**Pension Fund Committee**
Meeting to be held on Friday, 1 December 2017

Electoral Division affected:
(All Divisions);

**Implementation of the Markets in Financial Instruments Derivative (MiFID II)**
(Appendix 'A' refers)

Contact for further information: Abigail Leech, 01772 530808, Head of Fund,
abigail.leech@lancashire.gov.uk

## Executive 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.

## Recommendation

The Pension Fund committee is asked to:

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

2. Agree 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 acknowledge and agree to forgo the protections available to retail clients attached as Appendix A.

4. Agree to approve delegated responsibility to Abigail Leech, Head of Fund for the purposes of finalising the applications and determining the basis of the application as either full or single service.

## Background and Advice

### Context

Under the current UK regime, local authorities are automatically categorised as 'per se professional' clients in respect of non‑MiFID and 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'.

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.

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**

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.

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.

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 Financial Conduct Authority (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**

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.

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.

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.

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.

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.  This process has been adopted by LCPF in seeking elective professional status.

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.

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**

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.

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.  Due to the short timescales the Head of Fund has requested that LPPI start to engage with other counterparties.

**Consultations**

Local Pension Partnership

**Implications**:

This item has the following implications, as indicated:

**Risk management**

Risks are as set out in the report.

**Local Government (Access to Information) Act 1985**
**List of Background Papers**

| Paper | Date | Contact/Tel |
|---|---|---|
| Highlights | 2017 | Mukhtar Master/532013 |
| UK LA Opt-up process flowchart | 2017 | Mukhtar Master/532013 |
| LA Letter for Client Status Re-Categorisation | 2017 | Mukhtar Master/532013 |
| Questionnaire for LA Completion | 2017 | Mukhtar Master/532013 |

Reason for inclusion in Part II, if appropriate
N/A