Lincolnshire COUNTY COUNCIL Working for a better future

Regulatory and Other Committee

Open Report on behalf of Executive Director of Finance and Public Protection

Report to:	**Pensions Committee**
Date:	**21 September 2017**
Subject:	**Implementation of the Markets in Financial Instruments Derivative (MiFID II)**

Summary:

This report outlines the impact of the implementation of the Markets in Financial Instrument Directive 2014/65 ("MiFID II") and in particular the risk to the administering authority of becoming a retail client on 3rd January 2018 and recommends that the Committee agree that elections for professional client status should be made on behalf of the authority immediately.

Recommendation(s):

That the Committee:

i. Notes the potential impact on investment strategy of becoming a retail client with effect from 3rd January 2018

ii. Agrees to the immediate commencement of applications for elected professional client status with all relevant institutions in order to ensure it can continue to implement an effective investment strategy.

iii. In electing for professional client status, the Committee acknowledges and agrees to forgo the protections available to retail clients attached as **appendix A**.

iv. Agrees to approve delegated retrospective authority to the Pension Fund Manager for the purposes of completing the applications and determining the basis of the application as either full or single service.

Background

1. The Committee received a presentation from the Fund's Investment Consultant in January 2017, on the potential impacts of new regulations coming into force in 2018. The Markets in Financial Instruments Directive ('MiFID'), part of the European Commission's Financial Services Action Plan, is legislation for the regulation of investment services within the European Economic Area which came into force in November 2007. It was designed to:

- Achieve harmonisation throughout the economic area
- Aid transparency
- Protect investors
- Improve efficiency
- Increase competition

2. MiFID applies to all 'investment firms', including investment managers providing investment advice and portfolio management on a client-by-client basis.

3. 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’.

4. The European Commission instigated a review of the directive due to the increasing complexity of financial products and issues related to the 2008 financial crisis. The outcome of the review was a revised directive, the Markets in Financial Instrument Directive 2014/65 (MiFID II), which comes into effect from 3rd January 2018.

5. From that date, 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.

6. Furthermore, the 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.

<u>Potential impact</u>

7. 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.

8. 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.

9. 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 managers will no longer be able to even discuss (‘promote’) certain asset classes and vehicles with the authority as a retail client.

Election for professional client status

10. MiFID II does allow 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.

11. 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.

12. 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 B.

13. The election to professional status must be completed with all financial institutions prior to the change of status on 3rd 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.

14. 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.

15. A flowchart of the process is attached as appendix C and the letter and information templates are attached as appendices D and E.

16. 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.

17. 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 committee changed significantly resulting in a loss of experience or if the relationship with the authority's investment advisor was terminated.

LGPS pools

18. LGPS pools 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.

19. 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, however it is expected that the Fund will request opt-up to professional status with BCPP to allow access to all sub funds offered.

20. 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.

Next steps

21. In order to continue to effectively implement the authority's investment strategy after 3rd January 2018, applications for election to be treated as a professional client should be submitted to all financial institutions with which the authority has an existing or potential relationship with, in relation to the investment of the pension fund.

22. This process should commence as soon as possible 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.

23. In order to meet the very tight deadlines to ensure opt-ups are completed by the January deadline, investment managers have advised that they require the completed letter and template by no later than 30th September. This will allow them appropriate time to review the request and raise any questions. To enable this to happen, the Pension Fund Manager has already started progressing the documents with the investment managers that the Fund uses. Therefore the recommendation is that the Pension Fund Manager be granted the necessary retrospective delegation to make applications on the authority's behalf and to determine the nature of the application on either full or single service basis.

Conclusion

24. The impact of the implementation of MiFID II, and in particular the risk to the administering authority of becoming a retail client on 3rd January 2018, cannot be underestimated. Officers recommend that the Committee agree that elections for professional client status should be made on behalf of the authority immediately.

Consultation

a) Have Risks and Impact Analysis been carried out??

Yes

b) Risks and Impact Analysis

The Pension Fund has a risk register which can be obtained by contacting the author of this report.

Appendices

These are listed below and attached at the back of the report	
Appendix A	Retail client protections
Appendix B	Summary of FCA policy statement
Appendix C	Opt-up process flowchart
Appendix D	Opt-up letter template
Appendix E	Opt-up information template

This report was written by Jo Ray, who can be contacted on 01522 553656 or jo.ray@lincolnshire.gov.uk.

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