

Croydon Council

REPORT TO:	Local Pension Board 20 April 2017
AGENDA ITEM:	9
SUBJECT:	MiFID II
LEAD OFFICER:	Nigel Cook Head of Pensions and Treasury
CABINET MEMBER	Councillor Simon Hall Cabinet Member for Finance and Treasury
WARDS:	All
CORPORATE PRIORITY/POLICY CONTEXT: Sound Financial Management: This report provides an update on the London CIV which is the Croydon Pension Fund regional pool.	
FINANCIAL SUMMARY: In addition to being a requirement of the DCLG the London CIV should generate reduced costs for the Croydon Local Government Pension Scheme.	
FORWARD PLAN KEY DECISION REFERENCE NO.: N/A	

1. RECOMMENDATIONS

- 1.1 The Board is asked to note the contents of this report.

2. EXECUTIVE SUMMARY

- 2.1 This report describes the scope of the changes to the regulatory framework introduced by the Markets in Financial Instruments Directives and discusses the potential impact of these changes.

3 DETAIL

- 3.1 The Markets in Financial Instruments Directive (MiFID) is the EU legislation that regulates firms who provide services to clients linked to 'financial instruments' (shares, bonds, units in collective investment schemes and derivatives), and the venues where those instruments are traded. The new MiFID II environment is set to commence on 3rd January 2018, having been delayed by a year due to slower than anticipated progress in a number of key areas.
- 3.2 There is a key change affecting Local Authorities. Under the new regime, Local Authorities will be deemed "Retail" clients by default. They will have the option

to “opt-up” to “Professional” client status, or remain as “Retail”. In order to opt-up, clients will need to meet qualitative and quantitative test criteria. The references below are to the Financial Conduct Authority Handbook (the FCA), specifically the Conduct of Business Sourcebook (COBS).

Qualitative Test Criteria

- 3.3 *“Firms must undertake an adequate assessment of the expertise, experience and knowledge of the client to give reasonable assurance in light of the nature of the transactions or services envisaged, that the client is capable of making his own investment decisions and understanding the risks involved (COBS 3.5.3R(1))”.*
- 3.4 The qualitative test criteria are provided as guidance and it will be down to each investment counterparty to set its particular criteria. Rather than a simple pro-forma that could be used to meet each individual request, there are likely to be differences in each approach from each individual financial institution and fund manager. The differences could simply depend on the nature of the potential investment a client may make with the entity, or there could be other factors that also play a role.

Quantitative Test Criteria

- 3.5 *A re-calibrated quantitative test (based on COBS 3.5.3R(2)) – the criteria in paragraph (a) and the criteria in either paragraph (b) or (c) must be satisfied:*
(a) the size of the client’s financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds £15,000,000
(b) the client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters
(c) the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged
- 3.6 Clearly the current value of the Pension Fund satisfies the first test.
- 3.7 Tests b and c present challenges. Until the FCA produce guidance there are significant areas of uncertainty. It would seem to be the intention of the regulations to require investors to have experience in relevant markets. For the Croydon Fund this would include: listed equities; fixed interest instruments; property; cash and investments in the alternate space. However it may be that if the fund invests in a Short Dated Bond Fund this would be considered distinct from an Absolute Return Fund. Another consideration would be how to satisfy sections b / c when you might be considering a new asset class for investing. For example, if you were considering a as a new type of investment, you would struggle to meet the requirements of (b), and may even have issues dealing with (c) as well, even if you have been working in a professional position for at least one year. It could be that undertaking a formal selection process would allow you to meet criteria, or by some other means. However, once again, without clear guidance as to how investment counterparties are going to produce their own assessment processes, it is difficult to say at this stage. Also it is not clear whether working in local government would score against the financial sector criteria.
- 3.8 It is important to note that the option to opt-up is not a one off exercise. It will need to be undertaken with each and every counterparty or fund manager that the Fund may wish to transact. In some circumstances it may even be the case

that the Fund may not wish to take up the option to opt up, preferring instead to maintain its “Retail” status. However the decision to maintain “Retail” status may limit the investment options available, compared to “Professional” status. The decision may rest on what options are available under each status, and which is, therefore, most appropriate. As such, there may be instances where the Fund is deemed “Professional” by some counterparties, but “Retail” by others.

- 3.9 The deadline for implementing MiFID II is January 2018.
- 3.10 The Fund’s property portfolio manager has already contacted the authority to begin this process.
- 3.11 MiFID II extends regulatory transaction reporting obligations to a much broader segment of financial market participants and to ALL investment firms including:
- Investment managers providing advice and portfolio management to individual clients (e.g. managed accounts)
 - Credit institutions
 - Market operators, including all trading venues
 - All financial counterparties under the European Market Infrastructure Regulation on derivatives, central counterparties and trade repositories (EMIR)
 - All non-financial counterparties falling under Article 10(1)(b) of EMIR
 - Central Counterparties (CCPs) and persons with proprietary rights to benchmarks
 - Third-country firms providing investment services or activities within the EU
- 3.12 MiFID II does not apply to investment managers who carry out purely collective portfolio management of Alternative Investment Funds (AIFMs) and Undertakings for Collective Investment in Transferable Securities Funds (UCITS). In the UK, AIFMs and UCITS managers are subject to current MiFID I transaction reporting rules and it seems highly likely that the FCA will extend the obligation to fully include both of these categories.
- 3.13 Current MiFID transaction reporting applies only to financial instruments admitted for trading on a regulated market (and to Over The Counter (OTC) derivative contracts linked to those instruments). MiFID II extends the scope of reportable instruments to:
- Financial instruments admitted to trading or traded on an EU trading venue and to all financial instruments where the underlying instrument is traded on a trading venue.
 - Financial instruments where the underlying instrument is traded on a trading venue. This essentially widens the scope to capture all OTC transactions in such instruments.
 - Financial instruments where the underlying is an index or a basket composed of instruments traded on a trading venue. This means that just one component of either an index or basket will bring that financial instrument under the reporting obligation.
- 3.14 The definition of Financial Instruments has been extended to include further products and asset classes including currency, commodity and interest rate derivatives, as well as emission allowances.

- 3.15 A transaction does not need to have been executed on an EU trading venue to be subject to the reporting requirement. For example, derivatives traded outside of the EU where the underlying is traded on an EU trading venue will have to be reported. Investment firms must also report the details of any trade execution that changes a firm's or its clients' positions in a given product, for example, a short-selling flag for shares or sovereign debt. The Directive also imposes specific reporting obligations relating to equity execution quality and commodities positions.
- 3.16 In summary therefore the introduction of the Directive will impact on many of the Pension Fund's investments and create a significant additional administrative burden. Inevitably there is a risk that this will translate into an increase in the cost of managing these investments.
- 3.18 However, there are balancing factors. Officers have already instigated discussions with counter-parties and some initial conclusions have been reached, albeit with the caveat that FCA guidance is still pending. It is assumed throughout that Brexit will not impact upon the adoption of the Directive as the UK will still be a member of the European Union by January 2018. Pensions being classified as retail investors by the FCA should not be a problem in this instance for the following reasons:
- For context, MiFID doesn't apply to fund management activities, only investment advice.
 - The FCA's changes to the classification of pension funds only applies within the FCA's scope of oversight. Many of the funds that the Pension Fund has engaged with have been via a European passport; and regulated in other European countries, the US or Australia. As an example, the FCA's new rules on the classification of LGPS, above and beyond what's detailed in MiFID/MiFID 2 ("gold-plating", as such things are commonly called) do not appear in French texts, and therefore do not apply to French funds operating through the passporting system. This may present a problem if the passporting arrangements fall away when the UK leaves the Union.
 - .3) Should the Fund decide not to take the Retail client route, it remains possible for pensions to opt-up to the status of professional client by request; this option is used routinely with family offices and High Net Worth clients.
 - The worst-case scenario is that the FCA regulates that LGPS funds are now retail investors with no opt-up possible, then many managers will find that they will no longer be able to market their funds to UK LGPS.
- 3.19 Regardless of the outcome of this process all parties that officers have contacted place emphasis on the inevitable increase in the administrative burden.

London Collective Investment Vehicle (London CIV)

- 3.20 The London CIV is the Croydon Fund's vehicle for regional pooling, as required by the government. Comprising all of the London Boroughs plus the Corporation of the City of London, discussions have begun a number of Funds have started receiving communications from Investment Managers referring to Local Authorities retail status and the need for them to opt up.

- 3.21 With respect to Pension Funds, the cross pool working group, the body representing the interests of all 8 of the regional pools, has been pressing government and the FCA directly on the issue including holding a meeting with them in January and a follow up smaller group meeting. This is in addition to input from LGA and the LGPS Scheme Advisory Board. Whilst there can be no guarantees, the CIV is hopeful that progress is being made and indeed it has received correspondence from the Minister which would indicate that the issues which have been raised by the Funds themselves along with the cross pool group are being taken seriously by the various government departments.

The Bank of New York Mellon

- 3.22 The Bank of New York Mellon is the Fund's custodian and so plays a pivotal role in the effective management of the Fund. They also are addressing many of the issues discussed above.
- 3.23 The Bank has pointed out that, although potentially not directly impacting the Croydon Fund's business as MiFID II predominantly impacts Manufacturers and Distributors of funds, there may be wider implications of the Directive impacting many areas throughout the trade lifecycle. BNY Mellon has established a significant programme of work to deliver MiFID II compliance across all of their European, Middle East and African lines of business and legal entities. In particular for Asset Servicing, they are currently exploring impacts around:
- Elements of the Corporate Actions service
 - Impacts to the custody processes around requirements to reconstruct trades
 - Certain FX transactions
 - Safeguarding of assets
- 3.24 There is also a requirement to ensure that their contracts reflect MiFID II provisions and as they work our way through the Regulatory Technical Standards when they are published, they may find other areas of direct impact. They have undertaken to share additional detail around these areas as they work through them.
- 3.25 This item features on the Pension Fund risk register and has been added to the corporate risk register. This development represents a significant challenge for the authority, potentially impacting on many of the Fund's investments and requiring responses from all of the Fund's professional advisors.

4. RECOMMENDATIONS

- 4.1 The Board is asked to note the contents of this report.

5 FINANCIAL CONSIDERATIONS

- 5.1 There are no further financial considerations flowing from this report.

6. OTHER CONSIDERATIONS

- 6.1 Other than the considerations referred to above, there are no customer Focus, Equalities, Environment and Design, Crime and Disorder or Human Rights considerations arising from this report

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