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Sixty second summary

MiFID II, July 2017 update

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The Financial Conduct Authority ("FCA") has now issued its final policy statement setting out the rules for implementation of the Markets in Financial Instruments Directive ("MiFID II"), effective from 3 January 2018. A key change is that there is now greater clarity in the "opt-up" criteria that is expected to make it easier for local authorities administering LGPS pension funds to elect to be treated as "professional" (rather than "retail") clients.

The MiFID journey so far

The European Commission instigated a review of MiFID due to increasing complexity of financial products and issues related to the 2008 financial crisis. The outcome of the review was a revised Directive, MiFID II, which is to take effect from 3 January 2018.

During 2016 and early 2017, the FCA consulted on the implementation proposals for MiFID II. On 3 July, the FCA published a policy statement setting out the final rules on a number of matters.

July policy statement

The FCA reiterates that it is a MiFID II requirement for local authorities (currently treated as professional) to be classified as retail clients by default. Under such a classification LGPS Funds would face a reduced investment opportunity set and the potential need to offload assets in advance of MiFID II coming into effect. However, the FCA has acknowledged this and, recognizing that the LGPS already has its own governing regulations and oversight bodies, has revised its criteria for opting-up with the aim of making "it easier for local authorities investing on behalf of a LGPS pension fund to opt-up to professional client status".

Opting-up criteria

The opt-up criteria will continue to be a combination of quantitative and qualitative "tests".

Quantitative test

To pass the quantitative test, local authorities must meet a portfolio size requirement of £10m, (this amount reflects a lowering of the previous portfolio size threshold of £15m). The FCA thinks that £10m is more suitable to its policy goal, which is "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)." **AND**

One of the following tests (noting that iii has been newly added):

i. the client has carried out transactions, in significant size, on the relevant market at an average frequency of ten per quarter over the previous four quarters; or
ii. 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; or
iii. the client is an 'administering authority' of the Local Government Pension Scheme within the meaning of the version of Schedule 3 of The Local Government Pension Scheme Regulations 2013 or, (in relation to Scotland) within the meaning of the version of Schedule 3 of The Local Government Pension Scheme (Scotland) Regulations 2014 in force at 1 January 2018, and is acting in that capacity.

Given the scale of the LGPS we anticipate that the administering authorities of all LGPS Funds will satisfy at least two of these quantitative criteria and therefore pass the test.

Qualitative test

The qualitative test remains unchanged, requiring:

"Adequate assessment of the expertise, experience and knowledge of the client that gives 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."

However, the final policy statement acknowledges the typical LGPS governance arrangements (including the role of the elected committees) and states the following:

"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."

We support the use of a more collective assessment, as the qualitative test now reflects more closely how an LGPS fund typically operates. We also support the FCA's statement that adherence to CIPFA Codes (and other training) will help local authorities demonstrate their knowledge and expertise. In line with this, we strongly encourage local authorities to review their approach to recording learning and development activities.

Transitional arrangements

The FCA says that it has limited discretion with regard to transitional arrangements. Given this, it is important that any Funds that are invested in asset classes that are deemed as being unsuitable for retail investors are upgraded to professional client status before 3 January 2018 - therefore should treat this as a priority.

Ongoing updates

The FCA notes that professional clients have a responsibility to keep investment firms informed about any changes that affect their current categorisation. It also notes that if a client no longer fulfils the initial conditions that made it eligible to be opted-up to professional, "appropriate action" must be taken, highlighting that judgement must be made as to what action may be appropriate.

Summary and next steps

We view it positively that the FCA's final Policy Statement gives greater clarity regarding LGPS Funds and what actions must be taken for local authorities to be opted-up to professional status. We also understand that the LGA is developing a reporting template with the Investment Association that should simplify the opting-up process for investment managers. We are also discussing this matter to see if a similar approach can be adopted for investment advisors. We will be in touch in the near future regarding this matter. In the meantime, we recommend that you make contact with your investment stakeholders to confirm their requirements for opting-up to professional.