PENSIONS AND LIFETIME SAVINGS ASSOCIATION

FCA: MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE II IMPLEMENTATION –
CONSULTATION PAPER III: CONSULTATION RESPONSE BY THE PENSIONS AND LIFETIME SAVINGS ASSOCIATION

"THE RECLASSIFICATION OF LOCAL AUTHORITIES AS RETAIL INVESTORS WILL HAVE SERIOUS CONSEQUENCES FOR INVESTMENT IN INFRASTRUCTURE"

January 2016

INTRODUCTION

We're the Pensions and Lifetime Savings Association; the national association with a ninety year history of helping pension professionals run better pension schemes. With the support of over 1,300 pension schemes and over 400 supporting businesses, we are the voice for pensions and lifetime savings in Westminster, Whitehall and Brussels. We also represent public service pension schemes and have 74 LGPS funds in membership.

Our purpose is simple: to help everyone to achieve a better income in retirement. We work to get more money into retirement savings, to get more value out of those savings and to build the confidence and understanding of savers.

PARAMETERS FOR THIS RESPONSE

The PLSA's response to this consultation focuses on the questions relating to the reclassification of local authorities as retail investors and in particular question 16 in the consultation document which asks:

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?

EXECUTIVE SUMMARY

The PLSA believes that the reclassification of local authorities as retail investors is unnecessary, does not reflect the experience and expertise of local government pension funds and will have serious implications for their ability to effectively manage their investments in line with their pension fund liabilities. It will also severely impact their ability to invest in certain asset classes, such as infrastructure, a stated objective of Government as announced in Autumn Statement 2015. Therefore we recommend that **the FCA distinguish between the investment activity of local authorities and local authority pension funds, so the latter may retain its per se professional client status to continue its effective investment strategies.**

The FCA has proposed a number of mechanisms to enable local authority pension funds to continue operating as professional clients. However we believe these processes are costly, complex and difficult to apply given the way pension funds make investment decisions. We would therefore **recommend that, if the opt up process is still required, then 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.**

Some of the pooled vehicles currently being developed by the LGPS could provide an appropriate route to the range of asset classes required by local authorities and, with the assistance of FCA, could negate the need to undergo the elective professional process. The PLSA therefore recommends that **the FCA ensure that Qualified Investor Schemes 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.**

Whilst such an exemption will help it will not address the issues fully as the majority LGPS assets in England and Wales will not begin moving into the new pooled vehicles until April 2018 and this process will take decades to complete. It will also not assist local authority pension funds in Scotland and Northern Ireland where there are no plans to pool assets across funds.

In addition, should the reclassification go ahead, clarity is urgently needed with regard to investment transactions made prior to 3 January 2018 (when the Directive comes into force) and whether LGPS funds can remain in existing mandates beyond this date. Therefore the PLSA calls on the FCA **to provide reassurance that such transactions may be honoured and will not have to be terminated before 3 January 2018.** It is not appropriate to leave funds with little time to adjust

mandates which will result in extensive costs, risks to the funding of the scheme and potentially large market exodus.

These views are shared by the Local Government Pension Scheme Advisory Board which will also be responding to the consultation.

CLASSIFICATION

Whilst the Pensions and Lifetime Savings Association is a strong advocate of strong investment governance the shift from the current position (where local authorities are classed as *per se* professional clients) to the new position (where local authorities will be classed as retail clients but could opt up to elective professional status if they meet certain criteria) is unnecessary and does not reflect the experience and expertise of local government pension funds.

The thrust of the MIFID proposals (and of the FCA's implementation plans) appears to be to strengthen safeguards for local authorities in order to prevent a repeat of the situation in which some found themselves after the 2008 crisis.

Whilst this is laudable, local government pension funds, have quite different characteristics – with significant levels of investment expertise, within the funds and through their advisors. This is openly acknowledged in the consultation document in the setting of the threshold which would allow all local authority pension funds to opt up their size is a clear indication of their ability to access resources and expertise and knowledge.

Furthermore investment by local authorities for pension fund purposes are subject to specific 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.

It is not appropriate to class them as 'retail' clients, not least because this would be inconsistent with the treatment of private sector defined benefit pension schemes, many of which are smaller than LGPS funds and are likely to lack the same levels of governance and expertise.

The consultation seems to adopt the wrong starting point. The key concern appears to be that local authorities could be classed as 'professional' by default if the hurdles were set too low, whereas our members' concern is the other way around – that there is a risk of local government pension funds being classed as 'retail' when 'professional' would be more appropriate.

This re classification 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 have serious implications for their ability to effectively manage their investments in line with their pension fund liabilities;
- is inconsistent with the 'prudent person' approach provided for in the LGPS

investment regulations 2016 and may make it difficult for pension funds to access appropriate advice; and

- is inconsistent with the Government's desire for greater infrastructure investment by local authority pension funds[1].

A host of alternative investments (such as infrastructure) are designed to enable pension funds to manage their risk and hedge against their liabilities and, as a result, are typically illiquid and long duration. This makes them most suitable for sophisticated investors, rather than those more normally categorised as "retail" investors. As a consequence, the majority of investment firms offering alternative investment services are structured to specifically exclude retail investors. The Pensions Infrastructure Platform[2], which was established by UK pension schemes (including from the LGPS) to facilitate long term investment into UK infrastructure by pension schemes, has adopted this approach and does not have regulatory authorisation to conduct business with retail investors.

Whilst MIFID makes it clear that local authorities should be classified as retail clients for investment purposes we do not believe that this Directive was ever intended to cover the operation of pension funds for local authority workers. In fact MIFID explicitly excludes pension funds from any such reclassification.

Therefore we recommend **that the FCA distinguish between the investment activity of local authorities and local authority pension funds**, so the latter may retain its per se professional client status to continue its effective investment strategies.

ELECTION FOR PROFESSIONAL STATUS

The FCA has proposed a number of mechanisms to enable local authority pension funds to continue operating as professional clients. However we believe these processes are costly, complex and difficult to apply given the way pension funds make investment decisions.

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.

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[1] Following the Chancellor's Autumn Statement 2015 the Government published criteria and guidance that the government expected LGPS funds to take into account when formulating their proposals. This included a requirement that the pooled vehicles create an improved capacity and capability to invest in infrastructure.

[2] http://www.pipfunds.co.uk/

This adds unnecessary costs which the FCA's own market study[3] demonstrates will impact on member outcomes and will also potentially lead to an increased reliance on the advice of investment consultants, another area of concern.

It is important to recognise that opting up to elected professional status would not leave local government pension funds in the same position that they currently enjoy as *per se* professional investors, since they would be treated differently by their asset managers.

For example, asset managers are likely to feel obliged – as a matter of good practice – to conduct far more extensive checks on their elective professional clients, to ensure that their knowledge and expertise is thoroughly understood.

The situation would be even more difficult if local government pension fund clients were classed as retail clients. Retail clients involve extensive Retail Distribution Review work and can be blocked from investing in non-UCITs products. This could simply make them unattractive for some asset managers. Many asset managers currently providing services to the LGPS serve exclusively institutional clients and as a result have no procedures in place for 'opting up' clients nor processes for dealing with different clients with differing classifications. Implementing such processes could prove costly, a cost that is likely to be passed onto clients. In addition companies currently providing investment advice to local authority pension funds as professional clients may feel they are unable to do so should they be reclassified as retail investors. This may make it difficult for local authorities to access cost effective investment advice and, in extremis ultimately meet the requirement under the current investment regulations to obtain 'proper advice'.

Qualitative Test

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

[3] Asset Management Market Study Interim Report, FCA, November 2015

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 and as a result there is a wealth of experience and expertise being brought to bear when such decisions are made. However these decisions are almost always made collectively, rather than by an individual. The transaction itself would then 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 **recommend that, if the opt up process is still required, then 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.** Once done we believe such a process should stand for all transactions that pension fund may enter into with the asset manager and should not need to be applied for each transaction or asset class entered into.

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;*

Quantitative test

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 first will be satisfied by local authorities in respect of pension fund activities however, except in very particular circumstances, the second will not. 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 local authority pension funds must be able to pass test (c) in order to successfully complete the opt-up process. 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).

An administering authority, which manages the pension fund, 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* it is difficult to see how it could demonstrate work *in the financial sector for at least one year in a professional position.*

Pooled assets

Since November 2015, local authorities in England and Wales have been developing asset pools in line with criteria set out by Government, including the requirement to increase capacity and capability to investment in infrastructure. These pools are currently being established under a number of different structures and will therefore be subject to different impacts from the reclassification. The impact of the proposals on the different pooled structures needs to be made clear in order to ensure Local Authority pension funds can make decisions over the coming months about the structure of their pools with a full understanding of the impact it would have on investment decisions and capabilities.

A number of pools are, for example, operating, or planning to operate, Collective Investment Schemes and as a result they have already or are considering setting up Qualified Investor Scheme fund structure 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.

The PLSA therefore recommends that **the FCA ensure that asset pools can provide an effective point of access for local authority pension funds, in line Government policy objectives, by listing them as an exemption in their own right.**

This would result in local authority pension funds in England and Wales 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.

Whilst such an exemption will help it will not address the issues fully as the majority LGPS assets in England and Wales will not begin moving into the new pooled vehicles until April 2018 and this process will take decades to complete. It will also not assist local authority pension funds in Scotland and Northern Ireland where there are no plans to pool assets across funds.

Transitional issues

Under the proposals local authorities will become retail clients on 3 January 2018. For local authority pension funds in England and Wales there will be a transitional period (which in the case of longer mandates will be many years) before investments are switched to the pools.

Asset managers and local authorities across the country require clarity with regard to transactions made before that date as per se professional clients which could not be made after it as retail clients. Exiting such mandates before they have reached maturity is likely to generate significant costs for funds and could potentially create market distortions. The mandates in question are likely to be in more specialist, alternative asset classes where investment durations are typically longer and exit fees high. In addition local authorities are often bound by lengthy OJEU procedures which impact on the speed with which they can disinvest and establish new mandates. From our discussions with managers of alternative assets we believe that simply coming out of existing illiquid investments may be impossible by January 2018. Finally, given the amount of assets under management in the LGPS (£241bn at March 2016) significant movements out of certain asset classes in the run up to January 2018 could move certain markets.

Therefore the PLSA calls on the FCA **to provide reassurance that such transactions may be honoured and will not have to be terminated before 3 January 2018.** It is not appropriate to leave funds with little time to adjust mandates which will result in extensive costs, risks to the funding of the scheme and potentially large market exodus.