HERTFORDSHIRE COUNTY COUNCIL	Agenda Item No:
PENSION COMMITTEE **MONDAY, 4 SEPTEMBER 2017 AT 10:00AM**	**6**

MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE II (MIFID II)

Report of the Director of Resources

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1. Purpose of the Report

1.1 To provide the Pensions Committee with an update on recent developments regarding the Financial Conduct Authority's (FCA) final policy statement on the Markets in Financial Instruments Directive II (MiFID II) and request authority for officers to progress requisite actions.

2. Summary

2.1 The way that local authorities can access financial services will change in January 2018 as a result of the second Markets in Financial Instruments Directive. This EU directive tightens the regulation of the financial markets, including the client classification of local authorities. The existing Market in Financial Instruments Directive (MiFID I), introduced in 2008, allows all local authorities to be classed as professional clients, which permits wider market access and cheaper fees than retail clients such as individuals.

2.2 The draft FCA policy statement which set out the rules for the implementation of MiFID II was issued for consultation by the FCA late last year. The rules as drafted would treat all Local Government Pension (LGPS) schemes by default as retail clients. As a retail client an LGPS Fund would be faced with a reduced pool of asset managers and consultants willing to provide services, and exclusion from certain asset classes.

2.3 The draft policy allowed "opt-up" criteria for LGPS Funds to elect to professional client status; however, the "opt-up" criteria would also have proved difficult for local authorities to meet and did not take into account the decision making process of local authorities and the use of external advisors in informing those decisions. Hertfordshire County Council in consultation with the Executive Member for Resources expressed its concerns on the "opt-up" criteria in its response to the FCA consultation. The Local Government Authority (LGA) on behalf of its Members also expressed similar concerns to the FCA.

2.4 Following the consultation process, the FCA has now issued its final policy statement setting out the rules for the implementation of MiFID II, effective from 3 January 2018. LGPS Funds will still be treated as retail clients but a key change is that there is now greater clarity in the "opt-up" criteria that is expected to make it easier for local authorities administering LGPS pension funds to elect to be treated as "professional" clients.

3. Recommendations

3.1 That the Pension Committee notes the content of this report and gives approval to officers to complete the necessary actions with its investment managers to achieve *elective professional* status for the Fund w.e.f. 3 January 2018.

4. Context

4.1 The Market in Financial Instruments Directives are issued by the European Union and place requirements on market participants such as Pension Funds. The first (MiFID 1) was introduced in 2008 and a second (MiFID II) comes into force on 3 January 2018.

4.2 Although the United Kingdom (UK) has voted to leave the European Union (EU), MiFID II will still be implemented in the UK for three reasons. Firstly, we remain members of the EU and are subject to its laws until we leave; secondly, the UK Government is in favour of strengthening investor protection; and thirdly, UK firms will wish to continue providing financial services across the EU after the UK has left, so will need to comply with equivalent regulations.

4.3 Based on dialogue including both the FCA and the Local Government Association (LGA), the expectation is that post Brexit, arrangements similar to those contained within MiFID II will continue to apply throughout the United Kingdom albeit in a form of UK legislation as opposed to EU Directives. As a consequence, exiting the EU is not thought to alter the Fund's obligation to comply with requirements of this nature.

5. MiFID 1

5.1 MiFID 1 became effective in 2008, and introduced a range of measures aimed at improving the efficiency and competitiveness of financial markets. The measures included the requirement to categorise clients such as LGPS Funds in one of the categories listed below:

- *Eligible counterparties;*
- *Professional clients; and*
- *Retail clients.*

5.2 *Eligible counterparties* are entities authorised or regulated to operate in the financial markets that are not given investment advice (e.g. investment firms and credit institutions).

5.3 LGPS Funds have a regulatory obligation to take advice when making investment decisions. Under MiFID I all LGPS Funds were categorised per se as *professional clients* and not as *eligible counterparties. Retail clients* include individual investors.

6. MiFID II

6.1 MiFID II has been developed since the 2008 financial crisis. Among many other changes, MiFID II seeks to provide additional protections to investors. The FCA, the UK regulator of financial services, has some discretion on the implementation of this directive in the UK, and consulted on proposed rules in late 2016. The revised client categories are as follows:

- *Eligible counterparties;*
- *Elective professional clients; and*
- *Retail clients*

6.2 In a change from MiFID I, under MiFID II, LGPS Funds will by default be categorised as *retail clients.* Whilst this is not negotiable, it will be possible for LGPS Funds to “opt-up” to *elective professional status.*

7. Client categorisation – protections

7.1 Under both MiFIDs, differing levels of legal protection are available to different clients. *Eligible counterparties* are viewed as the most sophisticated market participants and are afforded the least protection. *Retail clients* on the other hand are considered the least sophisticated participants and therefore have the greatest legal protection.

7.2 *Professional clients* sit between the other two categories both in terms of the deemed level of sophistication and afforded degree of legal protection.

8. Client categorisation – limitations

8.1 *Retail clients* are not permitted to invest in as wide a range of investment products as professional clients. Specifically, investment in asset classes such as private equity, infrastructure funds, and certain forms of derivative products would not be permissible if the Fund is classified as a retail client.

9. Opting up to elected professional status

9.1 It will be possible for LGPS Funds to “opt-up” to *elective professional status*, and thereby attain similar status under MiFID II that prevailed under MiFID I.

9.2 In order to complete the opt-up process the FCA have proposed, consulted upon, and subsequently finalised their criteria for clients wishing to opt up from *retail* to *elective* professional status. These are set out below and highlight expanded policy wording and changes to the quantitative tests.

	Original	Final	Comment
Qualitative Assessment	To be undertaken by Investment Managers	To be undertaken by Investment Managers	expanded policy **
Quantitative Tests *	**A** £15m cash deposits **B** 10 transactions per quarter **C** Client experience	**A** £10m cash deposits **B** 10 transactions per quarter **C** Client experience **D** LGPS Fund	reduction new test

Notes
* Funds are required to pass at least two of the quantitative tests (one of which must be test A cash deposits).

** the final FCA policy includes the following wording:

"Firms [investment managers] 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."

9.3 The original proposals gave cause for concern that "opting up" may be problematic. Whilst most LGPS Funds would have passed the £15m *cash deposit* threshold, few (including Hertfordshire) would have completed *10 transactions per quarter* (as the Fund does not manage money in house). Furthermore, the initial draft policy on *client experience* was felt to give insufficient recognition to the decision making role of Members on s101 committees (such as the Pension Committee) who have a regulatory obligation to take advice. Ambiguity on that test was considered to have a likely knock on impact in how the Investment Managers undertook their own qualitative assessment.

9.4 Many Funds including Hertfordshire responded to the FCA's consultation in late 2016. Furthermore FCA officials engaged with the LGA, the Investment Association (IA) and British Venture Capital Association (BVCA). In January two FCA officers attended the Cross Pool Collaboration Group (CPGC) officer meeting chaired by ACCESS, and attended by a Hertfordshire officer, and further dialogue was held in February. The purpose of the FCA meetings with the CPGC was to get a better understanding of the issues that would impact LGPS Funds if the original opt-up criteria were introduced.

9.5 The outcome of this engagement is a revised set of criteria, set out in the table above. Critically an additional test – proposed by the CPCG – has been added which reflects the regulatory obligation an LGPS Fund has to take advice when making investment decisions. Furthermore the expanded policy wording in relation to the qualitative assessment reinforces this point. In addition to lowering the cash deposit threshold from £15m to £10m which will assist smaller Funds.

10. Next Steps

10.1 The LGA, in consultation with the IA and BVCA has developed a template designed to capture the information that an LGPS Fund will need to provide in order to demonstrate that it passes 2 of the 4 quantitative tests and relevant background for Investment Managers to undertake the qualitative assessment. The relevant background is expected to include details of each Fund's governance structure, committee membership & training arrangements along with officers and advisers who support the committee.

10.2 The template mentioned above will be consulted upon shortly. Once the final template is approved Funds, in liaison with each Investment Manager can then begin the process to submit the evidence required which enables the Fund to achieve *elective professional* status and continue to be able to invest in the asset classes that the Fund currently invests in.

11. Background papers

11.1 FCA final MIFiD II policy statement, Chapter 8c – Client Categorisation https://fca.org.uk/publication/policy/ps17-14.pdf