

TEESSIDE PENSION FUND

Administered by Middlesbrough Council

AGENDA ITEM 6

TEESSIDE PENSION BOARD REPORT

1 FEBRUARY 2016

CHIEF FINANCE OFFICER - PAUL SLOCOMBE

MiFIR/MiFID II OVERVIEW

1. PURPOSE OF THE REPORT

- 1.1 To inform the Pension Board of the Markets in Financial Instruments Regulations (MiFIR) and Directive II (MiFID II) and its impact on the Teesside Pension Fund.

2. RECOMMENDATIONS

- 2.1 That Members note the report and agree to introduce MiFIR/MiFID II on the Risk Register as a risk to the effective management of the Fund's financial assets.
- 2.2 That news-flow is continued to be monitored and Members of the both the Teesside Pension Board and Teesside Pension Fund & Investment Panel are kept informed of further developments.

3. FINANCIAL IMPLICATIONS

- 3.1 There are no immediate financial implications but the classification of the Fund will affect transaction costs and a Research Budget will need to be created.

4. BACKGROUND

- 4.1 The Markets in Financial Instruments Directive 2004/39/EC (MiFID) is a European Law that provides harmonised regulation for investment services across the 31 member states of the European Economic Area (the 28 EU member states plus Iceland, Norway and Liechtenstein). The directive's main objectives are to increase competition and consumer protection in investment services and help create a single market for financial services and activities in the European Union. MiFID came into force in 2004 with an implementation date of 1 November 2007.
- 4.2 The key measures implemented through the directive were: best execution and order handling practices, categorisation of clients, investment research, conflicts of interest, outsourcing, transaction reporting, pre- and post-trade transparency and regulation of trade-related market infrastructure. The introduction of the Directive has resulted in lower trading costs per transaction, reduced bid-ask spreads and faster trading times as envisioned by the European Commission.

- 4.3 However, expected benefits from the new competitive landscape have not flowed equally to all market participants. In particular, and it is the opinion of the European Commission that these benefits have not always been passed onto the end investor. The trading environment has become more complex and fragmented and the financial crisis has exposed weaknesses in the regulation of instruments (other than shares) traded mostly between professional investors (e.g. derivatives).
- 4.4 MiFID II, which repeals Directive 2004/39/EC, and MiFIR were published in the Official Journal of the European Union on 12 June 2014. The new rules will be applicable starting January 2017. MiFIR/MiFID II is split into two pieces of legislation: a Directive and a Regulation. Directives allow member states some flexibility in transposing to local law, whereas Regulations are binding on and take direct effect in all member states.

5. IMPACT ON THE TEESSIDE PENSION FUND

5.1 The new Regulation/Directive affects the Fund in three ways:

- Client Classification – stricter provisions for public sector entities,
- Inducements – restrictions on provision of free of charge research to clients, and
- Recording of Communications – records retentions increased to 5 years.

Client Classification

- 5.2 Previously, under MiFID, some discretion was left with broker/regulated financial institution and client to decide on the most appropriate client classification. The Fund was able to elect itself as a professional client, and therefore able to trade fully without any additional restrictions or protections from brokers/regulated financial institutions (e.g. best execution, disclosures, etc.).
- 5.3 Under MiFID II, clients can be classified as Per Se Professional, Eligible Counterparty or Retail. If a client does not meet either the Per Se Professional or Eligible Counterparty they must, by default, be considered as Retail. Counterparties can Opt Up to a higher classification or Opt Down to a lower classification if they meet specific criteria, and the broker must agree to the change.
- 5.4 There is a perception amongst European policy makers that Municipalities and Local Authorities have in the past invested in complex financial instruments without thorough product appropriateness checks being put in place. Under MiFID II, Local Authorities will no longer be permitted to be classified as Per Se Professionals or Eligible Counterparties. By default, therefore, pension funds managed and operated as part of a Local Authority will be classified as Retail Clients. A pension fund operated as a separate legal entity, but owned by a Local Authority can be classified as a Per Se Professional or an Eligible Counterparty.
- 5.5 Local Authorities may still be allowed to Opt Up to Elective Professional, however, this will be at the discretion of individual Member States (including what criteria must be met in

order to Opt Up). Elective Professionals will be prevented from Opting Up to Elective Eligible Counterparty.

- 5.6 The final Opt Up criteria will be set by the Financial Conduct Authority (FCA), the UK's financial regulator. The FCA is considering three options:
- Option 1: Meet 2 out of 3 criteria:
 - Traded at least 10 relevant transactions per quarter over the past year,
 - Portfolio of financial instruments portfolio (including cash deposits) exceeds EUR 500,000, or
 - Client worked in financial sector for at least 1 year in a role requiring knowledge of financial instruments.
 - Option 2: Either make all 3 criteria under Option 1 mandatory or increase the minimum size of portfolio to EUR 10 million.
 - Option 3: Require Local Authorities to meet 2 out of 3 of the current large undertakings criteria:
 - Balance sheet size of EUR 20 million or above,
 - Net turnover of EUR 40 million or above, or
 - Own funds of EUR 2 million or above.
- 5.7 The Local Government Association (LGA) has provided a briefing paper regarding MiFID II, which is attached (Appendix A). The briefing paper is more relevant to most other LGPS Funds who procure the services of External Investment Managers, as opposed to the Teesside Fund which is internally managed. However, it includes the next steps the LGA are looking to take, which is relevant.

Inducements

- 5.8 Currently, the Teesside Fund pays a commission to brokers for each trade and in return receives execution of the trade. Some brokers used by the Fund also provide investment research from Analysts and Commentators. The Fund does not make a direct payment for the research; rather the fee is bundled in with the commission rate of each trade.
- 5.9 The European Securities and Markets Authority (ESMA) and the FCA have been looking at how firms use dealing commission. That is, the charges paid when investment managers execute trades and acquire external research on their behalf.
- 5.10 ESMA has put forward a number of assertions in its final technical advice on research and inducements to the European Commission in December 2014.
- It has confirmed that, in its view, the current market practice where a broker agrees higher execution rates to enable the investment manager to receive higher value research falls within the scope of an inducement under the MiFID II and therefore a Level 1 restriction applies (i.e. there is a conflict of interest between investment manager and fund/client).
 - It perceives a risk that, without the restriction, the investment manager's duty to act in the best interests of its fund/clients will be impaired.

- It considers that there is a risk a firm may be influenced to direct order flow or churn portfolios to gain access to more valuable research.

5.11 ESMA's proposed solution is to separate investment managers' payments for research from execution arrangements and outlines a model for how research can still be paid for by investment managers without constituting an inducement. The FCA's feedback follows ESMA's final technical advice and ESMA's proposed two options for change. These proposals are strongly supported by the FCA.

5.12 The proposals are that the investment manager can purchase research:

- Directly out of its own resources (the manager can choose to reflect this in an increase to the firm's portfolio management or advice fees); or
- Through a "research payment account", funded by specific charge to the client which would be agreed and disclosed up front with the client. This charge would be based on a research budget set by the manager and would not be linked to execution volumes or value.

5.13 Brokers providing both execution and research services to investment managers must identify a separate fee for the execution service, with research services charged for separately and not influenced by levels of payment received for execution. Any surplus must either be rebated or offset against future research budgets.

Recording of Communications

5.14 FCA regulated financial institutions must record all telephone conversations and electronic communications. As the Teesside Fund is not regulated there is not a system in place to record telephone conversation or electronic communications, particularly those associated with trading orders.

5.15 MiFID II reinforces the need for effective recording of all communications and lengthens the period records are retained to five years.

6. RECENT PRESS ANNOUNCEMENTS

6.1 A proposal is being put forward that the implementation date for MiFID II is delayed by a year to January 2018. In a press release by the European Parliament on 27 November 2015 the European Parliament's Rapporteur for MiFID II, Markus Ferber, MEP, explained:

"The European Parliament's negotiation team has informed the European Commission that we are ready to accept a one-year delay of the entry into force of MiFID II. However, this only applies if the Commission finalises the implementing legislation swiftly and thereby takes into account the European Parliament's priorities. Furthermore, Commission and ESMA need to come up with a clear roadmap on the implementation work and especially for setting up the IT-systems. Naturally, I expect that the European Parliament will be informed regularly and comprehensively about any progress in the implementation work."

6.2 Reuters reported on 14 December 2015 that the European Union's executive European Commission, which will turn ESMA's recommendations into law, has opted for a more flexible approach on commission payments. The EU are looking are setting certain conditions where a single payment for both trade execution and research may be acceptable.

7. NEXT STEPS

7.1 The Teesside Fund has approached the Fund's Custodian (BNP Paribas Securities Services) and Property Manager (CBRE) and asked for their criteria under MiFID II to Opt Up to Eligible Professional classification. Responses received from these financial institutions will provide guidance as to the requirements of the Fund's stockbrokers, bond-brokers and money-brokers.

7.2 Take advice from the Middlesbrough Council's Procurement and Commissioning Section regarding the options for paying for research, and how they fit with the Council's procurement policy.

7.3 Further research the need to record all telephone and electronic communications and, if necessary, discuss options with Middlesbrough Council's Information and Communication Technology Section, particularly regarding recording and retaining telephone conversations.

CONTACT OFFICER: Paul Campbell (Head of Investments and Treasury Management)

TEL. NO.: (01642) 729024

LGA Briefing Paper – MiFID II

The Markets in Financial Instruments Directive (MiFID II) and its impact on LGPS investments

Why be concerned?

1. It is our understanding that under MiFID II local authorities will be defaulted to retail client status - currently they are professional clients. There will be the opportunity to elect for professional client status.

What does that mean for me as an LGPS administering authority?

2. As a retail client your authority could be faced with a much reduced pool of asset managers and consultants willing to provide services, many may not deal with retail clients at all.
3. Those managers who are willing to deal with you will offer a restricted range of products and due to the extra compliance checks and reporting required for retail clients those products could cost more. First estimates are that up to 50% of LGPS assets may be affected.
4. If when the directive comes into force (January 2017) you hold assets in products outside of the scope of those available to retail clients you may find that the manager will eject you from that product resulting in a 'fire sale' of assets. This could be mitigated if FCA were to provide some form of transition period or 'grandparenting' - allowing you to retain products purchased as a professional investor for a period of time.

How can I elect for professional status?

5. The process will be similar to that in MiFID I (see ANNEX A1) although there may be some changes to the criteria. Effectively you will have to demonstrate to each manager you use that you meet the qualitative and quantitative criteria as set out below.
6. The qualitative criteria - 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'

This assessment 'should be performed in relation to the person authorised to carry out transactions on its behalf.'

7. The quantitative criteria - (2 of the following 3 must be satisfied):
 - 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;
 - the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds EUR 500,000;

- 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.

How long will it take for an election to be completed?

8. Depending on how the actual criteria look when published in 2016 it could be a matter of weeks. However as each manager will have to assess each of its LGPS clients this cannot be able to be done all at once. Therefore it may be that some form of managed election process across the whole of the LGPS will be needed. For example if a significant number of authorities wait until very late 2016 to elect then don't be surprised if the process is not completed by the January 2017 implementation date.
9. There is a duty on elected professional clients to keep firms informed about any change that could affect that status. Such changes could result in the process having to be repeated and depending on the nature of the change the danger that the authority could be reverted back to retail client status.

What's the timeline?

- February 2015: Feedback Statement on dealing commission regime and potential changes under MiFID II
- March 2015: FCA Discussion Paper and ongoing dialogue in areas where we have policy choices to make
- Summer 2015: EU legislation on MiFID II implementing measures is adopted and formal approval process begins
- December 2015: Consultation on implementing MiFID II requirements Early 2016: EU legislation on MiFID II implementing measures is finalised and published
- June 2016: FCA Policy Statement (rules) on implementation of MiFID II
- January 2017: MiFID II rules come into effect for all investment firms

What should I do?

10. Make your committee aware of the issue as soon as possible.
11. Discuss the implications with your asset managers, find out if they will they still deal with you as a retail client and what assets will be affected.
12. Prepare for an assessment against the qualitative and quantitative criteria – what evidence would you put forward to back up your election for professional status? In particular assess who will be judged against the qualitative criteria and if necessary be prepared to amend your delegations appropriately.

What are LGA doing?

13. We are in discussions with the FCA, DCLG and the Investment Association (IA) to find ways to lessen the impact on LGPS authorities, in particular we are:
 - Investigating with DCLG and HMT the potential impact on pooling arrangements and in particular any impact on the potential for infrastructure investment via pools

- Discussing the election process under MiFID II with FCA to see if there are changes that could make the process smoother for local authorities in relation to their pensions functions
- Attempting to achieve a period of transition to avoid a forced sale of assets for those authorities who have not completed the election to professional status by January 2017
- Discussing with IA the possibility of standard documentation and process for election to professional status

LGA Pensions Team

16th October 2015

Extract from FCA New Conduct of Business Sourcebook Chapter 3 Client categorisation:

ELECTIVE PROFESSIONAL CLIENTS

3.5.3

A firm may treat a client as an elective professional client if it complies with (1) and (3) and, where applicable, (2):

(1) the firm undertakes 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 (the "qualitative test");

(2) in relation to MiFID or equivalent third country business in the course of that assessment, at least two of the following criteria are satisfied:

(a) 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;

(b) the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds EUR 500,000;

(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 "quantitative test"); and

(3) the following procedure is followed:

(a) the client must state in writing to the firm that it wishes to be treated as a professional client either generally or in respect of a particular service or transaction or type of transaction or product;

(b) the firm must give the client a clear written warning of the protections and investor compensation rights the client may lose; and

(c) the client must state in writing, in a separate document from the contract, that it is aware of the consequences of losing such protections.

[Note: first, second, third and fifth paragraphs of section II.1 and first paragraph of section II.2 of annex II to MiFID]

3.5.4

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.

[Note: fourth paragraph of section II.1 of annex II to MiFID]

3.5.5

The fitness test applied to managers and directors of entities licensed under directives in the financial field is an example of the assessment of expertise and knowledge involved in the qualitative test.

[Note: fourth paragraph of section II.1 of annex II to MiFID]

3.5.6

Before deciding to accept a request for re-categorisation as an elective professional client a firm must take all reasonable steps to ensure that the client requesting to be treated as an elective professional client satisfies the qualitative test and, where applicable, the quantitative test.

[Note: second paragraph of section II.2 of annex II to MiFID]

3.5.7

An elective professional client should not be presumed to possess market knowledge and experience comparable to a per se professional client

[Note: second paragraph of section II.1 of annex II to MiFID]

3.5.8

Professional client are responsible for keeping the firm informed about any change that could affect their current categorisation.

[Note: fourth paragraph of section II.2 of annex II to MiFID]

3.5.9

(1) If a firm becomes aware that a client no longer fulfils the initial conditions that made it eligible for categorisation as an elective professional client , the firm must take the appropriate action.

(2) Where the appropriate action involves re-categorising that client as a retail client, the firm must notify that client of its new categorisation.

[Note: fourth paragraph of section II.2 of annex II to MiFID and article 28(1) of the MiFID implementing Directive]