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Changing status of EU local authorities under MiFID II

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Asset managers located inside and outside the European Union ("EU") should be aware of the changing regulatory status of EU local authorities, and their pension funds, under the next iteration of the Markets in Financial Instruments Directive ("MiFID II"), that applies on 3 January 2018.

EU local authorities are active users of wholesale financial services, whilst their pension funds frequently invest in funds or engage investment managers to manage their assets. Any EU or non-EU firm that trades with or that is engaged directly by the local authority, or that is marketing a fund or other financial product to a local authority, will be affected.

Change under MiFID II

MiFID requires investment firms to classify their clients as retail clients, professional clients or eligible counterparties, with the level of classification determining the degree of protection afforded to the client. Under the current rules, investment firms within the scope of MiFID may classify local authorities and their pension schemes as *per se* professional clients if they meet any of the categories of clients that are considered *per se* professional clients, such as pension funds or large undertakings.

From January next year, MiFID II will exclude "public sector bodies, municipalities and local public authorities" from the list of per se professional clients. These terms are not defined in MiFID II, given the many different types of these bodies across the EU, but generally mean public institutions below state level, from large regional or city authorities to small town or village councils.

These types of clients will be treated under MiFID II as *per se* retail clients and given the same protections as individual investors. Asset managers and other investments firms will need to obtain the agreement of any such client to be treated as an "opted up" professional client, with an assessment by the firm of the client's expertise and knowledge. The change in MiFID II reflects a view that local authorities (and, in particular, their treasury functions) may not be as sophisticated as the *per se* professional client definition requires – the Directive stating that "the financial crisis has shown limits in the ability of non-retail clients to appreciate the risk of their investments".

Treatment of local authority pension funds

Local authority pension funds typically invest in many types of funds. The pension fund may be held within the local authority (where the pension fund is an asset of the local authority) or may be held by another person, such as a trustee. Whether or not the pension fund will be treated as a *per se* retail client may depend on whether or not the fund is legally segregated from the authority. In the UK, a common arrangement is for the local authority itself to hold and administer the assets, although local authorities have moved recently to pool their assets for greater efficiencies of scale. Given the relative sophistication of these funds and the size of their assets under management, it may seem incongruous to treat them as retail clients.

MiFID II includes criteria to opt up a client to professional client status. These are largely unchanged from the original MiFID, and require firms to apply a qualitative test (that, on an assessment of the expertise, experience and knowledge of the client, the client is capable of making investment decisions and understanding the risks involved) and a quantitative test (that the client meets two of three criteria, namely (i) that 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; (ii) that the size of the client's financial instrument portfolio exceeds 500,000 euros; and (iii) that 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). Under MiFID II, Member States may adopt additional or alternative criteria for the assessment of the expertise and knowledge of local authorities when they ask to be treated as professional clients.

These tests have largely been applied to date to individual investors. As such, questions arise in applying these tests to local authorities – for instance, when assessing whether the client has prior experience of working in the financial sector. In its work implementing MiFID II into UK law, the UK Financial Conduct Authority ("FCA") set its own criteria for the opt-up for UK local authorities, and provided guidance on application of the client's expertise, experience and knowledge, such as where investment decisions are made by a committee – in that circumstance, the firm may take a collective view of the expertise, experience and knowledge of committee members. Also, in light of the difficulties associated with applying some of the quantitative criteria to local authorities, the FCA added a fourth criterion to this test, that the client is subject to the Local Government Pension Scheme Regulation for its pension administration business. This will assist local authority pension fund administrators that wish to opt up to meet the quantitative test. The FCA also changed the portfolio size threshold from 500,000 euros (more suitable for an individual investor) to £10m, to reflect its policy goal of restricting the ability of the smallest and less sophisticated investor to opt up. The tests apply separately when dealing with a local authority for the administration of a pension scheme as opposed to the local authority's treasury function.

Firms will need to have regard to the local implementation of the test in other EU jurisdictions in which their local authority clients may be located.

Impact on asset managers

Asset managers that are engaged directly by a local authority or its pension fund – in particular, in the context of a segregated account mandate – should take steps to opt up the local authority. Although MiFID II has granted many of the pre-existing client protections for retail clients to professional clients, the implications of performing an investment service for a retail investor include stricter application of the "suitability" check when giving investment advice or performing portfolio management and the "appropriateness" check for execution only business.

To the extent they have the power to do so, asset managers are well advised to take steps to opt up local authority pension schemes that invest in their funds under management. The Alternative Investment Fund Managers Directive ("AIFMD") does not confer any particular protections on retail investors in alternative investment funds, although local law may do so. However, AIFMD allows marketing of alternative investment funds to retail investors only at the discretion of individual Member States, and managers are advised to opt up existing investors that are local authority pension funds or find that their future ability to market to such investors is limited. Additionally, the new EU Packaged Retail Investment and Insurance Products Regulation (applying from 31 December 2017) requires production of the "key information document" ("KID") for distribution of any fund to any retail investor in the EU – the time and expense of producing the KID to admit a single or small number of retail investors into a fund may be disproportionate.

Impact on non-EU firms

Where a non-EU asset manager has been engaged directly by the local authority (in particular, for a segregated account mandate), the asset manager should take steps to opt-up the local authority – although there are unresolved questions on the power of non-EU managers to perform the opt up. Whilst the non-EU manager will not be subject to the substantive requirements in MiFID that apply to EU firms that face retail clients, it may be prudent to perform the opt-up for the following reasons. Firstly, it may find its ability to market other services or products (such as interests in successor funds) to retail investors curtailed in the future. Secondly, where a non-EU manager is performing an investment service governed by MiFID directly to a local authority (such as a segregated mandate), the manager will need to have regard to the new rules in MiFID II on "third country" (non-EU) firms that provide such services to retail clients. Under current rules, the ability of a non-EU firm to market a service to, and provide a service to, retail clients in an EU state is a matter of local law. Under MiFID II, a Member State may require a third country firm that is providing services (with or without any ancillary services) to retail clients and opted-up professional clients to establish a branch in that state. Although current indications are that few Member States are imposing this new requirement, non-EU managers are well advised to opt up their local authority clients to avoid the application of local restrictions that apply performing investment services to retail clients in a jurisdiction.