ADMINISTERING AUTHORITIES UNDER THE LOCAL GOVERNMENT PENSION SCHEME AND REGULATION BY THE FINANCIAL CONDUCT AUTHORITY

OPINION

1. I am instructed to advise the Local Government Association ("the LGA"). The issue concerns the extent to which a local authority or other body which is the administering authority of a fund established for the purposes of the Local Government Pension Scheme ("LGPS") might in that connection be subject to regulation by the Financial Conduct Authority ("FCA") pursuant to the Financial Services and Markets Act 2000 ("FSMA"). This Opinion is by way of confirmation of advice previously given in consultation. I understand that the LGA will be providing the South Yorkshire Pensions Authority ("SYPA") with a copy of this Opinion.

2. Under r.53 of the Local Government Pension Scheme Regulations 2013 (SI 2013 No 2356 – "the LGPS Regulations"), each of the administering authorities listed in Part 1 of Schedule 3 must maintain a pension fund for the LGPS, and the administering authority is "responsible for managing and administering the Scheme" in relation to any person for whom it is the appropriate administering authority. There may be, and usually will be, a number of different employers in relation to any given LGPS fund. They may be the bodies listed in Schedule 2 to the 2013 Regulations, or they may be admission bodies. They are required to make the pension contributions and other payments into the fund provided for at r.67 et seq of the LGPS Regulations. Contributions will also be received from active members. Provision is made for what may be credited to and paid out of the fund, and for the management and investment of LGPS funds, by what will shortly be the Local Government Pension Scheme (Management and

Investment of Funds) Regulations 2016 (SI 2016 No 946, coming into force on 1 November 2016 to replace similar existing legislation).

3. I understand that hitherto the general assumption has been that the functions of administering authorities are not touched by FSMA regulation. On the basis of the detailed analysis below, my conclusion is that that assumption is essentially correct.

4. This request for advice has been prompted by a query raised by the external auditors to one particular authority (SYPA). As I explain at paragraph 25 below, the auditors' stated basis for raising that query is in my view misconceived. However, to come to a correctly analysed conclusion on the overarching issue does require a rather more detailed consideration of the legislation and the FCA Handbook. Because those materials are complex, and potentially give rise to numbers of sub-issues, the clearest approach will be to set out first my analysis of the most central question that arises, and then consider possible variants and other less crucial issues.

5. That central question is, in my view, whether an administering authority is subject to FCA regulation by virtue of article 37 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001 No 544 as amended – "the Activities Order"), which provides that:

> "Managing assets belonging to another person, in circumstances involving the exercise of discretion, is a specified kind of activity if – (a) the assets consist of or include any investment which is a security or a contractually based investment . . ."

6. Under FSMA s 19, there is a general prohibition on the carrying on of a "regulated activity" in the United Kingdom by anyone other than an authorised person or an exempt person. An administering authority would not be an exempt person, so it will require FCA authorisation if it carries on a regulated activity as defined by FSMA s 22. So far as material, s 22

provides that an activity is a regulated activity is an activity of a specified kind which is carried on by way of business and relates to an investment of a specified kind. Investments of a broad sort are specified, and would undoubtedly include those of an LGPS fund. So the question is whether the administering authority carries on a specified activity, and (if so) whether it does so by way of business.

7. Leaving aside the "by way of business" point for the moment, does an administering authority carry on the article 37 activity of "managing assets belonging to another person, in circumstances involving the exercise of discretion"? If so, the assets will certainly include securities or contractually based investments. There is likewise no doubt that an administering authority does manage assets, and that it does so in circumstances involving the exercise of discretion.

8. So the critical issue is whether the assets in an LGPS fund are assets "belonging to another person", i.e. a person other than the administering authority. There is no doubt that the assets in the fund are *legally* owned by the administering authority and no one else. However, article 37 would in my view also apply in a case in which the *beneficial* ownership of the assets was vested in another person.

9. Accordingly, article 37 would *prima facie* catch the administering authority if it held the fund assets as trustee for the scheme members and/or employers. However, I do not think that the administering authority is a trustee. The Court of Session held in relation to the similar Scottish scheme in *Re Bain* 2002 SLT 1112 that there was no free-standing trust apart from the statutory scheme, and therefore that the administering authority was not a trustee as such. The judgment in the earlier Scottish case of *Martin v City of Edinburgh DC* 1988 SLT 329 proceeds on the basis that the LGPS fund is a trust fund, but the point does not appear to have been argued in that case.

10. In my view, the reasoning in *Bain* is convincing and correct. There is no reason to think that any relationship of trustee and beneficiary is created separately from the terms of the statutory scheme. Whilst such a relationship could be created by the statute itself, that is not what the LGPS Regulations say that they are doing, and nor is it their effect. The administering authority has specific statutory duties, but it is not a trustee, even though in some respects it may resemble one. No doubt the administering authority also owes fiduciary duties to scheme employers and members (as I have advised on a previous occasion), but that is a different matter. No trust is expressly created, and there is no warrant for implying one where the statutory provisions by themselves are sufficient to define the relationship between the parties concerned.

11. If that is right, then the remaining point to consider is whether the concept of assets "belonging to another person" in article 37 might be one that was broad enough to extend beyond cases in which it was possible to identify one or more other persons as the legal or beneficial owners of those assets. Might it, rather, be possible to say that assets belonged to another person in any case where the legal owner was not entitled to treat those assets simply as his own, but rather had to administer them for the benefit of others? That would be an accurate characterisation of the position of the administering authority under the statutory scheme.

12. This broader interpretation is not impossible as a matter of language. The concept of "belonging to another person" is not a defined one, and must ultimately be interpreted in this particular statutory context. It could be argued that the purpose which the concept serves in article 37 is simply that of identifying the cases in which FSMA regulation is appropriate because the person managing the assets is not doing so simply for his own benefit, and where others are at risk if he does not discharge the task properly. It would then be said that the broader interpretation set out in the preceding paragraph was consistent with that purpose.

13. Although I acknowledge that this is an argument that could be advanced seriously, I do not ultimately think that it would be correct. I say that for a number of reasons:

    (i) Although it may be a possible meaning of "belonging to another", it is not the most natural meaning. For example, in *Stokes v Costain Property Investments Ltd* [1984] 1 WLR 763 the concept of belonging was treated as a matter of ordinary language, rather than as a term of art, and as being synonymous with ownership.

    (ii) I also note that in *Citicorp Trustee Co Ltd v Barclays Bank plc* [2013] EWHC 2608 (Ch), the court rejected an argument that the term "beneficial ownership" in a contractual document could refer to an economic as opposed to a proprietary interest.

    (iii) Applying the broader interpretation would make the precise reach of the FSMA and the Activities Order both wide and uncertain, something against which a court would probably lean given the potential criminal consequences of pursuing a regulated activity without authorisation. If pursued to its logical conclusion, that broad interpretation would potentially bring within article 37 a range of situations in which a party was managing its own assets but owed contractual duties to others in respect of them, in a way that seems unlikely to have been intended. Indeed, it might be said that in all cases where a statutory body has assets which it uses to perform or fund functions carried on in the public interest, it has to administer those assets for the benefit of others, yet it seems very unlikely that article 37 was intended to catch all such cases.

(iv) Finally, I think it is a telling point that article 66 of the Activities Order contains a number of exclusions from article 37 which are expressly for the benefit of trustees (and could not, in my view, be read as applicable to an administering authority, if the broader interpretation of article 37 applied so as to catch it). It would seem anomalous if article 37 was interpreted so as to catch managers of assets who were not trustees, without there being any equivalent exclusions. Rather, articles 37 and 66 should be interpreted as part of a consistent scheme, which is a further indication that "belonging to another" should be limited to cases where another person has legal or beneficial ownership of the assets.

14. If I am right in the views just expressed, then article 37 would not apply here. I note for completeness that, if I was wrong in saying that the administering authority is not a trustee, then it would become relevant to look at the article 66 exclusions. However, whilst article 66(3) contains a general exclusion of trustees from article 37, there is a clawback from that exclusion if the assets in question are held for the purposes of an occupational pension scheme (which would include the LGPS). That clawback only applies if the trustee is treated as carrying on the article 37 activity by way of business by virtue of article 4 of the Financial Services and Markets Act 2000 (Carrying on Regulated Activities by Way of Business) Order 2001 (SI 2001 No 1177 – "the Business Order"). In effect that takes one back to the question of whether the administering authority carries on the management of LGPS assets by way of business for the purposes of FSMA s 22, since article 4 of the Business Order will be the decisive provision in that respect as well. Subject to certain exceptions, article 4 deems the management of assets of an occupational pension scheme, as an article 37 activity, to be by way of business. In my view, if one of the exceptions applies, the intention of the legislation must be that the activity is *not* carried on by way of business, whatever the position

might be if one was simply applying the ordinary meaning of that concept. In other words, if the administering authority was (contrary to my view) a trustee, both the question of whether its management of assets was a specified activity, and the question of whether it was carried on by way of business, would turn upon whether it fell within one of the article 4 exceptions relating to occupational pension schemes.

15. The relevant exception here would be article 4(1)(b), which essentially applies where all day to day decisions in the carrying on of the activity are taken on behalf of the person concerned by a person authorised to carry on article 37 activities (or an exempt or overseas person). I was told at the consultation that the great majority of LGPS administering authorities do in fact delegate the management of scheme assets to authorised persons. Accordingly, whilst the application of article 4(1)(b) would ultimately have to be looked at on a case by case basis, it seems likely that most authorities would be able to rely upon it.

16. I therefore conclude, so far as article 37 is concerned, first, that it does not apply to LGPS administering authorities because they are not trustees; and secondly, that even if they were trustees, it is likely that most of them would be treated as not carrying on that activity by way of business (and, by the same token, would be within an exception to article 37).

17. If I am right in that conclusion about article 37, then I do not think that any of the other specified activities set out in the Activities Order will apply in a normal LGPS case. Specifically, I would make the following comments on some of the articles of the Activities Order that might potentially appear relevant:

    (i) The most obvious one, article 40, deals with the safeguarding and administration of investments, but again it only applies in relation to assets "belonging to another" – so the same reasoning as above again applies.

(ii) It does not seem to me that an administering authority buys or sells investments as an agent (article 21), arranges deals in investments within the meaning of article 25, or advises on investments (article 53).

(iii) Article 14 applies to a person who deals in investments as principal, but the administering authority would normally be excluded from that by article 15, so long as it was not doing something falling within article 15(1). I do not think that an administering authority carries on any of the article 15(1) activities. It is right that article 15(4) makes the article 15 exclusion from article 14 subject to article 4(4), which in effect means that an investment service or activity carried on by an investment firm on a professional basis will fall within article 14. However, an administering authority will not be an investment firm as defined by article 3(1), potentially for a number of reasons, but most obviously because of Schedule 3 paragraph 1(h) concerning pension funds.

18. It only remains to consider two possible respects in which an administering authority might possibly be carrying on a specified activity by virtue of something other than what might be described as its normal core functions.

19. First, article 53E of the Activities Order catches the activity of advising on the conversion or transfer of pension benefits, i.e. advice "on the merits" of a scheme member or survivor taking one of the steps identified in article 53E(1)(c). I was told at the consultation that administering authorities have been strongly advised by the LGA not to give such advice, and it can be assumed that they would not normally do so.

20. Secondly, article 52 of the Activities Order catches the activity of establishing or operating a stakeholder or personal pension scheme. The

LGPS itself obviously does not fall into those categories, but I did wonder whether the making of arrangements under r.17 of the LGPS Regulations might engage article 52. Under r.17, members' additional voluntary contributions may be made pursuant to a scheme established by an administering authority and an AVC provider. However, I was told at the consultation that such a scheme would not be in the nature of a stakeholder or personal pension scheme. It seems unlikely in any event that anything done by the administering authority under r.17 would involve carrying on the business of doing so, as required by article 3 of the Business Order before the requirement for FSMA authorisation would bite. I understand the FCA's general approach to such matters (which strikes me as correct) to be that carrying on a business calls both for some element of continuity in the activity, and for some commercial context. I would not have thought that either element would be present here.

21. I therefore conclude that an LGPS administering authority will not, certainly in any normal case, be carrying on a specified activity by way of business because of what it does in that capacity, as administering authority of its own fund.

22. It still remains to consider the position where the administering authority is an FSMA authorised person for some other reason. That is true of SYPA, because it manages another South Yorkshire fund on behalf of its administering authority, and has taken the view that it should be authorised for that purpose[1]. A local authority which was an administering authority might also be an authorised person for entirely unconnected reasons, e.g. because it was carrying on some form of consumer credit business.

23. In principle, if a person is authorised, then the FCA may regulate not only the activity that calls for authorisation, but other things done by that

[1] That seems likely to be correct, although I have not considered the issue specifically for the purposes of this Opinion.

person as well. It is easy to see why there are some cases in which that may be appropriate. The particular concern here is with the Client Assets Sourcebook (CASS) section of the FCA Handbook. In fact, CASS paragraph 1.2.2 provides specifically that it applies to unregulated activities "to the extent specified".

24. An administering authority which is an authorised person will fall within the CASS definition of an "OPS[2] firm" (which specifically includes an LGPS administering authority[3]), and it will carry on "OPS activity" within the meaning of CASS paragraph 1.4.1. So the gateway to regulation is crossed. However, so far as I can see, all the substantive provisions of CASS need there to be a "client" before they can bite. A client is defined as a person to whom the firm provides or intends to provide a service in the course of carrying on a regulated activity. I am sceptical that administering authorities, in fulfilling their statutory functions, should be regarded as providing a service either to scheme employers or to scheme members, but in any case they do not do so in the course of carrying on a regulated activity. The whole point, if my earlier analysis is correct, is that the administering by an authority of an LGPS fund is not a regulated activity.

25. SYPA's external auditors have made the point that the definition of "client" is said to include a fund even if it does not have separate legal personality. So far as I can see from the relevant communications, it is by dint of looking at this provision in isolation that they have suggested that the CASS provisions may bite on what SYPA does as administering authority.

[2] i.e. occupational pension scheme.

[3] It did strike me that it was surprising that such express provision was made, in view of my general conclusion that administering authorities do not require FSMA authorisation by virtue of their activities as such. However, what is in the FCA Handbook cannot drive the interpretation or application of the legislation that determines which activities need authorisation. In any case, it was explained to me at the consultation that there was a specific historical reason for this provision being included in the Handbook, namely to ensure that proper provision was made in relation to administering authorities if they did engage in giving advice to scheme members (cf. paragraph 19 above).

However, this is misconceived. First, even if it can be said that on this basis a service is provided to the fund, that does not mean that it is provided in the course of carrying on a regulated activity. For the reasons already given, SYPA is not carrying on a regulated activity when it acts as an administering authority. Secondly, the auditors' analysis overlooks the straightforward point that "fund" is itself a defined term. It means either an AIF (alternative investment fund) within the meaning of article 4(1)(a) of Directive 2011/61/EU, or a collective investment scheme within the meaning of FSMA s 235. The LGPS is neither of those things. Accordingly, the extended definition of "client" is simply irrelevant.

CONCLUSIONS

26. In managing an LGPS fund, the administering authority is not carrying on a regulated activity, and does not require FSMA authorisation. Nor do the substantive provisions of CASS apply to the activities of an administering authority acting as such, even though that authority may have FSMA authorisation for some other reason.

27. I shall be pleased to give my Instructing Solicitor any further advice which may be required.

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IN THE MATTER OF
THE LOCAL GOVERNMENT
ASSOCIATION

AND IN THE MATTER OF
ADMINISTERING AUTHORITIES
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OPINION

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