

# TEESSIDE PENSION FUND

Administered by Middlesbrough Council

AGENDA ITEM 14

## TEESSIDE PENSION BOARD REPORT

24 JULY 2017

### STRATEGIC DIRECTOR FINANCE, GOVERNANCE & SUPPORT – JAMES BROMILEY

#### MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE II – UPDATE

#### 1. PURPOSE OF THE REPORT

- 1.1 To follow up on the previous report presented (February 2016) and update Members of the Teesside Pension Board (the Board) of the Markets in Financial Instruments Directive II (MiFID II) and its impact on the Teesside Pension Fund.

#### 2. RECOMMENDATIONS

- 2.1 That Members note the report and pass any comments though relevant or appropriate.

#### 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 may be needed.

#### 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 was published in the Official Journal of the European Union on 12 June 2014. The new rules will be applicable starting January 2018.

## **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 each broker of fund manager 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 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 cannot Opt Up to Eligible or Per Se Professional Counterparties.

5.6 The final Opt Up criteria will be set by the Financial Conduct Authority (FCA), the UK's financial regulator. For LGPS Funds to Opt Up, the FCA will require individual investment manager to carry out a qualitative assessment and set a quantitative test.

5.7 The qualitative assessment will require:

*“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”*

5.8 Quantitative test a), below and one of 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 £15m;
- 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; and
- 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

5.8 Since the last Board report, a LGPS MiFID II working group has formed and been working with the FCA, Local Government Association (LGA) and Investment Association (IA) regarding the criteria for Local Authorities to Opt Up to elective professional status.

5.9 The FCA are considering a new policy statement which is expected to include a fourth criterion in the quantitative test which will be satisfied if the entity is an Administering Authority of an LGPS Fund. Investors need to satisfy two of the four criteria, which practically means Administering Authorities only need to meet the minimum size (£15 million), which all LGPS Funds meet.

5.10 It is also expected that the FCA will clarify that the qualitative test will continue to reference the individual but will make clear that this can include legal entities as well as natural persons and that the collective decision making structure of the client can be taken into account.

- The IA is in the process of drafting a template questionnaire which will then be shared with the LGPS and the LGA for comments. This is to ensure that administering authorities only have to provide a standard suite of documents to each investment manager rather than having to tailor it for each manager. The initial template is expected to be issued by the end of May 2017 with a final version targeted by the end of June 2017. Once the final questionnaire has been approved the IA are happy for this to be shared with investment managers who are not currently members of the IA.
- Discussions with asset managers leading on this work with the IA have indicated that this will require an assessment of the investment capabilities of the “decision makers” even where they are a collective, e.g. a Committee. While this will make

opting up easier than initially anticipated there will still be a process and information requirement from the Administering Authorities. Asset managers representing the IA on this indicated that to make an assessment they may still require evidence of the experience and capacity of the individuals of the collective, possibly supported by training policies, professional advice, etc. of those party to the collective decision making process.

- It is expected that investment managers will periodically review the information provided by the Administering Authorities to satisfy the opt-up criteria, probably on an annual basis.

5.11 Following the above developments it is anticipated that the opt-up process for the LGPS Funds will be much simpler than originally feared. Longer term, meeting these criteria will enable the Fund to transact with Border to Coast Pension Partnership (BCPP) and continue to manage other fund management relationships outside BCPP, e.g. limited partnerships in Alternatives.

### ***Inducements***

5.12 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 a flat commission rate is charged for each trade.

5.13 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.

5.14 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 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.

5.15 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.

5.16 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.

5.17 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.

5.18 The Fund is actively manages its relationships with its brokers. Since the previous Board report, brokers have been approached and asked to clarify their treatment of the Fund after MiFID II, and confirm whether they consider they are providing an execution only service or research is included in their service. So far, some have confirmed arrangements and others are waiting for more clarity after publication of the new FCA Handbook, due later in July 2017.

#### ***Recording of Communications***

5.19 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.

5.20 MiFID II reinforces the need for effective recording of all communications and lengthens the period records are retained to five years. Currently, when transaction orders are placed, all brokers maintain adequate record for compliance with MiFID II. In addition, the Fund maintains detailed records of all completed transactions.

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