

Non-Executive Report of the: PENSIONS COMMITTEE 21 September 2017	
Report of: Zena Cooke, Corporate Director of Resources	Classification:
Markets in Financial Instrument Directive (MiFID II) Opt Up Implementation Report	

Originating Officer(s)	Bola Tobun, Investment and Treasury Manager
Wards affected	All

Introduction

This report outlines the impact of the implementation of the Markets in Financial Instrument Directive 2014/65 (“MiFIDII”) and in particular the risk to the administering authority of becoming a retail client on 3rd January 2018. The report recommends that the Committee decide that elections for professional client status should be made on behalf of the authority immediately.

Recommendations:

Members of the Pensions Committee are recommended to:

- Note the potential impact on the Fund of becoming a retail client with effect from 3rd January 2018;
- 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;
- Acknowledge and agree to forgo the protections available to retail clients attached as **APPENDIX 1**; and
- Delegate responsibility to the s151 officer to complete the applications and determine the basis of the application as either full or single service.

1. REASONS FOR THE DECISIONS

- 1.1 Tower Hamlets Pension Fund will not be able to access the wide range of assets needed to implement an effective, diversified investment strategy when the Markets in Financial Instrument Directive 2014/65 comes into force on 3rd January 2018 unless it applies for a change in status from a retail client to a professional client. Remaining as a retail client will significantly restrict the range of financial institutions and instruments available for effective and

efficient management of the Fund because many institutions currently servicing the LGPS are not authorised to deal with retail clients and are unlikely to choose to undergo the required changes to resources and permissions in order to do so.

2. ALTERNATIVE OPTIONS

2.1 No alternative.

3. DETAILS OF REPORT

3.1 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’.

3.2 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 (in either case) does not manage public debt (“local 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.

3.3 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

3.4 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.

3.5 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.

- 3.6 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

- 3.7 MiFID II allows for retail clients that 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.
- 3.8 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.
- 3.9 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**.
- 3.10 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 will 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.
- 3.11 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.
- 3.12 A flowchart of the process is attached as **APPENDIX 3**.
- 3.13 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. Tower Hamlets Pension Fund 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. An example of this would be where , the next procurement is going to be achieved via the LGPS pool. It is recommended that officers determine the most appropriate basis of the application, either via full or single service.

- 3.14 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

- 3.15 LCIV is a professional investor in its own right so will not need to opt up with the external institutions they use. Tower Hamlets Pension Fund will however need to opt up with LCIV in order to access the full range of services and sub-funds on offer.
- 3.16 In some circumstances, such as where the pool only offers access to fund structures such as Authorised Contractual Scheme (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.
- 3.17 Elections to professional status will be needed for every financial institution that Tower Hamlets Pension Fund 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

- 3.18 In order to continue to effectively implement the authority's investment strategy after 3rd January 2018, applications for election to be treated as a professional client should be submitted to all financial institutions with whom the Fund has an existing or potential relationship in relation to the investment of the pension fund.
- 3.19 This process needs to 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 Fund's investments.
- 3.20 The Chief Finance Officer should be granted the necessary delegation to make applications on the Fund's behalf and to determine the nature of the application on either full or single service basis.

4. COMMENTS OF THE CHIEF FINANCE OFFICER

- 4.1 The Chief Finance Officer is satisfied that all material, financial and business issues and possibility of risks have been considered and addressed and that

the proposed MiFID II process offers a clear structure to opting up to elective professional status.

5. LEGAL COMMENTS

- 5.1 This report provides an update on the Markets in Financial Instruments Directive II (MiFIDII).
- 5.2 The policy statement from the Financial Conduct Authority in respect of the Markets in Financial Instruments Directive II (MiFIDII), sets out the final rules for implementation of MiFIDII. MiFIDII is due for implementation on 3rd January 2018. Local government pensions schemes will be particularly affected by the reclassification of local authorities as “retail” clients rather than their current classification of “professional per se” clients. This reclassification will affect the investment managers they can use and the investments they can make as there are fewer investment managers permitted to deal with retail clients and certain investments are not deemed to be suitable for retail clients. This restriction is at odds with the provisions of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 which dispensed with the explicit limits on specified types of investments and which instead charged administering authorities with determining the appropriate mix of investments for their funds and the requirement to pool their funds.
- 5.3 The FCA has recognised that the reclassification of local authorities as retail clients will not be in the best interests of their pension funds and has given them an option to opt up to “elective professional” client status subject to satisfying certain criteria. The FCA expects the criteria to appropriately balance the ability of local authorities to access the financial services they require whilst securing an appropriate degree of investor protection. It is incumbent upon the local authority as administrators to obtain the best possible investments for the fund and as such it should take up the option to opt up to “elective professional” client status following the process set out in the FCA policy statement. This will assist the authority to comply with its statutory duty to ensure the proper administration and management of the fund. Before making a decision on whether to opt up to professional client status, the Committee must have regard to the information in Appendix 2 attached to the report. This sets out the loss of protections which the authority will lose as a professional client. This should be weighed against the benefits of opting up to professional status as set out in the body of the report.
- 5.4 When considering the information and issues raised in this report, the Council must have due regard to the need to eliminate unlawful conduct under the Equality Act 2010, the need to advance equality of opportunity and the need to foster good relations between persons who share a protected characteristic and those who don't (the public sector duty).

6. ONE TOWER HAMLETS CONSIDERATIONS

- 6.1 The employer's contribution is a significant element of the Council's budget and consequently any improvement in investment management and performance will reduce the contribution and increase the funds available for other corporate priorities.

6.2 A viable pension scheme also represents an asset for the recruitment and retention of staff to deliver services to the residents.

7. BEST VALUE (BV) IMPLICATIONS

7.1 The effective and efficient management of Fund assets and achievement of performance targets are key to the achievement of the funding strategy objectives and this is considered to be a good decision which can result in greater cost savings to the fund.

8. SUSTAINABLE ACTION FOR A GREENER ENVIRONMENT

8.1 There is no Sustainable Action for A Greener Environment implication arising from this report.

9. RISK MANAGEMENT IMPLICATIONS

9.1 The overall objective of MiFID II is to reduce the risk of mis-selling by the investment industry. By classifying local authority clients as "retail" clients by default, thus requiring the elective professional opt up process, asset managers are required to assess the knowledge of the collective decision making group before taking them on as clients.

9.2 The rigorous robust management of LBTH Pension Fund results in better quicker and more effective decision making which can lead to better Fund performance and reduction in the contribution required from the Council towards the Fund. The monitoring arrangement for the Pension Fund and the work of the Pensions Committee should ensure that the Fund optimises the use of its resources in achieving the best returns for the Council and members of the Fund.

10. CRIME AND DISORDER REDUCTION IMPLICATIONS

10.1 There are no crime and disorder reduction implications arising from this report.

Linked Reports, Appendices and Background Documents

Linked Report

- NONE

Appendices

Local Government Act, 1972 Section 100D (As amended)

List of "Background Papers" used in the preparation of this report

APPENDIX 1 – Retail client protections

APPENDIX 2 – Summary of FCA policy statement

APPENDIX 3 – Opt up process flowchart

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