

**Report to:** Pension Board

**Date of meeting:** 3 August 2017

**By:** Chief Finance Officer

**Title:** Markets in Financial Instruments Directive (MiFID II) update

**Purpose:** This report provides Members with an update on MiFID II, a framework of European legislation governing investment firms providing certain investment services to clients.

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**RECOMMENDATIONS - The Board is recommended to -**

1. note the Markets in Financial Instruments Directive (MiFID II) updates.
  2. recommend to the Pension Committee that officers are authorised, in consultation with the Chair, to progress the necessary actions aimed at achieving elective professional status for the Fund with effect from 3 January 2018.
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**1. Background**

1.1 The Markets in Financial Instruments Directive (MiFID) is the EU legislation that regulates firms who provide services to clients linked to 'financial instruments' (shares, bonds, units in collective investment schemes and derivatives), and the venues where those instruments are traded.

1.2 The Financial Conduct Authority (FCA) has now issued its final policy statement setting out the rules for implementation of the Markets in Financial Instruments Directive (MiFID II), effective from **3 January 2018**.

1.3 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 Local Government Pension Scheme (LGPS) pension funds to elect to be treated as "professional" (rather than "retail") clients. 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.

**2. Markets in Financial Instruments Directive (MiFID II)**

2.1 Under MiFID II, UK local authorities will be re-classified as "retail" clients as opposed to their current classification of "professional" clients. If the local authority retains the retail client classification, they will be restricted in 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 suitable for retail clients.

2.2 There is an option for local authorities to opt-up to "elective professional" client status with individual asset managers in order to continue 'complex' investments. This procedure will include both a qualitative and quantitative test to be assessed by the asset manager. It is proposed that the opt-up criteria will be applied separately for local authorities depending on the capacity in which they are acting (i.e. either as treasury managers or as pension fund administrators).

**3. Opting up to elected professional status**

3.1 It will be possible for Funds to "opt up" to elective professional status, and thereby attain similar status under MiFID II that prevailed under MiFID I. In order to complete the opt up process the FCA has 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 *	<b>A</b> £15m cash deposits <b>B</b> 10 transactions per quarter <b>C</b> Client experience	<b>A</b> £10m cash deposits <b>B</b> 10 transactions per quarter <b>C</b> Client experience <b>D</b> LGPS Fund	reduction  new test

### Notes

\* Funds are required to pass at least two of the quantitative test (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.”*

3.2 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 East Sussex) would have completed 10 transactions per quarter (as the Fund does not manage money in house). The outcome of this engagement is a revised set of criteria. Critically an additional test 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.

## **4. Next steps**

4.1 The LGA, in consultation with the Investment Association, 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 test 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.

4.2 The template mentioned above will be consulted upon shortly. Funds, in liaison with each Investment Manager can then begin the process which enables the Fund to achieve elective professional status.

## **5. Conclusion and reasons for recommendations**

5.1 Though the regulatory demands are yet to be finalised, LGA project will kick-start research designed to see how the information needed to satisfy MiFID II requirements can be standardised and, as a result, reduce the burden on councils.

5.2 The Board is recommended to:

1. note the Markets in Financial Instruments Directive (MiFID II) updates.
2. recommend to the Pension Committee that officers are authorised, in consultation with the Chair, to progress the necessary actions aimed at achieving elective professional status for the Fund with effect from 3 January 2018.

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Background Documents

None