Cyngor Abertawe
Swansea Council

Report of the Section 151 Officer

Local Pension Board - 28 September 2017

Markets in Financial Instruments Directive II (MIFID II)

Purpose:	To note the opting up of the City & County of Swansea Pension Fund to Professional Investor status under MIFID II
Report Author:	Jeff Dong Chief Treasury & Technical Officer
Finance Officer:	Jeff Dong Chief Treasury & Technical Officer
Legal Officer:	Stephanie Williams
Access to Services Officer:	N/A
For Information	

1 Background

1.1 The City & County of Swansea Pension Fund Committee received on the 13th July 2017, an information report outlining the forthcoming requirements for Administering Authorities in light of MIFID II (attached at **Appendix 1)** and the approach to be adopted by LGPS funds in addressing the same. Since that date, the FCA in consultation with SAB, LGA and Administering Authorities have agreed a specific election to opt up to professional investor status process for LGPS funds. The recognition of the fund as a professional investor precludes the fund from a number of protections afforded to retail clients **(Appendix 2)**

2 Electing to Opt Up Process

2.1 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.

2.2 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.

2.3 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 2A**

2.4 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

2.5 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

2.6 A flowchart of the process is attached as **APPENDIX 3** and the letter and information templates are attached as **APPENDICES 4 and 5.** 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.

2.7 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

3 Wales Pension Partnership Investment Pool

3.1 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

3.2 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. 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.

4 Recommendation

4.1 It is recommended that the Pension Fund Committee:

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

ii. Approves 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 approves to forgo the protections available to retail clients.

iv. Delegates the Section 151 Officer the appropriate approvals for the purposes of completing the applications and determining the appropriate basis of the application

5 Legal Implications

5.1 The legal implications of non compliance are indicated within the Directive

6 Financial Implications

6.1 There are no financial implications arising from this report

7 Equality and Engagement Implications

7.1 There are no equality and engagement implications arising from this report

Background Papers: None

Appendices:

Appendix 1 – Mifid II July 2017

Appendix 2 - Warnings

Appendix 3 - UK Local Authority Client Opt-Up Process
Appendix 4 - Letter requesting categorisation as an elective professional client
Appendix 5 - Elective Professional Client - Status Assessment

APPENDIX 1

Item 8
Report of the Section 151 Officer

Pension Fund Committee, July 13th 2017

MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE II (MIFID II)

Purpose:	To update the Pension Fund Committee on MIFID II and its potential impact on the LGPS nationally and locally
Report Author:	Jeff Dong Chief Treasury & Technical Officer
Finance Officer:	Jeff Dong Chief Treasury & Technical Officer
Legal Officer:	Stephanie Williams
Access to Services Officer:	N/A
FOR INFORMATION	

1 Background

1.1 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. The Directive replaced the Investment Services Directive. It was designed to:

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

1.2 The European Commission instigated a review of the directive due to increasing complexity of financial products and issues related to the 2008 financial crisis. The outcome of the review was a revised Directive, MiFID II. The Financial Conduct Authority (‘FCA’) is now consulting on its third set of implementation proposals for MiFID II, which are due to take effect from 3 January 2018. The proposed changes to the FCA Handbook will have a significant impact on LGPS administering authorities.

2 Potential Impact on the LGPS

2.1

The main issue that administering authorities could face is a re-classification from 'per se professional' to 'retail' client status. If no action were taken, administering authorities could see restrictions as retail clients e.g. in terms of the universe of investment funds they may invest in.

2.2

The good news is that administering authorities will have the opportunity to "opt-up" to 'elective professional client', i.e. professional client status. The FCA believes that the ability to access financial markets will not be fundamentally affected by broader changes if classified as a professional client. The specific procedure for opting-up will include both qualitative and quantitative assessments, as outlined in the next section.

3 Assessment

3.1 The proposed assessment required to be undertaken by the fund manager of the client involves :

3.2 Qualitative Assessment

The qualitative assessment will require:

"adequate assessment of the expertise, experience and knowledge of the client that gives 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"

The above should not present a major hurdle for the majority of LGPS administering authorities. Indeed, it is expected that those in positions of authority will be suitably qualified and possess the necessary experience to fulfil their roles. Administering authorities will, however, need to have sufficient evidence to demonstrate that the qualitative assessment is satisfied.

3.3 Quantitative Assessment

Quantitative test a), below and one of 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 **£15m**

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

3.4 Given the sizes of funds under management across the local government sector, criteria a) is not likely to present an issue. Criteria b) will present a major issue for the majority of administering authorities, with quarterly transaction activity typically not close to this level. Reliance will need to be placed on the remaining test to ensure an administering authority can consider opting-up to professional client status. It is not entirely clear how changes in team should be reflected in criteria c). For example, it may be possible that the qualitative assessment will need to be re-run each time there is a material personnel change.

4 Financial Conduct Authority Consultation

4.1 The FCA is currently consulting on proposed changes to the FCA handbook in light of the new directive. The full consultation document is available via this link below:

https://www.fca.org.uk/sites/default/files/cp16-29.pdf

The LGA has responded to the consultation on behalf of Administering Authorities, Councils and other public sector bodies affected by the changes. The response is attached at Appendix 1.

5 Way Forward

5.1 In light of the responses it has received from the consultation, the FCA has engaged with the LGA and CIPFA with a view to addressing compliance at a national level or mitigating the impact of the criteria outlined in the initial directive. The City & County of Swansea Pension Fund is confident of satisfying the assessment criteria in either instance.

6 Legal Implications

6.1 The legal implications of non compliance are indicated within the Directive

7 Financial Implications

5.1 There are no financial implications arising from this report

8 Equality and Engagement Implications

6.1 There are no equality and engagement implications arising from this report