

LOCAL PENSION COMMITTEE – 1ST SEPTEMBER 2017

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

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

Purpose of the Report

1. To recommend action that will ensure that the Leicestershire Pension Fund can continue to access a full range of investment opportunities following implementation of the Markets in Financial Instrument Directive 2014/65 (MiFID II).

Background

2. 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. The Leicestershire Pension Fund satisfies the Large Undertakings test.
3. Following the introduction of MiFID II, local authorities (and the Pension Funds for which they act as the Administering Authority) must be classified as ‘retail clients’ unless they are opted-up by firms to an ‘elective professional client’ status. This part of MiFID II will become effective on 3rd January 2018.
4. The original opt-up process was complicated and placed a large onus on local authorities to provide evidence of the knowledge and experience of both individuals and committees. The process was not suited to the unique situation of local authorities and successful lobbying by a number of parties has made the opt-up process much more straightforward. Most importantly, there is an acceptance by the Financial Conduct Authority (FCA) that the qualitative tests can now be performed on the local authority as a collective rather than on individuals.

Impact of not opting-up from retail investor status

5. The purpose of MiFID II is to protect unsophisticated investors from investing in assets where they do not properly understand the potential risks. Reclassification as a retail investor would make it very difficult for the Fund to implement an effective, diversified investment strategy; furthermore, some of the Fund’s investment managers are not authorised to deal with retail clients so retail investor status could potentially mean the forced sale of some of the

Fund's existing assets. Without an opt-up to professional status under MiFID II, the Fund will become a retail investor by default.

6. Retail investor status provides various protections that are not open to professional investors, and these are protections that the Fund does not currently have as a 'per se professional' investor under MiFID. These protections (which are listed in the appendix to this report) are insignificant in comparison to the fact that not opting-up will deny access to many asset types, and potentially force the sale of some existing investments.

Opt-up process

7. The opt-up process is relatively straightforward and involves sending a letter and a completed questionnaire to each of the Fund's investment managers. The contents of the letter and questionnaire have been agreed by all parties and a template exists that involves the completion of a small amount of fund-specific information. Crucially, part of the questionnaire relates to how investment decisions are made by Funds and there is an expectation that the decision to opt-up is taken in line with this process. Within the Leicestershire Fund this would involve the Local Pension Committee agreeing that the Fund should request an opt-up to elective professional investor status.
8. In order to be able to continue to effectively implement the Fund's investment strategy after 3rd January 2018, it is sensible to begin the opt-up process as soon as possible. While the process is relatively straightforward some investment managers may require additional information to support the opt-up and the more time that is available to provide this, the more smoothly the process is likely to be.

Recommendation

9. It is recommended that the Local Pension Committee:
 - (i) Notes the potentially detrimental impact onto the Fund's investment strategy if becoming classed as a retail client with effect from 3rd January 2018;
 - (ii) Authorises the Director of Finance to commence the relevant applications in order for the Fund to be elected professional client status with all relevant institutions to enable it to continue to implement an effective investment strategy;
 - (iii) Notes that in electing for professional client status, the Fund will forgo the protections available to retail clients as listed in the appendix to this report;
 - (iv)

Equal Opportunities Implications

None specific

Background Papers

None

Officers to Contact

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Appendix

Warnings - loss of protections for the Local Authority if categorised 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 Schedule contains, for information purposes only, a summary of the protections lost when requesting and agreeing to be treated as a Professional Client.

Part 1 – Loss of protections as a Professional Client when receiving Services

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

As a Professional Client the simplicity and frequency in which firms communicate with you may be different to the way in which we would communicate with a Retail Client. Firms will ensure however that their communication remains fair, clear and not misleading.

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

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

- (A) It 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;
- (B) the information which it 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, it is required when offering packaged products and services to provide additional information to Retail Clients on the risks and components making up that package; and
- (C) when handling orders on behalf of Retail Clients, it 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 portfolio management services, when assessing suitability for Professional Clients, a firm is entitled to assume that, in relation to the products, transactions and services for which Professional Clients have been so classified, that they have the necessary level of experience and knowledge to understand the risks involved in the management of their investments. Firms cannot make such an assumption in the case of Retail Clients and must assess this information separately. Firms would be required to provide Retail Clients with a suitability report, where they provide investment advice.

4. **Appropriateness**

For transactions where a firm does not provide investment advice or portfolio management services (such as an execution-only trade), a firm may be required to assess whether the transaction is appropriate for the client in question. 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, a 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 determining best execution.

6. **Reporting information to clients**

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

7. **Client reporting**

Firms that manage a retail portfolio 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. Your rights (if any) to make a claim under the Financial Services Compensation Scheme in the UK will not be affected by being categorised as a Professional Client.

10. **Exclusion of liability**

A firms' ability to exclude or restrict any duty of liability owed to clients is narrower under the FCA rules in the case of Retail Clients 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, a 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, a firm may conclude title transfer financial collateral arrangements 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.