Greater Manchester Pension Fund

Administered by Tameside Metropolitan Borough

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The Financial Conduct Authority
Via Email : cp16-29@fca.org.uk

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Dear Sirs,

Markets in Financial Instruments Directive II Implementation: Consultation Paper III

I write on behalf of the Greater Manchester Pension Fund and set out below our response to this consultation.

Summary

The Financial Conduct Authority (FCA) is consulting on the implementation of the Markets in Financial Instruments Directive II (MiFID II).

The implementation on the basis set out in the consultation will impact on the Tameside Metropolitan Borough Council's ability, most significantly as the administering authority of Greater Manchester Pension Fund ('GMPF'), to invest in a wide range of financial instruments with a real cost to the contributing employers, both public and private sector.

Whilst there may be some smaller local authorities that may need additional protection, automatically treating the public sector differently from the private sector is not an appropriate approach. This is particularly true for those UK local authorities which have been vested with the responsibility of administering the Local Government Pension Scheme ("LGPS"). This response identifies the concerns, and as in the case of GMPF we are considering the investment of assets valued in excess of £20 billion, even a marginal reduction of return will be a significant loss which the employers, and ultimately tax payers, would then have to make good.

LGPS Administering Authorities should be treated as any private sector asset owner would be, automatically deemed to be professional under the large undertakings criteria if they pass two of three tests, annual income of €40m, assets of €20m or €2m in reserves.

Greater Manchester Pension Fund (GMPF)

GMPF is a fund of £20 billion administered by Tameside Metropolitan Borough Council on behalf of over 500 employers for the benefit of over 350,000 members. Tameside MBC is the legal 'person' (entity) in respect of these assets. Under the Council's constitution responsibility for GMPF is delegated to the Pension Fund Management Panel, which is a committee constituted under Section 101 of the Local Government Act 1972.

Background

The Markets in Financial Instruments Directive II (MiFID II) is a package of EU legislation, introduced in 2014, which regulates both retail and wholesale investment business in the UK. The aim of the MiFID legislation is to strengthen protection for investors. In this case investors includes local authorities, including the few which administer a local authority pension fund. It is noted that, although they are funds with no separate legal status (with the exception of the South Yorkshire Pension Fund Authority and the London Pension Fund Authority) under the proposals, pension fund authorities are treated as a separate investor from the authority that administers them – the FCA clearly recognises that there is a distinction, but does not follow through its own logic and recognise that the funds are administered by clients who are, by their very nature, both professional and sophisticated. Furthermore, given that private pension funds no matter their asset size are treated as professional clients – it is a further inconsistency to treat LGPS Administering Authorities differently, despite often dealing with much larger asset portfolios than private funds.

On the 29 September 2016, the Financial Conduct Authority (FCA), published a consultation on how the legislation will be implemented in the UK. There are some proposals in the consultation, which go far beyond the basic legislation, and therefore should be seen as discretionary for the UK.

The proposals would reclassify the status of local authorities having a major impact on the ability of local authorities to invest in financial instruments other than (in many cases) basic bank deposits. It will, for example, make it difficult for local authorities to lend to each other despite the fact that 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. They, unlike the private sector, are required under their primary legislation (local Government Act 1972 Section 151) to have an appropriately qualified and experienced financial officer appointed at all times. The impact on LGPS Administering Authorities will, as shown below, be even more significant.

Response to the Consultation

- GMPF strongly supports the view of the Local Government Association 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 (regardless of the pooling proposals), as well as for general Treasury Management by local authorities.
- The elective professional status process is not appropriate for local authorities, and will require substantial modification in order to effectively assess their decision making structures if it is to be implemented.
- Collective Investment Schemes may provide an appropriate route to the range of instruments needed by local authorities, particularly pension funds, but even with the assistance of the FCA is unlikely to negate the need to undergo the elective professional process, as not all assets will be invested through pools.
- The local authorities will, however, remain the ultimate asset owners, and therefore need to be a professional investor.

Classification

Before addressing the ‘opt up’ criteria we would wish to state our concern on behalf of the Fund and taxpayers in respect of who a fiduciary duty is owed 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.

Furthermore investment by local authorities for pension fund purposes are subject to regulations (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 discharging its responsibilities under these regulations.

This reclassification will 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 policy of encouraging greater infrastructure investment by local authority pension funds

The provision for elected professional status, although potentially mitigating a great deal of the impact of reclassification, will result in authorities having to go through (and bear the cost of) 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, more critically, 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, although even after pooling the asset owner will still be the local authority. In the case of GMPF the proposal is to create, jointly with other funds, an investment management company, which is compliant with the Alternative Investment Fund Managers (AIFM) Directive, which will only have the three participating LGPS funds as clients (and the relevant Administering Authorities would own the AIFM company) – the proposed classification would require the implementation of an entirely redundant, time-consuming election step for each new investment.

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 and leaves the Fund and ultimately taxpayers at a significant disadvantage.

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. These are managed within a regulartory framework with external audit oversight.

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, having taken proper advice in accordance with the regulations. 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. It would therefore seem logical that as the authority is obliged to take proper advice ahead of making decisions that the FCA should automatically consider the pension fund administering authorities as professional investors.

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. 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.

To be effective in this context COBS 3.5.4 would need to 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;

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.

Under Government policy for pooling, administering authorities of pension funds will be permitted to make direct investments for a variety of purposes, therefore a committee constituted under Section 101 of the Local Government Act 1972, and acting under the regulations (which as set out above requires proper advice), should be another listed exemption.

Transitional Issues
Local authorities will become retail clients on 3 January 2018. There will be a transitional period (which could be years) before investments are (mostly) within the pools. As set out above, the administering authority will have to be a professional investor from that date; using the elective process would be cumbersome and create unnecessary bureaucracy and significant cost for the tax payer.

Firms and local authorities need clarity with regard to transactions made before that date as per se professional clients, which could not have been made as retail clients. FCA are therefore requested to provide reassurance as a matter of urgency that such transactions may be honoured, and will not have to be terminated on 3 January 2018, which would be highly prejudicial, not to say expensive, to the tax payer. At the very least, this should be by listing a committee constituted under Section 101 of the Local Government Act 1972, and acting under the regulations (which as set out above requires proper advice),as an exemption.

Response to questions in the consultation directly affecting local authorities

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 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 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 council tax and business rates, receipts of central government grants, and significant payments made over a year, a local authority's daily balances can vary significantly. 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. The number excluded will increase over time as authorities use balances to balance budgets in this time of austerity, until none but the few which administer pension funds would qualify.

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 (a) and (c) 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 clearly 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.

Yours faithfully,

Sandra J Stewart
Executive Director, Greater Manchester Pension Fund