The FCA are consulting on their third set of implementation proposals for MiFID II and are seeking views on the proposed changes to the FCA Handbook.

MiFID II takes effect from 3 January 2018 and the proposed changes to the FCA Handbook will have significant implications for LGPS administering authorities.

The full consultation document can be found on the FCA website.

The SAB will be responding to the consultation before the closing date of 4 January 2017 and encourage LGPS administering authorities to do likewise; either by sending comments to liam.robson@local.gov.uk, or by responding to the FCA directly.

1. Implications for LGPS administering authorities

- The implications for LGPS administering authorities are dealt with specifically in chapter 4 of the consultation paper (extract overleaf)
- Local authorities, including for the purposes of administering LGPS pension funds, will be re-classified as retail clients; currently they are per se professional clients
- There will be an option for local authorities to opt-up to professional client status (‘elective professional clients’) with individual asset managers in order to continue ‘complex’ investments
- The opt-up procedure will include both a qualitative and quantitative test (see paragraph 4.13 of the extract overleaf)
- It is proposed that the opt-up criteria will be applied separately for local authorities depending on the capacity in which they are acting (i.e. either as treasury managers or as pension fund administrators)
- The FCA believe that where a local authority opts-up to elective professional client status their ability to access financial markets will not be fundamentally affected
- The move to pooled asset structures will have an impact on the implications

2. What actions should LGPS administering authorities take?

- Assess their status against the opt-up criteria noting that:
  - the qualitative test should be performed in relation to the person authorised to carry out the transactions on its behalf
  - administering authorities may not be able to meet criteria (b) of the quantitative test unless there is an in-house investment function
• Determine if current asset managers are willing and able to continue dealing with the administering authority on a retail basis, and if so, what instruments will be available

• Discuss with individual asset manager’s their approach to dealing with clients who have opted-up from retail to elective professional client status; some asset managers have a policy of not dealing with elective professional clients and each manager may take a different view on the interpretation of the qualitative test

3. Implications for pooling

• To assess the implications for their proposed asset pool administering authorities should determine the relationship between themselves, the pool and the external managers to see at what point the proposed changes will impact. For example:

  o If the administering authority is the client of the pool they will need to check that the pool can allow for ‘large investors’ to avoid the need to opt-up
  o If the pool cannot allow for ‘large investors’ the administering authority should check on what basis the pool can offer access to investments and what approach to opting-up will be taken by the pool
  o Where a direct client relationship will continue to exist between the administering authority and the asset manager(s):
    i) The FCA implies that as the test for retail clients is at a point of sale, assets already held by retail clients, which would under MiFID II have to be classed as professional, may or may not pass the transition period from January to March 2018;
    ii) For segregated mandates or exemptions from pooling, the actions set out in section 2 above should be followed

Extract from the consultation on the implementation of MiFID II Chapter 4 – Client categorisation

Who should read this chapter?
Firms conducting MiFID or equivalent third country business, and firms conducting non-MiFID business, local authorities and other public sector bodies.

Introduction
4.1 This chapter outlines our implementation approach to changes to the existing client categorisation regime introduced by MiFID II. The MiFID regime uses client ‘categories’ to recognise that investors have different levels of experience, knowledge and expertise, and it tailors regulatory protections accordingly.

4.2 The financial crisis highlighted limits in the ability of non-retail clients to fully appreciate investment risks. To address this, MiFID II introduces a number of key changes to the existing client categorisation regime. These include the extension of
additional conduct of business requirements to business with Eligible Counterparties (ECPs).

4.3 MiFID II seeks to increase regulatory protections for public bodies, specifying that only certain types of public body can be categorised as ECPs. It clarifies that elective professional clients will no longer be able to request treatment as ECPs and introduces new procedural requirements to be adhered to by firms when opting-up clients to become ECPs (including written confirmation, investor warnings).

4.4 Finally, MiFID II categorises local authorities as retail clients by default, with the ability to opt-up to professional client status (“elective professional clients”). We also have discretion to adopt alternative or additional criteria to assess the expertise and knowledge of local authorities requesting treatment as professional clients.

4.5 The paragraphs below set out our proposed approach to implementation for both MiFID and non-MiFID scope designated investment business, including where we propose to exercise discretion with respect to local authorities.

Existing provisions
4.6 Our Handbook rules on client categorisation are set out in COBS 3.

4.7 The client categorisation rules also apply to non-MiFID scope business, with some exceptions. For example, the ‘quantitative test’ for opting-up to professional client status in COBS 3.5.3R (2) does not apply to non-MiFID scope business.

4.8 Currently, national governments, including public bodies that deal with public debt, may be categorised, for the purposes of carrying out ECP business, as per se ECPs under COBS 3.6.2R(8). National or regional governments, and public bodies that manage public debt, may be categorised as per se professional clients under COBS 3.5.2R(4).

4.9 COBS 3.6.4R(1)(b) allows elective professional clients to opt-up to ECP status for either MiFID or non-MiFID scope business. COBS 3.6.6R allows firms to obtain the client’s confirmation that it wishes to be treated as an ECP, either in the form of a general agreement or for each individual transaction. However, for MiFID scope business, firms must also obtain express confirmation that the client agrees to be treated as an ECP.

4.10 Local authorities are categorised, for the purposes of MiFID scope business, as per se professional clients where they meet the MiFID Large Undertakings test in COBS 3.5.2R(2). If they do not satisfy this test, they are categorised as retail clients but may opt-up to professional client status if they fulfil the ‘opt-up criteria’ in COBS 3.5.3R. For non-MiFID scope business, local authorities are automatically categorised as per se professional clients under COBS 3.5.2R(3)(f).

Proposals
4.11 In line with MiFID II, we will amend COBS 3.6.2R(8) 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 ECP. We will also amend COBS 3.5.2R(4) to 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.

4.12 To give effect to MiFID II’s bar on opting-up elective professional clients to ECP status, we intend to delete COBS 3.6.4R(1)(b). We will also insert new text to implement the new procedural notification requirements (written confirmation, investor warnings) for firms who opt-up per se professional clients to ECP status.

4.13 To give effect to MiFID II’s retail categorisation of local authorities, we intend to delete COBS 3.5.2AR. We also propose to exercise our discretion to introduce either additional or alternative quantitative opt-up criteria for local authorities. Under our proposals, firms would be required to apply the following tests and procedural steps when opting-up local authority clients to professional client status:

• The qualitative test; firms must undertake an adequate assessment of the expertise, experience and knowledge of the client¹ 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))
• A re-calibrated quantitative test (based on COBS 3.5.3R(2)) – 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
• The procedural requirements in COBS 3.5.3R(3).

4.14 We propose to also clarify that the retail categorisation will apply to local authorities who act as pension fund administrators in the same way as it will to those acting in their main capacity, ie as treasury managers. The first of these refers to the portfolio management activities of administering entities of the local government pension scheme, the vast majority of which typically form part of the local authority (on behalf of which it manages staff pension funds). Accordingly, local authorities acting in this capacity will be able to opt-up under the same conditions as local authorities acting in their main capacity as treasury managers (as set out in the previous paragraph).

4.15 However, firms will be required to categorise the local authority separately depending on the capacity in which it is acting (ie either as treasury manager or a pension fund administrator), and apply the opt-up criteria in paragraph 4.13 separately to each business line. As such, when firms categorise local authorities acting in their main capacity as treasury managers, the quantitative test would not include the assets of the pension fund, which should be considered separately.

¹ COBS 3.5.4 (R) 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.
Equally, when categorising local authorities acting in their capacity as the administrator of a pension fund, the quantitative test would be applied only to the assets of the pension fund. So the assets from the treasury management function would not be included within the quantitative assessment.

4.16 Where firms provide MiFID or equivalent third country business to local authorities and municipalities located in another EU Member State or an EEA State, we propose that firms should defer to the status of the local authority or municipality as determined by the law or measures of the EU/EEA state in which that undertaking is established. For example, a UK firm carrying out business with, for example, a French local authority should categorise the local authority according to the specific criteria applied in that Member State.

4.17 We also propose, as explained in the Discussion section of this chapter below, to extend the MiFID II requirements (including in our exercise of discretion) to non-MiFID scope business including business conducted by Article 3 firms. We propose to apply all of the following to non-MiFID scope business:
- the narrowing of the scope of clients who can be categorised as ECPs
- the bar on opting-up elective professional clients (including the application of the procedural notification requirements)
- the re-categorisation and revised opt-up criteria for local authorities (including local authorities acting as pension fund administrators)

4.18 As highlighted above, the client categorisation rules in COBS 3 already generally apply to non-MiFID scope business, with some limited derogations (see, for example, COBS 18.2.3R in relation to energy market and oil market activity). The proposals as set out in this chapter will apply to non-MiFID scope business in the same way as to MiFID scope business.

4.19 To extend these proposals to non-MiFID scope business, we will delete COBS 3.5.2AR to ensure that local authorities can no longer be categorised as per se professional clients for non-MiFID scope business. Other handbook changes relating to the MiFID II reforms to the opt-up process for ECPs and to local authorities will then be applied to both MiFID and non-MiFID scope business. This will include firms which are exempt under Article 3 of MiFID II; namely financial advisers, corporate finance boutique firms and venture capital firms. For the remaining elements of the client categorisation regime, application with some exceptions will be retained.

**Implications for firms**

4.20 As elective professional clients will no longer be able to opt-up to ECP status, firms will have to re-categorise their ECP clients who have been opted-up from elective professional client status. Firms will also need to amend their opting-up processes for ECPs to comply with the procedural notification requirements (ie in the case of per se professional clients only).

4.21 For both MiFID and non-MiFID scope business, the re-calibrated quantitative criteria for local authorities mean that firms will have to review the categorisation of their existing local authority clients in order to ascertain what their proper categorisation should be (ie as retail or elective professional clients).
4.22 Given the differences in the way in which COBS requirements apply to the different client categories, firms may have to review the broader impact that this change may have on their business as some clients may need to be re-categorised. This may involve changes to firms’ internal systems and controls. Those firms with local authority clients who do not meet the re-calibrated quantitative criteria to become professional clients and which are not authorised to provide services to retail clients need to consider what permissions they need in order to continue servicing those clients.

**Implications for consumers**

4.23 MiFID II’s changes to the categories of client who can opt to become ECPs (ie the prohibition on opting-up elective professional clients) mean that some clients will benefit from additional regulatory protections if they remain as elective professional clients, although they may be subject to additional processes from a firm perspective, such as consent procedures. However, their ability to access financial markets will not be fundamentally affected.

4.24 We propose to exercise our discretion to apply alternative quantitative criteria to local authorities. The re-calibrated quantitative threshold (as set out in paragraph 4.13) is specifically designed to ensure that only smaller, less sophisticated local authorities (such as parish and town councils acting in their treasury function capacity) are likely to fall below the required threshold. We believe this threshold will serve to identify local authorities for whom more complicated financial services may not be appropriate given their level of resources and potentially lower level of knowledge and expertise, and therefore should be treated as retail, rather than professional clients. The resultant increased regulatory protections for these local authorities should reduce the risk of them being sold services or products which they may not understand, and prevent future cases of local authorities incurring significant losses, as seen in the recent past. This change should also have the benefit of enhancing investor protections for local authority treasury reserves.

4.25 The threshold is also intended to ensure that local authorities with the requisite resources and expertise and knowledge (including local authorities acting as pension fund administrators) can opt-up to become professional clients. Furthermore, those local authorities who meet the criteria (as set out in paragraph 4.13) will benefit from added regulatory protections compared with per se professional clients, since elective professional clients cannot be presumed to possess the market knowledge and experience comparable to a per se professional client. This proposal strikes a balance between ensuring local authorities acting on behalf of the beneficiaries of the Local Government Pension Scheme can access a wide range of investment opportunities, while providing enhanced regulatory protections compared to their current status.

4.26 Local authorities classified as retail clients may be unable to access the services of certain investment firms (eg alternative asset managers without retail permissions). This will be mainly limited to smaller local authorities and more complex products or services, and should not affect local authorities acting as pension fund administrators. We believe this potential restriction is proportionate
given the likelihood that such local authorities are less sophisticated consumers (as discussed further below).

**Discussion**

4.27 **We share the view underpinning the MiFID II reforms that elective professional clients should no longer be eligible to become ECPs, given that a number of important conduct of business requirements do not apply to ECPs (eg the rule on inducements and the obligation to provide best execution). Protections such as these are likely to be more important for such clients, who will be classified as retail clients at the outset, and therefore cannot be presumed to have the market knowledge and experience comparable to a per se professional client.**

4.28 **There have been significant concerns in recent years with respect to alleged mis-selling involving local authorities, so we are keen (as set out above) to ensure that only those with the requisite experience, knowledge and expertise can be treated as professional clients. As is the case with other client types, the size of a local authority often aligns with its level of knowledge and expertise. Further, the size of the local authority tends to reflect the resources and facilities it has available to it (eg to pay for in-house expertise or investment advice). In our view, therefore, the current portfolio size requirement of €500,000 in point (b) of the standard quantitative test for elective professional clients is not appropriately calibrated for local authorities; this test was primarily devised for high-net worth clients and small corporate entities, rendering it a less meaningful threshold for local authorities, most of which would easily meet it.**

4.29 **The increased portfolio size requirement of £15m is proposed on the basis that £10m typically reflects the average portfolio size of smaller local authorities. We consider that this threshold is set at a more meaningful level, given the relative size of local authorities' resources. This requirement, combined with the qualitative test, is aimed at precluding smaller, less sophisticated local authorities acting in their main capacity as treasury managers from being opted-up inappropriately. Taken together, these requirements should ensure that local authorities are properly assessed on both the quantitative and qualitative elements of their profile – a fundamental building block of the client categorisation regime. We are, however, aware that this increased portfolio size requirement of £15m may preclude some smaller, less sophisticated local authorities (eg parish and town councils) from being able to opt-up. In our view, however, these require more regulatory protection than larger local authorities as they will be less likely to be able to absorb losses, or have the in-house expertise or the resources available to them to fully appreciate the risks involved with investing in complicated financial products.**

4.30 **Separate application of the opt-up criteria for local authorities dependent on the capacity in which they are acting (ie either as treasury managers or as pension fund administrators) is proposed to ensure that treasury reserve funds and pension reserve funds are not co-mingled for the purposes of meeting the quantitative test. If this were the case, all local authorities could opt-up to professional client status based on their pension fund reserves alone, meaning that small treasury management functions might be inappropriately opted-up.**
4.31 Our proposal in respect of categorising local authorities located in other EU/EEA States is in line with the European Commission’s original policy intention, that Member States should be able to design specific opt-up criteria for local authorities within their territory, given the apparent differences in local government structures across the EU. Our proposal would ensure that local authorities across the EU/EEA are categorised by firms in accordance with the criteria deemed appropriate for local government in the territory in which they are located.

4.32 The rationale for extending our proposals to non-MiFID scope business is based on our view that the same regulatory protections should apply to non-MiFID scope as to MiFID scope business. For example, clients investing in units of a private equity fund with an alternative investment fund manager (non-MiFID scope) should benefit from the same regulatory protections as clients investing in a transferable security with a MiFID investment firm (MiFID scope). The same rationale applies to our decision to extend the quantitative test for opting-up local authorities to professional client status to non-MiFID scope business.

References
4.33 Existing provisions are set out at: COBS, 3.5.2, COBS 3.5.3, COBS 3.5.7G, COBS 3.6.2, COBS 3.6.4, COBS 18.2.3, 18.3.3, 18.6.

4.34 The new requirements are as follows:
• Recital 104, Article 24(5), Article 30 (1), Article 30(2), Annex II.1 (1) and (3), and Annex II.II.1, paragraph 1, 3, 5 & 6 of MiFID II
• Article 71 of the MiFID II delegated regulation.

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?

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