

REPORT OF CORPORATE DIRECTOR RESOURCES

AGENDA ITEM: 5

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

Reason for this Report

1. The Pension Committee Terms of Reference set out the Committee's responsibility for the strategic governance of the Cardiff & Vale of Glamorgan Pension Fund.
2. 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 3 January 2018. It recommends that the Committee agree that applications for elected professional client status should be made on behalf of the authority immediately.

Background

3. 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'.
4. 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 does not manage public debt 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.
5. Furthermore, 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

6. 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.

7. 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.
8. 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

9. 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.
10. 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.
11. 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 2**.
12. The election to professional status must be completed with all financial institutions prior to the change of status on 3 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.
13. 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.
14. A flowchart of the process is attached as **Appendix 3** and the letter and information templates are attached as **Appendices 4 and 5**.
15. 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.

16. 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.

Wales Pension Partnership Investment Pool

17. 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.
18. 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.
19. 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.

Next steps

20. In order to continue to implement effectively the authority's investment strategy after 3 January 2018, applications for election to be treated as a professional client should be submitted to all financial institutions with whom the authority has an existing or potential relationship with in relation to the investment of the pension fund.
21. 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.
22. The Corporate Director Resources should be granted the necessary delegation to make applications on the authority's behalf and to determine the nature of each application on either full or single service basis.

Legal Implications

23. The report makes various recommendations to Pensions Committee and the relevant legal implications appear in the text of this report and the attached appendices together with the Directive.
24. Pensions is a very specialised area and paragraph 13 of the report confirms that the Local Government Pension Scheme Advisory Board, Local Government Association, Investment Association, the British Venture Capital Association and others have developed a standard opt up process to standardize and assist authorities with this process.
25. It should be noted that Appendix 1 details the protections that the Council will lose in proceeding with the request to be treated as a Professional Client and the body of the report details the impact to the Council of not proceeding with this application.
26. All decisions taken by or on behalf of the Council must (a) be within the legal powers of the Council; (b) comply with any procedural requirement imposed by law; (c) be within the powers of the body or person exercising powers on behalf of the Council; (d) be undertaken in accordance with the procedural requirements imposed by the Council eg. standing orders and financial regulations; (e) be fully and properly informed; (f) be properly motivated; (g) be taken having regard to the Council's fiduciary duty to its tax payers; and (h) be reasonable and proper in all the circumstances and comply with all equalities legislation.

Financial Implications

27. There are no financial implications arising directly from this report.

Recommendations

28. That the Committee:
 - a. notes the potential impact on the Fund's investment strategy of becoming a retail client with effect from 3 January 2018.
 - b. agrees to the immediate commencement of applications for elected professional client status with all relevant institutions in order to ensure that it can continue to implement an effective investment strategy.
 - c. acknowledges and agrees that in electing for professional client status it will forgo the protections available to retail clients listed in **Appendix 1**.
 - d. delegates responsibility to the Corporate Director Resources for the purpose of completing the applications and determining the appropriate basis of each application as either full or single service.

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Appendices

- Appendix 1** – Retail client protections
- Appendix 2** – Summary of FCA policy statement
- Appendix 3** – Opt up process flowchart
- Appendix 4** – Opt up letter template
- Appendix 5** – Opt up information template