

**Investment, Governance and Engagement
Committee
5 December 2016**

MIFID II Consultation Response

The FCA issued a third consultation paper on MIFID II in July 2016 with comments invited by 4 January 2017. A draft response (at Annexe A) is attached for the committee's consideration.

Report

1. The main points in the draft response include :-

- The re-classification of local authorities as retail investors is unnecessary;
- Pension fund authorities are already regulated by secondary legislation which requires them to take proper advice when making investment decisions;
- Properly considered investment strategies will be placed at serious risk;
- Elected professional status will be a time consuming process and may not provide fund authorities with an effective route to professional status;
- The proposed quantitative test represents a serious challenge to all but a small handful of internally managed funds, and
- The proposals fail to recognise the decision making process of those responsible for making investment decisions.
- Asset pools could provide an alternative to elected professional status with assistance from FCA

The committee is asked to approve the draft response for consideration by the Board.

FCA consultation

Proposed response

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?

Summary

We are strongly of the opinion that:

- the reclassification of local authorities as retail investors is unnecessary and will have serious consequences for the effective implementation of pension fund investment strategies..
- The elective professional status process is not appropriate for local authorities and will require adapting to effectively assess their decision making structures
- Collective Investment Schemes can provide an appropriate route to the range of instruments needed by local authorities and with the assistance of FCA could negate the need to undergo the elective professional process
- Clarity is needed with regard to transactions made prior to 3rd January 2018

Classification

1. Before addressing the opt up criteria we would wish to state our disappointment that the reclassification of local authorities as retail investors is taking place. Local authorities in the UK have a robust track record of effective risk management with regard to investment and in respect of their pension funds considerable experience across a wide range of asset classes.
2. Furthermore investment by local authorities for pension fund purposes are subject to regulation (SI 2016 No. 946 PUBLIC SERVICE PENSIONS, ENGLAND AND WALES The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016) which include the requirement to take 'proper advice' when appointing investment managers.
3. This re classification will in our view place local authorities at a significant disadvantage when implementing properly considered and constructed investment strategies. In particular the reclassification to retail client status:
 - Will prevent authorities accessing the full range of asset classes and vehicles they currently use to execute investment strategy
 - Is inconsistent with the 'prudent person' approach provided for in the LGPS investment regulations 2016
 - Is inconsistent with the Government's desire for greater infrastructure investment by local authority pension funds
4. The provision for elected professional status, although potentially mitigating the impact of the reclassification, will result in authorities having to go through a significant and time consuming process which, depending on the nature of its application by managers, provides no guarantees that future investment strategies will be able to be effectively executed with existing managers or on existing terms.
5. Finally the timing of the shift of classification provides a significant challenge to the introduction, at the instigation of the Government, of asset pooling for local authority pension funds.

Election for professional status

6. Although the question refers only to the revised quantitative test we would wish to comment on the complete election process. We do not consider that the process as it stands provides local authorities with an effective route to professional status in regard to their pension fund activities.

Qualitative test

7. The qualitative test states that:
firms must undertake an adequate assessment of the expertise, experience and knowledge of the client to give reasonable assurance in light of the nature of the transactions or services envisaged, that the client is capable of making his own investment decisions and understanding the risks involved (COBS 3.5.3R(1))
8. The existing COBS 3.5.4 states that
If the client is an entity, the qualitative test should be performed in relation to the person authorised to carry out transactions on its behalf.
9. Local authorities have structures of delegation and internal controls designed to ensure proper decision making, risk management and execution.
10. With regard to pension fund investments the decision to invest in a particular asset class or vehicle or to engage a firm will normally be made by a committee acting on behalf of the council. Investment decisions are a function of the local authority with pension fund responsibilities and as such, can only be discharged by a committee constituted under Section 101 of the Local Government Act 1972 or by an officer given delegated authority to make such decisions. Section 101 committees consist of elected members with support from officers of the council, statutory advisors and consultants.
11. The transaction itself would normally be executed by an officer with delegated authority to enact the decision of the committee.
12. When assessing a local authority for this test, firms should be able to do so in a consistent manner that reflects the decision making process and governance arrangements which led to the transaction. There is a concern that the wording of COBS 3.5.4 would lead to the assessing of the individual who executes the transaction on behalf of the council and not those who made the decision to enter into the transaction.
13. We would therefore ask that COBS 3.5.4 be amended to enable firms to assess collectively *the expertise, experience and knowledge* which resulted in the decision by the local authority as a body corporate to enter into the transaction.
14. Such an assessment would reflect the collective principle proposed for passing the 'fit' requirement in IORP II Article 23 1 (a) as below:

(i) for persons who effectively run the IORP, this means their qualifications, knowledge and experience are collectively adequate to enable them to ensure a sound and prudent management of the IORP;

Quantitative test

15. The quantitative test (based on COBS 3.5.3R(2)) requires that the criteria in paragraph (a) and the criteria in either paragraph (b) or (c) must be satisfied:
(a) the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds £15,000,000

(b) the client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters
(c) the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged

16. The first will be satisfied by local authorities in respect of pension fund activities however, except in very particular circumstances, the second will not. The LGPS Advisory Board's investigations in this area indicated that only 3 LGPS funds (all with internal investment operations) would have any possibility of meeting this test.

17. This means that local authorities must be able to pass test (c) in order to successfully complete the opt up process. As with the qualitative test the uncertainty lies in who is being assessed. COBS 3.5.4 does not apply therefore it is 'the client' against whom the assessment is made.

18. COBS 3.2 defines a client as

- (1) A person to whom a firm provides, intends to provide or has provided:*
(a) a service in the course of carrying on a regulated activity; or
(b) in the case of MiFID or equivalent third country business, an ancillary service..

19. The Handbook Glossary defines a person as

(in accordance with the Interpretation Act 1978) any person, including a body of persons corporate or unincorporate (that is, a natural person, a legal person and, for example, a partnership).

20. A local authority is a corporate body therefore the above would lead to the conclusion that the assessment in (c) should be against that body corporate. However the wording of (c) does not comfortably fit with that conclusion as it reads as if the firm should be assessing an individual. Although a local authority as a body corporate can possess *knowledge of the transactions or services envisaged* how can it work *in the financial sector for at least one year in a professional position?*

Pooled assets

21. Since November 2015, local authorities have been developing asset pools at the behest of Government. These pools will have a number of different structures and will therefore be subject to different impacts from the reclassification.

22. Where pools are operating Collective Investment Schemes they have already or are considering setting up Qualified Investor Scheme fund structures in order to access the wide range of asset types necessary to effectively implement local authority pension fund investment strategies.

23. COLL 8.1.3 R states that the manager of the QIS *must take reasonable care to ensure that ownership of units in that scheme is recorded in the register only for a person to whom such units may be promoted under COBS 4.12.4R.*

24. COBS 4.12.4R sets out the exemptions from 4.12.3 which states that retail clients should not be sold *non-mainstream pooled investments*. There are 13 exemptions including elected professional clients (exemption 7) and certified and self-certified sophisticated investors (exemptions 8 and 9) each of which could provide a means of local authorities accessing the full range of assets offered by the pool.

25. However all the exemptions listed above include a level of uncertainty with regard to the required assessments and the potential for inconsistent application. We therefore request that FCA ensure that asset pools can provide an effective point of access for local authority pension funds, in line Government policy objectives, by listing them as an exemption in their own right.
26. This would result in local authorities being able to invest in a full range of assets via Collective Investment Schemes without having to undergo an elective process. The elective process would still be required where authorities continue to invest outside of pools or where pools do not operate Collective Investment Schemes.

Transitional issues

27. Local authorities will become retail clients on 3rd January 2018. There will be a transitional period (which in some cases will be years) before investments are switched to the pools and/or the authority successfully elects for professional status.
28. Firms and local authorities need clarity with regard to transactions made before that date as per se professional clients which could not be made after it as retail clients. FCA are therefore requested to provide reassurance that such transactions may be honoured and will not have to be terminated on 3rd January 2018.

JH 18.11.2016