Agenda Item 9

MiFID 2 and Opting Up for Professional Status

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FALKIRK COUNCIL

Subject: **MiFID 2 and Opting Up for Professional Status**

Meeting: **Joint Meeting of Pensions Committee and Pension Board**

Date: **24 August 2017**

Submitted by: **Director of Corporate and Housing Services**

1. Purpose of Report

1.1 This report highlights the impact of MiFID 2 - the Markets in Financial Instrument Directive 2014/65 - being applied to UK law from 3 January, 2018. In particular, it outlines the risk to the Pension Fund in being treated as a retail client by Fund Managers and recommends that the Fund should “opt up” for professional client status.

2. Recommendations

2.1 The Pensions Committee and Board are invited to note the potential impact of MiFID 2 being incorporated into UK law on 3 January 2018.

2.2 The Pensions Committee is asked to agree to applications for professional client status being submitted to all relevant institutions; and

2.3 The Pensions Committee is asked to note that in electing for professional client status, the Fund will forgo certain protections available to retail clients as outlined in Appendix 1.

3. Background

3.1 Under the existing UK regime, local authority pension funds are generally categorised as professional clients. From 3 January 2018, this will no longer be the case. Instead, local authorities funds will be classified as “retail clients” unless they are opted-up by firms to what is called an “elective professional client” status.

4. Potential impact

4.1 Under MiFID 2, retail clients are provided with a higher level of protection than professional clients. This includes the financial institution having to ensure that investment products are suitable for the client's needs, and that all risks and product features have been fully explained. Many institutions currently servicing the Local Government Pensions industry are not authorised to deal with retail clients and may not wish to undergo the required changes in order to do so.

4.2 For local authority pension funds, being a retail client would mean not being able to access the wide range of assets and financial institutions needed to implement an effective, diversified investment strategy.

4.3 Even if the institution in question secured the ability to deal with retail clients, the range of instruments it could make available to the client would be limited to those defined under Financial Conduct Authority (FCA) rules as 'non-complex' and would therefore exclude many of the asset classes currently included in fund portfolios.

5. Election for professional client status

5.1 MiFID 2 allows for retail clients who meet certain conditions to elect "opt up" to professional client status. There are two tests which must be met by a client when being assessed by the financial institution - the quantitative and the qualitative tests.

5.2 The Scheme Advisory Board (SAB) in England and Wales, the Local Government Association (LGA), Department of Communities and Local Government (DCLG) and the Investment Association (IA) have successfully lobbied the Financial Conduct Authority (FCA) to make the tests better fitted for local authority pension funds.

5.3 The FCA now accepts that LGPS funds meet the quantitative test by virtue of their structure and regulatory framework, whilst the qualitative test (i.e. the ability of a client to understand an investment vehicle) can now be assessed against the Fund collectively rather than being an assessment of one person's skills and knowledge.

5.4 The recent change to the Fund's governance arrangements, whereby recommendations on investment strategy are made through a Joint Investment Strategy Panel with Lothian Pension Fund, should be very helpful in demonstrating that the Falkirk Fund meets the qualitative test.

5.5 Failure to complete the opt up to professional status by 3rd January 2018 would result in a financial institution having to take 'appropriate compliance action' which could include a termination of the relationship at a significant financial risk to the Fund.

5.6 The Scheme Advisory Board (SAB) in England and Wales and the LGA have been working with industry representatives to develop a standard opt-up process to prevent authorities having to submit a variety of information in different formats.

5.7 Going forward, Funds will be required to notify managers of any changes in circumstances which could affect their client status (e.g. if there was a significant loss of expertise or knowledge from the Fund).

6. Implications

Financial

6.1 Failure to opt up for professional status could limit the range of financial products into which the Fund can invest; prevent the Fund's investment strategy being delivered; increase risk through limiting diversification and ultimately damage returns.

Resources

6.2 The process of opting up – both initially and in respect of any new mandates - involves an additional administrative overhead.

Legal

6.3 None.

Risk

6.4 Failure to complete the opt up process by 3 January, 2018 could result in the Fund's managers' terminating mandates on the grounds of non-compliance with MiFID 2.

Equalities

6.5 None.

Sustainability/Environmental Impact

6.6 None.

7. Conclusion

7.1 The MiFID 2 directive comes into effect on 3 January 2018. In order to continue to deliver its investment strategy, applications to "opt up" for professional status should be submitted to those parties undertaking regulated FCA activities for the Fund.

7.2. Subject to approval being granted, the application process can begin immediately to enable applications to be submitted and agreed by the January 2018 deadline.

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Date: 14 August 2017

Appendices

Appendix – Loss of Protections as Professional Client

List of Background Papers:

None

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.