The Markets in Financial Instruments Directive (MiFID II) and its impact on LGPS investments

Why be concerned?

1. It is our understanding that under MiFID II local authorities will be defaulted to retail client status - currently they are professional clients. There will be the opportunity to elect for professional client status.

What does that mean for me as an LGPS administering authority?

2. As a retail client your authority could be faced with a much reduced pool of asset managers and consultants willing to provide services, many may not deal with retail clients at all.

3. Those managers who are willing to deal with you will offer a restricted range of products and due to the extra compliance checks and reporting required for retail clients those products could cost more. First estimates are that up to 50% of LGPS assets may be affected.

4. If when the directive comes into force (January 2017) you hold assets in products outside of the scope of those available to retail clients you may find that the manager will eject you from that product resulting in a 'fire sale' of assets. This could be mitigated if FCA were to provide some form of transition period or 'grandparenting' - allowing you to retain products purchased as a professional investor for a period of time.

How can I elect for professional status?

5. The process will be similar to that in MiFID I (see ANNEX 1) although there may be some changes to the criteria. Effectively you will have to demonstrate to <u>each</u> manager you use that you meet the qualitative and quantitative criteria as set out below

6. The qualitative criteria - 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'

This assessment 'should be performed in relation to the person <u>authorised to carry out transactions on its behalf</u>.'

7. The quantitative criteria - (2 of the following 3 must be satisfied)

- 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;
- the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds EUR 500,000;
- 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

How long will it take for an election to be completed?

8. Depending on how the actual criteria look when published in 2016 it could be a matter of weeks. However as each manager will have to assess each of its LGPS clients this cannot be able to be done all at once. Therefore it may be that some form of managed election process across the whole of the LGPS will be needed. For example if a significant number of authorities wait until very late 2016 to elect then don't be surprised if the process is not completed by the January 2017 implementation date.

9. There is a duty on elected professional clients to keep firms informed about any change that could affect that status. Such changes could result in the process having be repeated and depending on the nature of the change the danger that the authority could be reverted back to retail client status.

What's the timeline?

February 2015: Feedback Statement on dealing commission regime and potential changes under MiFID II

March 2015: FCA Discussion Paper and ongoing dialogue in areas where we have policy choices to make
Summer 2015: EU legislation on MiFID II implementing measures is adopted and formal approval process begins
December 2015: Consultation on implementing MiFID II requirements
Early 2016: EU legislation on MiFID II implementing measures is finalised and published
June 2016: FCA Policy Statement (rules) on implementation of MiFID II
3 January 2017: MiFID II rules come into effect for all investment firms

What should I do?

10. Make your committee aware of the issue as soon as possible.

11. Discuss the implications with your asset managers, find out if they will they still deal with you as a retail client and what assets will be affected.

12. Prepare for an assessment against the qualitative and quantitative criteria - what evidence would you put forward to back up your election for professional status? In particular assess who will be judged against the qualitative criteria and if necessary be prepared to amend your delegations appropriately.

What are LGA doing?

13. We are in discussions with the FCA, DCLG and the Investment Association (IA) to find ways to lessen the impact on LGPS authorities, in particular we are:

- Investigating with DCLG and HMT the potential impact on pooling arrangements and in particular any impact on the potential for infrastructure investment via pools
- Discussing the election process under MiFID II with FCA to see if there are changes that could make the process smoother for local authorities in relation to their pensions functions
- Attempting to achieve a period of transition to avoid a forced sale of assets for those authorities who have not completed the election to professional status by January 2017

- Discussing with IA the possibility of standard documentation and process for election to professional status

LGA Pensions Team

16th October 2015

ANNEX 1

Extract from FCA New Conduct of Business Sourcebook Chapter 3 Client categorisation

ELECTIVE PROFESSIONAL CLIENTS

3.5.3

A firm may treat a client as an elective professional client if it complies with (1) and (3) and, where applicable, (2):

(1) the firm 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 (the "qualitative test");

(2) in relation to MiFID or equivalent third country business in the course of that assessment, at least two of the following criteria are satisfied:

(a) 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;
(b) the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds EUR 500,000;
(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;
(the "quantitative test"); and

(3) the following procedure is followed:

(a) the client must state in writing to the firm that it wishes to be treated as a professional client either generally or in respect of a particular service or transaction or type of transaction or product;
(b) the firm must give the client a clear written warning of the protections and investor compensation rights the client may lose;
and

(c) the client must state in writing, in a separate document from the contract, that it is aware of the consequences of losing such protections.

[Note: first, second, third and fifth paragraphs of section II.1 and first paragraph of section II.2 of annex II to MiFID]

3.5.4

If the client is an entity, the qualitative test should be performed in relation to the person authorised to carry out transactions on its behalf.

[Note: fourth paragraph of section II.1 of annex II to MiFID]

3.5.5

The fitness test applied to managers and directors of entities licensed under directives in the financial field is an example of the assessment of expertise and knowledge involved in the qualitative test.

[Note: fourth paragraph of section II.1 of annex II to MiFID]

3.5.6

Before deciding to accept a request for re-categorisation as an elective professional client a firm must take all reasonable steps to ensure that the client requesting to be treated as an elective professional client satisfies the qualitative test and, where applicable, the quantitative test.

[Note: second paragraph of section II.2 of annex II to MiFID]

3.5.7

An elective professional client should not be presumed to possess market knowledge and experience comparable to a per se professional client

[Note: second paragraph of section II.1 of annex II to MiFID]

3.5.8

Professional client are responsible for keeping the firm informed about any change that could affect their current categorisation.

[Note: fourth paragraph of section II.2 of annex II to MiFID]

3.5.9

(1) If a firm becomes aware that a client no longer fulfils the initial conditions that made it eligible for categorisation as an elective professional client , the firm must take the appropriate action.

(2) Where the appropriate action involves re-categorising that client as a retail client, the firm must notify that client of its new categorisation.

[Note: fourth paragraph of section II.2 of annex II to MiFID and article 28(1)
of the MiFID implementing Directive]