

Bath & North East Somerset Council		
MEETING:	AVON PENSION FUND COMMITTEE	
MEETING DATE:	11 December 2015	AGENDA ITEM NUMBER
TITLE:	MIFID II – Implications for LGPS funds	
WARD:	ALL	
AN OPEN PUBLIC ITEM		
List of attachments to this report:		
Nil		

1 THE ISSUE

- 1.1 The Markets in Financial Instruments Directive (MIFID II) which comes into effect from 1 January 2017 has the effect on LGPS funds is potentially very significant implications for LGPS funds.
- 1.2 LGPS funds are currently classified as professional investors under MIFID I. However, under MIFID II, all local authorities will be classified as retail investors. As the pension funds are not a separate legal entity to the local authority, the pension fund will fall under the retail classification. This could severely restrict the investment opportunities available to LGPS funds and could force the sale of assets that are not approved for retail investors.
- 1.3 The Fund is assessing the risk from MIFID II to its investment strategy. Where necessary to maintain its investment strategy, the Fund will elect to become a professional investor, providing it can satisfy the criteria.
- 1.4 The report sets out issue in more detail and the actions being taken to manage the risk to the investment portfolio.

2 RECOMMENDATION

That the Committee notes

- 2.1 **The potential impact of MIFID II on the Fund and the actions being taken to manage the risk to the Fund's investment portfolio**

3 FINANCIAL IMPLICATIONS

- 3.1 If the Fund is categorised as a retail investor, the Fund may become a forced seller of specific mandates. This could incur significant transaction costs.

4 BACKGROUND TO MIFID II

- 4.1 The Markets in Financial Instruments Directive (MIFID II) aims to improve the functioning of financial markets, especially over the counter markets, and to strengthen investor protection via more robust restrictions on appropriate investment products and greater disclosure on fees. It is currently being transposed into national law in EU states (led by the FCA in the UK) and the effect on LGPS funds is potentially very significant. MIFID II comes into effect from 1 January 2017.

(NOTE: at time of drafting this paper, there is pressure on the EU from national regulators and investment managers to delay implementation by a year; they are concerned that the compliance systems required under MIFID II cannot be put in place by January 2017).

- 4.2 LGPS funds are currently classified as professional investors under MIFID I. However, under MIFID II, all local authorities will be classified as retail investors. As the LGPS funds are not a separate legal entity from the local authority, the pension fund will also fall under the retail classification (corporate pension schemes are trust-based schemes where the scheme is a separate legal entity from the sponsoring company). There will be an opportunity for funds to elect for professional investor status. It is thought that the LGPS is the only DB occupational pension fund that will be classified as retail under MIFID II.
- 4.3 The shift from professional to retail investor classification has serious negative implications for the LGPS funds. Most significantly:
- (1) **Forced sale of assets** - If, when the directive comes into force, a fund holds assets outside the scope of those available to retail investors, the manager may force a fund to sell out of the assets. This could be mitigated if the FCA provides a transition period to enable funds to achieve professional status or have a managed sale of the assets.
 - (2) **Restricted investment opportunities** - Retail investors are prevented from investing in more “complex” investments so this will reduce the investment options available to funds. Under MIFID II some investment managers and advisors (who currently provide services to professional investors) may be less willing to deal with retail investors (due to FCA regulations).
 - (3) **Increase in costs** – Management costs could increase due to extra costs of compliance and reporting for retail products and if the funds elect for professional status there will be extra compliance costs for both the manager and the funds. Every time a manager goes for a mandate, managers will have to satisfy itself that the fund to whom it is pitching is a professional investor if the product is not retail compliant.
- 4.4 The initial estimate from the DCLG is that up to 50% of LGPS assets may be affected. These assets could include infrastructure, private equity/debt/real estate, hedge funds and some multi asset funds.
- 4.5 The LGA are in discussions with the FCA, HMT, DCLG and Investment Management Association to find ways to lessen the impact on LGPS funds. There are significant implications around the potential pooling of LGPS assets and the Treasury’s desire for LGPS funds to invest in infrastructure; both may be

more difficult to implement under MIFID II if indeed they can. The process of opting up to professional status is being discussed with the FCA in order that the differences between the LGPS funds and local authorities are recognised or that the opt-up process is made easier for LGPS funds. In addition there are discussions about a period of transition post January 2017 to avoid the forced sale of assets for those funds that have not completed the election process in time.

- 4.6 This issue links into work being done by the LGPS Scheme Advisory Board about greater separation of LGPS funds from the administering authority.

Elect for Professional Investor status

- 4.7 Funds will be able to opt up for professional investor status if they meet specific criteria. They will have to demonstrate they meet the criteria to each manager and each manager will have their own process of deciding whether professional status can be granted. Even if professional status is granted, it will not be the same as those classified as professional investors under the regulations and there will be ongoing compliance requirements.

- 4.8 The criteria includes:

- (1) Quantitative - the size of assets, number of transactions in relevant markets over set time periods, length of time the individuals have worked in the financial sector (need to satisfy 2 out of 3).
- (2) Qualitative – “an 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.”

5 FUND'S RESPONSE

- 5.1 The risk that arises from MIFID II has been added to the risk register. The risk will be manageable assuming the Fund successfully elects to be a professional investor.
- 5.2 The Fund is writing to each manager to ascertain whether they will still manage the existing investment mandate if Avon is classified as a retail investor. Some mandates already satisfy the requirements for retail investors so there will not be a need to elect for professional status with these managers.
- 5.3 Although the manager will carry the regulatory risk of ensuring they do not sell non-retail products to retail investors, it is the funds that have to collate the information to prove that they are professional investors, or elect for professional status. The Fund will prepare the assessment against the criteria and, with particular reference to the qualitative criteria, decide whether any amendment to the current delegations is required to satisfy the criteria.
- 5.4 The Committee will have a progress update at Committee meetings until the issue is resolved.

6 RISK MANAGEMENT

- 6.1 The Avon Pension Fund Committee is the formal decision-making body for the Fund. As such it has responsibility to ensure adequate risk management processes are in place. It discharges this responsibility by ensuring the Fund has an appropriate investment strategy and investment management structure in place that is regularly monitored. The creation of an Investment Panel further

strengthens the governance of investment matters and contributes to reduced risk in these areas.

7 EQUALITIES

7.1 An equalities impact assessment is not necessary.

8 CONSULTATION

8.1 N/a

9 ISSUES TO CONSIDER IN REACHING THE DECISION

9.1 Set out in the report.

10 ADVICE SOUGHT

10.1 The Council's Monitoring Officer (Divisional Director – Legal and Democratic Services) and Section 151 Officer (Divisional Director – Business Support) have had the opportunity to input to this report and have cleared it for publication.

Contact person	Liz Woodyard, Investments Manager 01225 395306
Background papers	LGA MIFID II Paper – Oct 2015
Please contact the report author if you need to access this report in an alternative format	