

# Local Government Association

## Response to Markets in Financial Instruments Directive II Implementation – Consultation Paper III

December 2016



### About the Local Government Association

The Local Government Association (LGA) is the national voice of local government. We work with councils to support, promote and improve local government.

We are a politically-led, cross party organisation that works on behalf of councils to ensure local government has a strong, credible voice with national government. We aim to influence and set the political agenda on the issues that matter to councils so they are able to deliver local solutions to national problems. The LGA covers every part of England and Wales, supporting local government as the most efficient and accountable part of the public sector.

This response has been approved by LGA's Resources Board and, for the impacts on pension fund authorities only, the Local Government Pensions Committee (LGPC), and is submitted jointly with the Local Government Pension Scheme Advisory Board (SAB).

### General points on the approach taken to status of local authorities in the proposals

The LGA is 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, as well as for general Treasury Management by local authorities.
- The elective professional status process is not appropriate for local authorities and will require adapting to effectively assess their decision making structures.
- The process for opting up to elective professional status as designed is not fit for purpose and will prevent the majority (and maybe all) local authorities, including pension funds, from opting up. They will therefore have to stay at retail status.
- UK local authorities have a good track record in managing their investments, particularly those encompassed by MiFID. The consultation offers no evidence that there is a problem with UK local authority investments, or that there is any evidence backed reason why local authorities should be prevented from retaining professional status.
- UK local authorities rely on the income they generate from their investments as part of their annual budgeting process. If this income is decreased through lack of access to investment opportunities, shortfalls will have to be met by reductions elsewhere in council budgets – and this is at a time when council budgets are already under severe pressure from major reductions in core funding.

# Submission

- Local Authorities are complex public sector bodies with tight financial governance processes in place that work well. These proposals will add an additional layer of governance or will simply prevent local authorities from continuing with their current investment activities, even if they are low risk - for example, they would prevent local authorities from making some investment and loan transactions with other local authorities.
- Collective Investment Schemes can provide an appropriate route to the range of instruments needed by local authorities, particularly pension funds, and with the assistance of the FCA could negate the need to undergo the elective professional process.
- Clarity is needed with regard to transactions made prior to 3<sup>rd</sup> January 2018.

### **Classification**

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. The original EU directive did not highlight any problems being experienced by UK local authorities in last quarter century or so.

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.

This reclassification 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 Local Government Pension Scheme (LGPS) investment regulations 2016
- Is inconsistent with the Government's desire for greater infrastructure investment by local authority pension funds

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.

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**

Although the question in the consultation 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 or other investment activities.

The proposed tests do not take account of the regulatory processes that local

authorities have to undertake in managing their finances and the checks and balances that these place on their activities. This will impact on the practical application of the proposed tests. In addition, these checks and balances should give reassurance of local authorities' suitability for professional status and so obviate the need for such difficult tests in the first place.

### **Qualitative test**

The questions in the consultation do not refer directly to the proposals around the qualitative test. However, we believe there are significant problems with the approach proposed.

- 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))*

- 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.*

Local authorities have structures of delegation and internal controls designed to ensure proper decision making, risk management and execution.

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. The transaction itself would normally be executed by an officer with delegated authority to enact the decision of the committee.

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.

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.

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;*

## **Pooled assets**

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.

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.

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.

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.

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 with Government policy objectives, by listing them as an exemption in their own right.

This would result in local authority pension funds 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, and for local authorities acting in their own right and not as a pension fund.

## **Transitional issues**

Under the proposals 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. 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 a retail clients. FCA are therefore requested to provide reassurance that should the proposal be implemented such transactions may be honoured and will not have to be terminated on 3rd January 2018

## **Response to questions in the consultation directly affecting local authorities (questions 16 and 17).**

*Question 16: 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?*

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*

The size of the portfolio cut off (a) has been set so that any local authority that does not qualify under this criterion alone cannot qualify for opt up and so be excluded in all cases from MiFID scope business. The consultation states that the £15,000,000 cut off is to exclude smaller authorities from opt up status as "the size of a local authority often aligns with its level of knowledge and expertise". No evidence has been offered to back up this assertion and to demonstrate that smaller authorities are per se not capable of holding professional status; indeed the FCA's own analysis in the consultation states that a number of local authorities currently carrying out MiFID scope business will be excluded in the future due to this criterion.

The requirement for the cut-off point to be £15,000,000 has come from the FCA; the EU directive was based on 500,000 euros and no evidence based reason has been given in the consultation for this not to be used in the UK's implementation. As is acknowledged in the consultation, a portfolio size of 500,000 euros would not be a significant bar to UK local authorities

The consultation states that the typical portfolio size for a smaller local authority is £10,000,000, yet the analysis carried out by the FCA itself in the consultation concludes that the £15,000,000 cut off would exclude about half of all UK local authorities.

The FCA's analysis in the consultation of the size of local authority investment portfolios is based on annual statistics published by DCLG. This is problematical as it only shows a snapshot of the investment portfolio, including cash balances, at a single year end date. Due to significant in year cash flows such as influxes of tax revenues such as council tax and business rates, receipts of central government grants, and significant payments made out over a year, a local authority's daily balance can vary significantly between different dates. Using a large figure such as £15,000,000 (as opposed to the EU directive figure of 500,000 euros) means that there will be days when a snapshot of local authority balances will show that even some of the biggest local authorities in the country will not qualify on that day. This can be seen from the DCLG statistics published for the year after that used in the analysis in the consultation which shows some very large authorities with balances below £15,000,000 on that date. It is therefore doubtful whether the proposal as drafted will achieve the stated aim, and may in fact exclude the vast majority of local authorities acting in a non pension fund capacity. In conclusion, the proposed limit of £15,000,000 represents a major barrier for local authorities and its impact will go far beyond the aims of the original EU directive and even the stated aims of the FCA in proposing it. We would urge reversion to the original 500,000 euro limit in the EU directive.

Pension Fund Authorities will all qualify under (a) however except in very particular circumstances they will not under (b). 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. This means that only local authorities, including pension fund authorities, able to pass tests (c) and (a) will be able to successfully complete the opt up process. This means test (c) is particularly important.

With test (c), 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.

COBS 3.2 defines a client as

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

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).*

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?

*Question 17: Do you agree with our approach to extend these proposals to non-MiFID scope business? If not, please give reasons why.*

As outlined in the rest of this response, we believe the proposed approach to the implementation needs to be rethought before any consideration can be given to extending proposals to non-MiFID scope business. Since we believe the current proposals to be flawed, we cannot see any advantage in extending them.