Report to:	**Pension Committee**
Date:	**4 September 2017**
By:	**Chief Finance Officer**
Title of report:	**Markets in Financial Instruments Directive (MiFID II) Implementation**
Purpose of report:	**This report provides Members with an update on MiFID II, a framework of European legislation governing investment firms providing certain investment services to clients.**

RECOMMENDATIONS

The Committee is recommended to:

1. **Note the potential impact on investment strategy of becoming a retail client with effect from 3rd January 2018;**
2. **Agrees 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;**
3. **In electing for professional client status the committee acknowledges and agrees to forgo the protections available to retail clients attached as Appendix 1; and**
4. **Agree to approve delegated responsibility to the Chief Finance Officer in consultation with the Chair for the purposes of completing the applications and 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 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 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 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 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.

3.3 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. A summary of and extracts from the FCA policy statement which set out these new tests is attached as Appendix 2. A flowchart of the process is attached as Appendix 3 and the letter and information templates are attached as Appendices 4 and 5.

3.4 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.

3.5 LGPS pools including ACCESS will be professional investors in their own right so will not need to opt up with the external institutions they use. The Fund, however, will need to opt up with the pool operator in order to access the full range of services and sub-funds on offer.

4. Next steps

4.1 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 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.

4.2 In order to continue to effectively implement the Fund 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 Fund has an existing or potential relationship with 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 avoids the need for appropriate action to be taken by institutions in relation to the Fund's pension fund investments.

5. Conclusion and reasons for recommendations

5.1 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 the Pension Fund of becoming a retail client on 3 January 2018 and recommends that the Committee agree that elections for professional client status should be made on behalf of the Fund immediately.

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Appendix 1 – Retail client protections
Appendix 2 – Summary of FCA policy statement
Appendix 3 – Opt up process flowchart
Appendix 4 – Opt up letter template
Appendix 5 – Opt up information template