



REPORT PREPARED FOR

**Warwickshire County Council  
Pension Fund**

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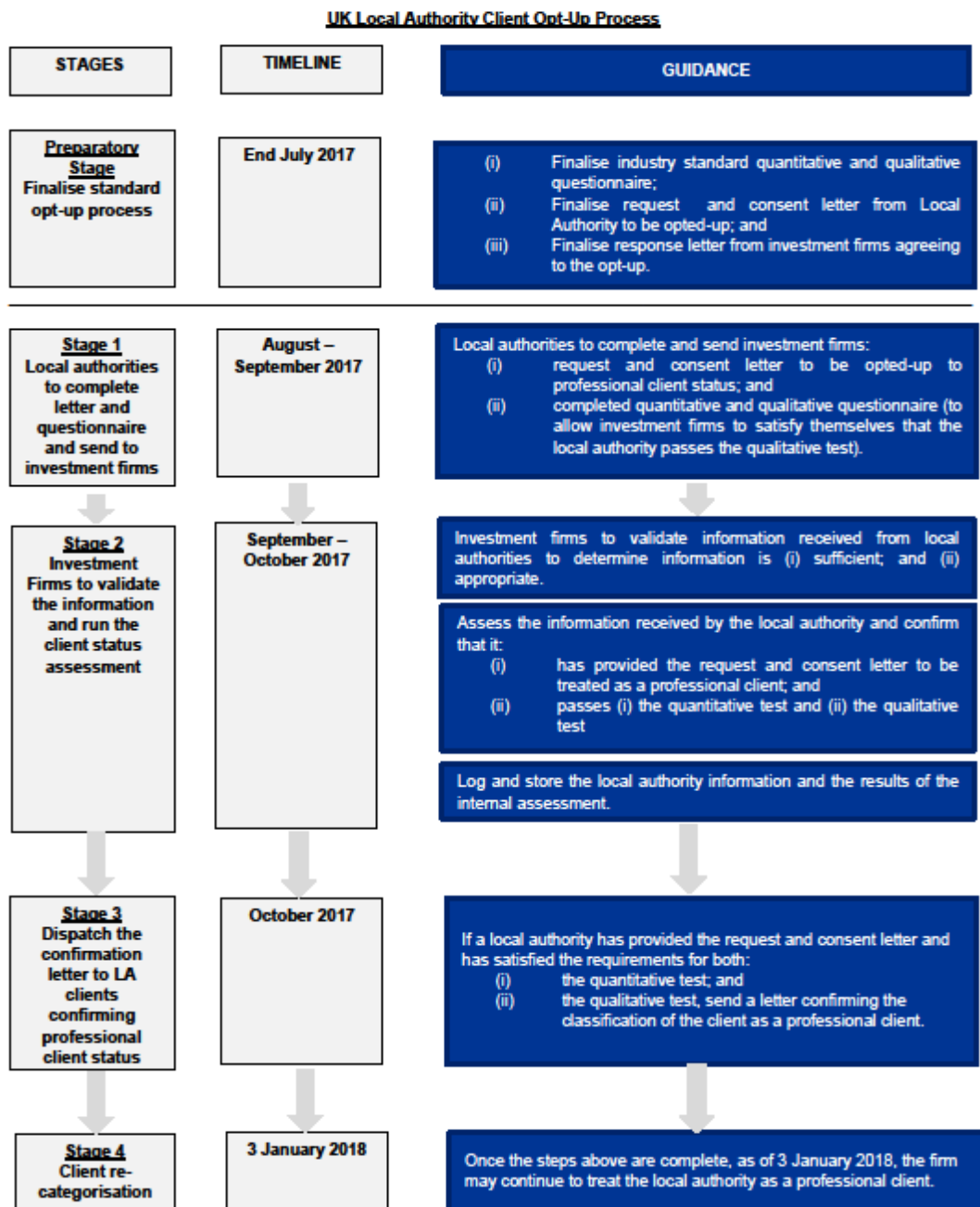
**This report, by your independent investment adviser Karen Shackleton, considers the implications of MiFID II regulations which take effect from 3rd January 2018.**

## **1. Introduction**

- 1.1. Following the 2008 financial crisis, the European Commission commissioned a review of the Markets in Financial Instruments Directive (MiFID). MiFID is the legislative framework for all investment firms that provide services to clients in shares, bonds, collective investment schemes and derivatives. It originally took effect in the UK in November 2007. The commissioning of the review reflected a concern that financial products were becoming increasingly complex, as well as a desire to strengthen investor protection.
- 1.2. The new regulatory framework, known as MiFID II, is to come into effect on 3<sup>rd</sup> January 2018. The new framework is designed for the entire European Union across all investor types. The important point to note for the Pension Fund Investment Sub-Committee is that **the directive will by default categorise LGPS funds as “retail investors”**.
- 1.3. A “retail” classification could have a significant impact on the pension fund, for example:
  - Restricting the ability to use advanced portfolio management tools such as liability hedging and currency hedging;
  - Access to a more restricted range of investment products;
  - An increase in costs, as a result of the above and/or the need for your managers/advisers to take more care to ensure you understand the products and services they are providing;
  - A more restricted ability to invest in illiquid assets such as infrastructure.
- 1.4. A “retail” classification will also result in a more restricted range of institutions who can deal with the LGPS. Many firms, including Allenbridge, do not have FCA authorisation to deal with retail clients, and some of these may not wish to allocate the necessary resources to apply to the FCA for a wider level of authorisation.
- 1.5. One option for the pension fund is to “**opt up**” to “**elected professional status**”. There are criteria for opting up which are outlined later in this report. However, it is worth noting that even opting up will have an impact on the pension fund, compared with the automatic professional status previously given. Going forward, investment firms will no longer be able to presume that clients have the necessary knowledge and experience of a professional investor. Nor can it be assumed that their client has the ability to bear investment risks consistent with the pension fund’s investment objectives, where the service being provided is investment advice.
- 1.6. This means that the pension fund’s investment managers, consultants and advisers will need to review the fund’s status at the outset, and on an ongoing basis. Even after the initial assessment, the pension scheme will still have an ongoing duty to notify financial service providers if there are changes to personnel involved in the scheme, as well as providing the accompanying evidence that they are appropriately qualified and experienced.

1.7. In terms of timelines, administering authorities are being advised by the Local Government Association (LGA) to act as soon as possible. The flow chart in Table A indicates the LGA's recommended process. An important consideration for the Pension Fund Investment Sub-Committee is the need to move quickly on the paperwork. In order to achieve this, **delegated authority to officers to sign opt-up forms is being recommended.**

1.8. **Table A – LGA's flow chart for a UK Local Authority Client Opt-Up Process**



## 2. Opt Up Criteria

- 2.1. There are a number of tests that an LGPS must pass if financial service providers wish to opt it up to elected professional client status. It is the product/service provider (manager, adviser etc) that must conduct these tests to determine whether they consider the LGPS in question is eligible to be opted up either generally or in respect of a specific product/service. This means that two investment firms may classify the same client differently or indeed an investment firm might classify the applicant as professional in respect of for example an equity portfolio but retail in respect of a corporate bond portfolio.
- 2.2. If the LGPS agrees to be treated as a professional client, the opt up process focuses on a qualitative assessment of the investor as well as some quantitative criteria. On 3<sup>rd</sup> July 2017, the FCA published their final policy statement and amendments around the implementation of MiFID II. These amendments were important because they made it easier for an LGPS fund to opt up. The criteria shown below take into account these amendments, which were agreed after successful lobbying by the LGA. The FCA's detailed commentary can also be viewed here: <http://www.lgpsboard.org/images/PDF/MiFIDII/Chapter8.pdf>.
- 2.3. **Quantitative test:** in order to pass the quantitative test, the pension fund must meet a minimum portfolio size requirement of £10 million. **The Warwickshire County Pension Fund meets the requirements of this test.**
- 2.4. The assessment also requires the pension fund to pass one of three tests:
- The client has carried out transactions, in significant size, on the relevant market at an average frequency of ten per quarter over the previous four quarters;
  - The person authorised to carry out transactions on behalf of the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the provision of services envisaged
  - The client is an 'administering authority' of the Local Government Pension Scheme within the meaning of the version of Schedule 3 of The Local Government Pension Scheme Regulations 2013 and is acting in that capacity.
- The Warwickshire County Pension Fund meets the requirements of the third of these tests.**
- 2.5. **Qualitative assessment:** the pension scheme must be able to demonstrate expertise, experience and knowledge around the transactions or services being provided as well as demonstrating a capability in making investment decisions and understanding the risks involved. Importantly, the FCA now acknowledges the role of the elected committee members and states that: "Firms may take a collective view of the expertise, experience and knowledge of committee members, taking into account any assistance from authority officers and external advisers where it contributes to the expertise, experience and knowledge of those making the decision." **It is the expectation that the Warwickshire County Pension Fund will meet these requirements but there are some points to note in section 4 of this report.**
- 2.6. **It is the responsibility of the administering authority to apply to the investment firm in writing to opt up to elected professional status either generally or in respect of a specific service.** However, it is then the decision

of the investment firm as to whether or not to approve that application. Note that “investment firm” includes investment managers, investment advisers and investment consultants (to the extent they provide investment services). Warwickshire County Pension Fund is not a client for the purposes of MiFID II in respect on any pooled fund but to the extent such pooled funds are Alternative Investment Funds, it may need to opt up in order to be classed as a professional investor.

- 2.7. For information, full notes on the opt up process can be found here: [http://lgpsboard.org/images/PDF/MiFIDII/MiFIDII\\_LGPS\\_opt\\_up\\_notes\\_curren20170811.pdf](http://lgpsboard.org/images/PDF/MiFIDII/MiFIDII_LGPS_opt_up_notes_curren20170811.pdf).
- 2.8. In order to simplify the application process, the LGA has worked with the investment community, LGPS funds and the FCA to draw up a standard template questionnaire. This has reduced the anticipated workload on officers by a significant amount. The new template can be viewed here: [http://lgpsboard.org/images/PDF/MiFIDII/Stand\\_alone\\_questionnaire\\_for\\_completion\\_by\\_local\\_authorities\\_FINAL\\_37165946\\_3.pdf](http://lgpsboard.org/images/PDF/MiFIDII/Stand_alone_questionnaire_for_completion_by_local_authorities_FINAL_37165946_3.pdf).
- 2.9. However, the decision on whether to approve an opt up application is likely rest with the service provider’s Compliance Officer who has the responsibility to make the decision. They have the right to ask for further information as they see fit. This could mean multiple requests for further information as the application process gets underway.
- 2.10. Under the qualitative assessment, the questionnaire has five sections:
  - Questions about the decision-making body for pension investing;
  - Expertise, experience and knowledge of committee members;
  - Investment history and strategy (asset classes and types of investments);
  - Questions about the committee’s ability to understand risks;
  - Support for investment decisions from officers, advisers and consultants.
- 2.11. It is particularly worth noting that the last section requires information on the level of knowledge and experience of **officers, consultants and advisers** who support the committee in its decision-making. In that respect, Warwickshire is well placed because the committee has an experienced team of officers, a consultant and two independent advisers attending meetings and providing advice.

### **3. Protections that are lost by opting up**

- 3.1. The process for opt-up will consist of the following:
  - First, the client asks the service provider to be opted up and provides the necessary evidence;
  - The service provider reviews the evidence, accepts the client’s eligibility for opt up and **sends the client a list of the protections lost**;
  - The client then acknowledges that they understand this and confirms they want to opt up;
  - Only then will the service provider implement the opt up.
- 3.2. The type of lost protections, appearing in the service provider’s letter when they opt up an LGPS client from retail to elected professional status, are likely to include:
  - Communications from the supplier may be more complex in nature;

- Granularity over services and remuneration may be less specific, with less comprehensive information over costs and charges;
- It is assumed that a professional client has the necessary level of experience to understand the risks of a product being sold;
- It is assumed that a professional client can articulate their investment objectives without needing to go through a fact finding exercise;
- For execution-only transactions, the required timeframe for confirming the trade is less onerous;
- Reporting on changes in value for leveraged trades are not required;
- The services of the Financial Ombudsman Service may not be available;
- Firms can sell market alternative investment funds and unregulated collective investment schemes to professional investors;
- More relaxed rules on communicating promotions.

3.3. The draft letter prepared by the LGA for service providers to send to clients as part of the opt up process can be found here: [http://www.lgpsboard.org/images/PDF/MiFIDII/LA\\_Request\\_letter\\_for\\_client\\_status\\_recategorisation\\_FINAL\\_37129756\\_2.pdf](http://www.lgpsboard.org/images/PDF/MiFIDII/LA_Request_letter_for_client_status_recategorisation_FINAL_37129756_2.pdf)

#### 4. Implications for members

4.1. Members of the Pension Investment Sub Committee are particularly advised to note the requirements of the opt-up criteria as it applies to them, as individuals. Questions that the officers will be responding on include:

- Are members provided with a written brief on joining the committee?
- Are members provided with training on investment matters?
- Please indicate the total number of hours of training offered and delivered to the committee over the last 12 months.
- Is the attendance of members at training monitored and recorded?
- Please state the average number of hours of training committee members have attended over the last 12 months.
- Please state the average number of hours at investment conferences that committee members have attended over the last 12 months.
- Are members required to complete a self-assessment with regard to their knowledge of investments?
- Please state the number of years served on the committee (or other such investment committees) on average for each member years.
- Please provide any other information which may assist with the assessment of the knowledge, experience and expertise of the committee or subcommittee (such as the average number of years of independent investment experience by members).

4.2. **The requirement for recorded investment training and attendance at investment conferences is being formalised** as part of the assessment process and there is an expectation that all committee members will undertake suitable training. Members will need to maintain a register when they undertake training or attend conferences, which can be passed across to officers. The guidance notes do not go so far as to dictate a minimum number of hours, however.

## **5. Other considerations**

- 5.1. A recommendation is for the “elected professional” status be added to the risk register. If this status were removed in the future by an investment firm (for example, following a change in personnel of officers/advisers), it could result in subsequent restrictions on investments which in turn could impact the fund’s ability to meet its investment objectives.
- 5.2. The Pension Fund Investment Sub-Committee may also wish to refer to the opt-up status in the annual accounts. An annual review of status criteria, ahead of the annual accounts preparation, would reduce the risk in 5.1 above. Whilst authorities are not required to renew the elected professional status on a regular basis, they are required to review the information provided in the opt-up process and notify all institutions of any changes in circumstances which could affect their status, for example, if the membership of the committee changed significantly resulting in a loss of experience, or if the relationship with the authority’s investment adviser was terminated.
- 5.3. The Border to Coast Pool will be a professional investor, in its own right, so it will not need to opt up with the external institutions it uses. The Warwickshire County Pension Fund will, however, need to opt up with Border to Coast in order to access the full range of services and sub-funds on offer.

## **6. Next steps**

- 6.1. In order to continue to effectively implement the authority’s investment strategy after 3rd January 2018, applications for election to be treated as a professional client should be submitted to all financial institutions with whom Warwickshire County Council has an existing (or potential) relationship with, in relation to the investment of the pension fund.
- 6.2. This process should commence as soon as possible in order to ensure it is completed in good time and avoids the need for appropriate action to be taken by institutions in relation to the authority’s pension fund investments.
- 6.3. Members are asked to grant delegation to officers to make applications on the authority’s behalf and to determine the nature of the application on either full or single service basis.
- 6.4. Members are asked to prepare a training record and a list of conferences attended for the twelve months to September 2017.

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**August 2017**