



ADVICE TO ESMA

SMSG advice on ESMA's Consultation Paper on draft guidelines on certain aspects of the MiFID II compliance function

I. Background

1. On 15 July 2019, ESMA published a consultation paper on “Guidelines on certain aspects of the MiFID II compliance function requirements”. The draft guidelines are mainly aimed at enhancing clarity and fostering convergence in the implementation of certain aspects of the new MiFID II compliance function requirements and replace the existing ESMA guidelines on the same topic, issued in 2012. The consultation paper builds on the text of the 2012 guidelines, taking into account new requirements under MiFID II.

II. General comments

1. Approach followed for the review of the 2012 guidelines

1. The SMSG welcomes the general approach followed by ESMA of not introducing a completely different regime, but to build upon the text of 2012, refining and supplementing the guidelines where necessary. In general it also approves of the choice to delete from the 2012 guidelines references to aspects which are now directly incorporated in MiFID II provisions, in order to avoid unnecessary repetitions. However, it should be noted that in some cases the corresponding supporting guidelines, which have been generally and acceptably confirmed, appear less clear, given that the relevant statement has now been deleted (see, for example Guidelines 3 and 8).
2. The SMSG believes that in such cases, it would be advisable to include in the supporting guidelines a specific reference to the relevant piece of regulation.

2. On the description of specific practices of competent authorities (Annex III – Guidelines point 7)

1. While it is clear that the aim of describing specific practices of competent authorities is limited to provide the reader with additional information on different approaches of competent authorities without introducing additional requirements for firms or competent authorities, the SMSG believes that the inclusion of such practices in the guidelines can in any case create a behavioral expectation for companies and supervisory authorities, with potential different applications within the Union.

2. In addition, the SMSG notes that there may be overlaps with the competence assigned by the ESMA Regulation, as amended by in the ESA review,¹ which establishes that ESMA elaborates and updates a Union Supervisory Handbook on the supervision of financial institutions in the Union that defines the best practices in the field of supervision and methodologies and processes of high quality and takes into account the evolution of business practices and models of financial institutions.
3. In case ESMA would keep the additional information on the different approaches of the different national authorities in the guidelines, the SMSG believes that it should, at least, be well highlighted in the text, also through the use of different typefaces, that these are mere illustrative indications and that they are without prejudice to how much can be contained in the Union Supervisory Handbook.
4. The SMSG further suggests that points 6 and 7, currently included in the Definitions Section, should be relocated to Section V. Guidelines on certain aspects of the MiFID compliance function requirements, after point 17.

III. Comments on different questions in the consultation

Q1: Do you believe that guideline 1 should be further amended and/or supplemented?

1. The SMSG observes that the efficient allocation of resources of the compliance function is now traced back to the findings of the compliance risk assessment. The SMSG considers that an express reference to a risk-based approach in this respect should be reintroduced, in order to make explicit that the efficient allocation of resources reflects both the results of the risk assessment and an evaluation based on a risk-based approach.
2. The SMSG considers that the MiFID II Delegated Regulation describes the contents of the risk-assessment to be carried out by the compliance function, integrating at a legislative level most of the indications contained in the Recommendations of 2012 and providing that all areas of investment services and activities and any ancillary services provided by the investment firm are taken into consideration.
3. In this context, the SMSG considers that the indication according to which the risk assessment should also consider the reference to the types of financial instruments traded or distributed is an extension of the content of the compliance risk assessment and not a simple clarification of the practical application (see Background point 11) of the contents required by the MiFID II Delegated Regulation. Although the reference to the types of instruments does not constitute an absolute obligation (thus the use of the word "should"), the fact that national authorities must commit themselves to ensuring that firms adhere to the guidelines makes compliance with this additional requirement for compliance risk assessment very demanding in practice.
4. The SMSG is of the opinion that in point 22, the last sentence should be amended as follows: "other changes in the firm's structure or *material* changes in the *relevant* regulatory framework".

Q2: Do you agree with the suggested approach in relation to the compliance function's monitoring obligations?

¹ Not yet published in the Official Journal, this advice is based on the text adopted by the European Parliament in its legislative resolution of 16 April 2019.

1. While the SMSG agrees with ESMA's approach on the monitoring obligations of the compliance function, it notes that the reference to mandatory compliance reports provided for by Articles 22(2)(c), 22(3)(c), and 25(2) and (3) of the MiFID II Delegated Regulation, although suitable to warrant the necessary management attention, does not specifically provide for tools and methodologies for monitoring activities.
2. The SMSG considers that the reference to these reports could be kept in point 25, indicating that mandatory compliance reports are a fundamental tool to warrant the necessary management attention.

Q4: Do you agree with the addition to paragraph 26?

1. The SMSG believes that the development of effective methodologies for monitoring the compliance of firms is an important policy objective, to be pursued in balance with the principles of proportionality and adequacy of tools.
2. The compliance function should be given the discretion to engage directly with customers and, especially, complainants, as and when appropriate.

Q5: Do you agree with the suggested general content of the compliance function reports (paragraph 31 of the guidelines)?

1. The SMSG, while appreciating the general approach of the guidelines not to take up the content of the primary legislation to avoid duplication, evaluates that the shift from supporting guideline to general guideline reduces the scope of the guidelines, which now refer only to the number of business lines covered, while a qualitative reference to the content of the reports would also be useful. The above takes into account that the supporting guidelines refer to contents and not to the specific structure of the business lines.
2. The SMSG believes it would also be appropriate to specifically state what the written compliance reports are, recalling Article 25(2) of the MiFID II Delegated Regulation.
3. In relation to point 32, the SMSG considers it appropriate to rephrase the first sentence as follows: "In analyzing the topics listed in Article 22(2) of the MiFID II Delegated Regulation, the written compliance reports should contain information on the following matters", having in mind that those are mostly specifications of the topics provided for by the Delegated Regulation, rather than further matters.
4. With reference to point 32(e), please refer to comments under Q15 and Q16.

Q6: Do you agree with the suggested content of the compliance function reports in relation to product governance arrangements (paragraph 3[3] of the guidelines)?

1. The SMSG generally agrees with the contents of the revised paragraph 32 of the guidelines.
2. However, whilst compliance reports are generally very important and should therefore be shared with all higher management levels within an organization, it is likewise important for management

to provide compliance with its responses, which should comprehensively be forwarded to the organization's higher level for further analysis and possibly further feedback. One-way reporting without a feedback loop serves no purpose for an organization which intends or is required to have a robust compliance culture built into its structures.

Q7: Do you agree that the information that should be included in the compliance function reports should be proportional to the complexity and level of risks of the financial instruments manufactured and/or distributed by the firm? Do you believe that additional criteria should be taken into account?

1. Paragraph 33 (second paragraph) of the guidelines state the following:

“The compliance report is subject to the proportionality principle in accordance with Article 22(1) of the MiFID II Delegated Regulation. Therefore, when reporting, for example, on the firm’s product governance arrangements, the information for simpler, more common products may be less in-depth, whereas products characterised by complexity/risk features or by other relevant features (such as, for example, illiquidity and innovation) should be described in more detail”.

2. The use of terminology such as “simpler, more common products” is vague and should be defined or, at best, linked to existent rules. What is considered simple in one market may not necessarily be deemed so in another.
3. Furthermore, the SMSG agrees that more detailed reports should definitely be produced for products that are classified as complex. Indeed, compliance should be monitoring the offering of such products at a higher level of scrutiny compared to non-complex products.
4. The SMSG stresses that the principle of proportionality, expressed in Article 22(1) of the MiFID II Delegated Regulation, constitutes a general and overarching principle which must be applied with regard to the entire scope of this guideline and the content of the report. It should be clarified that proportionality as such also refers to the scale, complexity of the business, nature and range of investment services and activities undertaken.
This is also taking into account what is provided in point 17.
5. For this reason, the SMSG suggests the reference to this principle to be explicitly placed alternatively within the general guideline 3 or in a separate point of the supporting guidelines, rather than in the final part of point 33 (considering that this last point is limited to the section of the report concerning product governance arrangements).

Q8: Do you believe that further guidance is needed to clarify how firms should address the potential conflicts arising from the combination of the complaints management function with the compliance function? What practical solution could be envisaged?

1. The compliance function should monitor the complaints process and have the possibility to put forward recommendations for complaints management. Conflicts, if any, should be managed by the firm in accordance with its general organizational policies. The SMSG recommends that, through empirical evidence, ESMA assesses how, when and in which circumstances firms choose to integrate or closely associate the two functions.
2. The SMSG observes that a most notable conflict which could possibly arise (when the two functions are integrated or closely associated), is when complaints could be traced to shortcomings in the compliance function (possibly going back to previous years as complaints will usually surface after

some time following a sale, for example). No firm is immune from mistakes and there are abundant examples of past compliance failures that have led to substantial complaints. A robust compliance culture should be supportive of admitting past mistakes, improving or overhauling internal process for the same mistakes not to recur and putting forward redress recommendations if that firm's failures have led to consumer detriment. However, decisions on how to handle such a complaint should be taken in accordance with the firm's organizational policies, in principle by a senior person from outside the compliance team, such as the legal department.

3. In addition, the SMSG considers that the compliance function's management of complaints is a tool for the efficient management of overall compliance risk by firms, the effectiveness of which, however, must be safeguarded.
4. In this sense, the report of the compliance function should also contain an indication from the function itself as to the continuing adequacy of the tools adopted to minimize conflicts of interest and as to the appropriateness of maintaining the management of complaints by the function itself, with a view to safeguarding the effective management of compliance risk.

Q9: Do you believe that further topics/areas should be included in the compliance function reports?

1. It is evident that a major chore for compliance is the multi-tiered reporting requirements that are required to be produced at particular intervals. Other than financial data, qualitative compliance assessment could be a major source of intelligence for a regulator if such compliance reporting is made obligatory for all firms. Technology could assist for such analysis.
2. With reference to point 36, which refers to certain specific practices followed by certain competent authorities, please refer to General comments. II above.
3. If ESMA confirms point 36, the SMSG suggests making an express reference to the contents of point 7 of the Guidelines.

Q10: Do you agree with the approach taken for the review of guideline 4? Do you believe that guideline 4 should be amended and/or supplemented further?

1. The SMSG agrees in general terms with the proposed review of guideline 4, with two minor suggestions: (i) insert the words "and assistance" in the first sentence of point 37, after the word "advisory", aligning the language with that of the new heading of the guideline; (ii) relocate the examples of policies from point 37 to point 44.

Q11: Do you believe that guideline 5 should be amended and/or supplemented further?

1. The SMSG agrees in general terms with the proposed review of guideline 5, with two minor suggestions: (i) in point 44 align the language adopted with the general principle of proportionality, set out in Article 22(1) of the MiFID Delegated Regulation and recalled in point 17, including the insertion of a reference to the complexity of business and to the nature and range of services and activities; (ii) in point 49 include between the brackets a reference to the complaints management function, where applicable (i.e., when not directly carried out by the compliance function).

Q12: Do you agree with the creation of a new guideline solely focused on the skills, knowledge, expertise and authority of the compliance function?

1. The SMSG is in favour of creating a new guideline focused on the skills, knowledge, expertise and authority aspects of the compliance function, its staff and the function manager, considering that these aspects are in fact crucial for the effective performance of the tasks assigned to the function for the benefit of the protection of compliance risk.

Q13: Do you agree with the additions to guideline 6 (formerly part of guideline 5)?

1. With reference to point 56, which refers to certain specific practices followed by certain competent authorities, please refer to General comments. II above.
2. If ESMA confirms point 56, the SMSG suggests making an express reference to point 7 of the Guidelines.
3. The same comment applies to the reference to certain practices introduced in point 57.

Q14: Do you believe that guideline 7 should be further amended and/or supplemented?

1. The SMSG, considering that in point 61 reference is made to the contents of the "compliance policy", suggests that Article 22(1) MiFID II Delegated Regulation be included among the regulatory references of the heading of the guideline. The SMSG further suggests to align the language adopted with the general principle of proportionality, set out in Article 22(1) of the MiFID Delegated Regulation and recalled in point 17, including the insertion of a reference to the complexity of business and to the range of services and activities.

Q15: Do you believe that guideline 8 should be further amended and/or supplemented?

1. This is a crucial guideline that is often under-estimated. The guideline requires that compliance staff should "act independently when performing their tasks". That does not mean that their approach should be an absolute do-as-you-please as they are still required to answer to the firm's board or most senior management. However, compliance work is often over-ruled by a multitude of other considerations, which may highlight tensions between the compliance function and other internal structures. In this cases, a fast track escalation process to firm's management body should be ensured.
2. Moreover, the SMSG (i) considers that the content of point 65 is now already included in point 32(e) and therefore appears to be reproductive of what is indicated there and (ii) would consider it useful to introduce an indication according to which the head of the function records and represents in the reports the existence of deviations from the principle that the other business units must not issue instructions or otherwise influence compliance staff and their activities.
3. Consequently, the SMSG would suggest to rephrase point 65 by integrating it with the indications under (ii) and by providing in point 32(e) that the reports contain the information under point 65 (as reformulated).

Q16: Do you believe that guideline 9 should be further amended and/or supplemented?

1. The SMSG considers that a sentence should be inserted in point 70, specifying that the compliance officer shall state in its reports its assessment of the continuing appropriateness of the arrangements to minimize conflicts of interest.
2. Similarly, a reference to the information in point 70, as amended, should be introduced in point 32(e).

Q17: Do you agree that, subject to the proportionality principle, a firm should consider establishing and maintaining a core team of compliance staff whose sole area of responsibility is MiFID II?

1. In general, the SMSG agrees that, subject to the principle of proportionality, firms should consider structuring a core compliance team dedicated to specialized areas. However, rather than creating a team dedicated to MiFID – which as such contains relatively diverse requirements (investor protection & markets-related rules), the SMSG advises that the guidelines would state that, subject to the principle of proportionality, firms should consider structuring a core compliance team dedicated to investor protection rules (in MiFID II, but also in the IDD for insurance-based investment products, and possibly also certain closely aspects of the PRIIPs Regulation), and another team dedicated to MiFID II market-related rules. Moreover, the SMSG advises to explicitly add to the guideline that the principle of proportionality also relates to the relevance of the performance of activities falling within the scope of MiFID II compared to all the activities carried out by the company (consider a credit institution which, in practice, concentrates on the performance of investment services rather than on the provision of core banking services).

Q19: Do you agree with the amendments made to guideline 11?

1. The SMSG agrees with the express indication, consistent with Article 31(1) MiFID Delegated Regulation, that a firm that outsources the compliance function remains fully responsible for the tasks that are outsourced.

Q20: Do you believe that guideline 11 should be further amended and/or supplemented?

1. The SMSG suggests to expressly indicate that if the firm, in case of termination, intends to guarantee the continuity of the function outsourced through reinternalisation (as provided by Article 31(2)(l) MiFID Delegated Regulation), it shall give evidence of the prompt availability of the resources through which to continue to perform the reinternalised function.

Q21: Do you agree with the amendments made to guideline 12?

1. With reference to points 85-87, which refer to certain specific practices followed by certain competent authorities, please refer to General comments. II above.
2. If ESMA confirms the points in question, the SMSG suggests making an express reference to point 7 of the Guidelines.

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA's website.

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[signed]

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