

Title: Markets in Financial Instrument Directive 2014/65 – Professional Client Election
Contains Confidential or Exempt Information?: <i>NO - Part I</i>
Member reporting: Councillor Lenton, Chairman Berkshire Pension Fund and Pension Fund Advisory Panels
Meeting and Date: Berkshire Pension Fund and Pension Fund Advisory Panels – 11 September 2017
Responsible Officer(s): Nick Greenwood, Pension Fund Manager
Wards affected: None

REPORT SUMMARY

1. This report outlines 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.
2. It recommends that the Panel agree that elections for professional client status should be made immediately.
3. It also recommends that delegated authority be granted to the Pension Fund Manager and the Investment Manager to complete all and any documentation required for completing elections for professional client status.

1. DETAILS OF RECOMMENDATION(S)

RECOMMENDATION: That Panel notes the report and:

- i. **Notes the potential impact on investment strategy of becoming a retail client with effect from 3rd January 2018.**
- ii. **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.**
- iii. **In electing for professional clients status, the committee acknowledges and agrees to forgo the protections available to retail clients attached as Annex 1.**
- iv. **Agrees to grant delegated authority to the Pension Fund Manager and Investment Manager for the purposes of completing the applications and determining the basis of the application as either full or single service.**

2. REASON(S) FOR RECOMMENDATION(S) AND OPTIONS CONSIDERED

- 2.1 Under the current UK regulatory 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’.
- 2.2 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.
- 2.3 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

- 2.4 A move to retail client status (see Annex 1) would mean that all financial services firms such as 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.
- 2.5 Such protections would come at the price 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.
- 2.6 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

- 2.7 MiFID II allows 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.
- 2.8 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 Financial Conduct Authority to make the test better fitted to the unique situation of local authorities.
- 2.9 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.
- 2.10 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 will 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.
- 2.11 The Local Government Pension Scheme Advisory Board (SAB) and the LGA have worked with industry representative bodies including the Investment Association (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 although at the end of the day it is up to individual financial institutions what documentation they require. It is by no means certain that our managers will require this template to be completed as most will have developed their own questionnaire.
- 2.12 An example of the opt-up letter that a manager may require completing is attached as Annex 2.
- 2.13 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. Officers recommend that opt-ups are made for all services offered by the institution.
- 2.14 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 Panel or Investment Working Group changed significantly resulting in a loss of experience.

LGPS Pooling

- 2.15 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. Officers will clarify this position with Local Pensions Partnership (LPP).
- 2.16 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.

Next steps

- 2.17 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 which the authority has an existing or potential relationship with in relation to the investment of the pension fund.
- 2.18 This process should commence as soon as possible in order to ensure it is completed in good time and avoids the need for appropriate action to be taken by institutions in relation to the authority's pension fund investments.
- 2.19 Officers request that the Pension Fund Manager and Investment Manager are granted delegated authority to make applications to opt-up on a full service basis on RBWM's (as administering authority for the Pension Fund) behalf.

Table 1: MiFID II options

Option	Comments
Do not opt-up to Professional Client Status	Not recommend as this would impact adversely on the Fund's investment strategy (no access to private equity, infrastructure funds)
Opt-up to Professional Client Status on a "single service" basis	Not recommended as this would require new opt-ups for any additional services requested from a financial institution
Opt-up to Professional Client Status on a "full service" basis	Recommended as this gives the maximum flexibility to the Fund

3. KEY IMPLICATIONS

- 3.1 MiFID II is a European Union directive designed to give additional protection to retail clients when purchasing "complex" financial products. The Financial Conduct Authority has ruled that local authorities should be treated as retail clients unless they opt-up to professional client status having met certain

criteria; however, they have agreed that administering authorities can opt-up in respect of their pension funds based solely on their status as an administering authority.

- 3.2 Failure to opt-up to professional client status will restrict the ability of the Fund to invest in private equity, infrastructure, commodity, private debt and other “complex” funds. This would have an adverse impact on the Fund’s ability to maintain its investment strategy and could result in forced sales (probably at prices below fair value) of existing investments.

4. FINANCIAL DETAILS / VALUE FOR MONEY

- 4.1 None/Not Applicable

5. LEGAL IMPLICATIONS

- 5.1 MiFID II is a European Directive

6. RISK MANAGEMENT

- 6.1 The key risk is that non-compliance with MiFID II or the failure to opt-up to professional client status will not only impact on the Fund’s ability to maintain its investment strategy but may also result in the forced sale of assets at prices substantially below their true value.

7. POTENTIAL IMPACTS

- 7.1 Not Applicable

8. CONSULTATION

- 8.1 This report is based on a template provided by the LGPS Scheme Advisory Board

9. TIMETABLE FOR IMPLEMENTATION

- 9.1 **Table 5: Timetable**

Date	Details
Immediate	Issue of Opt-up Letters
3 January 2018	MiFID II comes into force

Annex 1 - 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.

Annex 2 - Example Opt-up Letter requesting categorisation as an elective professional client

[ON [AUTHORITY] HEADED PAPER]

[Manager name]

[Manager address]

[Date]

Dear [●]

Request to be treated as a professional investor

I am writing to you ahead of the implementation in the UK of the Markets in Financial Instruments Directive (2014/65/EU) (MiFID II). I have been authorised by NAME OF AUTHORITY (the “Local Authority”) to inform you that, in its capacity as an administering authority of a local government pension scheme, it wishes to be treated as a professional client for the purpose of:

(a) any and all investment service(s) which it receives from you (the “Services”); and/or

(b) the promotion to us of, and investment in, any and all fund(s) managed or advised by you (the “Fund Promotions/Investments”).

We understand you are required to categorise all of your clients as either professional clients or retail clients and that you currently categorise the Local Authority as a Professional Client (“Professional Client”). However as of 3 January 2018, under new rules deriving from MiFID II, you will be obliged to re-categorise the Local Authority as a Retail Client (“Retail Client”) as regards receiving Services from you and/or as regards existing fund investments and any future Fund Promotions/Investments, unless you are satisfied you can otherwise treat the Local Authority as an elective Professional Client and opt-up the Local Authority to this particular client status.

I confirm and acknowledge that the Local Authority is aware that, being categorised as a Professional Client, it will not benefit from the protections and investor compensation rights set out in more detail in Schedule 1. In doing so, I confirm that the Local Authority has reviewed and considered the loss of these protections and rights very carefully and has, if it felt so appropriate, taken advice from legal, financial or other advisors.

I wish to inform you that the Local Authority wishes to be categorised as a Professional Client for the purposes of the Services and/or Fund Promotions/Investments, as applicable in its capacity as an administering authority of the Local Government Pension Scheme.

Prior to re-categorising the Local Authority, as a Professional Client, I understand that you will be required to assess the Local Authority on certain quantitative and qualitative grounds.

Subject to you being reasonably assured that, as of 3 January 2018, the Local Authority satisfies the necessary quantitative and qualitative grounds and may be categorised as an elective Professional Client, the Local Authority confirms the following:

- (a) its request to be categorised as a Professional Client, in its capacity as an administrating authority of the Local Government Pension Scheme, in relation to the Services and/or Fund Promotions/Investments.
- (b) all information provided to you by us (for the purposes of facilitating your assessment of the Local Authority's request to be categorised as a Professional Client) is true, accurate and complete.
- (c) the Local Authority understands the contents of Schedule 1 which contains summaries of the protections and investor compensation rights, if any, that the Local Authority will lose once it is categorised as a Professional Client. Please note that I can confirm that the Local Authority is fully aware of the consequences of losing such protections and still wishes to apply to be categorised as Professional Client in respect of the Services and/or Fund Promotions/Investments.
- (d) the Local Authority has had sufficient time to consider the implications of categorisation as a Professional Client and has separately taken any legal, financial or other advice that it deems appropriate.
- (e) the Local Authority will inform you of any change that could affect its categorisation as a Professional Client. I also confirm that the Local Authority understands its responsibility to ask you for a higher level of protection if it is unable to properly assess or manage the risks involved with the investments comprised within the portfolio management mandates which you have been appointed to manage.
- (f) I acknowledge the Local Authority understands that you shall be permitted, in your sole discretion and without providing any reason, to re-categorise the client as a Retail client or cease to provide the Services or otherwise carry out any fund promotion to us or allow future investment in funds by us.

If you have any questions regarding this application please contact [name] on [number] or alternatively e-mail us at [email address].

Yours sincerely,

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[insert name and position] [Authority]