

## MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE II

### Report of the County Treasurer

Please note that the following recommendations are subject to consideration and determination by the Committee before taking effect.

- 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 acknowledges and agrees to forgo the protections available to retail clients attached as Appendix 1.**
  - (4) That the County Treasurer be authorised to complete the appropriate opt up process with all the relevant institutions and determine the basis of the application as either full or single service.**

### 1. Introduction

- 1.1 Following the financial crisis in 2008 the European Commission instigated a review of the regulations around the management of financial instruments as a result of the increasing complexity of investment instruments available and their perceived influence on the financial crisis. As a result of the review the Commission issued a revised Markets in Financial Instruments Directive (MiFID II). LGPS funds are currently regarded as professional clients under various regulations, but the implementation of MiFID II will result in them automatically being reclassified as retail clients.
- 1.2 The Financial Conduct Authority (FCA) has responsibility for implementing the directive in the UK, and has been undertaking a consultation on how MiFID II should be implemented in the UK. The FCA has now issued its final policy statement setting out the rules for implementation of MiFID II, effective from 3 January 2018. The FCA has reiterated that it is a MiFID II requirement for local authorities (currently treated as professional) to be classified as retail clients by default. However, it has provided greater clarity on the criteria for local authorities administering LGPS pension funds to “opt up” to be treated as “professional” (rather than “retail”) clients.

## **2. Implications of retail status**

- 2.1 Professional clients are presumed to have a higher level of understanding of the products that they are investing in and therefore will receive a lower level of protection than retail clients. As a retail client, the Fund could be faced with a much reduced pool of asset managers and consultants willing to provide services, many may not deal with retail clients at all. Those managers who are willing to deal with us will offer a restricted range of products and due to the extra compliance checks and reporting required for retail clients those products could cost more. Initial estimates were that up to 50% of LGPS assets may be affected.
- 2.2 If, when the directive comes into force, the Fund holds assets in products outside of the scope of those available to retail clients, then the manager may eject us from that product resulting in a 'fire sale' of assets. The FCA says that it has limited discretion with regard to transitional arrangements. Given this, it is important that the Fund takes action to opt up to professional client status before 3 January 2018 with each of the managers that we currently have investments with. This will also apply to other service providers, such as the Fund Custodian, and investment advisors and consultants.
- 2.3 A summary of the protections lost as a result of opting up to Professional Client status is attached at Appendix 1 to this report.

## **3. Opt up criteria**

- 3.1 Following a consultation exercise, the FCA, recognizing that the LGPS already has its own governing regulations and oversight bodies, has revised its criteria for opting-up with the aim of making it "easier for local authorities investing on behalf of a LGPS pension fund to opt-up to professional client status". In order to opt up the Devon Fund will need to meet quantitative and qualitative criteria.
- 3.2 To pass the quantitative test, local authorities must firstly meet a portfolio size requirement of £10m, (this amount reflects a lowering of the previous portfolio size threshold of £15m). The FCA thinks that £10m is more suitable to its policy goal, which is "restricting the ability of the smallest, and by implication the least sophisticated, local authorities (town and parish councils, and the smallest county and district councils) to opt-up, but giving larger ones the ability to do so more readily (provided they meet the other criteria)." Clearly the Devon Pension Fund will meet this criteria.
- 3.3 Secondly they must meet ONE of the following tests:
  - a) the client has carried out transactions, in significant size, on the relevant market at an average frequency of ten per quarter over the previous four quarters; or
  - b) the person authorised to carry out transactions on behalf of the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the provision of services envisaged; or
  - c) the client is an 'administering authority' of the Local Government Pension Scheme within the meaning of the version of Schedule 3 of The Local Government Pension Scheme Regulations 2013, and is acting in that capacity.

- 3.4 The third of these was added following the FCA's consultation, and means that the Devon fund will meet the quantitative criteria to opt up.
- 3.5 The qualitative test requires an: *“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.”*
- 3.6 However, the final policy statement acknowledges the typical LGPS governance arrangements (including the role of the elected committees) and states the following: *“Firms may take a collective view of the expertise, experience and knowledge of committee members, taking into account any assistance from authority officers and external advisers where it contributes to the expertise, experience and knowledge of those making the decisions.”*
- 3.7 We are confident that with the training plans that have been put in place for the Committee in recent years, together with the level of advice received from qualified and experienced officers, investment advisors and consultants, the Devon Fund should be also be able to meet the qualitative test. However this will have to be assessed by each of the external investment managers the Fund currently uses and each will require the completion of required paperwork in order to make the assessment. This will include details of the experience of and training received by members of the Committee, and the requirement for self-assessments. The Local Government Association has agreed a generic template with the majority of investment managers which should make the task easier.
- 3.8 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.
- 3.9 It should be noted that the Fund will continue to need to opt up to professional client status in order to invest through the Brunel Pension Partnership Ltd, although the Brunel company itself will automatically have professional client status as an FCA regulated entity.

#### **4. Conclusion**

- 4.1 It is vital that the Devon Fund takes action to opt back up to professional client status before the January deadline. It is therefore recommended that the Committee agree that Devon County Council in its capacity as the administering authority of the Devon Pension Fund should seek to opt up to professional client status following implementation of MiFID II.
- 4.2 This process should commence as soon as possible in order to ensure completion in good time and avoid the need for appropriate action to be taken by institutions in relation to the Devon Pension Fund's investments.

- 4.3 The County Treasurer 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.

Mary Davis

Electoral Divisions: All

Local Government Act 1972

List of Background Papers – Nil

Contact for Enquiries: Mark Gayler

Tel No: (01392) 383621 Room G97

## **Warnings - loss of protections as a Professional Client**

Professional Clients are entitled to fewer protections under the UK and EU regulatory regimes than is otherwise the case for Retail Clients. This document contains, for information purposes only, a summary of the protections that you will lose if you request and agree to be treated as a Professional Client.

### **1. Communicating with clients, including financial promotions**

As a Professional Client the simplicity and frequency in which the firm communicates with you may be different to the way in which they would communicate with a Retail Client. They will ensure however that our communication remains fair, clear and not misleading.

### **2. Information about the firm, its services and remuneration**

The type of information that the firm provides to Retail Clients about itself, its services and its products and how it is remunerated differs to what the firm provides to Professional Clients. In particular,

- (A) The firm is obliged to provide information on these areas to all clients but the granularity, medium and timing of such provision may be less specific for clients that are not Retail Clients; and
- (B) there are particular restrictions on the remuneration structure for staff providing services to Retail Clients which may not be applicable in respect of staff providing services to Professional Clients;
- (C) the information which the firm provides in relation to costs and charges for its services and/or products may not be as comprehensive for Professional Clients as it would be for Retail Clients, for example, they are required when offering packaged products and services to provide additional information to Retail Clients on the risks and components making up that package; and
- (D) when handling orders on behalf of Retail Clients, the firm has an obligation to inform them about any material difficulties in carrying out the orders; this obligation may not apply in respect of Professional Clients.

### **3. Suitability**

In the course of providing advice or in the course of providing discretionary management services, when assessing suitability for Professional Clients, the firm is entitled to assume that in relation to the products, transactions and services for which you have been so classified, that you have the necessary level of experience and knowledge to understand the risks involved in the management of your investments. The firm will assess this information separately for Retail Clients and would be required to provide Retail Clients with a suitability report.

### **4. Appropriateness**

For transactions where the firm does not provide you with investment advice or discretionary management services (such as an execution-only trade), it may be required to assess whether the transaction is appropriate. In respect of a Retail Client, there is a specified test for ascertaining whether the client has the requisite investment

knowledge and experience to understand the risks associated with the relevant transaction. However, in respect of a Professional Client, the firm is entitled to assume that they have the necessary level of experience, knowledge and expertise to understand the risks involved in a transaction in products and services for which they are classified as a Professional Client.

## 5. **Dealing**

A range of factors may be considered for Professional Clients in order to achieve best execution (price is an important factor but the relative importance of other different factors, such as speed, costs and fees may vary). In contrast, when undertaking transactions for Retail Clients, the total consideration, representing the price of the financial instrument and the costs relating to execution, must be the overriding factor in any execution.

## 6. **Reporting information to clients**

For transactions where the firm does not provide discretionary management services (such as an execution-only transactions), the timeframe for our providing confirmation that an order has been carried out is more rigorous for Retail Clients' orders than Professional Clients' orders.

## 7. **Client reporting**

Investment firms that hold a retail client account that includes positions in leveraged financial instruments or contingent liability transactions shall inform the Retail Client, where the initial value of each instrument depreciates by 10% and thereafter at multiples of 10%. These reports do not have to be produced for Professional Clients.

## 8. **Financial Ombudsman Service**

The services of the Financial Ombudsman Service may not be available to you as a Professional Client.

## 9. **Investor compensation**

Eligibility for compensation from the Financial Services Compensation Scheme is not contingent on your categorisation but on how your organisation is constituted. Hence, depending on how you are constituted you may not have access to the Financial Services Compensation Scheme.

## 10. **Exclusion of liability**

The FCA rules restrict the firm's ability to exclude or restrict any duty of liability which the firm owes to Retail Clients more strictly than in respect of Professional Clients.

## 11. **Trading obligation**

In respect of shares admitted to trading on a regulated market or traded on a trading venue, the firm may, in relation to the investments of Retail Clients, only arrange for such trades to be carried out on a regulated market, a multilateral trading facility, a systematic internaliser or a third-country trading venue. This is a restriction which may not apply in respect of trading carried out for Professional Clients.

12. **Transfer of financial collateral arrangements**

As a Professional Client, the firm may conclude title transfer financial collateral arrangements with you for the purpose of securing or covering your present or future, actual or contingent or prospective obligations, which would not be possible for Retail Clients.

13. **Client money**

The requirements under the client money rules in the FCA Handbook (CASS) are more prescriptive and provide more protection in respect of Retail Clients than in respect of Professional Clients.

It should be noted that at all times you will have the right to request a different client categorisation and that you will be responsible for keeping the firm informed of any change that could affect your categorisation as a Professional Client.