

FSC Newsletter

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**Financial Services
Commission**

Introduction

This newsletter is directed at firms and banks that are authorised under the Financial Services (Markets in Financial Instruments) Act ("the Act"). This newsletter covers the generic findings from the Risk Assessment visits in relation to the Markets in Financial Instruments Directive (MiFID).

One of the objectives of the Risk Assessments conducted by the FSC is to improve the FSC's understanding of the business and control risks faced by the firm, focusing in particular on those Key Risk Areas deemed to be significant.

A number of common themes have emerged from the reviews conducted to date. We have therefore issued this paper as a guide to the Commission's expectations concerning the operations of authorised firms. Firms are therefore asked to consider the contents of this newsletter within the context of their operation.

Background

MiFID came into effect on 1 November 2007, replacing the Investment Services Directive (ISD). MiFID extended the coverage of the ISD and introduced new and more extensive requirements that firms would have to adapt to, in particular for their conduct of business and internal organisation.

Firms were required to comply with these more detailed requirements as from 1 November 2007.

Best Execution

MiFID sets prescriptive rules on best execution and requires firms to execute orders on a prompt, fair and expeditious basis. Best execution rules are intended to produce the best possible results for the execution of client orders to buy and sell financial instruments covered by MiFID. A firm is required to document the processes and procedures applied to orders. The Commission has found that arrangements in some firms, to ensure best execution, have not been fully documented.

MiFID also requires firms to disclose important appropriate information about their execution policy to consumers. In order for this information to be useful to clients it should include sufficient detail to enable them to make meaningful choices about the nature and quality of the execution arrangements. In some cases information supplied to clients has been found to be limited.

Firms should refer to the Suitability, Appropriateness and Best Execution Guidance Note to ensure that arrangements are documented and information supplied to clients contain all the required detail.

Conflicts of Interest

Firms subject to MiFID are required to establish, implement and maintain an effective conflicts of interest policy set out in writing, and which should be appropriate to the size and organisation of the firm and the nature, scale and complexity of its business. Furthermore, firms are required to supply certain details of their conflicts of interest policy to clients.

It has been observed on occasions that firms' policies are somewhat of a limited nature as they have not provided sufficient details of actual potential conflicts of interest and the measures in place to mitigate these. For further guidance on the requirements please refer to the Managing Conflicts of Interest & related Organisational Requirements Guidance Note.



Suitability and Appropriateness

When providing investment advice or discretionary portfolio management services, suitability should be tested for retail and professional clients. The firm must obtain sufficient information regarding the client's knowledge and experience, financial situation and investment objectives to enable it to recommend investment services and financial instruments suited to the client. In some firms there has been insufficient evidence to show how firms have tried to establish suitability. Likewise there is little evidence that areas such as: investment objectives; financial situation; knowledge and experience, have been taken into account.

When providing execution only business, information must be sought to enable the firm to determine whether the client has the necessary knowledge and experience to understand the risks involved in the transaction or service concerned and whether the service or product is appropriate for the clients. This is known as the Appropriateness Test. The FSC has found examples of inadequate evidence of how firms have assessed appropriateness for clients. In some cases there were no assessments to show how the firm complies with the requirements, in particular in determining whether the transaction that the client is entering into is appropriate. Furthermore, the firm must ensure it provides appropriate risk warnings to the client when the instrument is not appropriate for them.

Firms should refer to the Suitability, Appropriateness & Best Execution Guidance Note.

The document available via the following link has been issued by The Committee of European Securities Regulators (CESR) and provides further useful guidance on the above raised issues. <http://www.cesr-eu.org/popup2.php?id=4984>.

Reporting to Senior Management

The FSC would like to remind firms that MiFID requires increased senior management responsibility in order to comply with the obligations. In implementing MiFID, senior management will need to be involved and take decisions on the appropriate course of action for the imposed requirements, and the firm will be required to ensure that senior management meet the requirements for responsibility as set out in Regulation 9 of the Financial Services (Markets in Financial Instruments) Regulations.

In addition, the firm should ensure that on a frequent basis and at least annually, senior management receive written reports on the matters covered by the Financial Services (Markets in Financial Instruments) Regulations 6 (Compliance), 7 (Risk Management) and 8 (Internal audit), indicating in particular whether the appropriate remedial measures have been taken in the event of any deficiencies. On a regular basis the supervisory function¹ must also be provided with written reports on the same matters. The Commission has found that some firms have not yet implemented this requirement.

Furthermore some of the reports seen did not cover all aspects mentioned in the said regulations.

Risk Management

Firms must establish, implement and maintain adequate policies and procedures designed to detect any risk of failure by the firm to comply with its obligations under the Act, as well as the associated risks. Additionally firms must put in place adequate measures and procedures designed to minimise such risk and to enable the competent authority to exercise its powers effectively under the Act. The Commission has found that some firms have failed to comply with Regulation 7 in this respect.

¹ Regulation 9 (4) of MiFID states that for the purpose of this regulation, "supervisory function" means the function within an investment firm responsible for the supervision of its senior management.



Internal Audit

Firms must establish and maintain an internal audit function which is separate and independent from the other functions and activities of the investment firm. This will have to be appropriate and proportionate in view of the nature, scale and complexity of the business and the nature and range of investment services and activities undertaken in the course of that business. The Commission has found that this has not always been dealt with by firms.

Segregated Compliance Function

Firms are required to establish and maintain a permanent and effective compliance function which operates independently. However, it has been noted that in some cases a firm's compliance function is not segregated from the business. MiFID has specific requirements in this respect.

MiFID does, however, also cater for smaller firms where such segregation is not possible or feasible, and subject to these firms meeting the criteria set out in Regulation 6(4), a firm can formally apply in writing to the Commission for an exemption. Firms should refer to the Financial Services (Markets in Financial Instruments) Regulations 2007 for further direction.

The FSC asks that firms promptly familiarise themselves with the requirements in the Act, Regulations and in addition the Guidance Notes that have been issued by the FSC.

These can be found on the FSC website via the following link - <http://www.fsc.gi/r2b/mifid.htm>

Firms that have not finished applying and implementing all the requirements introduced by MiFID should be aware that the FSC, in line with the requirement set out in Regulation 2(1) of the Financial Services (Markets in Financial Instruments) (Penalty Fees) Regulations 2007, may levy a penalty fee of £5,000 . The Commission has not yet levied such a penalty but will do so in cases of persistent or material breaches

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The advice or interpretation given in this publication represents the views of the FSC as to its expectations of how the requirements of the relevant legislation in question are to be complied with and/or how it falls to be applied. This, however, is not intended as a definitive interpretation of the applicable legislation which is ultimately a matter for the courts to determine. You are, therefore, strongly advised to seek appropriate legal advice before any action or decision is taken (if you have not already done so). The FSC does not provide, or purport to offer, legal advice.