

# Pensions CIV Sectoral Joint Committee Item no: 10

## Markets in Financial Instruments Directive 2 (MiFID2)

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<b>Date:</b>	8 February 2017		
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### Summary:

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**Recommendations:** The committee is recommended to consider and discuss the contents of this report.

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## **Markets in Financial Instruments Directive 2 (MiFID2)**

### **Background**

1. MiFID2 is the European Union's second Markets in Financial Instruments Directive. The original version of MiFID (MiFID1) established a pan European framework for the provision of investment services and the operation of markets. It has been in force since November 2007.
2. The existing MiFID1 framework is being substantially amended via legislation published in 2014, which splits MiFID1 into two parts. First, there is a "recast" MiFID1 (commonly referred to as "MiFID2") dealing primarily with authorisation, systems and conduct requirements in relation to investment business. Second, there is a Markets in Financial Instruments Regulation ("MiFIR") dealing with transparency, transaction reporting, clearing, and supervision of positions.
3. MiFID2 and MiFIR significantly increase the scope of MiFID1, in part, as a response to the financial crisis. Other key catalysts for the proposed revisions include: (i) technological developments, particularly around algorithmic trading and direct market access systems; (ii) perceived weaknesses in transparency in relation to investments other than shares; and (iii) a desire to enhance investor protection.
4. MiFID2 was planned for implementation from January 2017 but that has been deferred until January 2018.
5. The committee last discussed the impact of MiFID2 at its meeting of 4 November 2015 when representatives of the Financial Conduct Authority (FCA) and HM Treasury were in attendance.

### **Impact**

6. The most significant impact for UK local government is the complete downgrading of local authorities from "professional" to "retail" investor status. This is in response to examples of poor investment decisions by local authorities across Europe and a desire on the part of European regulators to 'protect' such authorities from riskier investment options available in the markets. The FCA has no scope to dis-apply this change in the UK.
7. While the impact on treasury management will fall across the whole of the EU, and indeed was the target area for the directive, the impact on pensions will only prevail in the UK as no other EU country has its local government pension arrangements directly linked to its local authorities. It seems likely that the regulators had no awareness of the LGPS and that the impact is an entirely unintended consequence.
8. The effect will be that all financial services firms like banks, brokers, advisers and fund managers will have to treat local authorities in the same way as they do individuals and small businesses. That includes ensuring that investment products are suitable for the customer's needs (potentially closing the option for the LGPS to invest in certain products), and that all the risks and features have been fully explained. This involves significantly more paperwork for both the firm and the client, to prove to the regulator that all the steps have been taken, and as evidence in case of alleged miss-selling.

9. MiFID2 includes an option for certain retail clients to opt for professional status ("Elective Professional Client" status) and this option would be available to local authorities in the UK. As things currently stand opting up would need to be done with each fund manager and in each asset class, and separately for treasury management and LGPS purposes.
10. The FCA published a consultation in September 2016 (<https://www.fca.org.uk/publications/consultation-papers/cp16-29-mifid-ii-implementation>) which set out their proposals for the opt-up regime that would apply to UK local government. London CIV responded to the consultation and a copy of the submission is attached for information.
11. The regime has a qualitative element and a quantitative element. In the consultation these two elements were defined as:
  - **Qualitative test:** the firm [fund manager] undertakes an adequate assessment of the expertise, experience and knowledge of the client that gives reasonable assurance, in light of the nature of the transactions or services envisaged, that the client is capable of making his own investment decisions and understanding the risks involved;
  - **Quantitative test:** criteria (a) and either criteria (b) or (c) must be satisfied:
    - (a) the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds £15,000,000
    - (b) the client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters
    - (c) the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged
12. The qualitative test would appear to allow some scope for interpretation by each individual fund manager, but is specific to the "...nature of the transactions or services envisaged" which would suggest that the individual at each authority will need to have a very broad based background to open up the full range of asset classes that would be required for a LGPS fund.
13. On the quantitative test; every LGPS fund would pass criteria (a), however, it seems very unlikely that any pension fund would pass criteria (b) as it would require an exceptional scale of churning across all asset classes. It may be that some funds could pass criteria (c) but that would depend on having a Member or Officer with the requisite work experience and, again, it would appear to be required across all asset classes.

## Conclusion

14. It remains to be seen how the final opt-up criteria will be framed, but as things stand the impact on LGPS funds could be disastrous. The range of investment options could be severely curtailed and the government's desire for the LGPS to invest more in infrastructure entirely undermined.

15. Officers of London CIV and the wider LGPS community (under the leadership of the LGA) are engaged in on-going discussion with the FCA with a view to developing a workable solution.

### **Recommendations**

16. The committee is recommended to consider and discuss the contents of this report.

### **Legal Implications**

17. Legal implications as currently known are contained in the body of this report.

### **Financial implications**

18. Financial implications as currently known are contained in the body of this report.

### **Equalities Implications**

19. There are no equalities implications for London Councils

### **Attachments**

20. London CIV response to the FCA's MiFID2 consultation



## **FCA: MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE II IMPLEMENTATION – CONSULTATION PAPER III**

### **London CIV Response to the Reclassification of Local Authorities as Retail Investors**

**Question 16: Do you agree with our approach to revise the quantitative thresholds as part of the opt-up criteria for local authorities by introducing a mandatory portfolio size requirement of £15m? If not, what do you believe is the appropriate minimum portfolio size requirement and why?**

London LGPS CIV Limited (“London CIV”) is fully authorised by the FCA as an Alternative Investment Fund Manager (AIFM) with permission to operate a UK based Authorised Contractual Scheme fund (ACS Fund).

Approval for the structure has been signed off by the 33 participating London Local Authorities with each authority formally approving the decision to join the London CIV. The London CIV was formed as a voluntary collaborative venture by the London Local Authorities in 2014 and has led the way in pooling of investments in the LGPS. London Local authorities and their pension funds have been working together for over 3 years to bring the benefits of pooling of investments in London.

In considering the FCA consultation on the implementation of MiFID II, the London CIV would like to register its concerns on the reclassification of Local Authorities as retail investors and in particular as this relates to the Pension Funds administered by those authorities. We do not believe that the quantitative criteria as proposed by the FCA is appropriate for Local Authority Pension Funds, which whilst the size criteria would not be an issue (Pension Funds in London range between £506m to £1.25bn), the transactions and financial sector experience as relating to individuals would cause London Funds a problem in terms of being able to opt-up to professional status. We are extremely concerned about the impact the proposed quantitative tests would have on both our clients (London LGPS Funds) and ourselves as the Investment Pool of choice for London LGPS Funds.

We have reviewed responses to the consultation from the LGPS Scheme Advisory Board, the Local Government Association and the Pensions and Lifetime Savings Association and would like to endorse the comments provided within those responses in addition to providing our own comments below.

- Whilst recognising that the FCA are consulting on the implementation of the directive rather than on the directive itself, we believe that the reclassification of Local Authorities, particularly in relation to the Pension Funds, as retail investors is unnecessary given the breadth and depth of experience in managing these Funds and will add significant complexity to the management of these Funds at a time when other significant regulatory changes are underway.

- Local Authority Pension Funds have considerable regulatory requirements which ensure appropriate levels of governance and decision making is in place with requirements to seek 'proper advice' before making investment decisions. They are required to set out their Funding Strategies and Investment Strategy Statements, along with full financial disclosures and as such meet high exacting financial and regulatory standards and it seems at odds that they are now to be classified as retail investors. This is especially so when considered against other defined benefit pension schemes which are likely to retain professional status despite in many cases being smaller in assets under management and possibly with less scrutiny than many of the LGPS Funds that face constant public scrutiny.
- The London CIV as an FCA Regulated AIFM is likely to face significant challenges in trying to assess all London Funds suitability for investing in a wide range of investments, particularly at a time when the Government is pressing the London CIV and other LGPS Pools to deliver pooling of investments within relatively short timeframes given the requirements for pools of £25bn plus. As the largest of the LGPS Pools by number of participants, the London CIV will face considerable pressure in assessing each of the now 32 (following the merger of 2 Funds) investing funds, as it is our understanding as a Fund Manager we will be required to undertake these assessments to ensure they meet the opt up criteria. The timing of such assessments coinciding with the Government's requirement for Funds to transition liquid assets into their designated Pools will add considerably to the financial and administrative burdens of pooling.
- The need to undertake the elective professional status will have operational cost implications for both the individual Pension Funds and the Collective Investment Schemes set up by LGPS Funds to comply with HM Government's mandated pooling agenda.
- Whilst all Funds in London are able to meet the scale criteria in the Quantitative Test being proposed of £15m, we do not believe that any will be able to meet the transactional criteria of an average of 10% per quarter over the previous four quarters. Indeed this again seems at odds with the nature of long term defined benefit pension schemes, who need to set long term strategies to meet their liabilities and such levels of transactional turnover, would run counter to the normal good governance practices of long term pension schemes.
- The alternative quantitative test to the transactions test is to assess whether the client has worked in the financial sector for at least one year in a professional position again poses considerable challenges given the nature of decision making in local authorities. In the majority of LGPS Funds, the decision making is undertaken by a Committee acting on behalf of the Administering Authority of the Pension Fund, rather than an individual. We would request that should this test remain, then amendments should be included to incorporate for decision making structures of local authorities.



- One of the objectives of pooling is to provide improved access to a wider range of investment opportunities that are more difficult for smaller funds including investments such as direct property and infrastructure, the reclassification of LGPS Funds will make this more protracted at a time when government policy is encouraging funds to invest in infrastructure. We would like here to support the proposals put forward by the Scheme Advisory Board response: “We therefore request that FCA ensure that asset pools can provide an effective point of access for local authority pension funds, in line Government policy objectives, by listing them as an exemption in their own right. This would result in local authorities being able to invest in a full range of assets via Collective Investment Schemes without having to undergo an elective process.” This would certainly have the effect of ensuring that where the Pools are able to provide wide ranging investments, the Funds would be able to invest through the Pool in the same way as they would have done with professional status.
- Assuming that the reclassification to retail status proceeds for Local Authorities and by default their Pension Funds, the move to retail client status on 3<sup>rd</sup> January 2018 will cause issues for some of our investing authorities where longer term commitments are in place, particularly as they relate to alternative asset classes. Even if the London CIV were provided exemption status, we would not be in a position to pool some of the investments that Funds currently have that would otherwise require successful election to professional status, leaving them and their providers with considerable uncertainty over the status of these investments and possible forced sellers. We would request that consideration be given to allowing any investments made prior to January 2018 be exempted until such time as either authorities are able to successfully opt up to professional status or the London CIV and other Pools are in a position to make arrangements for the pooling of such investments where appropriate to do so.