

LCP GUIDE TO THE NEW EUROPEAN PENSIONS DIRECTIVE DECEMBER 2016

*The IORP II Directive has finally arrived and is intended to improve the way pension schemes are governed, encourage responsible investment and enable clear information to be provided to members and beneficiaries.*



**LCP** Guide to the new European Pensions Directive December 2016

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*Even though the UK will be leaving the European Union we currently consider it likely that [IORP II](#) will be implemented into UK law before Brexit. This will involve some far-reaching changes to the way in which pension schemes are run from towards the end of 2018.*

*This guide is intended to help our clients navigate this important new piece of pension law.*



IORP II is a Directive of the European Parliament and of the Council on the activities and supervision of institutions for occupational retirement provision.

### **1. Who does it apply to?**

“IORPs” – Institutions for occupational retirement provision, are defined as “... an institution, irrespective of its legal form, operating on a funded basis, established separately from any sponsoring undertaking or trade for the purpose of providing retirement benefits in the context of an occupational activity on the basis of an agreement or a contract agreed”.

In practice, this covers all funded UK occupational pension schemes, but not personal pension schemes.

As with the IORP I Directive, Member States can choose to exempt schemes with less than 100 members from much of its scope, but IORP II further provides that schemes with more than 15 members must be subject to much of the general governance and “prudent person” investment requirements.



Tony Bacon

Senior consultant

*These requirements are the keystone of the Directive; far reaching requirements that will require a material step-change in governance standards for many UK pension schemes.*

## 2. Pension scheme governance

The Directive requires that schemes have in place an *"effective system of governance"* which provides for *"sound and prudent management"* of their activities including an *"adequate transparent organisational structure"* with a *"clear allocation and appropriate segregation of responsibilities"* and an effective system for ensuring this.

This must include the consideration of environmental, social and governance (ESG) factors in relation to making investments (see section 9 below).

All the above must be *"proportionate to the nature, scale and complexity of the activities"* of the scheme.

The following particular requirements of the system of governance are prescribed:

- To establish and apply *"written policies"* in relation to risk management, internal audit and, where relevant, actuarial activities and outsourced activities. These must be reviewed at least every three years and be adapted in view of any significant change in the system or area concerned.
- Schemes must have in place an effective *"internal control system"*. This must include administrative and accounting procedures, an internal control framework, and appropriate reporting arrangements at all levels of the scheme's governance structure.
- Schemes must take reasonable steps to ensure continuity and regularity in the performance of their activities, including the development of *"contingency plans"*, employing appropriate and proportionate systems, resources and procedures.
- At least two persons must effectively run the scheme, unless a Member State allows that only one person effectively runs it, on the basis of a reasoned assessment conducted by the regulator. The assessment shall take into account the role of social partners in the overall management of the scheme, as well as the size, nature, scale and complexity of the activities of the scheme.

### 3. Key functions

Central to the concept of a system of governance is a requirement that schemes must have three “key functions”. These are a risk-management, internal audit and an actuarial function.



Schemes will have to formally appoint individuals or firms, whether from within the trustee body or outsourced externally, to undertake these roles, via formal named individual or firm appointments. Function holders will have whistleblowing obligations towards the regulator. This may involve an overhaul of the existing UK whistleblowing regime.

#### 3.1 Risk-management function

In addition to the written policy (see section 2 above), schemes will be required to have an effective risk-management function.

This must:

- be proportionate to the size and internal organisation, as well as the nature, scale and complexity of the scheme’s activities;
- be structured in such a way as to facilitate the functioning of a risk-management system for which the scheme “shall adopt strategies, processes and reporting procedures necessary to identify, measure, monitor, manage and report to [the trustees] regularly the risks, at an individual and at an aggregated level, to which [the scheme] are or could be exposed, and their interdependencies”; and
- be effective and well-integrated into the organisational structure and in the decision-making processes of the scheme.

The Directive is prescriptive about which risks shall be covered by the risk-management system. The specified risks are set out overleaf.

#### LCP comment

*The risk-management function is a substantial undertaking and should not be considered a box ticking exercise.*

*One particular point to note is that sponsor covenant risk is not one of the risks specified as needing to be covered under the risk-management system. This seems like quite a glaring omission compared to some of the other risks specified, bearing in mind the greatly increased focus on the strength of sponsor support in UK DB pension provision currently.*

*However, covenant risk is a feature of the “own risk assessment” (see section 4. below) also required for the system of governance.*

#### Risks to be covered by the risk-management function

- Underwriting and reserving;
- Asset-liability management;
- Investment, in particular derivatives, securitisations and similar commitments;
- Liquidity and concentration risk management;
- Operational risk management;
- Insurance and other risk-mitigation techniques; and
- ESG risks relating to the investment portfolio and its management.

Where members and beneficiaries bear risks, for example where DC pensions are concerned, the risk management system must also consider those risks from the perspective of members and beneficiaries.



*Jonathan Camfield*

**Partner**

*The internal audit function has special provisions above the risk-management and actuarial functions. For example, a single person or organisational unit may carry out a key function but the internal audit function must be carried out independently of any of the other key functions.*

#### 3.2 Internal audit function

In addition to the written policy (see section 2 above), schemes will be required to have an effective internal audit function. This is specified to include an evaluation of the adequacy and effectiveness of the internal control system and other elements of the system of governance, including the remuneration policy and “*fit and proper*” requirements (see sections 5 and 6 below).

### 3.3 Actuarial function

In addition to the written policy (see section 2 above), schemes which provide cover against biometric risks or guarantee an investment performance or a given level of benefits must have an effective actuarial function to:

- co-ordinate and oversee the calculation of technical provisions;
- assess the appropriateness of the methodologies and underlying models used in the calculation of technical provisions and the assumptions made for this purpose;
- assess the sufficiency and quality of the data used in the calculation of technical provisions;
- compare the assumptions underlying the calculation of the technical provisions with the experience;
- inform the trustees of the scheme of the reliability and adequacy of the calculation of technical provisions;
- express an opinion on the overall underwriting policy in the event of a scheme which has such a policy;
- express an opinion on the adequacy of insurance arrangements in the event of the scheme having such arrangements; and
- contribute to the effective implementation of the risk management system.

At least one independent person, inside or outside the scheme, must be designated as responsible for the actuarial function.

#### LCP comment

*We do not anticipate that there will be a great deal of disruption to the current system by which actuarial services are delivered to pension schemes. We note the following though:*

- *While the Directive envisages that the actuarial function may be provided “in house”, current UK legislation prohibits a trustee from acting as scheme actuary – it is unclear whether this will continue.*
- *DC schemes which self-insure death benefits or provide pensions from within the scheme will be required to have an actuary. The position is less clear where such benefits are covered by a matching insurance policy, such as a life insurance or annuity policy, although the Directive can be read so that such schemes are also required to have an actuarial function.*
- *It seems possible for the same person to act as both the risk-manager and the actuary (but not the internal auditor) and it may make sense in many situations for this structure to be adopted.*

**LCP comment**

*This is a material and dynamic documentation requirement. It is quite similar to the documentary requirements applicable to insurance companies under the Solvency II Directive and is envisaged to be a critical part of the good governance of schemes operating under IORP II.*

**4. Own risk assessment**

As part of the system of governance, and with particular relevance to the risk-management system, schemes will be required to carry out and document their own risk assessment (ORA).

The ORA must be performed at least "every three years" or without delay following any significant change in the risk profile of the scheme.

The ORA must include the following:

**Content of ORA**

- A description of how the ORA is integrated into the management process and into the decision-making processes of the scheme;
- An assessment of the effectiveness of the risk-management system;
- A description of how the scheme prevents conflicts of interest with the sponsor, in case the scheme outsources key functions to the sponsor;
- An assessment of the overall funding needs of the scheme, including a description of the recovery plan where applicable;
- An assessment of the risks to members and beneficiaries relating to the paying out of their retirement benefits and the effectiveness of any remedial action taking into account, where applicable, indexation mechanisms; and benefit reduction mechanisms, including the extent to which accrued pension benefits can be reduced, under which conditions and by whom;
- A qualitative assessment of the mechanisms protecting retirement benefits, including, as applicable, guarantees, covenants or any other type of financial support by the sponsor, insurance or reinsurance by an insurer regulated by the Solvency II Directive or coverage by a pension protection scheme;
- A qualitative assessment of the operational risks; and
- Where ESG factors are considered in investment decisions, an assessment of new or emerging risks, including risks related to climate change, use of resources and the environment, social risks and risks related to the depreciation of assets due to regulatory change.

When carrying out the ORA schemes must have in place methods to identify and assess the risks they are or could be exposed to in the short and in the long term and that may have an impact on the scheme's ability to meet its obligations. Those methods shall be proportionate to the nature, scale and complexity of the risks inherent in its activities and must be described in the ORA, which must be taken into account in the strategic decisions of the scheme.



## 5. Fit and proper requirements for trustees

The Directive sets out “*fit and proper*” requirements which people must fulfil to be involved in the running of pension schemes. These will be applicable to trustees and key function holders including where the key function has been outsourced.

### The “fit” requirements

- For trustees their qualifications, knowledge and experience are collectively adequate to enable prudent management of the scheme.
- For persons who carry out key functions (see section 3 above) their qualifications knowledge and experience must be adequate for them to properly carry out their key functions. (Excludes the risk manager function).

The regulator will have the role of assessing whether trustees or key function holders fulfil these requirements.

Clearly an actuarial function holder in the UK will need to be a UK qualified actuary. It is less clear what the appropriate qualifications for an internal auditor or risk manager will be.

The “*proper*” requirements are not prescriptive – it is left up to Member States to decide how to establish the “*good repute and integrity*” of trustees and key function holders.

### LCP comment

*There had been some speculation that the fit requirements would apply at the individual, instead of the collective, trustee level. This has turned out not to be the case but it remains to be seen where the benchmark for fit will be set at the collective level.*

*It is possible that the fit requirements will provide ammunition for the Pensions Regulator in the battle against pension scams.*



James Atherton

**Partner**

*The introduction of remuneration policies for pension schemes will be an entirely new requirement in the UK. How it will be implemented remains to be seen, but it may result in a lot more transparency, particularly regarding the cost of service providers.*

## 6. Remuneration policy

Schemes will be required to establish and apply a sound remuneration policy for all those persons who effectively run the scheme, perform key functions and other categories of staff whose professional activities have a material impact on the risk profile of the scheme in a manner that is proportionate to their size and internal organisation, as well as to the nature, scale and complexity of their activities.

Schemes must regularly disclose publicly relevant information regarding the remuneration policy unless otherwise provided for under EU data protection legislation.

The principles for setting remuneration policy are set out below.

### Principles for setting remuneration policy

- It is established, implemented and maintained in line with the activities, risk profile, objectives, and the long-term interest, financial stability and performance of the scheme as a whole, and the remuneration policy supports sound, prudent and effective management;
- It is in line with the long-term interests of members and beneficiaries of the scheme;
- It includes measures aimed at avoiding conflicts of interest;
- It is consistent with sound and effective risk management and does not encourage risk-taking which is inconsistent with the risk profiles and rules of the scheme;
- It shall apply to the scheme and any of its outsourced service providers, unless those service providers are covered by the EU data protection legislation;
- The scheme must establish the general principles of the remuneration policy, that it shall be reviewed and updated at least every three years, and be responsible for its implementation; and
- There shall be clear, transparent and effective governance with regard to remuneration and its oversight.

### 7. Cross-border activity

It may be marginally easier for a pension scheme to operate as a cross-border scheme in more than one Member State. This is because the requirement for such schemes to be “fully funded at all times” has been relaxed a little so that if the scheme is not fully funded then there must be a prompt regulatory intervention aimed at protecting the members.

### 8. Cross-border bulk transfers

Member States must allow schemes authorised or registered in their territories to transfer all or a part of a pension scheme’s liabilities, to a receiving scheme in another Member State.

The costs of such a bulk transfer must not be incurred by the remaining members and beneficiaries of the transferring scheme or by the incumbent members and beneficiaries of the receiving scheme.

Transfers shall be subject to prior approval by the sponsoring employer and a majority of members and a majority of the beneficiaries concerned or their representatives. Information on the conditions of the transfer shall be made available to the members and beneficiaries concerned and, where applicable, to their representatives, in a timely manner by the transferring scheme before the application referred to below is submitted.

The transfer shall be subject to prior authorisation by the regulator of the home Member State of the receiving scheme after obtaining the prior consent of the regulator of the home Member State of the transferring scheme. A detailed procedure for the obtaining of the necessary authorisations is set out.

#### LCP comment

*We continue to anticipate little demand for cross-border schemes and this modest relaxation will do little to change this. This is because this side of Brexit, cross-border activity is of little relevance to UK trustees, apart from the small number that operate with Irish members.*

*Post Brexit, it is unclear whether or not pension schemes will be able to operate in both the UK and the EU. There seems to be nothing in EU law which prevents this, but whether or not it will be possible in practice remains to be seen. The cross-border issue could become much bigger should Scotland leave the UK and join the EU.*

**LCP comment**

*This is potentially a big change, although it will depend on how the UK government chooses to implement it. It seems that, for the first time, UK trustees will have a legal obligation to consider ESG factors as part of their governance and risk management systems.*

**9. Responsible investment**

While the Directive does not go quite so far as imposing a requirement on trustees to take ESG factors into account when making investment decisions it comes very close. However, they must take ESG factors into account in their system of governance.

This is because:

- The required system of governance (see section 2 above) mandates that trustees will have to include a consideration of ESG factors "*related to investment assets in investment decisions*" which must be subject to regular internal review.
- The provisions of the IORP I Directive regarding investment are largely replicated, and so trustees are still required to invest in the best interests (although it now states the best "*long-term*" interests) of the members and within a "*prudent person*" rule. However, the prudent person rule is now modified so that Member States shall allow schemes to (sic) "*take into account the potential long-term impact of investment decisions on [ESG] factors*".
- The statement of investment principles (which must now be publically available) must contain a statement on how the investment policy takes ESG factors into account (there is already a weaker version of this in UK legislation).
- Part of the risk-management system (see section 3.1 above) is that it must, where applicable "*cover the ESG risks relating to the investment portfolio and management thereof*".
- The own risk assessment (ORA) must cover, where ESG factors are considered in investment decisions, an assessment of new or emerging risks, including risks related to climate change, use of resources and the environment, social risks and risks related to the depreciation of assets due to regulatory change.



## 10. Outsourcing

Any activities of a scheme including key functions and the management of the scheme, in whole or in part, may be outsourced, so long as doing so does not lead to any of the following:

- impairment of the quality of the scheme's system of governance;
- unduly increasing the operational risk;
- impairing the ability of the regulator to monitor the compliance of the scheme with its obligations; or
- undermining continuous and satisfactory service to members and beneficiaries.

Schemes must ensure the proper functioning of the outsourced activities through the process of selecting a service provider and the on-going monitoring of the activities of that service provider.

Where key functions, the management of the scheme or other activities which are covered by the Directive are outsourced then there must be a written agreement with the service provider. This agreement shall be legally enforceable and shall clearly define the rights and obligations of the scheme and the service provider.

Schemes will have to notify in a timely manner the regulator of any outsourcing of the activities covered by the Directive and where key functions or scheme management is outsourced the regulator must be notified in advance.

## 11. Depositary

The Directive newly enables (but does not require) Member States to appoint one or more depositaries for safekeeping of assets and oversight duties, in relation to occupational pension schemes in which members and beneficiaries fully bear the investment risk. Further details are provided in relation to both the safekeeping of assets and depositary liability and the depositary's oversight duties.

### LCP comment

*These requirements do not appear to be very onerous, but they are new in the UK context.*

**LCP comment**

*We anticipate that amendments to the UK pension disclosure regulations will be made to implement these requirements. Key changes include a requirement to provide an annual statement to deferred pensioner and pensioner scheme members and, for DC schemes, the provision of investment performance information going back five years.*

**12. Disclosure**

The Directive includes significant member disclosure requirements. There are some interesting general requirements about the information which must be furnished, which must:

- be regularly updated, be written in a clear manner, using clear, succinct and comprehensible language, avoiding the use of jargon and avoiding technical terms where everyday words can be used instead;
- not be misleading and consistency is to be ensured in vocabulary and content;
- be presented in a way that is easy to read;
- be available in an official language of the Member State; and
- be made available to prospective members, members and beneficiaries free of charge through any electronic means, including on a durable medium or by means of a website, or on paper.

The specific disclosures required by the Directive are set out overleaf.

### 12.1 General information about the scheme

The following general information on the pension scheme shall be provided to members and beneficiaries.

#### The required information

- The name of the scheme, the Member State in which it is registered or authorised and the name of the national competent authority;
- The rights and obligations of the parties involved in the pension scheme;
- Information on the investment profile (although exactly what is not specified);
- The nature of financial risks borne by the members and beneficiaries;
- The conditions of full or partial guarantees or of a given level of benefits, if any, or a statement that no guarantees are provided by the scheme;
- The mechanisms protecting accrued entitlements or the benefit reduction mechanisms, if any;
- Where members bear investment risk or can take investment decisions, information on the past performance of the pension scheme for a minimum of five years (for most UK schemes, past performance must already be disclosed over at least a three year period), or for all the years that the scheme has been operating where this is less than five years;
- The structure of costs borne by members and beneficiaries, for schemes which do not provide for a given level of benefits;
- The options available to members and beneficiaries in receiving their retirement income; and
- In case a member has the right to transfer pension rights, further information about the arrangements relating to such a transfer.

For schemes in which members bear an investment risk and which provide for more than one option with different investment profiles, the members shall be informed of the conditions regarding the range of investment options available, and, where applicable, the default investment option and, the pension scheme's rule to allocate a particular member to an investment option.

Members and beneficiaries or their representatives shall receive within a reasonable time, any relevant information regarding changes to the pension scheme rules. In addition, schemes shall make available to them an explanation of the impact on members and beneficiaries of significant changes to technical provisions.



Jonathan Camfield

Partner

*The requirement to provide the PBS to “each member” is an important development. Currently, under UK pensions disclosure legislation, there is no statutory requirement for schemes to provide an annual benefit statement for pensioners or deferred members. There will be if IORP II is implemented here.*

## 12.2 The Pension Benefit Statement

The centrepiece of the IORP II disclosure requirements is the “*Pension Benefit Statement*” (PBS).

The PBS is described as a concise document containing key information for each member. It must contain the words “Pension Benefit Statement” and state prominently the exact date to which the information in it refers.

The information in the PBS must be accurate, and updated and made available to each member free of charge through any electronic means, including on a durable medium or by means of a website, or on paper, at least annually. A paper copy shall be provided to members on request in addition to any information through any electronic means.

Any material change to the information contained in the PBS compared to the previous year shall be clearly indicated.

The PBS must include, at least, the following key information for members:

### Contents of the PBS

- Personal details of the member, including a clear indication of, as applicable, the statutory retirement age, the retirement age laid down in the pension scheme or estimated by the scheme, or the retirement age set by the member;
- The name of the scheme and its contact address and identification of the pension scheme of the member;
- Where applicable, information on full or partial guarantees under the pension scheme and if relevant, where further information can be found;
- Information on pension benefit projections based on the retirement age as specified in the first bullet point above, and a disclaimer that those projections may differ from the final value of the benefits received. If the pension benefit projections is based on economic scenarios, that information shall also include a best estimate scenario and an unfavourable scenario, taking into consideration the specific nature of the pension scheme;
- Information on the accrued entitlements or accumulated capital taking into consideration the specific nature of the scheme;
- Information on the contributions paid by the sponsoring employer and the member into the scheme, at least over the last twelve months; taking into consideration the specific nature of the scheme;
- A breakdown of the costs deducted by the scheme at least over the last twelve months; and
- Information on the funding level of the pension scheme as a whole.



The PBS must also specify where and how to obtain supplementary information including:

- Further practical information about the member's options provided under the scheme;
- Where to obtain the scheme's annual report and accounts and statement of investment principles;
- Where applicable, information about the assumptions used for amounts expressed in annuities, in particular with respect to the annuity rate, the type of provider and the duration of the annuity;
- Information on the level of benefits, in case of cessation of employment; and
- For schemes where members bear investment risk and where an investment option is imposed on the member by a specific rule specified in the pension scheme, an indication about where additional information is available.

### 12.3 Information for prospective members

The Directive also prescribes information and documents to be provided to prospective members of pension schemes.

#### The required information

Prospective members, if not to be auto-enrolled, must be informed before they join that pension scheme about:

- Any relevant options available to them including investment options;
- The relevant features of the scheme including the kind of benefits;
- Information on whether and how environmental, climate, social and corporate governance factors are considered in the investment approach; and
- Where further information is available.

This information must also be given to members who are auto-enrolled into the scheme "*promptly*" after their enrolment.

Where members bear investment risk or can take investment decisions the prospective members shall be provided with information on the past performance of the pension scheme for a minimum of five years (or for all the years that the scheme has been operating where this is less than five years) and information on the structure of costs borne by members and beneficiaries.



Tony Bacon

Senior Consultant

*We do question the point of introducing a whole new raft of disclosure requirements on top of the existing, highly prescriptive, pensions disclosure regime in the UK. Although many EU countries have little in the way of disclosure requirements and these IORP II provisions are intended to help these countries come up to modern standards, in the UK context it is quite a concrete example of unnecessary regulation being imposed by the EU.*

#### 12.4 Information to be given to members during the “pre-retirement phase”

Schemes must provide to each member, in due time before the retirement age, or at the request of the member, information about the benefit payment options available in taking their retirement income.

#### 12.5 Information to be given during the “pay-out phase”

The following information must be provided to beneficiaries during the “pay-out phase”.

##### Required information

- Schemes must periodically provide beneficiaries with information about the benefits due and the corresponding payment options;
- Schemes must inform beneficiaries without delay after a final decision has been taken resulting in any reduction in the level of benefits due, and three months before that decision is implemented; and
- When a significant level of investment risk is borne by beneficiaries in the pay-out phase, beneficiaries must receive “appropriate information” regularly.

#### 12.6 Information is to be given on request

The following information must be given on request to members and beneficiaries (most of this is already in the UK disclosure regulations):

##### Required information

- the annual report and accounts;
- the statement of investment principles; and
- any further information about the assumptions used to generate the projections required in the PBS.

### 13. Final word

In what is likely to be its parting shot to UK pensions the EU has produced a Directive whose rationale is to bring into greater harmony the disparate occupational pension structures that exist across its Member States. It is significantly more detailed and covers much greater ground than IORP I.

Produced to assist in the deepening of the single market and to facilitate cross-border provision, the reality is that occupational pension schemes will continue to be regulated primarily by Member States because there is no great need for harmonisation. At least in IORP II we have been spared the imposition of a holistic balance sheet, with a specific mention in the recitals that *“No quantitative capital requirement... should be developed... as they could potentially decrease the willingness of employers to provide occupational pension schemes”*.

It is now over to each Member State, with the Department for Work and Pensions taking the lead in the UK, to interpret and implement the Directive.

## LCP Guide to the new European Pensions Directive December 2016



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