

PENSIONS COMMITTEE

19 SEPTEMBER 2017

Subject Heading:

**IMPLEMENTATION OF THE MARKETS
IN FINANCIAL INSTRUMENTS
DERIVATIVE (MiFID 11)**

CLT Lead:

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Policy context:

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**Continuation of effective investment
strategy**

Financial summary:

**No direct costs for the opting up
process**

**The subject matter of this report deals with the following Council
Objectives**

Communities making Havering	[X]
Places making Havering	[X]
Opportunities making Havering	[X]
Connections making Havering	[X]

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.

RECOMMENDATIONS

That the Committee:

1. Notes the potential impact on investment strategy of becoming a retail client with effect from 3rd January 2018
2. 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.
3. In electing for professional client status the committee acknowledges and agrees to forgo the protections available to retail clients attached as **APPENDIX 1 (Retail client protections)** and that this means no change to the existing arrangements.
4. Agrees to approve delegated responsibility to the Statutory Section 151 Officer Finance (Interim) for the purposes of completing the applications and determining the basis of the application as either full or single service.

REPORT DETAIL

1. **Background**

- a) 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’. London Borough of Havering is currently classified as a ‘per se professional client’.
- b) 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 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.
- c) 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.

Potential impact of Retail Client Status

- d) 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.
- e) 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.
- f) 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. By not opting up LB Havering would not be able to access the whole range of assets needed to implement an effective, diversified investment strategy.

Election for professional client status

- g) As mentioned above 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.
- h) Professional clients do not have the same protections available to them as offered to retail clients as shown in Appendix 1. Election of professional status will have the effect of retaining existing arrangements.
- i) 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.

- j) 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 and takes into account the advice it receives, 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 (Summary of FCA policy Statement)**.
- k) The election to professional status must be completed with **all affected** 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.
- l) 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.
- m) A flowchart of the process is attached as **APPENDIX 3 (Opt up process flowchart)** and the letter and information templates are attached as **APPENDICES 4 (Opt up letter template) and 5 (Opt up information template)**.
- n) 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.
- o) 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 or changed.

LGPS pools

- p) 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.
- q) In some circumstances, in particular where the pool only offers access to fund structures such as an Authorised Contractual Scheme (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.

- r) Elections to professional status will be needed for every affected financial institution that the authority uses outside of the pool, both existing and new, together with a continuing review of all elections.
- s) 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 would be required, the number of which would reduce as assets are liquidated and cash transferred.

Next steps

- t) In order to continue to effectively implement the authority’s investment strategy after 3rd January 2018, applications for election to be treated as professional clients should be submitted to all affected financial institutions with whom the authority has an existing or potential relationship with in relation to the investment of the pension fund.
- u) 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.
- v) The officer named in the recommendations should be granted the necessary delegation to make applications on the authority’s behalf and to determine the nature of the application on either full or single service basis. Whilst there is no hard criteria to assess whether to apply on a full or single service basis, consideration should be given to the future scope of the services that may be provided and apply for the full service, this will alleviate having to submit future opt up requests should any of the existing mandates change for any reason.
- w) Applications to opt up must be sent to ALL investment firms with which the authority wishes to become an elected professional investor. ‘Firms’ for this purpose include all financial institutions with which the authority has a client relationship in relation to the investment of pension fund monies, for example, asset managers, fund providers and consultants.
- x) For the Havering Pension Fund application to opt up to professional clients will be as follows:
 - i. GMO
 - ii. London CIV
 - iii. Royal London
 - iv. SSgA

- v. UBS
 - vi. HG Capital
 - vii. Hymans (Investment Advisor)
- y) Other financial institutes that do not require professional status with whom we have a financial relationship include Hymans (Actuary), State Street Global Services (performance measurers and custodial services)

IMPLICATIONS AND RISKS

Financial implications and risks:

Potential impact of being classified as retail or professional clients is covered within the report under paragraph d) to e).

There is a risk that not opting up to professional clients and not being able to access the wide range of investment products would prohibit continuation of implementing the current investment strategy and impact on the Fund's ability to reduce the deficit position. Not meeting the investment objectives and reducing the deficit could consequently increase costs to the General Fund over the long term.

Legal implications and risks:

The EU Regulation - Markets in Financial Instrument Directive 2014/65 ("MiFID II") will have direct effect within the UK as from 3 January 2018. The content of this Directive is set out in the body of the Report.

Whilst the consequences of failing to apply for elected professional client status cannot be predicted with certainty, there is a significant risk that it will inhibit the Authority in continuing to conduct its pension investment activities as it does at present with adverse financial consequences.
None arising directly

Human Resources implications and risks:

There are no immediate HR implications.

Equalities implications and risks:

None arising that directly impacts on residents or staff.

BACKGROUND PAPERS

Pensions Committee, 19 September 2017

None