

Committee: Financial Investment Board	Date: 5 September 2017
Subject: Implementation of the Markets in Financial Instruments Derivative (MiFID II)	Public
Report of: The Chamberlain	For Decision
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Summary

This report outlines the impact of the implementation of the Markets in Financial Instrument Directive 2014/65 (“MiFID II”); highlighting in particular the risk to the City of London Corporation as the administering authority of the City of London Pension Fund and in its treasury management role becoming a retail client on 3rd January 2018. The recommendation is that the Financial Investment Board (the Board) agree that elections for professional client status should be made on behalf of the authority immediately.

Recommendations

Members are asked to:

- i. Note the potential impact on investment strategy of becoming a retail client with effect from 3rd January 2018
- ii. Agree 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.
- iii. Note that in electing for professional client status the Board acknowledges and agrees to forgo the protections available to retail clients attached as Appendix 1.
- iv. Note that a training programme will need to be formalised to better evidence the expertise, experience and knowledge of the Board as set out in paragraph 9 and that a report will follow in due course.
- v. Agree to delegate responsibility to the Chamberlain for the purposes of completing the applications and determining the basis of the application as either full or single service.

Main Report

Background

1. 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'.

2. Following the introduction of the Markets in Financial Instrument Directive 2014/65 ("MiFID II") from 3 January 2018, financial service institutions (fund managers, advisors, consultants, banks etc.) will no longer be able to categorise a local public 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 institutions to an "elective professional client" status.
3. The opt-up process includes both a qualitative and quantitative test that will be assessed by the individual institutions and the criteria will be applied separately to local authorities depending on the capacity in which they are acting – either as treasury managers or as pension fund administrators. The decision to opt up an authority lies solely with the institution to whom the application is made and it may, at its discretion request alternative/further information in support of an application. For example institutions that are not regulated by the Financial Conduct Authority may have their own opt up processes/questions.

Potential Impact

4. A move to retail client status would mean that all financial services institutions will have to treat local authorities (including the City) in the same way they do non-professional individuals and small businesses. That includes a raft of protections ensuring 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 financial institution and the client, for the purpose of proving to the regulator that all such requirements have been met.
5. Such protections would mean that the City would not be able to access the wide range of assets needed to implement an effective, diversified investment strategy. Retail status would significantly restrict the range of financial institutions and instruments available to us. Many financial institutions currently servicing the Local Government Pension Scheme (LGPS) and the treasury management function 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.
6. Even if the institution secures the ability to deal with retail clients the range of instruments it can make available to the client will be limited to those defined under Financial Conduct Authority (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 authority as a retail client.

Election for professional client status

7. MiFID II does allow for retail clients which meet certain conditions to elect to be treated as professional clients (to 'opt up'). There are two tests which must be met by the client when being assessed by the financial institution - the quantitative and the qualitative test. In electing to be treated as professional clients the authority will forgo the protections available to retail clients as set out in Appendix 1.

8. 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.
9. 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 authority as a collective rather than an individual. A summary of and extracts from the FCA policy statement which set out these new tests is attached as Appendix 2. The Chamberlain's review of the qualitative tests indicate that improvements will need to be made to the training programme, such as the introduction of a self-assessment and recognition of currently ad hoc specific 'needs-based training' as part of a wider training programme
10. 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.
11. 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 for the LGPS. This process should enable a consistent approach to assessment and prevent authorities from having to submit a variety of information in different formats. The LGA and CIPFA are working on a similar template to cover the treasury management function.
12. A flowchart of the process is attached as Appendix 3 and the letter and information templates (for the LGPS) are attached as Appendices 4 and 5.
13. Applications can be made in respect of either all of the services offered by the financial institution (even if not already being accessed) or a particular service only. A local authority may wish to do the latter where the financial institution offers a wide range of complex instruments which the authority does not currently use and there is no intention to use the financial institution again once the current relationship has come to an end, for example, for the Pension Fund, if the next procurement is achieved via the London CIV. It is recommended that officers determine the most appropriate basis of the application, either via full or single service.
14. 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 financial institutions of any changes in circumstances which could affect their status, for example, if the membership of the Board changed significantly resulting in a loss of experience or if the relationship with the authority's investment advisor was terminated.

LGPS pools

15. LGPS pools will be professional investors in their own right so will not need to opt up with the external institutions they use. Local authorities will however need to opt up with their LGPS pool in order to access the full range of services and sub-funds on offer.

16. In some circumstances, in particular where the pool only offers access to fund structures such as Authorised Contractual Scheme (ACS) the pool could use 'safe harbour' provisions resulting from local authorities continuing to be named as professional investors in both the Financial Promotion Order (the "FPO") or in the Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order (the "PCISO"). These provisions would enable the promotion and potential sale of units in fund structures to local authorities as retail investors.
17. Elections to professional status will be needed for every financial institution that the authority uses outside of the pool, both existing and new, together with a continuing review of all elections. If all new purchases are made via fund structures within the pool then no new elections will be required, only an ongoing review of the elections made with the pool and any legacy external institutions the number of which would reduce as assets are liquidated and cash transferred.

Conclusion

18. In order to continue to effectively implement the City's investment strategy after 3rd January 2018, applications for election to be treated as professional clients should be submitted to all financial institutions with whom we have an existing or potential relationship with in relation to the investment of the pension fund and the treasury management function.
19. This process should start as soon as possible in order to ensure completion in good time as failure to do so could 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.
20. The Chamberlain should be granted the necessary delegation to make applications on the City's behalf and to determine the nature of the application on either full or single service basis.

Appendices

- 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

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