

## **Committee: Pension Fund Advisory Panel**

**Date: 6<sup>th</sup> December 2017**

Agenda item: 6

Wards: All

## **Subject: IMPLEMENTATION OF THE MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE (MiFID II)**

Lead officer: Caroline Holland, Director of Corporate Services

Lead member: Councillor Philip Jones

Forward Plan reference number: N/A

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### **Recommendations:**

- a) To note the content of this report and in particular, the potential impact on investment strategy of becoming a retail client with effect from 3<sup>rd</sup> January 2018.
- b) To agree to the immediate commencement and progress of applications for elected professional client status with all relevant institutions in order to ensure it can continue to implement an effective investment strategy.
- c) To acknowledge and agree that the Authority, in electing for Professional Client status, will forgo the protections available to retail clients attached as **APPENDIX 1**.
- d) To agree to give the Director of Corporate Services delegated retrospective responsibility for the purposes of completing and lodging applications and determining the basis of the application as either full or single service.

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### **1. PURPOSE OF REPORT AND EXECUTIVE SUMMARY**

- 1.1 This report outlines the impact of the implementation of the Markets in Financial Instruments Directive 2014/65 ("MiFID II") and in particular the risk to the administering authority of becoming a retail client on 3<sup>rd</sup> January 2018 and that this report recommends that the Pension Fund Advisory Panel (PFAP) at this meeting agree, albeit retrospectively, that elections for professional client status should be made by the Director of Corporate Services on behalf of the authority immediately.
- 1.2 Under the current UK regime, local authorities are automatically categorised as 'per se professional' clients in respect of non-MiFID scope business and are categorised as 'per se professional' clients for MiFID scope business if they

satisfy the MiFID Large Undertakings test. Local authorities that do not satisfy the Large Undertakings test may opt up to elective professional client status if they fulfil certain 'opt-up criteria'.

- 1.3 Following the introduction of the Markets in Financial Instruments Directive 2014/65 ("MiFID II") from 3<sup>rd</sup> January 2018, firms will no longer be able to categorise a local public authority or a municipality that (in either case) does not manage public debt ("local authority") as a 'per se professional client' or elective eligible counterparty (ECP) for both MiFID and non-MiFID scope business. Instead, all local authorities must be classified as "retail clients" unless they are opted up by firms to an 'elective professional client' status.
- 1.4 Furthermore, the UK Financial Conduct Authority (FCA) has exercised its discretion to adopt gold-plated opt-up criteria for the purposes of the quantitative opt-up criteria, which local authority clients must satisfy in order for firms to reclassify them as an elective professional client.

## **2. POTENTIAL IMPACT**

- 2.1 A move to retail client status would mean that all financial services firms like banks, brokers, advisers and fund managers will have to treat local authorities the same way they do non-professional individuals and small businesses. That includes a raft of protections ensuring that investment products are suitable for the customer's needs, and that all the risks and features have been fully explained. This provides a higher standard of protection for the client but it also involves more work and potential cost for both the firm and the client, for the purpose of proving to the regulator that all such requirements have been met.
- 2.2 Such protections would come at the price of local authorities not being able to access the wide range of assets needed to implement an effective, diversified investment strategy. Retail status would significantly restrict the range of financial institutions and instruments available to authorities. Many institutions currently servicing the LGPS are not authorised to deal with retail clients and may not wish to undergo the required changes to resources and permissions in order to do so.
- 2.3 Even if the institution secures the ability to deal with retail clients, the range of instruments it can make available to the client will be limited to those defined under FCA rules as 'non-complex' which would exclude many of the asset classes currently included in LGPS fund portfolios. In many cases fund managers will no longer be able to even discuss ('promote') certain asset classes and vehicles with the authority as a retail client.

## **3. ELECTION FOR PROFESSIONAL CLIENT STATUS**

- 3.1 MiFID II allows for retail clients which meet certain conditions to elect to be treated as professional clients (to 'opt up'). There are two tests which must be

met by the client when being assessed by the financial institution: the quantitative and the qualitative test.

- 3.2 The Local Government Pension Scheme Advisory Board (SAB) and the Local Government Association (LGA) along with the Department of Communities and Local Government (DCLG) and the Investment Association (IA) have successfully lobbied the FCA to make the test better fitted to the unique situation of local authorities.
- 3.3 The new tests recognise the status of LGPS administering authorities as providing a 'pass' for the quantitative test while the qualitative test can now be performed on the authority as a collective rather than an individual. A summary of and extracts from the FCA policy statement which set out these new tests is attached as **APPENDIX 2**.
- 3.4 The election to professional status must be completed with all financial institutions prior to the change of status on 3<sup>rd</sup> January 2018. Failure to do so by local authorities would result in the financial institution having to take 'appropriate action' which could include a termination of the relationship at a significant financial risk to the authority.
- 3.5 The SAB and the LGA have worked with industry representative bodies including the IA, the British Venture Capital Association (BVCA) and others to develop a standard opt-up process with letter and information templates. This process should enable a consistent approach to assessment and prevent authorities from having to submit a variety of information in different formats.
- 3.6 A flowchart of the process is attached as **APPENDIX 3** and the letter and information templates are attached as **APPENDICES 4 and 5**.
- 3.7 Applications can be made in respect of either all of the services offered by the institution (even if not already being accessed) or a particular service only. A local authority may wish to do the latter where the institution offers a wide range of complex instruments which the authority does not currently use and there is no intention to use the institution again once the current relationship has come to an end, for example, if the next procurement is achieved via the LGPS pool. It is recommended that officers determine the most appropriate basis of the application, either via full or single service.
- 3.8 Authorities are not required to renew elections on a regular basis but will be required to review the information provided in the opt-up process and notify all institutions of any changes in circumstances which could affect their status, for

example, if the membership of the Pension Fund Advisory Panel changed significantly resulting in a loss of experience, or if the relationship with the authority's investment advisor was terminated.

#### **4. LONDON COLLECTIVE INVESTMENT VEHICLE (CIV)**

- 4.1 LGPS Pools such as the London CIV will be professional investors in their own right so will not need to opt up with the external institutions they use. Local authorities will however need to opt up with their LGPS pool in order to access the full range of services and sub-funds on offer.
- 4.2 In some circumstances in particular where the pool only offers access to fund structures such as ACS, the pool could use 'safe harbour' provisions resulting from local authorities continuing to be named as professional investors in both the Financial Promotion Order (the "FPO") or in the Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order (the "PCISO"). These provisions would enable the promotion and potential sale of units in fund structures to local authorities as retail investors.
- 4.3 Elections to professional status will be needed for every financial institution that the authority uses outside of the pool, both existing and new, together with a continuing review of all elections. If all new purchases are made via fund structures within the pool then no new elections will be required, only an ongoing review of the elections made with the pool and any legacy external institutions, the number of which would reduce as assets are liquidated and cash transferred.

#### **5. NEXT STEPS**

- 5.1 In order to continue to effectively implement the authority's investment strategy after 3<sup>rd</sup> January 2018, applications for election to be treated as a professional client have been submitted to all financial institutions with whom the authority has an existing or potential relationship in relation to the investment of the pension fund.
- 5.2 This process has commenced in order to ensure completion in good time and avoids the need for appropriate action to be taken by institutions in relation to the authority's pension fund investments.
- 5.3 As mentioned above in paragraph 1.1 the FPAP are asked to agree to grant the necessary retrospective delegation to the Director of Corporate Services to make applications on the authority's behalf and to determine the nature of the application on either full or single service basis.

#### **6. CONSULTATION UNDERTAKEN OR PROPOSED**

- 6.1 N/A

## **7. FINANCIAL, RESOURCE AND PROPERTY IMPLICATIONS**

- 7.1 The investment strategy chosen will affect the return on the Fund, its actuarial valuation and the cost to the Council.

## **8. LEGAL AND STATUTORY IMPLICATIONS**

- 8.1 Local Government Pension Scheme (Management and Investment of Funds) Regulations) 2016 came into force on 1 November 2016 superseding the Local Government Pension Scheme (Management and Investment of Funds) Regulations) 2009 (as amended). The Regulations give the Secretary of State power of intervention.
- 8.2 MiFID II Directive imposes strict new requirements on administering authorities with potential financial consequences for loss of administering authorities' current client status.

## **9. HUMAN RIGHTS, EQUALITIES AND COMMUNITY COHESION IMPLICATIONS**

- 9.1 N/A

## **10. CRIME AND DISORDER IMPLICATIONS**

- 10.1 N/A

## **11. RISK MANAGEMENT AND HEALTH AND SAFETY IMPLICATIONS**

- 11.1 The use of the CIV, if suitable, would enable a quicker, simpler process, but any delays in their ability to take investments could impinge on the Council's ability to have the new allocations and fund managers in place by the end of 2017/18. Use of the CIV is also contingent upon the authority maintaining its current professional client status when MiFID II comes into effect from 3<sup>rd</sup> January 2018.

## **12. APPENDICES**

1. Retail client protections
2. Summary of FCA policy statement
3. Opt up process flowchart
4. Opt up letter template
5. Opt up information template

## **13. BACKGROUND PAPERS**

1. Other reports to this Board
2. SAB Guidance

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