects the level of employer contribution which, in turn, affects the resources available for the Council’s priorities there are no impacts arising directly from this report.

## **Risk Management Implications**

34. If the changes to the Articles of Association and Shareholder Agreement are not made there is a risk that the London CIV will have its licence to operate revoked by the FCA and this will lead to an inability to manage the £24bn of assets under management. Therefore, the CIV has requested all of its shareholders (the 32 London LGPS Pension Funds) urgently asked to review the changes and agree to these.
35. The LBH Pension Fund currently has approximately £380 million (38% of its investments) managed via the London CIV.

## **Equalities implications / Public Sector Equality Duty**

36. Was an Equality Impact Assessment carried out? No  
There are no direct equalities implications arising from this report.

## **Council Priorities**

37. The performance of the Pension Fund directly affects the level of employer contribution which then, in turn, affects the resources available for the Council’s priorities.

## **Section 3 - Statutory Officer Clearance**

**Statutory Officer: Dawn Calvert**

Signed by the Chief Financial Officer

**Date: 10/11/2021**

**Statutory Officer: Caroline Eccles**

Signed on behalf of the Monitoring Officer

**Date: 15/11/2021**

**Chief Officer: Dawn Calvert**

Signed on behalf of the Corporate Director

**Date: 11/11/2021**

## **Mandatory Checks**

**Ward Councillors notified: Not applicable**

## **Section 4 - Contact Details and Background Papers**

**Contact:** Jeremy Randall – Interim Pensions Manager

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**Background Papers: None**