Financial Services Commission

Guidance Note

Managing Conflicts of Interest & related Organisational Requirements

Markets in Financial Instruments Directive [MiFID]

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1 Introduction

The Markets in Financial Instruments Directive (MiFID) came into effect on 01 November 2007, when it replaced the Investment Services Directive (ISD). MiFID has been implemented in Gibraltar via the Financial Services (Markets in Financial Instruments) Act 2006 ("the Act") and the Financial Services (Markets in Financial Instruments) Regulations 2007 ("the Regulations").

The aim of this Guidance Note is to supplement the legislation in regard to Managing Conflicts of Interest and related Organisational Requirements.

2 Managing Conflicts of Interest

To date the ISD imposed a general obligation on firms to manage conflicts of interest. Currently firms should try to avoid conflicts of interest and where not possible they should ensure that clients are fairly treated.

MiFID provides for conflicts of interest to be managed effectively. It goes into greater detail by requiring firms to maintain and operate effective organisational and administrative arrangements by taking all reasonable steps in order to prevent conflicts of interest[1] from affecting the interests of its clients. Under Section 18 of the Act, firms are required to identify all conflicts of interests that may arise in relation to the provision of investment and ancillary services, between themselves (including their managers, employees and tied agents, or any person directly or indirectly linked to them by control) and their clients, or between one client and another.

Where organisational or administrative arrangements made by the firm to manage conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented, the firm is obliged to clearly disclose actual or potential conflicts to the client. This is explained in more detail in section 2.5.

2.1 The Requirement under MiFID

The Regulations require firms to identify, manage, record and, where relevant, disclose actual or potential conflicts of interests between themselves and their clients and between one client and another and to have a policy in place to deal with conflicts of interest ("the Requirement").

In the first instance, a firm needs to determine whether it is subject to the Requirement by assessing the following factors:

- Does the conflict arise in the course of carrying out regulated activities, ancillary activities or ancillary services (but only where the ancillary service constitute MiFID business) or any combination of thereof?
- Does the firm, when carrying out activities as described above, provide a service to a client?

[1] As described under S18 of the Act – 'Conflicts of interest between themselves, including their managers, employees or any person directly or indirectly linked to them by control and their clients or between one client and another that arise in the course of providing any investment and ancillary services, or combinations thereof'.

- Is there material risk of damage to the interests of the client to whom it is providing a service to in the course of carrying out the activities as described above?

If the firm has answered 'YES' to any of the factors above then the Requirement applies to it. It applies regardless of the type of client the firm is dealing with. The Requirement applies on a home state basis. This means that firms are required to comply with the Requirement as implemented in Gibraltar, regardless of whether they operate under the single passport on a cross-border basis or through local branches in other EEA member states.

If a firm determines it has to follow the Requirement then it needs to:

- Take all reasonable steps to identify conflicts of interest between (i) itself or any relevant person[2] and its clients or (ii) one client and another;
- Maintain and operate effective organisational and administrative arrangements by taking all reasonable steps designed to prevent the conflict of interest from occurring or giving rise to a material risk of damage to the interests of its clients;
- Disclose the general nature and/or sources of a conflict with the interests of the client, where the arrangements to manage a conflict of interest are deemed insufficient to ensure, with reasonableness, that risks of damage to the interests of a client will be avoided;
- Prepare, maintain and implement an effective written conflicts of interest policy (in the event that the firm is a member of a group, this policy must take account of circumstances of which it has knowledge that may give rise to a conflict of interest arising out of the structure and business interests of other members of the group);
- Provide retail clients, or potential retail clients, with a summary of the policy (although further details must be provided should the client require it); and
- Keep records of the instances in which a conflict has arisen or may arise, stating in particular the services and activities where it has been identified.

2.2 Identifying the conflicts

A firm is required to take all reasonable steps to identify conflicts of interest and to manage them.

The manner in which a firm is organised and the nature of the business it undertakes will impact on the scale and the materiality of the conflicts of interest that arise or may arise, and this will in turn impact on the steps that it will be reasonable for the firm to take.

Firms may take into account the following when determining what steps should be taken:

[2] Is defined under the Regulations as any of the following '(a) a director, partner or equivalent, manager or tied agent of the firm; (b) a director, partner or equivalent, or manager of any tied agent of the firm; (c) an employee of the firm or of a tied agent of the firm, as well as any other natural person whose services are placed at the disposal and under the control of the firm or a tied agent of the firm and who is involved in the provision by the firm of investment services and activities; (d) a natural person who is directly involved in the provision of services to the firm or its tied agent under an outsourcing arrangement for the purpose of the provision by the firm of investment services and activities.

- The probability that a conflict of interest may amount to, or give rise to, a material risk of damage to the interests of a client or clients.
- The nature, scale and complexity of the firm's business locally and internationally.

  Firms carrying out a simple range of services and activities might encounter fewer conflicts than those firms which carry a diverse range of services and activities. Therefore policies and procedures for the former type of firm may be less detailed.

  However, a firm providing only investment management services could regularly encounter conflicts of interest while allocating securities to different funds and different client portfolios.
- The nature and range of products and services offered in the course of that business.

  Firms providing services which carry a high risk of damaging client interests as a result of conflicts will need to apply greater resources to managing such conflicts.

  Where the services provided by a firm to its clients carry a low risk of those clients' interests being damaged by conflicts, a firm may be able to dedicate less resources to manage such conflicts.

The requirement to identify and manage conflicts of interest applies equally to all types of clients regardless of their categorisation.

A firm should, as part of its processes and procedures, assess situations within its business activities (where the firm is part of a corporate group this should include other members) that could potentially give rise to conflicts of interest.

In identifying conflicts that may arise, firms should consider services and activities carried out by each line of business. The firm should have in place processes that enables it to identify any new conflicts that may arise, for example as part of new business approval processes if a new activity is being carried out or a new client segment is being targeted by the business.

Each firm will encounter its own particular set of conflicts, relevant to its specific services and activities and will have to develop its own policy in relation to those conflicts.

Examples of circumstances in which conflicts may arise generally are found below:

Firm and client conflicts	A firm trading its proprietary positions in a security when at the same time it has information about future transactions with clients in relation to that security.
	An employee of a firm engaging in personal account dealing in respect of securities where the firm has a client with an interest that potentially conflicts with such dealing.
	A firm being the syndicate agent for a financing arrangement for a client where the firm's corporate finance team is looking to advise another firm targeting that client.
	A firm having information in relation to distressed assets where the firm trades proprietary positions in those assets.
	A firm providing corporate finance advice to one corporate client and subsequently, when that corporate client becomes a

	target of a bid, the firm is also seeking to act for the bidder.
	A firm providing advice to a corporate in relation to a debt issuance and advising other clients as to the pros and cons of investing in the debt.
	A part of a multi-service financial institution being used by another part of the same institution which owes fiduciary obligations.
	A firm receiving substantial gifts and entertainment (including non-monetary gifts) that may influence behaviour in a way that conflicts with the interests of the clients of the firm.
Client and client conflicts	A firm providing corporate finance advice in relation to the same target to clients who are direct competitors of one another.
	A firm providing investment research in relation to an entity or group to which it also provides corporate finance advisory services.
	A firm providing advisory and financing services to one client in respect of a bid and seeking to provide financing services to another client in respect of the same bid.
	A firm acting as a discretionary portfolio manager for more than one client or fund.

The above is not an exhaustive list of examples.

2.3 Managing the conflicts

Firms are required to maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps to prevent the conflict of interest taking place or giving rise to a material risk of damage to the interests of its clients.

Firms must implement effective procedures which prevent the exchange of information between relevant persons in order to achieve the requisite level of independence to prevent circumstances which may give rise to a conflict of interest. Furthermore relevant persons should be separately supervised when involved in providing a service to clients whose interests may conflict.

In the event that a firm is part of a corporate group, by ensuring that all members of the group operate independently from each other, the entities shall not be deemed to have knowledge of each other for the purposes of managing conflicts of interest. However, this excludes instances in which the firm has actual knowledge which gives rise to conflicts of interest because it has been informed of the conflict by a member of the group or has been informed via other means such as the press etc.

When formulating organisational structures, firms should ensure that these do not give rise to behaviour that may lead to conflicts, such as the rewarding of performance, which may put the interests of the firm or other clients before the interests of the client.

Firms shall put in place arrangements and policies that limit the possibility of conflicts arising between itself and clients. An example of this would be restrictions on directorships of other companies.

Senior management is responsible for ensuring that a firm's systems, controls and procedures, are vigorous and suitable to identify and manage any conflicts of interest that may arise within the full range of business activities for which they are responsible. Senior management should ensure, as far as practicable, that those arrangements operate effectively and that the policies and procedures in place achieve a consistent treatment of conflicts throughout the organisation. In order to help senior management achieve this, they should receive regular management information on the scope of, and mitigation of, conflicts.

2.4 A written conflicts of interest policy

Firms are required under Section 22(1) of the Regulations to establish, implement and maintain an effective conflicts of interest policy which needs to be set out in writing and be appropriate to the size and organisation of the firm and the nature, scale and complexity of its business.

The policy must:

- Identify what reasonable steps the firm will take to identify conflicts of interest between:
  - (i) the firm, including its managers, employees, tied agents, or any person directly or indirectly linked to them by control and a client of the firm; or
  - (ii) one client of the firm and another client.
- Identify by reference to the specific services and activities carried out by or on behalf of the firm, the circumstances which constitute or may give rise to a conflict of interest entailing a material risk of damage to the interest of one or more clients; and
- State, by way of minimum criteria, how the firm will assess whether it or a relevant person, or person directly or indirectly linked by control to the firm:
  - (i) is likely to make a financial gain, or avoid a financial loss, at the expense of the client;
  - (ii) has an interest in the outcome of a service provided to the client or of a transaction carried out on behalf of the client, which is distinct from the client's interest in that outcome;
  - (iii) has a financial or other incentive to favour the interest of another client or group of clients over the interests of the client;
  - (iv) carries on the same business as the client;
  - (v) receives or will receive from the person other than the client an inducement in relation to a service provided to the client, in the form of monies, goods or services, other than the standard commission or fee for that service.
- Specify procedures to be followed and measures to be adopted in order to manage such conflicts.

The policy should also specify the level below which small gifts and minor hospitality are irrelevant in relation to inducements.

The policy must ensure that relevant persons engaged in different business activities involving a conflict of interest carry on these activities independently

of one another in a manner appropriate to the size and activities of the firm and group to which it belongs, and to the materiality of the damage envisaged to the interests of its clients.

2.5 Disclosure

Under MiFID firms are required, where organisational or administrative arrangements to manage conflicts of interest are insufficient to ensure (with reasonable confidence) that risks of damage to client interests will be prevented, to disclose to clients, or potential clients, the general nature and/or sources of conflicts of interest before undertaking the business.

This disclosure must be made in a durable medium and include sufficient detail, taking into account the client's categorisation, to enable the client to take an informed decision with respect to that particular service. For example, where the client is a retail client it may be necessary to provide greater detail of the conflict than if the client were a professional client or an eligible counterparty, in order to enable the client to make an informed decision on whether to go ahead with the business.

The written disclosure should be clear, fair and not misleading irrespective of the client's categorisation.

Disclosure should only be used where all methods of managing a conflict of interest have been tried and have been deemed as insufficient. It should not be seen as a method of managing a conflict in itself.

2.6 Record of conflicts

Firms are required to keep, and regularly update, a record of the kinds of investment or ancillary service or investment activity carried out by or on behalf of the firm in which a conflict of interest has arisen or may arise. This record will be inspected by the FSC when conducting a risk assessment visit and should therefore always be readily available.

Firms are able to ensure compliance with the record keeping requirement by keeping a record of the updated policy for a period of 5 years.

2.7 Inducements

A firm must take all reasonable steps to ensure that neither it nor any of its employees or agents either offers or gives, or solicits, or accepts, any inducement that is likely to conflict with any duty owed to customers.

The FSC may assess compliance with the inducement requirements on the basis of the effective use that is made of inducements received by a given firm.

Section 26 of the Regulations, 'Inducements', sets out further requirements in relation to the receipt or payment by a firm of a fee, commission or non-monetary benefit that could place the firm in a situation where it would not be acting in compliance with the principle, namely where firms must act honestly, fairly and professionally in order to serve the best interest of clients. The main objective behind this rule under MiFID is investor protection.

The Committee of European Securities Regulators ("CESR") set out to provide recommendations[3] intended to aid a consistent implementation and to promote a level playing field, in relation to the inducement rules, without

[3] The Committee of European Securities Regulators, 'Inducements under MiFID – Recommendations paper May 2007, ref: CESR/07-228b.

imposing additional requirements on firms. These recommendations have been discussed with the European Commission and the latter has agreed with the legal interpretation given by CESR. The FSC will therefore apply these recommendations in its day-to-day supervisory processes. The recommendations are in relation to Section 26 of the Regulations and are outlined below:

The FSC considers that:

(a) Section 26 applies to fees, commissions and non-monetary benefits paid or received by a firm in relation to the provision by it of an investment or ancillary service to a client. Such fees, commissions and non-monetary benefits include commissions or fees that may be paid or provided to or by a firm and which are standard in the market. It does not deal with payments made within the firm, such as internal bonuses for example, which could give rise to a conflict of interest as defined under Section 21 of the Regulations.

(b) This section also applies to a payment or non-monetary benefit provided to or made by a legal entity within the same group as the firm, as it is to one provided to or made by any other legal entity.

The FSC considers that Section 26(1)(a) applies when the payment is made/received by the client or by a person on behalf of the client. This includes where the client pays a firm's invoice directly or it is paid by an independent third party who has no relevant connection with the firm regarding the investment service provided to the client, such as an accountant or lawyer, acting on behalf of the client. A separate, specific instruction issued by the client to the firm to receive or make a payment on his/her behalf will also be relevant. The fact that the economic cost of a fee, commission or non-monetary benefit is borne by the client is not alone sufficient for it to be considered under Section 26(1)(a).

The FSC considers in relation to Section 26(1)(b), the following are among the factors that should be considered in determining whether an arrangement may be deemed to be designed to enhance the quality of the service provided to the client and not impair the duty of the firm to act in the best interests of the client:

(a) The type of the investment or ancillary service provided by the firm to the client, and any specific duties it owes to the client in addition to those under Section 26, including those under a client agreement, if any;

(b) The expected benefit to the client(s) including the nature and extent of that benefit, and any expected benefit to the firm; the analysis about the expected benefit, can be performed at the level of the service to the relevant client or clients;

(c) Whether there will be an incentive for the firm to act other than in the best interests of the client and whether the incentive is likely to change the firm's behaviour;

(d) The relationship between the firm and the entity which is receiving or providing the benefit (although the mere fact that a group relationship exists is not by itself a relevant consideration);

(e) The nature of the item, the circumstances in which it is paid or provided and whether any conditions attach to it.

The FSC also consider that:

(a) in order to contain the "essential terms" a summary disclosure must provide adequate information to enable the investor to relate the disclosure to the particular investment or ancillary service that is provided to him, or, to the products to which it relates, to make an informed decision whether to proceed with the investment or ancillary service and, whether to ask for the full information;

(b) a generic disclosure which explains merely that the firm will or may receive or pay or provide items within Section 26(1)(b) is not sufficient to enable a client to make an informed decision and therefore will not be considered as providing the "essential terms of the arrangements" referred to in Section 26(2) of the Regulations;

(c) when a number of entities are involved in the distribution channel, each investment firm that is providing an investment or ancillary service must comply with its obligation of disclosure to its clients.

The list of items mentioned under Section 26(1)(c) is not exhaustive, but in considering whether items that are not specifically mentioned also fall within this list the factors that are mentioned within it need to be considered. Of particular importance is whether an item by its nature cannot give rise to conflicts with the firm's duty to act, honestly, fairly and professionally in accordance with the best interests of its clients.

Recital 39[4] of Directive 2006/73 (the Implementing Directive) which has been transposed into Gibraltar law via the Regulations, makes clear that where a firm provides investment advice or general recommendations which are not biased as a result of the receipt of commission, then the advice or recommendations should be considered as having met the condition of being designed to enhance the quality of the service to the client.

Recital 39 is relevant to cases in which a firm is giving unbiased investment advice or general recommendations. It is not exhaustive and does not prohibit other distribution arrangements under which a firm receives a commission (from, for example, a product provider or issuer) without giving investment advice or general recommendations. For these cases, payments can be seen as being designed to enhance the quality of the service to the client by allowing a given investment service to be performed over a wider range of financial instruments.

CESR also provides visual guides in order to help firms assess how they should treat inducements paid or received by them. These are included as appendices A & B.

2.8 Use of Dealing Commission

Where a firm receives goods or services which are in addition to the execution of its customers' orders it must not pass on such charges to its customers unless the following conditions are satisfied –

[4] Recital 39 – "For the purposes of the provisions of this Directive concerning inducements, the receipt by an investment firm of a commission in connection with investment advice or general recommendations, in circumstances where the advice or recommendations are not biased as a result of the receipt of commission, should be considered as designed to enhance the quality of the investment advice to the client".

(a) the only benefits to be provided under the agreement are goods and services which can reasonably be expected to be related to the execution of trades on behalf of the firm's customers;

(b) the goods and services comprise the provision of research which:

i) is capable of adding value to the investment or trading decision

ii) represents original thought and careful consideration and assessment of new and existing facts

iii) has intellectual rigour and does not merely state what is self-evident, and

iv) involves the analysis of data to reach meaningful conclusions;

(c) the firm is satisfied on reasonable grounds that the terms of business and methods by which the relevant broking services or packaged product will be supplied do not involve any potential for comparative price disadvantage to the customer or impair compliance with the duty of the firm to act in the best interest of its customers; and

(d) adequate prior and periodic disclosure is made to the customer.

Where a firm pays for execution and research services with dealing commission it must disclose the following to its customers:

(a) a description of its policies, process and procedures in the management of costs paid on behalf of its customers;

(b) information on how commissions paid have been generated and how this has been used, including a split between commission spent on execution and research;

(c) the firm's pattern of trading and sources and uses of commissions for all customers in that asset class to enable the comparison of the use of commission between a particular customer and the rest of the firm's customers.

A firm may not acquire any of the following list of products or services with dealing commission:

(a) services relating to the valuation or performance measurement of portfolios;

(b) computer hardware or administrative software;

(c) connectivity services such as electronic hardware and dedicated telephone lines;

(d) seminar fees;

(e) subscriptions for publication, including electronic publications;

(f) travel, accommodation or entertainment costs;

(g) order and execution management systems;

(h) membership fees for professional associations;

(i) purchase or rental of standard office equipment or ancillary facilities;

(j) employees' salaries;

(k) direct money payments;

(l) publicly available information; and

(m) custody services relating to designated investments belonging to, or managed for, clients other than those services that are incidental to the execution of trades.

2.9 CoB requirements when providing investment services to clients

Organisational requirements:

- Firms are required to act honestly, fairly and professionally, when providing investment services and/or, where appropriate, ancillary services.
- All information addressed to clients or potential clients, by firms, should be fair, clear and not misleading. In the case of marketing communication, this should be clearly labelled as such.*
- Appropriate information shall be provided to clients or potential clients, in a comprehensible form about: the firm and its services; financial instruments and proposed strategies to be used in its investments (to include appropriate guidance and warnings of the risks associated with the investments being sought); execution venues; and costs and associated charges. This allows both clients and potential clients to understand the nature and risks of the investment service and enables them to take investment decisions on an informed basis.*
- The firm shall, when providing investment advice or portfolio management, obtain the necessary information regarding the client's, or potential client's, knowledge and experience in the investment field relevant to the specific type of product or service, their financial situation and investment objectives. This will enable the firm to recommend suitable investment services and financial instruments.
- When providing investment services, other than investment advice or portfolio management, firms shall ask the client or potential client to provide information regarding their knowledge and expertise in the relevant investment field in order to assess whether the investment service or product is appropriate. Furthermore, if the firm considers that information provided is not appropriate it shall warn its client or potential client. If the information received by the firm is insufficient, then the firm is obliged to inform their client or potential client that it is unable to determine whether the service or product is appropriate for them. Warnings may be provided in a standardised format.
- When providing investment services that only consist of execution and/or the reception and transmission of client orders with or without ancillary services, firms need not obtain the information as required above provided that certain conditions are met. These are outlined in Section 19(6) of the Act.
- Firms need to keep a record for each client that includes the document or documents agreed between the firm and the client that sets out the rights and obligations of the parties, as well as the other terms on which the firm will provide services to the client.*
- The firm is obliged to send the client adequate reports on the service it is providing. These reports shall include, where applicable, the costs associated with the transactions and services undertaken on the client's behalf.

* Further requirements when reporting to clients are covered in the Record Keeping & Client Reporting guidance note.

3 Outsourcing

When assessing conflict of interests under MiFID, a firm also needs to consider those individuals directly involved in the provision of services to a firm under an outsourcing arrangement. For example, the interests of employees of service providers may be relevant when managing conflicts of interest.

Further requirements on this can be obtained in the FSC's Guidance Note on Outsourcing. This is available on our website: http://www.fsc.gi/download/adobe/GuidanceNote-Outsourcing.pdf .

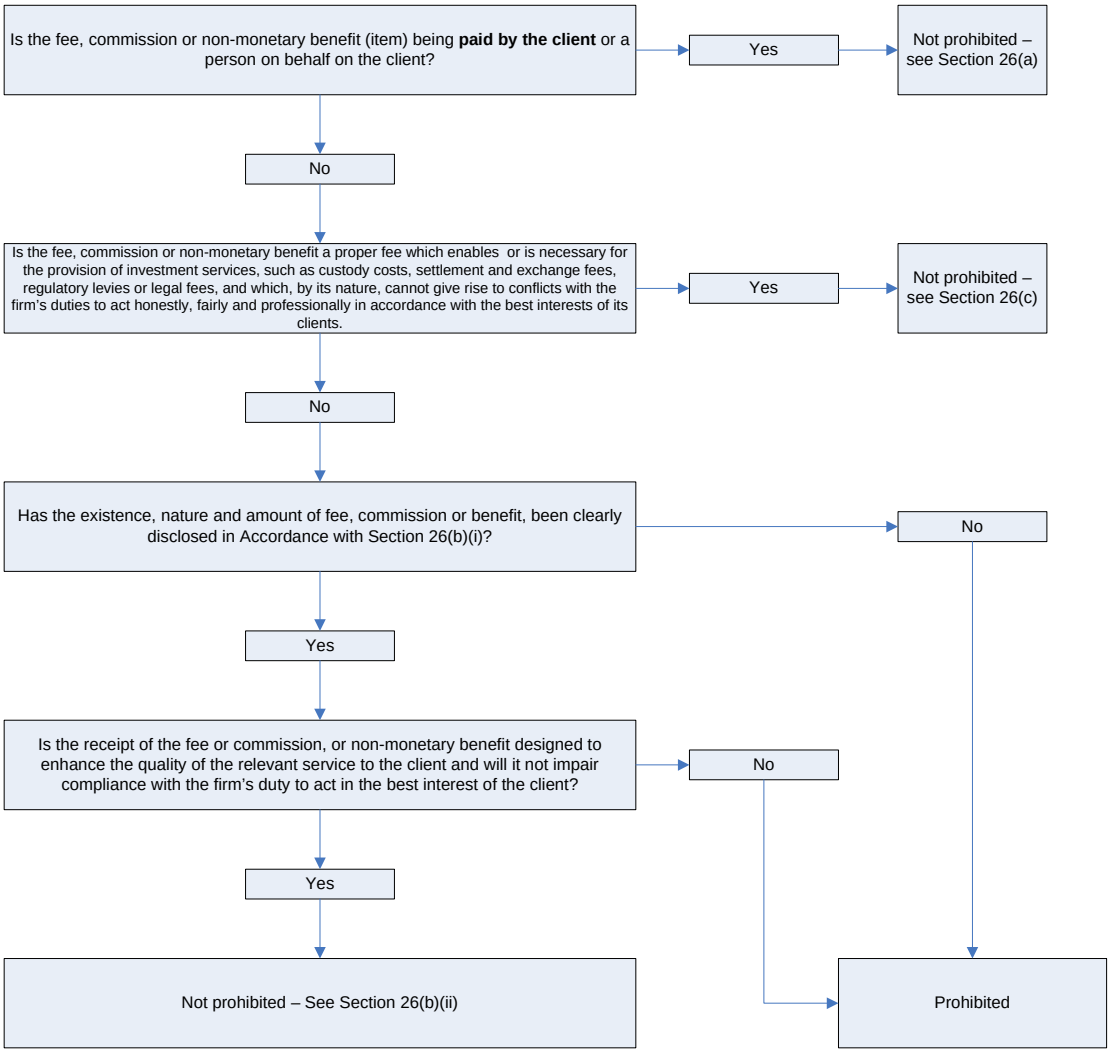
4 Action Required

Firms should give consideration to the following action points in order to ensure that they are compliant in relation to the conflicts of interest requirement:

- Firms should conduct a 'top to bottom' review of business lines, supervision, remuneration, and influence to identify circumstances where conflicts of interest as defined in Section 18 of the Act could arise;
- Firms should then identify measures to manage the conflicts of interest identified;
- Firms should draft a conflicts management policy in line with the relevant requirements;
- Firms should revise policies and procedures to take into account the conflicts management policy;
- Firms should, where necessary, train staff in relation to the conflicts management policy.

Appendix A

How a firm should treat, under Section 26 of the Regulations, a fee, commission or non-monetary benefit <u>received by it</u> in connection with a service provided to its client



Appendix B

How a firm should treat, under Section 26 of the Regulations, a fee, commission or non-monetary benefit paid by it in connection with a service provided to its client