8
Client categorisation

Introduction

8.1 This chapter summarises the feedback we received on the changes we proposed to make to the client categorisation rules in respect of local authorities, and our response.

8.2 In CP16/29 we proposed to:

- Clarify that only a national government or a public body dealing with public debt at national level can be categorised as a per se eligible counterparty (ECP).
- Clarify that only a national or regional government or a public body which manages public debt at national or regional level can be categorised as a per se professional client.
- Give effect to MiFID II's bar on opting-up elective professional clients to ECP status.
- Give effect to MiFID II's retail categorisation of local authorities.
- Exercise our discretion to introduce either additional or alternative quantitative opt-up criteria for local authorities, so that certain local authorities can potentially be categorised as elective professional clients. As part of this, we proposed the separate application of opt-up criteria for local authorities' treasury management functions and pension fund administration functions, and to apply consistent rules across MiFID and non-MiFID business.

8.3 In CP15/43 we proposed to:

- update PRIN 1 Annex 1 to remove the possibility of firms categorising local authorities as ECPs for non-MiFID investment business when applying the FCA Principles for Businesses, (PRIN).

8.4 We modified our approach following feedback, and have now:

- added a fourth quantitative criterion to COBS 3.5.3BR(2), that the local authority is using investment services as part of administration of a pension fund within the local government pension scheme (LGPS);
- decided to apply the same requirements to both MiFID and non-MiFID investment business conducted with local authorities; and
- made further changes to the discretionary criteria, which should allow a greater number of local authorities to be able to opt-up to professional client status.

8.5 Our proposed approach remains the same to:

- prevent smaller local authorities from being able to opt-up to professional client status (particularly when exercising their treasury management functions), while allowing larger ones to be able to exercise this option;
- have a common approach to categorisation of clients across MiFID and non-MiFID business for this type of client; and
- exclude local authorities from the list of eligible counterparties in PRIN 1 Annex 1 for the purposes of applying PRIN in respect of non-designated investment business.

Categorising local authorities as 'retail' or 'elective professional' clients

8.6 Most respondents agreed that smaller local authorities should be categorised as retail clients and be given extra regulatory protections, but felt larger authorities and local authority pension business should not be the subject of these rules given their sophistication and existing statutory protections.

8.7 Others asked whether we could continue to allow local authorities administering LGPS pension funds to be categorised as per se professional clients.

8.8 Many noted that being categorised as 'retail' may prevent local authorities from making certain investments (eg private equity and infrastructure funds, and certain forms of derivatives). They felt this may increase investment costs, hamper investment returns, prevent effective risk management and result in having to purchase higher cost alternatives.

8.9 Finally, some asked for a definition of what a 'local public authority or municipality' is, and highlighted potential difficulties of distinguishing between treasury management and pension scheme administration business.

Our response on categorising local authorities as 'retail' or 'elective professional' clients

It is a MiFID II requirement that local authorities are categorised as 'retail' clients. We have chosen to exercise a discretion we have to set 'alternative or additional quantitative criteria' for local authorities requesting to be opted-up to professional client status. We discuss these criteria in the following sections.

We would note more generally that being a 'retail' client when receiving investment services is intended to provide appropriate additional protections, not necessarily to exclude parties from certain products or services. However, we recognise that this may be a practical consequence of the categorisation in some limited cases, due to the interplay with other regulatory requirements and/or the commercial decisions of investment firms.

A 'local public authority or municipality' is not defined in MiFID or MiFID II, given the many different types of these bodies across the EU. To ensure legal consistency with MiFID II, we will not introduce our own definition. It is our view that firms should be able to distinguish between treasury management and pension fund administration, given the need for pension funds to be separately recorded and funds held in segregated accounts. However, we recognise that investment firms may need to modify their processes to provide appropriate treatment to different functions of the same entity.

The opt-up process

8.10 Many firms and local authorities commented that, compared with being categorised as *per se* professional clients, the need to go through an opt-up process to become an elective professional client would be time-consuming, burdensome and costly. However, we received little challenge to our CBA or alternative assessments of the time, cost and burden involved with opting up.

8.11 Respondents thought that the process may be inconsistently applied in practice, leading to varied outcomes. A few queried our view that investment firms should apply the rules on client categorisation of local authorities as implemented in the client's jurisdiction, rather than that of the firm. They further noted that a non-harmonised approach would hamper the cross-border provision of services in the EU.

Our response on the opt-up process

It is a MiFID II requirement that local authorities are categorised as 'retail' clients, with the ability to opt-up upon satisfying a set of qualitative and quantitative criteria, using the procedure described. We recognise that having to opt-up to a professional client status, rather than automatically being a professional client, will involve some extra work from investment firms and their local authority clients. We looked at this as part of our CP16/29 CBA, and we received no new evidence to challenge our assumptions that the impact would likely be proportionate and relatively small.

We intend that the process and criteria for opting up should be clear and transparent, to make it as easy to apply as possible. The tests must be carried out by the investment firm and it will need to gather sufficient evidence to satisfy itself that the tests have been met in relation to each client. We recognise that individual firms may make different judgements about the same local authority client, but such judgements may be appropriate with respect to the qualitative test depending on the specific products or services a firm intends to offer.

The client categorisation rules in COBS 3 will apply to firms authorised to do business in the UK, and our rules are designed to give appropriate levels of regulatory protection to UK local authorities. MiFID II specifically allows for a non-harmonised approach to opting up

local authorities in different member states, depending on the specific needs of those clients in each jurisdiction. EEA member states are thus given discretion to set alternative or additional quantitative criteria to those in the fifth paragraph of Annex II (II.1) of MiFID II. Therefore, we continue to believe it is in line with the intention behind MiFID II that firms should defer to the criteria deemed appropriate for local government in the territory in which they are located. Where such member state discretion is not used, or the client is located in a third country, we would expect firms to use the quantitative test in the fifth paragraph of Annex II (II.1).

The qualitative test

8.12 Respondents supported the application of the qualitative test, as a broader assessment by firms on the expertise, experience and knowledge of their clients regarding the types of investment or service being offered and the risks involved. Many asked for more detail about how this should be applied in practice, including who (eg which individual(s) or group of individuals within an entity) needs to be assessed for this purpose.

8.13 Explanations were provided of typical arrangements for the governance of, and decision-making in relation to, local authorities' pension funds, including the role of elected officials on pension committees, section 151 officers[42], other staff and external advisors. Some respondents noted their adherence to the CIPFA Code of Practice for Treasury Management, which they suggested may help demonstrate treasury managers' ability to understand the risks of certain investments.

Our response on the qualitative test

MiFID II requires the qualitative test to be applied to local authorities seeking to opt-up to professional client status, with the test itself unchanged from MiFID. It is important that an investment firm is confident that a client can demonstrate their expertise, experience and knowledge such that the firm has gained a reasonable assurance that the client is capable of making investment decisions and understanding the nature of risks involved in the context of the transactions or services envisioned.

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

42 Section 151 of the Local Government Act 1972 requires appointment by a local authority of an officer who has responsibility for the proper administration of their financial affairs (eg, a chief financial officer).

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.

The quantitative test – approach for Local Government Pension schemes (LGPS)

8.14 Respondents particularly queried the need to re-categorise local authorities as retail clients under MiFID II in respect of their administration of their authorities' employee pension scheme. It was noted that although there had been previous failings in treasury management at some authorities as outlined in CP16/29, there were contrasting examples of successful and appropriate investment of local authority pension funds.

8.15 Information was provided on the LGPS of which larger authorities in England & Wales are members, with similar schemes in Scotland and Northern Ireland. Respondents also directed us to the LGPS Regulations[43] which make express provision for authorities being assisted to appropriately fulfil this role (eg the requirement to take 'proper advice'[44]). It was explained that in England and Wales, the LGPS is undergoing changes to create eight 'pooled' investment vehicles that would each invest on behalf of a number of local authorities to reduce costs and bring scale to investments. Further, the UK Government's hope that such funds would include increased investment in UK infrastructure was noted. There was a concern that MiFID II and our proposals would hold back or hamper the pooling agenda.

Our response on the quantitative test – approach for Local Government Pension Schemes (LGPS)

We recognise that local authority pension schemes are established within the framework of the LGPS Regulations and are subject to the oversight of the Pensions Regulator, as well as the broader public policy

43 Eg, The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016.
44 Ibid, Regulation 7.

goals of the pooling agenda. These measures have similar goals to those in MiFID II, such as ensuring that local authority pension schemes receive appropriate investment services, and that they understand the costs and risks involved with such service.

Some expressed concerns about interpreting the quantitative criteria in light of the common governance of local authority pension scheme administration, and recognise that the drafting of our proposed rules was not sufficient to achieve our policy intention of allowing all local authorities administering LGPS pension funds to have the ability to successfully opt up. 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. This will assist all local authority pension fund administrators who wish to opt-up to meet the quantitative test, but maintain the need for local authorities to qualitatively demonstrate their sophistication to become professional clients. We agree with views that compliance with the LGPS Regulations, including taking proper advice, will contribute to the assessment of knowledge and expertise of the local authority client when making decisions.

The quantitative test – undertaking 10 transactions on average per quarter

8.16 In CP16/29 we thought that in respect of local authority pension business, all local authorities (with the exception of a handful of internally managed funds) would not undertake an average of 10 transactions per quarter in their pension business. This is largely because local authorities investing pension fund money tend to invest in collective investment schemes or delegate management of their portfolio to an external portfolio manager, and this form of investment occurs infrequently.

8.17 It was also suggested that many treasury managers would not undertake 10 or more transactions per quarter, owing to their agreed budgeting and financing strategy. A few respondents felt that local authorities may be tempted to 'churn' their portfolio (buying and selling, and re-buying investments) in order to hit the 10 transactions per quarter level to achieve or retain elective professional client status.

Our response on the quantitative test – undertaking 10 transactions on average per quarter

We accept that some local authorities will not be able to meet this part of the quantitative test (particularly when investing pension funds). However, it continues to be our view that regular and recent experience of carrying out relevant transactions remains a useful proxy for assessing sophistication. We have received no arguments against this view, and so confirm that we will retain this test as one of the four available criteria for enabling a local authority body to opt up.

While theoretically this criterion could be 'gamed' by firms and clients by churning portfolios, we believe it is an unlikely course of action for local authorities who are accountable to the electorate and have specific statutory duties requiring prudent management of their financial affairs.[45] In future, we could scrutinise any firm who appeared to be recommending this course of action to its client and question whether the firm was acting in the client's best interest and whether the firm believed that an artificially higher number of trades contributed to the expertise, experience and knowledge of their client.

The quantitative test – employment in the financial sector for at least 1 year in a professional position

8.18 Many respondents expressed concern and confusion about how firms were supposed to apply the test that the client works or has worked in the financial sector for at least 1 year. In those responses, it was asked whether the test should apply to the local authority as a legal entity, the relevant local elected officials responsible for the decision, the section 151 officer, or the professional advisor.

8.19 Some questioned what constituted the 'financial sector' within our proposed rules. They noted that local authority staff in treasury or pension management functions are professional treasury managers and accountants, but have often not worked for FCA authorised firms, and elected officials typically are not expected to have experience working at financial institutions. Many also believed that the 'financial sector' was limited to the regulated financial sector, but noting that we did not define the term.

Our response on the quantitative test – employment in the financial sector for at least 1 year in a professional position

We accept we could be clearer about who this test is applied to, while ensuring it can be applied flexibly to different governance arrangements. We also recognise that employment in the financial sector is a criterion that can only apply to a natural person.

In response, we have amended the proposed drafting in COBS 3.5.3BR(b)(ii) to note that 'the person authorised to carry out transactions on behalf of the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the provision of services envisaged'. This should allow local authorities to delegate authority to make investment decisions on their behalf to professional staff with at least one year's experience. We recognise that this redrafted criterion may not be useful for assessing the collective decision making involved in investing local authority pension funds. However, we think this will be less problematic given our new fourth criterion aimed at LGPS administering authorities.

45 Section 12, Local Government Act 2003

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. This meets the purpose of the test, to ensure the person acting on behalf of a client has the expertise, experience and knowledge necessary in relation to the investment or service being sold and the risks involved.

The quantitative test – portfolio size threshold

8.20 In CP16/29, we asked:

- Q16: Do you agree with our approach to revise the quantitative thresholds as part of the opt-up criteria for local authorities by introducing a mandatory portfolio size requirement of £15m? If not, what do you believe is the appropriate minimum portfolio size requirement, and why?

8.21 We received a range of responses to this question extending from full support for the £15m mandatory portfolio size requirement to suggestions that the UK should not use its discretion provided and retain the default £500,000 threshold in Annex II (II.1) of MiFID II. A common alternative proposal was to set the threshold at £10m.

8.22 Many respondents quoted the size of their own financial portfolio balances, in relation to their treasury management activities and their pension fund administration. A number of respondents questioned the basic assumption of our analysis leading to the £15m threshold, and felt that this number restricted many more authorities than just small town and parish councils, with some believing it captured "half" of all local authorities.

8.23 It was noted that local authorities could 'game' this requirement by borrowing extra funds with which to invest, so as to meet the minimum threshold.

Our response on the quantitative test – portfolio size threshold

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.

We believe £10m is closer to our policy goal of restricting the ability of the smallest, and by implication the least sophisticated, local authorities (town and parish councils, and the smallest county and district councils) to opt-up, but giving larger ones the ability to do so more readily, (provided they meet the other criteria).

Based on the number of local authorities we estimated were investing in MiFID scope instruments and understanding the quoted portfolio size in the DCLG dataset for 2014/15, in CP16/29 we estimated that 63

additional local authorities would not be able to opt-up to professional client status for the purposes of engaging in MiFID business as a result of our consulted upon policy.

At a £15m portfolio size threshold, this increased to 78 additional local authorities which would not be able to opt-up to professional client status for the purposes of engaging in MiFID business when we used the new 2015/16 DCLG dataset.[46]

Applying the £10m threshold to data over the following years:

- 2014/15 – 27 local authorities would not be able to opt-up to professional client status; and the estimated one-off costs for investment firms would decrease from £1.7m to £0.8m and on-going costs from £0.8m to £0.3m.

- 2015/16 – 42 local authorities would not be able to opt-up, and the one-off costs for investment firms would decrease from £2.0m to £1.1m, and on-going costs would reduce from £0.9m to £0.5m.[47]

While a local authority's ability to borrow extra funds to 'game' this requirement may be possible, it is questionable whether local authorities would be able to justify this approach while at the same time making budgets and investment strategies available for public scrutiny.

Application to non-MiFID scope business

8.24 In CP16/29, we asked:

- Q17: Do you agree with our approach to extend these proposals to non-MiFID scope business? If not, please give reasons why.

8.25 Most respondents supported extension of our proposals to cover the provision of non-MiFID scope investment services to local authorities, on the proviso that we establish a sensible and workable regime. A minority felt that we should not extend our approach to non-MiFID business given the limits of our approach as set by MiFID II, which they believed to be inappropriate. These respondents typically favoured retention of the automatic 'per se' professional client categorisation of a 'local authority or public authority' as a large undertaking under COBS 3.5.2R(3)(f). Similar comments were made in response to Q26 in CP15/43 regarding a change to the client categorisation of local authorities for MiFID and non-designated investment business in relation to the application of PRIN.

46 The 2015-16 DCLG data did not become available until after the publication of CP16/29. Now available here: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/612305/Borrowing_and_Investment_Live_Table_Q4_2016_17.xlsx

47 Where respondents quoted that "half" of all local authorities would be unable to opt-up to professional client status, we believe this refers to the absolutely number of local authorities potentially impacted, rather than only those who are currently believed to use MiFID services but may not be able to in the future.

Our response on the application to non-MiFID scope business

Given most support our proposal and view that clients receiving similar investment products or services should receive similar protections, we will extend the same criteria for the categorisation of local authority clients to MiFID and non-MiFID investment business. We believe this establishes common criteria, and requires investment firms to provide retail investor protections to local authorities, unless following an assessment they find that the client is sophisticated enough to understand the nature and risks of the proposed investments as professional clients. We believe we have addressed questions about the clarity of the application of our rules, as noted above.

Principles for Businesses (PRIN)

8.26 In CP15/43, we asked

- Q26: Do you agree with our proposal to update PRIN 1 Annex 1 to delete the possibility of local authorities being treated as ECPs for the purposes of PRIN in respect of non-designated investment business? If not, please give reasons why.

8.27 Respondents to this question made similar comments and expressed similar concerns to those that were made to Q16 of CP16/29. These included concerns about transitional arrangements for re-categorising local authority clients, who may no longer be eligible counterparties. On balance, most respondents supported this proposal and felt that it was appropriate to apply consistent treatment in respect of MiFID and non-designated investment business when applying PRIN.

Our response on the Principles for Businesses (PRIN)

Considering all feedback received to both consultations, we have decided to apply our changes to PRIN 1 Annex 1 to both designated and non-designated investment business. This means that local authorities should not be considered as eligible counterparties for the purposes of those rules. We discuss transitional arrangements below. As noted above, we continue to believe that clients receiving similar investment products or services should receive similar protections, particularly between MiFID and non-MiFID investment business and we set out our case for this in CP16/29.

Transitional arrangements

8.28 Although we did not cover the issue of transitional arrangements in CP16/29, many respondents requested an appropriate transitional arrangement so that firms would have time to assess their local authority clients after 3 January 2018. Additionally, they questioned whether, if an existing investment product had been previously sold or

service provided, they would need to sell the assets or cease the service if the client could not be opted-up under the proposed new criteria.

Our response on transitional arrangements

MiFID II gives us very limited discretion with regard to transitional arrangements for applying these rules in respect of local authorities and provides no ability to extend the deadline for compliance with this requirement beyond 3 January 2018. We consulted in CP16/43 on proposed transitional arrangements that would allow investment firms to re-assess the categorisation of local authority clients between the 3 July 2017 implementation deadline and 3 January 2018. These proposals are being taken forward (see Chapter 24). However, firms will not be expected to re-consider categorisation of existing clients other than local authorities, where MiFID II rules are the same as existing MiFID rules transposed at COBS 3.

Otherwise, we have made further consequential drafting changes to transitional provisions at COBS TP 1 that were added when MiFID was implemented in 2007, but that are no longer carried across into MiFID II.

More generally, COBS 3.5.8G notes that professional clients have the responsibility to keep investment firms informed about any changes that affect their current categorisation. Further, at COBS 3.5.9R, if the firm becomes aware that the client no longer fulfils the initial conditions that made the client eligible to be an elective professional client, it must take "appropriate action". Neither MiFID II, nor our rules specify what 'appropriate action' is, which will depend on the facts of the case and what would be in the client's best interest. Firms must exercise judgement and consider what would be in the best interests of the client. For example, if a client no longer meets the quantitative test to opt up to professional client status, a firm may decide it is appropriate to cease providing investment services but to do so in a way that minimises losses to the client.