

# Investment, Governance and Engagement Sub Committee

## Item 3 – Paper B

### **Markets in Financial Instruments Directive II (MiFIDii) - Update**

This paper sets out a brief summary of what MiFIDii is, its impact on local authorities (Treasury and Pensions) and the work undertaken by the SAB and Local Government Association (LGA) to aid implementation of the Directive. The paper also summarises the final policy announcement made by the FCA and suggests the way in which the opt-up process should be taken forward.

#### **1. MiFIDii – A brief summary and its impact on Local Authorities:**

- 1.1. MiFiD II is the European Union's second Markets in Financial Instruments Directive. Examples of poor investment decisions and mis-selling by local and public authorities across Europe have resulted in provisions within MiFiD II which aim to give greater protection to such authorities by re-classifying them as retail clients from their current Professional client status with effect from 3rd January 2018.
- 1.2. This reclassification will mean that all financial services firms like banks, brokers, advisers and fund managers will have to treat local authorities in the same way they do individuals and small businesses. That includes ensuring that investment products are suitable for the customer's needs, and that all the risks and features have been fully explained. This increased level of protection will both restrict the firms, assets and vehicles available to the client and also increase the reporting and disclosure requirements paperwork for both the firm and the client, to prove to the regulator that all the necessary steps have been taken, and as evidence in case of alleged mis-selling.
- 1.3. MiFID does include an option for retail clients to 'opt up' provided certain tests are passed which are designed to ensure the client has sufficient knowledge, expertise and experience to understand the additional risks they will be taking as a professional client.
- 1.4. Local authorities will need to consider whether to exercise their right to apply to be opted up to professional status or not, however it is difficult to see how an LGPS authority could manage an effective

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investment strategy without doing so. The application to opt up will be assessed by each relevant firm which provides MiFID business (asset management, consultancy etc). The decision to allow an opt up will be made on a firm-by-firm basis. So for example for the purposes of treasury management it will be possible to apply to be a professional client when dealing in more familiar markets, such as for wholesale deposits via money brokers, and be a retail client in the more arcane instruments, such as structured loans.

## 2. SAB/LGA role:

2.1. Over the last two years, the SAB and LGA has been in discussion with the Financial Conduct Authority (FCA) (which is responsible for transposing the directive into UK law) alongside DCLG, HMT and the Investment Association (IA) to find ways to lessen the impact on LGPS authorities; and in particular to:

- Investigate with DCLG and HMT the potential impact on pooling arrangements and in particular any impact on the potential for infrastructure investment via pools.
- Discuss the opt up process under MiFIDii with FCA to see if there are changes that could make the process and tests more appropriate to the decision making structures of local authorities in relation to their treasury and pensions functions.
- Attempt 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 2018, and
- Discuss with IA the possibility of standard documentation and process for opting up to professional status

2.2. Both SAB and LGA responded to the FCA consultation and focused strongly on the opt-up criteria and process, the qualitative and quantitative tests, pooling and transition of assets.

2.3. Follow up meetings with FCA were very constructive and enabled them to better understand the concerns of both local authorities and the investment management industry with regard to the suitability of the opt up tests

2.4. The outcome of this lobbying has resulted in significant changes to the FCA's original proposals as described below.

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## 3. The Way Forward:

4.1 On 3 July, the FCA published its policy statement setting out the final rules for the MiFIDii implementation. A copy of the statement can be found at <https://www.fca.org.uk/publication/consultation/cp17-19.pdf>. (1006 pages)

Appendix three of the statement covers the policy statement in detail; the important part for authorities is chapter 8 – Client categorisation (page 64 onwards).

4.2 The policy statement is an improvement on the consultation issued last year and incorporates a lot of the comments that the sector made in response to that; the rules for opt up for professional status now better recognise how local government works in practice.

4.3 The main points are as follows:

- The recognition by FCA that a public sector client can be assessed as a ‘collective’.

*‘..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’ [page 67]*

- The reduction in amount required to meet the first quantitative criteria from £15 million to £10 million.

*‘We have changed the portfolio size threshold to £10m. This follows further data and case studies provided by local authorities, Department for Communities and Local Government (DCLG) new data, and wider CP responses’ [page 71]*

- The clarification that experienced Treasury managers should meet the third quantitative criteria.

*‘We do not interpret the term ‘financial sector’ in a limited way for the purposes of COBS 3.5.3BR(2)(b)(ii), and firms may reasonably assess that a professional treasury manager has worked in the financial sector for at least one year, if their role provides knowledge of the provision of services envisaged.’ [page 70]*

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- The addition of a fourth quantitative criteria which acknowledges the legislative status of the client under LGPS regulation.

*‘Therefore, our rules will add a fourth criterion that the client is subject to the LGPS Regulation for their pension administration business. Local authorities must continue to meet the size requirement, as well as one of the two previous criteria or the new fourth criterion’ [page 68]*

4.4 The new proposals also contain provisions to allow authorities that wish to continue to use MiFID type financial instruments to apply for an opt up to professional status in advance of the change of status in order to avoid the need for a transition period.

4.5 The SAB and LGA are now working with the IA, the British Venture Capital Association (BVCA), the Alternative Investment Managers Association (AIMA), the Association of Real Estate Funds (AREF) and the Chartered Institute of Public Finance and Accountancy (CIPFA) in order to develop standardised opt up processes for use across the sector. The process will include standard letters and a template which will contain a series of questions which the local authority will need to answer should they wish to opt-up.

4.6 The Opting up process will entail:

- The local authority informing the firm that they are willing to relinquish their protection rights under MiFIDii and wish to be treated as a Professional as opposed to a Retail client
- The opt-up template is completed by authority and included with the application.
- The application is then assessed by the firm and a decision is made
- The firm communicates the result of the assessment back to the client and if successful reminds the client of the protections they are forgoing.

4.7 Once a local authority has been opted up, they will need to disclose any material change that could affect their status. This could be done via their web-site and Annual Report. Material changes are those that fundamentally change their status i.e. a change in membership of the Committee or officer or advisor; a change in training policy etc.

## 4. Conclusion

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- 4.1. Publication of the FCA's policy statement setting out final rules for their implementation of MiFIDii is welcomed. It recognises the unique nature of decision making within authorities in the conducting of pension fund and treasury management investment activities. This is good news for local government but there remains a significant amount of work to be done to ensure the opt up process is complete by the end of the year.