



Committee and Date
Pensions Committee
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10.00am

Item
Public

IMPLEMENTATION OF THE MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE (MIFID II)

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1. Summary

- 1.1 The report outlines the impact of the implementation of the European Markets in Financial Instrument Directive 2014/65 ("MiFID II") and in particular the risk to the administering authority of becoming a retail client on 3 January 2018. It recommends that the Committee agree that elections for professional client status are made on behalf of the Shropshire County Pension Fund, as soon as possible.

2. Recommendations

That the Pensions Committee:

- 2.1 Notes the potential impact on investment strategy of becoming a retail client with effect from 3 January 2018.
- 2.2 Agrees to the immediate commencement of applications for elected professional client status with all the Fund's current investment and financial service providers in order to ensure it can continue to implement an effective investment strategy.
- 2.3 In electing for professional client status, the committee acknowledges and agrees to forgo the protections available to retail clients attached at Appendix 1.
- 2.4 Agrees to approve delegated responsibility to the Head of Finance Governance & Assurance and Scheme Administrator for the purposes of completing the applications and determining the basis of the application as either full or single service.

REPORT

3. Risk Assessment and Opportunities Appraisal

- 3.1 Risk Management is part of the Pension Fund's structured decision-making process by ensuring that investment decisions are taken by those best qualified to take them.
- 3.2 The recommendations contained in this report are compatible with the provisions of the Human Rights Act 1998.

- 3.3 There are no direct environmental, equalities or climate change consequences of this proposal.
- 3.4 Failure to opt up to professional client status would put the authority at risk of not being able to access the wide range of assets needed to implement an effective, diversified investment strategy.

4. Financial Implications

- 4.1 There are no direct financial implications arising from this report.

5. Background

- 5.1 Under the current UK regulatory framework, local authorities are automatically categorised as 'professional' clients for investment purposes, both in terms of their treasury management and pension fund administration functions.
- 5.2 Following the introduction of the European Markets in Financial Instrument Directive 2014/65 ("MiFID II") from 3 January 2018, local authorities will lose the automatic right to be categorised as professional clients. Financial service providers such as banks, investment fund managers, brokers and advisors will have to treat them as retail clients, unless they are 'opted up' to professional client status. The criteria for 'opting up' in the UK are specified by the Financial Conduct Authority (FCA). They require an assessment of quantitative factors (relating to the nature and scale of the client's business); and qualitative factors (relating to the expertise, experience and knowledge of key decision makers).
- 5.3 The aim of the assessment is to demonstrate whether, in the light of the nature of the transactions or services envisaged, the client is capable of making its own investment decisions and understanding the risks involved. It is for the service provider to determine whether or not, based on the information submitted by clients, the appropriate 'opting up' criteria are met.

6. Potential Impact

- 6.1 If, as administering authority for the Shropshire County Pension Fund, Shropshire Council does not successfully opt up to professional client status; the Fund's investment managers and advisers will have to treat it in the same way as non-professional clients, private individuals and small businesses. That includes providing a raft of protections to ensure the suitability of investment products, and evidence that all the risks and product features have been explained. This provides a higher standard of protection for the client but it also involves more work (and higher costs) for both the service provider and the investor and additional obligations in terms of satisfying the regulator that all such requirements have been met.
- 6.2 The Fund would not also, be able to access a range of products and financial instruments which are deemed unsuitable for retail investors, and would have fewer options in terms of which financial institutions or fund managers it could appoint, as many who currently deal with local authorities, are not licensed for retail business, and may not wish to incur the costs involved in seeking additional regulatory permissions.

- 6.3 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 and would exclude many of the asset classes currently included in LGPS fund portfolios including Shropshire's. In many cases managers will no longer be able to even discuss certain asset classes with the authority as a retail client.
- 6.4 In electing for professional client status, the Fund would effectively, forego the protections afforded to retail clients (the details of which are set out in Appendix 1), although the Committee should note that these protections are not currently enjoyed by the Fund with the associated risks being mitigated through a range of different controls, including:-
- Access to independent actuarial and investment advice
 - The LGPS investment regulations themselves
 - The Fund's own governance and policy framework,
 - The Council's constitution and financial procedure rules
 - Access to professional networks
 - Experienced and well qualified officer team

7. Opting Up to professional client status

- 7.1 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.
- 7.2 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 opt up test better suited to the unique situation of local authorities.
- 7.3 The latest guidance recognises the status of LGPS administering authorities as providing a 'pass' in terms of the quantitative test, and now allows for the qualitative criteria to be assessed on a collective rather than an individual basis. A summary of the new tests and relevant extracts from the FCA policy statement is set out in Appendix 2.
- 7.4 The election to professional status must be completed with all financial service providers prior to the change of status on 3 January 2018. Failure to do so would result in providers having to take 'appropriate action' in accordance with their own internal compliance procedures, which could include termination of their relationship with the Fund.
- 7.5 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, including supporting information templates and pro-forma correspondence. This should enable a consistent approach to assessment and avoid authorities having to submit different information, in different formats to the various different financial institutions they use. A summary of the process is set out in the flow chart in Appendix 3.

- 7.6 Applications for professional client status can be made in respect of either all of the services offered by the provider (irrespective of whether they are currently used) or just for particular services only. Given that all future procurement will be undertaken by LGPS Central Ltd on the Fund's behalf, it may make sense to limit applications to cover only those services currently used, particularly if this is likely to speed up the assessment process. It is recommended that the Head of Finance Governance & Assurance & Scheme Administrator determines the most appropriate basis of the application, either via full or single service.
- 7.7 Authorities will not be required to renew their elections on a regular basis but they will be required to review the information provided in the opt-up process and notify providers of any material changes in circumstance which could affect their status.

8. LGPS Pooling

- 8.1 LGPS pools, including LGPS Central will be professional investors in their own right so will not need to opt up with the external institutions they use. Individual partner funds will however, need to opt up with their pool Operator in order to access the full range of services and sub-funds on offer.
- 8.2 Elections to professional status will however, be required for every financial institution that the Fund uses outside of the pool. This will include investment managers who are retained to manage legacy assets pending their transition into the pool.

9. Next steps

- 9.1 It is proposed that opting up applications are submitted to all the Fund's current investment and financial service providers as soon as possible, so that professional client status is maintained. This will avoid any potential disruption to the delivery of the Fund's Investment Strategy and ensure compliance with the new regulatory provisions which take effect from 3 January 2018.
- 9.2 The Committee are asked to grant the necessary delegation to the Head of Finance Governance & Assurance & Scheme Administrator to make applications on the authority's behalf and to determine the nature of the application on either full or single service basis.

List of Background Papers (This MUST be completed for all reports, but does not include items containing exempt or confidential information)

N/A

Cabinet Member

N/A

Local Member

N/A

Appendices

1. Retail client protections

2. Summary of FCA policy statement
3. Opt up process flow chart