

# Pensions CIV Sectoral Joint Committee      Item no: 10

## MiFID II Update

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**Date:**                              13 September 2017

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**Summary:**                      This report provides the Committee with an update on the current status of opting up LGPS from retail to professional clients pursuant to MiFID II.

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

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## MiFID II Final Rules for opting-up

1. As was noted in the report to the Committee by Mr Houston (LGA) in April, the FCA was proactively consulting on the criteria to facilitate LGPS funds opting up from Retail Investor to Elected Professional Investor status once MiFID II goes live in January 2018.
2. To opt-up an authority a Fund Manager (which includes London CIV) must assure itself that specified quantitative and qualitative criteria are met.
3. As discussed in previous reports to this Committee, the original three quantitative criteria were set in a manner which would have been impossible to meet for LGPS funds – the requirement being to ‘pass’ two out of the three.
4. In July, the FCA published a policy statement (PS 17/14 Markets in Financial Instruments Directive II Implementation – Policy Statement II) which recognised the need to adapt the criteria to better align with LGPS governance arrangements. To achieve this an additional fourth criteria has been added to the quantitative test. The FCA have introduced this with the following statement:

*“...our rules will add a fourth criterion that the client is subject to the LGPS Regulations for their pension administration business.”*

5. The requirement now being to ‘pass’ two out of the four criteria, which is achievable for all LGPS funds.
6. The qualitative test remains the same, requiring London CIV to make an ‘adequate assessment of the **expertise, experience and knowledge** of the client to give 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’.
7. In recognition of the governance arrangements in place for the majority of LGPS funds (i.e. a committee based decision making structure) the FCA have clarified how a fund manager should apply the test, stating:

*“COBS 3.5.4 requires that the qualitative test should be carried out for the person authorised to carry out transactions on behalf of the legal entity. ‘Person’ in this context may be a single person or a group of persons. We understand that the persons within a local authority who invest on behalf of pension funds are elected officials acting as part of a pensions committee. In those circumstances, firms 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. We also understand that typically the person(s) within local authorities who invest the treasury reserves of those authorities are likely to be officers of the authorities, who are delegated authority from elected members and act under an agreed budget and strategy.*

*Given different governance arrangements, we cannot be prescriptive, but we would stress the importance of firms exercising judgement and ensuring that they understand the arrangements of the local authority and the clear purpose of this test. It remains a test of the individual, or respectively the individuals who are ultimately making the*

*investment decisions, but governance and advice arrangements supporting those individuals can inform and contribute to the firm's assessment.*

*We agree that adherence to CIPFA Codes or undertaking other relevant training or qualifications may assist in demonstrating knowledge and expertise as part of the qualitative test."*

### **London CIV and opting-up**

8. The process for opting up to professional status requires each London Authority to request that they be treated as a professional client and voluntarily forego certain retail protections as set out in the SAB letter at Appendix A.
9. Were a LGPS fund to decide not to opt-up it will not be possible for London CIV (or any other Fund Manager) to offer the full range of investment strategies and asset classes that are currently utilised as these (in most cases) are not considered appropriate for retail clients.
10. In addition, the London CIV ACS fund is restricted to professional investors as a Qualified Investor Scheme.

### **The opt-up process**

11. The LGPS Scheme Advisory Board ("SAB") has worked with industry to create a unified opt-up process which London CIV has decided to follow.
12. The SAB website provides a suite of resources to assist funds with the opt up process. these can be accessed at <http://www.lgpsboard.org/index.php/mifidii-lgps>, and include:
  - Pensions Committee template report approving the opt up;
  - Report on the retail protections which the LGPS fund will forego;
  - Opt-up request letter from the LGPS fund to its managers (including London CIV), attached at Appendix A;
  - Information template setting out how the LGPS fund satisfies the opt-up test.
13. London CIV has asked colleagues across London LGPS funds to complete and returned opt-up documentation by the 30 September. This will permit the London CIV to review the completed forms and revert with clarification issues, if necessary, during the autumn.
14. Where necessary the London CIV will engage with Members and Officers to assist in remediating any issues identified in demonstrating the capacity to satisfy the qualitative test.

## Appendix A \_-Retail Protections

### Letter requesting categorisation as an elective professional client

[ON [AUTHORITY] HEADED PAPER]

[Manager name]

[Manager address]

[Date]

Dear [●]

#### **Request to be treated as a professional investor**

I am writing to you ahead of the implementation in the UK of the Markets in Financial Instruments Directive (2014/65/EU) (MiFID II). I have been authorised by NAME OF AUTHORITY (the “Local Authority”) to inform you that, in its capacity as an administering authority of a local government pension scheme, it wishes to be treated as a professional client for the purpose of:

- (a) any and all investment service(s) which it receives from you (the “Services”); and/or
- (b) the promotion to us of, and investment in, any and all fund(s) managed or advised by you (the “Fund Promotions/Investments”).

We understand you are required to categorise all of your clients as either professional clients or retail clients and that you currently categorise the Local Authority as a Professional Client (“Professional Client”). However as of 3 January 2018, under new rules deriving from MiFID II, you will be obliged to re-categorise the Local Authority as a Retail Client (“Retail Client”) as regards receiving Services from you and/or as regards existing fund investments and any future Fund Promotions/Investments, unless you are satisfied you can otherwise treat the Local Authority as an elective Professional Client and opt-up the Local Authority to this particular client status.

I confirm and acknowledge that the Local Authority is aware that, being categorised as a Professional Client, it will not benefit from the protections and investor compensation rights set out in more detail in Schedule 1. In doing so, I confirm that the Local Authority has reviewed and considered the loss of these protections and rights very carefully and has, if it felt so appropriate, taken advice from legal, financial or other advisors.

I wish to inform you that the Local Authority wishes to be categorised as a Professional Client for the purposes of the Services and/or Fund Promotions/Investments, as applicable in its capacity as an administering authority of the Local Government Pension Scheme.

Prior to re-categorising the Local Authority, as a Professional Client, I understand that you will be required to assess the Local Authority on certain quantitative and qualitative grounds. In order to facilitate this assessment, please find attached a completed questionnaire for your review and consideration.

Subject to you being reasonably assured that, as of 3 January 2018, the Local Authority satisfies the necessary quantitative and qualitative grounds and may be categorised as an elective Professional Client, the Local Authority confirms the following:

- (a) its request to be categorised as a Professional Client, in its capacity as an administering authority of the Local Government Pension Scheme, in relation to the Services and/or Fund Promotions/Investments.

- (b) all information provided to you by us (for the purposes of facilitating your assessment of the Local Authority's request to be categorised as a Professional Client) is true, accurate and complete.
- (c) the Local Authority understands the contents of Schedule 1 which contains summaries of the protections and investor compensation rights, if any, that the Local Authority will lose once it is categorised as a Professional Client. Please note that I can confirm that the Local Authority is fully aware of the consequences of losing such protections and still wishes to apply to be categorised as Professional Client in respect of the Services and/or Fund Promotions/Investments.
- (d) the Local Authority has had sufficient time to consider the implications of categorisation as a Professional Client and has separately taken any legal, financial or other advice that it deems appropriate.
- (e) the Local Authority will inform you of any change that could affect its categorisation as a Professional Client. I also confirm that the Local Authority understands its responsibility to ask you for a higher level of protection if it is unable to properly assess or manage the risks involved with the investments comprised within the portfolio management mandates which you have been appointed to manage.
- (f) I acknowledge the Local Authority understands that you shall be permitted, in your sole discretion and without providing any reason, to re-categorise the client as a Retail client or cease to provide the Services or otherwise carry out any fund promotion to us or allow future investment in funds by us.

If you have any questions regarding this application please contact **[name]** on **[number]** or alternatively e-mail us at **[email address]**.

Yours sincerely,

.....

**[insert name and position]** [Authority]

## **Schedule 1**

### **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.



## **Part 2 – Loss of protections for the Local Authority as a potential investor if categorised as a Professional Client for the purposes of Fund Promotions**

### **1. Fund promotion**

It is generally not permitted for firms to market alternative investment funds (AIFs) to investors who are Retail Clients (although there are certain limited exceptions to this rule). As a Professional Client, firms will (subject to complying with applicable marketing rules) be generally permitted to market shares or units in AIFs to you, without being subject to this restriction.

### **2. Non-mainstream pooled investments**

For the purposes of the UK regulatory regime, AIFs typically fall within the definition of an “unregulated collective investment scheme”. The UK regulator considers unregulated collective investment schemes to be a high-risk investment, which are not generally suitable investments for Retail Clients. As such, firms are not permitted to promote investments in unregulated collective investment schemes to Retail Clients (although there are certain limited exceptions to this rule). As a Professional Client, firms will be generally permitted to promote an investment in unregulated collective investment schemes to you, without being subject to this restriction (and without making any assessment of whether the investment would be suitable or appropriate for you).

### **3. Communicating with clients, including financial promotions**

Detailed rules govern generally the form and content of financial promotions which are issued to investors who are Retail Clients. However, these detailed form and content rules apply less rigorously where a promotion is issued only to investors who are Professional Clients. As a Professional Client, firms will be generally permitted to issue promotions to you which do not satisfy the detailed form and content rules for Retail Clients. Firms must ensure however that communications remains fair, clear and not misleading.

### **4. Financial Ombudsman**

The services of the Financial Ombudsman Service may not be available to you as a Professional Client

### **5. 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.