

DERBYSHIRE COUNTY COUNCIL
PENSIONS AND INVESTMENTS COMMITTEE

6 September 2017

Report of the Director of Finance & ICT

**IMPLEMENTATION OF THE MARKETS IN FINANCIAL INSTRUMENTS
DERIVATIVE (MiFID II)**

1 Purpose of the Report

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 Derbyshire County Council as the administering authority for the Derbyshire Pension Fund of becoming a retail client on 3 January 2018 and seeks approval to elect for professional client status for the administering authority.

2 Information and Analysis

Context

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’.

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.

Furthermore, the Financial Conduct Authority (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 such as banks, brokers, advisers and fund managers will have to treat local authorities as they do non-professional individuals and small businesses. This would include applying a series of protections to ensure 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 prevent local authorities being able to access the wide range of assets needed to implement an effective, diversified investment strategy as 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 an institution secured the ability to deal with retail clients, the range of instruments it could make available to the client will be limited to those defined under 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 local 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 that 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 local authority as a collective rather than on an individual in the local authority.

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.

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.

A flowchart of the process is attached as Appendix 1.

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 Central

LGPS Central will be a professional investor in its own right so will not need to opt up with the external institutions it uses. Derbyshire County Council will however need to opt up with LGPS Central 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 LGPS Central, both existing and new, together with a continuing review of all elections. If all new purchases are made via fund structures within LGPS Central then no new elections will be required, only an ongoing review of the elections made with LGPS Central and any legacy external institutions, the number of which would reduce as assets are liquidated and cash transferred into LGPS Central.

Next Steps

In order to continue to effectively implement 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 in relation to the investment of the pension fund.

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 authority's pension fund investments.

It is recommended that the Director of Finance & ICT should be authorised to make applications on the Authority's behalf and to determine the nature of each application on either full or single service basis.

3 Considerations

In preparing this report the relevance of the following factors has been considered: financial, legal and human rights, human resources, equality and diversity, health, environmental, transport, property, social value and prevention of crime and disorder considerations.

4 Officer's Recommendations

That the Committee:

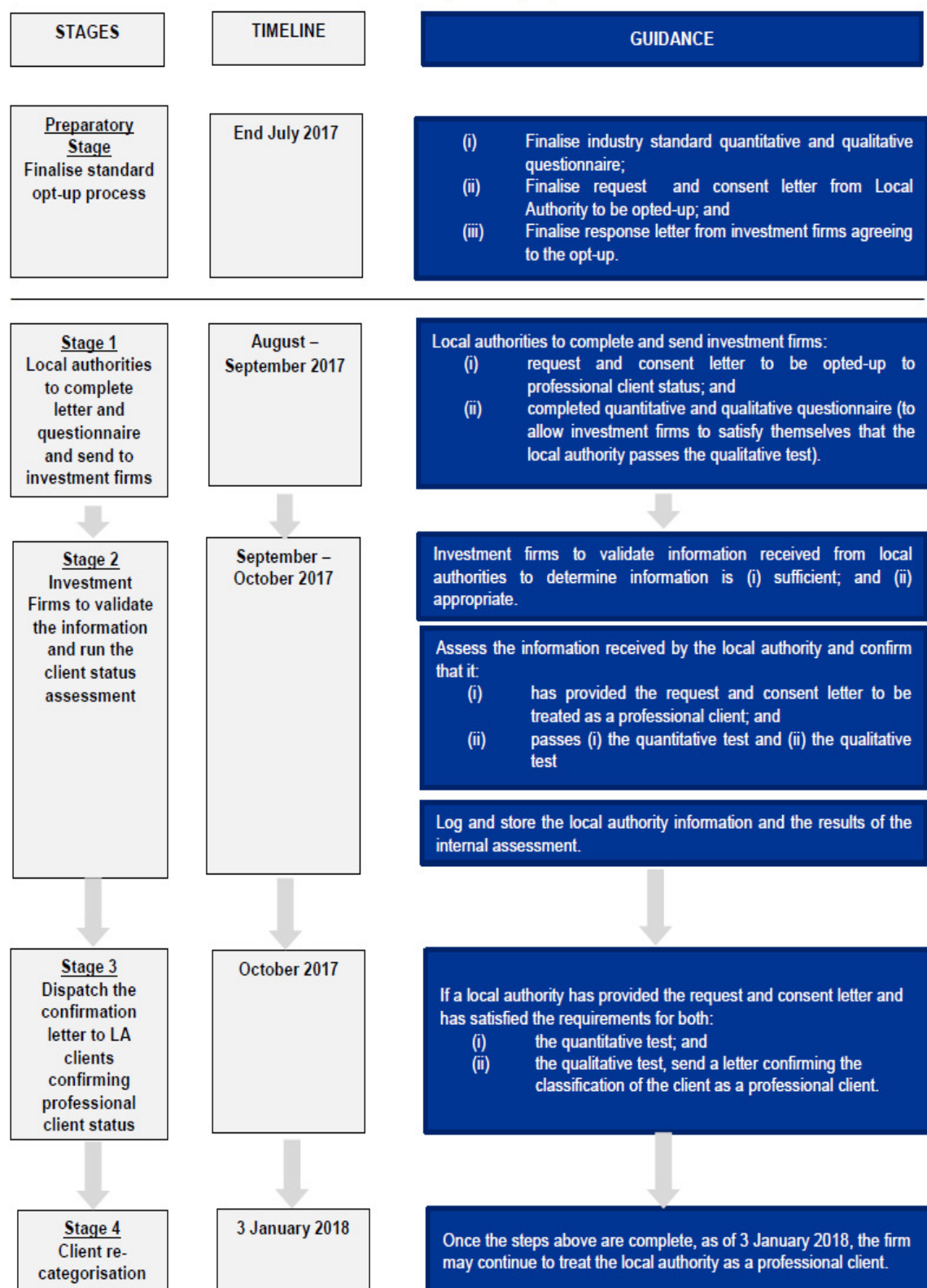
- 4.1 notes the potential impact on investment strategy of the implementation of the Markets in Financial Instruments Directive 2014/65 with effect from 3 January 2018.
- 4.2 acknowledges that in electing for professional client status, the Pension Fund will lose the protections available to retail clients attached as Appendix 2.
- 4.3 authorises the Director of Finance & ICT to apply for elected professional client status with all relevant institutions in order to ensure the Derbyshire Local Government Pension Fund can continue to implement an effective investment strategy and to determine the basis of each application as either full or single service.

PETER HANDFORD

Director of Finance & ICT

APPENDIX 1

UK Local Authority Client Opt-Up Process



APPENDIX 2**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.