

16 November 2017

Agenda Item: 4

REPORT OF THE SERVICE DIRECTOR, FINANCE, PROCUREMENT & IMPROVEMENT

IMPLEMENTATION OF THE MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE (MiFID II)

Purpose of the report

1. The purpose of this report is to outline the impact of the implementation of the Markets in Financial Instrument Directive 2014/65 (“MiFID II”) and in particular the risk to the administering authority of becoming a retail client on 3rd January 2018 and recommend that the committee agree that elections for professional client status should be made on behalf of the authority.

Information and advice

2. 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’.
3. Following the introduction of the Markets in Financial Instrument Directive 2014/65 (“MiFID II”) from 3 January 2018, firms will no longer be able to categorise a local public authority or a municipality that (in either case) does not manage public debt (“local 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 firms to an ‘elective professional client’ status.
4. Furthermore, the FCA has exercised its discretion to adopt gold-plated opt-up criteria for the purposes of the quantitative opt-up criteria, which local authority clients must satisfy in order for firms to reclassify them as an elective professional client.

Potential impact

5. A move to retail client status would mean that all financial services firms like banks, brokers, advisers and fund managers will have to treat local authorities 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 firm and the client, for the purpose of proving to the regulator that all such requirements have been met.

6. Such protections would come at the cost of local authorities not being 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 authorities. Many institutions currently servicing the LGPS 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.
7. 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

8. MiFID II allows 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.
9. 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.
10. 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.
11. 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.
12. 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. This process should enable a consistent approach to assessment and prevent authorities from having to submit a variety of information in different formats.
13. Applications can be made in respect of either all of the services offered by the institution (even if not already being accessed) or a particular service only. A local authority may wish to do the latter where the institution offers a wide range of complex instruments which the authority does not currently use and there is no intention to use the institution again once the current relationship has come to an end, for example, if the next procurement is achieved via the LGPS pool. 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 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 adviser 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. 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.

Decision making within Nottinghamshire

17. The Investment Strategy Statement sets out the responsibilities of the Pension Fund Committee and officers as follows:-

The Administering Authority

The Administering Authority for the Pension Fund is Nottinghamshire County Council. Under the terms of the Council's constitution, the functions of the Council as administering authority are delegated to the Nottinghamshire Pension Fund Committee supported by two Sub-Committees. The full governance arrangements of the Fund are detailed in the Fund's Governance Compliance Statement.

The members of the Committees are not trustees (as the LGPS is a statutory scheme) but do have fiduciary duties towards the scheme members and employers.

Committee Members

The Committee Members recognise their full responsibility for the oversight of the Fund, and operate to a Code of Conduct. They shall:

- *Determine the overall asset allocation and investment strategy of the Fund*
- *Determine the type of investment management to be used and, until LGPS Central is operational, appoint and dismiss fund managers*
- *Receive regular reports on performance from the main fund managers and question them regularly on their performance*
- *Receive independent reports on the performance of fund managers on a regular basis*
- *Be encouraged to receive suitable training to help them discharge their responsibilities and attend such training courses, conferences and meetings that deliver value for money to the Fund.*

Chief Finance Officer

Under the Council's constitution, the Service Director (Finance, Procurement & Improvement) is designated the Council's Chief Finance Officer (also known as the Section 151 Officer).

The Group Manager (Financial Management) is the deputy Section 151 Officer. Financial Regulations specify that the Section 151 Officer is responsible for arranging the investment of the Pension Fund. Operational matters falling under this responsibility are exercised by the Senior Accountant (Pensions & Treasury Management).

Authorised signatories for operational matters relating to pension fund investments are:

- *Service Director (Finance, Procurement & Improvement)*
- *Group Manager (Financial Strategy & Compliance)*
- *Group Manager (Financial Management)*
- *Senior Accountant (Pensions & Treasury Management)*
- *Investments Officer*

18. Consequently the MiFID application will be made on the basis that the officers named above are responsible for making investment decisions.

Independent Adviser

19. The requirement to opt up with Linchpin has been discussed, but it is felt that this is not required as the contract is to provide general advice, and therefore does not constitute regulated advice under FCA rules.

Next steps

20. In order to continue to effectively implement the authority's investment strategy after 3rd January 2018, applications for election to be treated as a professional client should be submitted to all financial institutions with whom the authority has an existing or potential relationship in relation to the investment of the pension fund.

21. 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 authority's pension fund investments.

22. The officer named in the recommendations should be granted the necessary delegation to make applications on the authority's behalf and to determine the nature of the application on either full or single service basis.

Other Options Considered

23. The authority could accept the status change to a retail client which will occur by default when the provisions of MiFID II come into effect on 3rd January 2018. However this would undermine the investment strategy of the fund, potentially causing the forced sale of some investments and limiting options going forwards. Future investments would be limited to those available to retail clients; this is likely to impact on the ability of the fund to deliver the planned level of returns which would have associated financial implications for employers. For these reasons this option is not felt to be appropriate.

Reason/s for Recommendation/s

24. The recommended opt-up process is the only way to enable the Pension Fund to continue its current Investment Strategy after 3rd January 2018.

Statutory and Policy Implications

15. This report has been compiled after consideration of implications in respect of crime and disorder, finance, human resources, human rights, the public sector equality duty, safeguarding of children and vulnerable adults, service users, sustainability and the environment and ways of working and where such implications are material they are

described below. Appropriate consultation has been undertaken and advice sought on these issues as required.

RECOMMENDATIONS

- 1) Approves 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.
- 2) Acknowledges and agrees to forgo the protections available to retail clients (attached as Appendix 1) as a result of electing for professional client status.
- 3) Confirms that investment decisions to implement the agreed strategy are operational decisions taken by officers.
- 4) Agrees that there is no requirement to opt up with Linchpin due to the general nature of advice provided.
- 5) Delegates responsibility to the Service Director for Finance, Procurement & Improvement and Section 151 Officer for the purposes of completing the applications and determining the basis of the application as either full or single service.

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Constitutional Comments (SLB 20/10/17)

25. Pension Fund Committee is the appropriate body to consider the content of this report

Financial Comments (TMR 20/10/17)

26. The financial implications are set out in the report.

Background Papers and Published Documents

Except for previously published documents, which will be available elsewhere, the documents listed here will be available for inspection in accordance with Section 100D of the Local Government Act 1972.

None

Electoral Division(s) and Member(s) Affected

All.

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