

# HAMPSHIRE COUNTY COUNCIL

## Decision Report

<b>Decision Maker:</b>	Pension Fund Panel and Board
<b>Date:</b>	29 September 2017
<b>Title:</b>	Investments: Implementation of the Markets in Financial Instruments Directive (MiFID II)
<b>Report From:</b>	<i>Director of Corporate Resources – Corporate Services</i>

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### 1. Executive Summary

1.1. This report outlines the impact of the implementation of the Markets in Financial Instruments Directive (MiFID II) and in particular the risk to the investment strategy if the administering authority were to become a retail client on 3 January 2018. This report recommends that the Pension Fund Panel and Board agrees that elections for professional client status should be made on behalf of the Pension Fund.

### 2. Background

2.1. The European Union, through its Market in Financial Instruments Directive (MiFID II), is aiming to improve the functioning of financial markets in light of the financial crisis and to strengthen investor protection. This changing of rules will impact how local authorities can access regulated financial services. Although the UK has voted to leave the EU, MiFID II will still be implemented in the UK on 3 January 2018 for three reasons. Firstly, the UK's residents remain members of the EU and subject to its laws until the UK leaves; secondly, the UK government is in favour of strengthening investor protection; and thirdly, UK firms will wish to continue providing financial services across the EU after the UK has left the EU, so will need to comply with equivalent regulations.

2.2. The MiFID regulations are issued by the European Union and place requirements on market participants such as Pension Funds. The first set of regulations (MiFID I) was introduced in 2008, and a second set of regulations (MiFID II) comes into force on 03 January 2018. Under MiFID I Hampshire County Council, including in its capacity of managing the Pension Fund, has been automatically categorised as a 'per se professional client' for MiFID-scope business.

2.3. Following the introduction of MiFID II, firms will no longer be able to categorise a local authority as a 'per se professional client'; instead all local authorities, including in their capacity of managing Pension Funds, must be classified as

'retail clients' unless they are opted up by firms to an 'elective professional client' status.

- 2.4. Furthermore the Financial Conduct Authority (FCA) confirmed in July 2017, that it has exercised its discretion to adopt 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.

### **3. Retail Client Status**

- 3.1. 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 involves more work and cost for both the firm and client, for the purpose of proving to the regulator that all such requirements have been met.
- 3.2. Such protections would come at the price of local authorities, including in any capacity of managing LGPS funds, 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.
- 3.3. All of the Fund's investment managers and its custodian, J.P. Morgan, have confirmed that they would not be able to retain the Fund as a client, managing its investments in their current form.
- 3.4. 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 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 certain asset classes and vehicles with the authority as a retail client.

### **4. Election for Professional Client Status**

- 4.1. Opting up to professional status will allow continued access to the current asset classes the Fund is invested in, without the increased fees that retail asset classes demand. Opting up will mean the Fund will not be able to take advantage of the increased protections available to retail clients (retail protections are available at Appendix 1 – this list was provided by the Local Government Association and represents protections for all different types of investment that LGPS funds invest in). However, this will not be a change from the current status, as these protections are not currently afforded to professional clients.
- 4.2. Local authorities, on behalf of their management of LGPS funds, will be permitted to "opt-up" from retail to professional client status, providing they meet the following criteria:

- the firm has assessed that the person [i.e. the Pension Fund Panel and Board] authorised to carry out transactions on the local authority's behalf has the expertise, experience and knowledge to give reasonable assurance in light of the nature of the transactions or services envisaged, that they are capable of making their own investment decisions and understanding the risks involved;
- the size of the local authority's investment portfolio (including cash deposits) [i.e. the total market value of the Pension Fund's assets] exceeds £10 million; and
- at least one of the following is true:
  - the local authority has carried out transactions, in significant size, on the relevant market at an average frequency of ten per quarter over the previous four quarters;
  - the person authorised to carry out transactions on behalf of the local authority works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the services envisaged; or
  - the local authority is a Local Government Pension Scheme administering authority and is acting in that capacity (this has been added following the original consultation).

4.3. The election to professional status must be completed with all financial institutions prior to the change of status on 3 January 2018. Failure to do so 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.

4.4. The Scheme Advisory Board and the Local Government Association have worked with industry representative bodies including the Investment Association to develop a standard opt-up process with letter and information templates, which should enable a consistent approach to assessment and prevent funds from having to submit a variety of information in different formats.

4.5. Within this template, the Fund will be required to complete information regarding the training, knowledge and advice received by the Pension Fund Panel and Board members, to enable the financial institutions to assess that decision-makers have the expertise, experience and knowledge to give reasonable assurance in light of the nature of the transactions or services envisaged, that they are capable of making investment decisions and understand the risks involved. The Training Needs Analysis (TNAs) and records of training completed by members may therefore become evidence that the Pension Fund requires and relies upon as part of the opting up process. The identification and participation in Panel and Board training is therefore of even further importance. Currently there are two members of the Panel and Board still to complete their TNA for 2017.

4.6. 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 Fund 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. It is recommended that officers determine the most appropriate basis of the application, either via full or single service.

- 4.7. Funds 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.

## **5. The ACCESS Pool**

- 5.1. Regarding imminent LGPS pooling, the Fund will need to opt up with ACCESS' Operator in order to access the full range of services and sub-funds on offer. ACCESS' Operator will not need to opt up with financial service organisations, as the Operator will be a regulated financial company, and so MiFID regulations do not apply to this relationship.
- 5.2. Elections to professional status will be needed for every financial institution that the Fund 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 ACCESS 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.

## **6. Next Steps**

- 6.1. In order to continue to effectively implement the Fund's investment strategy after 3 January 2018, applications for election to be treated as a professional client should be submitted to all financial institutions with whom the administering authority has an existing or potential relationship in relation to the investment of the Fund.
- 6.2. This process should commence as soon as possible to ensure completion in good time, avoiding the need for appropriate action to be taken by institutions in relation to the Fund's investments.
- 6.3. The Director of Corporate Resources should be granted the necessary delegation to make applications on the Fund's behalf and to determine the nature of the application or either full or single service basis.

## **7. Recommendations**

- 7.1. That the Panel and Board notes the potential impact on investment strategy of becoming a retail client with effect from 3 January 2018.
- 7.2. That the Panel and Board agrees 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.
- 7.3. In electing for professional client status, the Panel and Board acknowledges and agrees to forgo the protections available to retail clients attached as Appendix 1.

- 7.4. That the Panel and Board note the importance of their identification and participation in training in the Pension Fund securing elected professional client status
- 7.5. That the Panel and Board agrees to approve delegated responsibility to the Director of Corporate Resources for the purpose of completing the applications and determining the basis of the application as either full or single service.

**CORPORATE OR LEGAL INFORMATION:****Links to the Strategic Plan**

<b>Hampshire maintains strong and sustainable economic growth and prosperity:</b>	no
<b>People in Hampshire live safe, healthy and independent lives:</b>	no
<b>People in Hampshire enjoy a rich and diverse environment:</b>	no
<b>People in Hampshire enjoy being part of strong, inclusive communities:</b>	no
<b>OR</b>	
<b>This proposal does not link to the Strategic Plan but, nevertheless, requires a decision because:</b> For the ongoing management of the Hampshire Pension Fund.	

**Section 100 D - Local Government Act 1972 - background documents**

**The following documents discuss facts or matters on which this report, or an important part of it, is based and have been relied upon to a material extent in the preparation of this report. (NB: the list excludes published works and any documents which disclose exempt or confidential information as defined in the Act.)**

DocumentLocation

None

## **IMPACT ASSESSMENTS:**

### **1. Equality Duty**

1.1. The County Council has a duty under Section 149 of the Equality Act 2010 ('the Act') to have due regard in the exercise of its functions to the need to:

- Eliminate discrimination, harassment and victimisation and any other conduct prohibited under the Act;
- Advance equality of opportunity between persons who share a relevant protected characteristic (age, disability, gender reassignment, pregnancy and maternity, race, religion or belief, gender and sexual orientation) and those who do not share it;
- Foster good relations between persons who share a relevant protected characteristic and persons who do not share it.

**Due regard in this context involves having due regard in particular to:**

- a) The need to remove or minimise disadvantages suffered by persons sharing a relevant characteristic connected to that characteristic;
- b) Take steps to meet the needs of persons sharing a relevant protected characteristic different from the needs of persons who do not share it;
- c) Encourage persons sharing a relevant protected characteristic to participate in public life or in any other activity which participation by such persons is disproportionately low.

#### **1.2. Equalities Impact Assessment:**

Equality objectives are not considered to be adversely affected by the proposals in this report.

### **2. Impact on Crime and Disorder:**

The proposals in this report are not considered to have any direct impact on the prevention of crime.

### **3. Climate Change:**

- a) How does what is being proposed impact on our carbon footprint / energy consumption?

No specific impact.

- b) How does what is being proposed consider the need to adapt to climate change, and be resilient to its longer term impacts

No specific impact.

## **Warnings - loss of protections 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 document contains, for information purposes only, a summary of the protections that you will lose if you request and agree to be treated as a Professional Client.

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

As a Professional Client the simplicity and frequency in which the firm communicates with you may be different to the way in which they would communicate with a Retail Client. They will ensure however that our communication remains fair, clear and not misleading.

### **2. Information about the firm, its services and remuneration**

The type of information that the firm provides to Retail Clients about itself, its services and its products and how it is remunerated differs to what the firm provides to Professional Clients. In particular,

(A) The firm 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; and

(B) there are particular restrictions on the remuneration structure for staff providing services to Retail Clients which may not be applicable in respect of staff providing services to Professional Clients;

(C) the information which the firm 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, they are required when offering packaged products and services to provide additional information to Retail Clients on the risks and components making up that package; and

(D) when handling orders on behalf of Retail Clients, the firm 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 discretionary management services, when assessing suitability for Professional Clients, the firm is entitled to assume that in relation to the products, transactions and services for which you have been so classified, that you have the necessary level of experience and knowledge to understand the risks involved in the management of your investments. The firm will assess this information separately for Retail Clients and would be required to provide Retail Clients with a suitability report.



#### 4. Appropriateness

For transactions where the firm does not provide you with investment advice or discretionary management services (such as an execution-only trade), it may be required to assess whether the transaction is appropriate. 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, the 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 any execution.

#### 6. Reporting information to clients

For transactions where the firm does not provide discretionary management services (such as an execution-only transactions), the timeframe for our providing confirmation that an order has been carried out is more rigorous for Retail Clients' orders than Professional Clients' orders.

#### 7. Client reporting

Investment firms that hold a retail client account 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. Hence, depending on how you are constituted you may not have access to the Financial Services Compensation Scheme.

#### 10. Exclusion of liability

The FCA rules restrict the firm's ability to exclude or restrict any duty of liability which the firm owes to Retail Clients more strictly 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, the 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, the firm may conclude title transfer financial collateral arrangements with you 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.

It should be noted that at all times you will have the right to request a different client categorisation and that you will be responsible for keeping the firm informed of any change that could affect your categorisation as a Professional Client.