

Pension funds: new provisions on investment limits and conflicts of interest

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On November 13, 2014 the decree of the Ministry of Economy and Finance dated September 2, 2014 no. 166 (the “**Decree 166**”) has been published on the Italian official journal the *Gazzetta Ufficiale* no. 264, implementing Article 6, paragraph 5-*bis*, of Legislative Decree no. 252 of December 5, 2005, providing rules on the investment criteria and limits of the assets of the pension funds as well as rules regarding conflicts of interest.

The Decree 166 replaces the previous Ministry of Economy and Finance Decree dated November 21, 1996 no. 703, pursuing a new approach in regulating investment restrictions and conflicts of interest in the managing of pension funds, moving from a quantitative approach to one more focused on the valuation of the processes and the management of risks associated with investments.

The Decree 166 will come into force with effect from November 28, 2014. However, the pension funds registered with COVIP pursuant to Article 19, paragraph 1, of Legislative Decree no. 252 of December 5, 2005, have 18 months to comply with the new provisions. Pending this transitional period Ministerial Decree no. 703 still applies.

Below is a brief summary of the main changes introduced by the new Decree 166.

1. Investment criteria and limits for pension funds

The Decree 166 provides general rules regarding investment policy and criteria in the management of the assets of pension funds. In particular, the Decree 166 requires that pension funds:

- pursue an optimization of the **combination profitability-risk** of the portfolio as a whole, through the choice of the suitable instruments for quality, liquidity, return and risk level, in line with the relevant investment policy;
- achieve **portfolio diversification** aimed at reducing the concentration of risk and the dependence of the results of management from certain issuers, groups, sectors and geographical areas;
- pursue an efficient finalized management to **optimize the results**, limiting transaction, management and operational **costs** in relation to the size, complexity and characteristics of the portfolio;
- adopt **investment strategies** in line with the risk profile and the long/short term structure of liabilities, to ensure the availability of eligible and sufficient assets to cover liabilities, to pursue the financial stability and the safety, cost-effectiveness and liquidity of investments, preferring financial instruments with low risk, including through the use of debt securities issued or guaranteed by an EU member state, OECD Countries or EU public international bodies;
- adopt **procedures and internal structures** as well as other techniques in line with the size and complexity of the portfolio, with the investment policy adopted, the risks undertaken, the management model (direct or through an external managers) and the percentage of investments in instruments not traded on regulated markets, adopting suitable processes and strategies allowing to establish, implement and respect risk management and monitoring procedures.

Moreover, pension funds are required to verify the results of management activity in respect of benchmarks consistent with the objectives and criteria set out in the relevant investment policy as well as, where applicable, with the management agreement entered into with external manager. Moreover Decree 166 provides for further reporting obligations with COVIP (which is required to verify, *inter alia*, the adequacy of the organizational, professional and technical structure and the policies and risk management and monitoring

procedures) concerning ethical, environmental, social and corporate governance aspects to be considering in the selection of the eligible investment, as well as in case of any relevant change.

As per the eligible financial instruments, and save the prohibition of lending and provision of guarantees in favor of third parties, Decree 166 allows pension funds:

- to carry out **repo transactions** and securities lending, for the purpose of an efficient portfolio management, cleared within a standardized system, managed by a certified clearing and settlement body or entered into with primary counterparties with a solid reputation and supervised by a public authority;
- **to hold liquidity** according to the adopted investment policy;
- to use **derivatives**, entered into exclusively for reducing **investments risks and for efficient portfolio management**.

However, there remains a prohibition on short selling and derivatives transactions equal to short selling.

The Decree 166 also provides that the assets of the pension fund should be invested for the most part in financial instruments traded on regulated markets, while the investment in **financial instruments not traded on regulated markets and alternative collective investment schemes (FIA)** will be maintained at prudent levels and within the **limit of 30%** of the total assets of the pension fund. In any case, the pension fund will have to explain the use of alternative investments having regard to the feature of the pension fund as well as on the relevant investment policy.

The Decree 166 also modifies the **investments limits in a single issuer**. In particular, pension funds, also taking into account the exposure arising from investments in derivatives, would not be allowed to invest more than **5%** of their total assets in financial instruments of the same issuer, and no more than **10%** in financial instruments of entities belonging to the same group.

Specific provisions of Decree 166 also concern investments in collective investment schemes (e.g. pensions funds are required, *inter alia*, to evaluate if the investment policy of the relevant collective schemes is in line with the investment policy of the pension fund, and are required to monitor any risk related to each collective investment schemes to ensure compliance with the principles and criteria established by the portfolio as a whole, etc.).

As per the **financial instruments relating to commodities**, the Decree 166 clarifies that pension funds are allowed to invest in these instruments within the **limit of 5%** of their total assets to the extent that such instruments are issued by counterparties with good solidity, trustworthiness and reputation; however pension funds are not allowed to enter into derivatives transactions on commodities physically settled at expiration date.

COVIP may determine the cases in which above-mentioned limits may be exceeded for proven needs of the pension fund. At the same time COVIP has the right to establish more stringent operational limits of pension funds on a case by case analysis.

2. Conflict of interest and incompatibility

The Decree 166 amends the legislative framework concerning conflicts of interest pursuant to which it reiterates the obligation of the managers of the pension funds, in fulfilling the duties imposed on them by law and by bylaws, to pursue the interests of the members and beneficiaries of pension benefits, making it clear that in respect of these members and beneficiaries, the regulations concerning civil law of Article 2391 of the Italian Civil Code are applicable.

In addition, the boards of directors of pension funds are required to adopt all reasonable measures to identify and manage conflicts of interest, in order to prevent that such conflicts adversely affect the interests of the members and beneficiaries. Pension funds are also required to adopt a written policy for managing conflicts of interest.

Equivalent measures are also provided for the managers of the companies and entities in which are instituted the pension funds.

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An incompatibility is expected between the performance of administration, management and control functions in the pension fund and the performance of administration, management and control functions by the fund manager, the depositary and in other companies of the groups of which the fund manager or the depositary are part of.

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