

Croydon Council

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| REPORT TO: | Local Pension Board 19 October 2017 |
| SUBJECT: | Implementation of the Markets in Financial Instruments Derivative (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 sets out the process by which the Pension Fund should react to changes in the regulated financial environment as it relates to Pension Fund Investments. | |
| FINANCIAL SUMMARY: These changes go to the heart of the investment process and therefore have the potential to significantly impact upon the viability of the local government pension scheme. | |
| FORWARD PLAN KEY DECISION REFERENCE NO.: N/A | |

1. RECOMMENDATIONS

- 1.1 The Board is asked to note the steps adopted by the Pensions Committee to ensure that the Pension Fund can successfully elect to be recognised as a professional investor following the adoption of MiFID II in January 2018.

2. EXECUTIVE SUMMARY

- 2.1 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 in delaying electing up to professional client status on 3rd January 2018 and sets out the steps that the committee agreed to take to elect for professional client status.

3 DETAIL

Context

- 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 This new directive introduces 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. These criteria have been relaxed, following lobbying on behalf of local government, to recognise the status of the local government pension scheme.
- 3.3. 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.
- 3.4. Following the introduction of the Markets in Financial Instrument Directive 2014/65 ("MiFID II") from 3 January 2018, firms will no longer be able to categorise a local public 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.
- 3.5 Furthermore, the Financial Conduct Authority (the 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.

Potential impact

- 3.6. 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. Appendix A provides more detail of these protections.
- 3.7 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.
- 3.8 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

- 3.9. 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.
- 3.10 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.
- 3.11. 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.
- 3.12. 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.
- 3.13. The SAB and the LGA have worked with industry representative bodies including the Investment Association, 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.
- 3.14. A flowchart of the process is attached as Appendix C and the letter and information templates are attached as Appendices D and E.
- 3.15. 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.
- 3.16. 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

- 3.17. 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.
- 3.18. 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.
- 3.19. 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

- 3.20. 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 clients should be submitted to all financial institutions with whom the authority has an existing or potential relationship in relation to the investment of the pension fund.
- 3.21. Following the decision by the Pensions Committee on 19 September, 2017, to delegate to the Executive Director of Resources (Section 151 Officer) the authority to make applications for elected professional client status on the authority's behalf and to determine the nature of the application on either full or single service basis, officers have written to all of the pension fund managers with Pension Fund investments.
- 3.22. Including the Fund's custodian and investment advisors this represents 17 firms. 12 of these companies have now been formally written to to request that the Pension Fund be considered as elective professional investors from January 2018. An evidence pack to support that request is being prepared. Those firms that have been contacted are engaged with the process and a positive outcome is anticipated.

4 FINANCIAL CONSIDERATIONS

- 4.1 The implementation of MiFID II (Markets in Financial Instruments Directive) reclassifies local and public authorities as retail investors from 3rd January 2018. Such a reclassification would severely limit both the financial instruments and providers available to authorities for pensions purposes which could be both costly and reduce the potential for returns.

5. OTHER CONSIDERATIONS

- 5.1 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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APPENDICES:

- 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