Sackers

Finance & investment briefing

December 2017

Sackers finance & investment group takes a look at current issues of interest to pension scheme investors

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Abbreviations

CJEU: Court of Justice of the European Union

DB: Defined benefit

DC: Defined contribution

DWP: Department for Work and Pensions

ESG: Environmental, social and corporate governance

EU: European Union

FCA: Financial Conduct Authority

FSA: Financial Services Authority

HMRC: HM Revenue & Customs

HMT: HM Treasury

LDI: Liability-driven investment

LEI: Legal entity identifier

MiFID: Markets in Financial Instruments Directive

OTC: Over-the-counter

PLSA: Pensions and Lifetime Savings Association

SEC: Securities and Exchange Commission

SIF: Special Investment Fund

VAT: Value Added Tax

Finance & investment focus

"Welcome to the final 2017 issue of our finance & investment briefing.

In this edition we have decided to focus on MiFID II, which will be coming into force on 3 January 2018. MiFID II will have a significant impact on:

- how financial services firms do business
- trading of equities, fixed income and derivatives
- the extent to which activities need to be reported to the authorities.

In our recent seminar, we teamed up with Yuhang Wang from Bank of America Merrill Lynch to look at some of the practical implications of MiFID II for pension schemes. Whilst most of the onus will be on investment managers rather than pension fund trustees, there are a few things trustees might like to do to prepare and on page 4 Mike Fallow sets out our MiFID II "to-do" list.

We finish the year with a round-up of the changes to anti-money laundering requirements and a look at the latest update in the long-running question of VAT treatment for (pension fund) investment management fees.

As we look forward to 2018, Sackers finance & investment group will once again be attending the PLSA Investment Conference in March – please see our website for further details.

With best wishes for Christmas and the New Year."

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MiFID II

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MiFID II: What's coming?

After some delay, MiFID II will come into force on 3 January 2018. Like MiFID, MiFID II is implemented through a framework directive (which necessitates UK legislation) and a regulation (which will have direct effect).

MiFID II substantially updates and changes MiFID. Its application to a broader range of asset classes, including assets in both equities and non-equities classes (such as bonds, structured finance products, derivatives) means it will change the way financial services firms can conduct their business. This will affect a variety of institutional investors, such as pension schemes.

MiFID: The Fundamentals

The MiFID Framework Directive came into force at the end of April 2004 with "an overarching objective to further integration, competitiveness and efficiency of EU financial markets". It opened up financial markets by abolishing Member States' ability to require trading on traditional exchanges and therefore ensured competition between exchanges along with the development of alternative trading venues. MiFID prescribed the prudential and conduct of business rules applicable to investment firms and increased transparency requirements, developing a new regulatory regime for securities markets. Passporting rights not previously enjoyed allow banks and investment firms to provide services across the EU, subject to registration with appropriate regulatory authorities and observation of conduct rules in the relevant jurisdiction. In short, MiFID sought to, and succeeded in, further integration of EU financial markets and services.

In the UK, much of MiFID was implemented through amendments to the FSA (as it then was) Handbook. The FSA and HMT took an "intelligent copy-out" approach, meaning that MiFID provisions were largely transposed into UK regulations.

MiFID: Scope

In terms of scope, MiFID:

- divided clients into different categories
- applied information requirements on investment firms
- extended the "know your customer" requirements to professional clients
- updated the methodology for best execution
- required the adoption of formal conflicts policies by firms which need to address specific conflicts relevant to the firm
- increased transparency requirements (particularly pre-trade transparency for firms transacting off-market)
- set a framework for outsourcing of critical functions
- abolished the right of professional clients to opt out of client money protection
- introduced the concept of tied agents.

MiFID II: Policy objectives

MiFID II's main policy objectives are transparency, managing conflicts of interest, investor protection and accountability and market integrity. These flow through to a number of updated rules on brokers and asset managers and may therefore affect UK pension schemes' current contractual relationships with such parties. We look more closely at the main points below. Whilst much of MiFID II will not have a direct impact on pension scheme trustees, there are certain action points that they should be considering.

MiFID II cont.

Your MiFID II to-do list

Issue	Action
LEI Numbers	Obtain one. As a result of the changes, most pension schemes are required to obtain an LEI by 3 January 2018. An LEI is a global reference number which identifies legal entities that are party to financial transactions across all jurisdictions. LEI numbers can be obtained from the London Stock Exchange. Without one, the scheme's managers will be unable to execute trades on behalf of the scheme.
Charging structures	Talk about them. A discussion about fees is something most of us won't want to confront, but you should be considering whether, as a result of the unbundling of charges, your managers will be looking to update charging structures. In particular, you should be asking how research will be paid for in the future.
Conflicts and best execution	Ask for and review new policies. MiFID II results in managers being required not only to treat customers fairly in relation to conflicts of interest, but to develop and maintain a written policy outlining how they intend to do so. This is a welcome development for investors as they will get further clarity on how managers view and handle conflicts of interest. However, it does mean that more time will be taken reviewing these policies in future. In addition to the changes around conflicts of interest, the rules on best execution have been updated and gold-plated. Managers are required to evidence and monitor best execution, increase their due diligence on broker execution capabilities and enhance governance in the area generally.
Reporting requirements	Understand them. A discussion with your managers should also include asking them about the new reporting requirements and how these will be covered in any agreement you have.
Market infrastructure	Test it. Ask managers how the changes to the market infrastructure could impact the mandate.

Most changes will affect the way financial services firms will conduct their business and offer services to their clients. Here are some key changes:

Knowledge is a good thing

Dealing commissions (the amount paid by an investment manager to a broker, primarily for its execution services) may also be used to pay for other services, such as research. The current regime does not prevent bundling for execution-related and research-related goods and services. The new regime requires unbundling; managers will have to pay for research out of a separate account.

The biggest impact is likely to be in the fixed income markets, where a deal's spread pays for the trade, and research has been seen as a free component. Dividing the payment for research in this way may result in smaller spreads. It may also, ultimately, mean paying directly for research. Trustees may wish to clarify with their investment managers whether external research costs will be charged as an expense to the scheme, as we've mentioned in the MiFID II to-do list.

MiFID II cont.

Across the pond

Conflicting US approach – guidance expected

The line that the SEC has taken in the US has made unbundling a contentious point. While MiFID II will require unbundling the cost of research from the cost of executing trades, under US rules those who sell research for "hard" dollars must register as an investment adviser (in contrast to those using "soft" dollar arrangements, where research services are bundled into the dealing commissions).

It is not yet known how the US and EU regimes will coexist, but the SEC is expected to provide some guidance. Meanwhile, some institutions have simply taken the plunge and registered with the SEC as investment advisers so they can continue providing research to managers in the EU once MiFID II takes effect.

I can see clearly now the rain is gone (and MiFID II is here)

Transparency measures

In relation to clients (eg trustees of pension schemes), managers will be required to provide periodic statements outlining activities undertaken and performance. Whilst current contractual requirements under many schemes' investment management arrangements will require managers to report on costs and performance, it will now be required by the legislation and you may see a greater focus on this type of reporting in future. Indeed, you may receive updated guidance on risks associated with the types of investments and strategies to which the scheme is exposed.

In addition, trade and transaction reporting have been revamped. MiFID II expands the scope of trade reporting obligations from just equities to equities plus fixed income, derivatives and commodities. Under the current regime, it is usual that buy-side firms will agree that trade reporting will be done by their broker with no further action required. Parties to a transaction can agree which one of them will take the responsibility for reporting the trade. In most cases, MiFID II places responsibility for reporting on the seller.

Transaction reporting is also updated and this may impact directly on the amount of information required from schemes. There has been a substantial increase (from 26 to 65) in the number of reporting fields required; the updated fields include, for example, personal data about the investment committee that approved the transaction. Buy-side firms currently benefit from an exemption that allows them to forgo making a report where they have reasonable grounds to believe that the broker will make a transaction report to the relevant regulator (eg the FCA). This easement will continue under MiFID II, but only where the broker agrees to make an additional report on the firm's behalf.

The place to be…

Increased trading regulation

Transparency also flows through into trading venues. MiFID originally set out to open up financial markets by abolishing Member States' ability to require trading on traditional exchanges, and adding additional categories of regulated markets for the trading of financial instruments. However, the classes of financial instruments which then had to be traded on these regulated markets was restricted. MiFID II broadens the regulation of these alternative venues and, crucially, requires that more financial instruments now need to be traded on them. In the future, products such as bonds, structured finance products, emissions allowances and derivatives will become subject to increased trading regulation.

Dark pools

Understanding new venue services will mean understanding the sources of liquidity across the market. Restrictions on "dark pools" is a case in point. Dark pools are private forums or exchanges for trading and allow institutional investors (such as pension schemes) to trade large blocks of equities discreetly at non-public prices. MiFID II will cap the trading on dark pools.

Legal update

Anti-Money Laundering ("AML") requirements

As has been the case since 2007, an individual or company offering professional trustee services to occupational pension schemes falls within the definition of "trust and company service providers" ("TCSPs"). As such they must comply with the AML requirements, but will not be required to register with HMRC. For example, they must:

Requirements for TCSPs

- undertake a risk assessment to identify and assess the risks of money laundering and terrorist financing to which their business is subject
- establish and maintain policies, controls and procedures to mitigate and manage effectively the risks of money laundering and terrorist financing identified in the risk assessment
- in certain circumstances, undertake customer due diligence to verify the identity of the person or the beneficial owner of an entity with whom they are forming a contractual relationship.

Record-keeping

All trustees of occupational pension schemes are now subject to extensive record-keeping requirements in respect of their beneficial owners, broadly the participating employers, the trustees and the members / prospective members, including survivors.

There is still some uncertainty as to the level of information to be recorded and the Association of Pension Lawyers continues to explore this with HMRC. Trustees should speak to their usual Sackers contact to clarify what is needed for their scheme.

HMRC's register of beneficial owners

In addition, schemes which incur certain UK taxes (including stamp duty land tax and stamp duty reserve tax) in any tax year must provide information for HMRC's register of beneficial owners. Schemes which hold direct property or equity portfolios (as opposed to those which invest in pooled funds) are most likely to incur such liabilities, but we recommend all trustees confirm with their accountants at the end of each tax year whether any relevant charges have arisen.

Trustees should check whether the scheme has incurred a relevant tax liability in the tax year 2016/17. If it has, the necessary information must be entered into HMRC's register of beneficial owners by 31 January 2018.

Proposed changes to investment disclosure

The Government has concluded that requiring DC schemes to disclose information relating to their pooled funds (strictly, collective investment schemes) will build confidence in pension saving. In its October 2017 consultation, "Disclosure of costs, charges and investments in DC occupational pensions", it therefore proposes:

Pooled Fund Disclosure

- imposing a duty on trustees to disclose, on request, to members and recognised trade unions, the top level of funds in which members are invested and for which public information is available
- requiring trustees to tell members, via their annual benefit statement, that this information can be obtained on request
- requiring trustees to disclose the fund holdings over the scheme year.

Currently there is no intention to require this information to be published, but the DWP notes that "schemes with larger or more actively engaged memberships may decide that this is a more cost effective way of complying with this proposed requirement".

Legal update cont.

VAT treatment of pension fund management services

Key characteristics of a SIF

Since the CJEU's judgment in *ATP Pension Services*, HMRC has accepted that UK DC pension funds which have all of the following key characteristics are SIFs for the purposes of the fund management exemption:

- they are solely funded (whether directly or indirectly) by persons to whom the retirement benefit is to be paid (ie the pension customers)
- the pension customers bear the investment risk
- the fund contains the pooled contributions of several pension customers
- the risk borne by the pension customers is spread over a range of securities.

This means that the services of managing and administering those funds are, and always have been, exempt from VAT.

HMRC reverses policy on pension fund management services

As HMRC understands that there will now be no further review of EU rules in this area before Brexit, it intends to update its policy to reflect the settled case law. This means pension fund management services provided by insurers to DB occupational pension funds will change from being VAT exempt (as insurance) to being subject to VAT at the standard rate. In announcing this change, HMRC said that it understands that the great majority of pension fund management services provided by insurers are supplied for DC pension funds and therefore qualify for exemption as SIFs. However, we understand that DB schemes do use fund management services provided by insurers and anticipate discussion about how those services will be affected by the change.

The change was intended to take effect from 1 January 2018, but HMRC has agreed to postpone in order to provide insurers with more time to take action. HMRC will announce the revised implementation date shortly.

Measures on the horizon

Future changes?

The Government is "looking again" at whether legislative change might be helpful in clarifying trustees' legal duty to consider financially material risks including, where appropriate, those arising from environmental, social and governance factors". It intends to publish an interim response to the Law Commission on this "no later than December 2017".

In addition, the DWP is considering whether to expand and / or require publication of a scheme's Statement of Investment principles.

Sackers

Contact

Sackers is the UK's leading commercial law firm for pension scheme trustees and employers. Over fifty lawyers focus on pensions and its related areas, including Sackers' finance and investment group, a team of lawyers who provide cutting edge advice to trustees, employers, corporate investors and providers on all aspects of pension scheme finance and investment.

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