



European Securities and  
Markets Authority

# Final report

Guidelines on certain aspects of the MiFID compliance function requirements





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## **Acronyms**

ESMA	European Securities and Markets Authority
EU	European Union
MiFID	Markets in Financial Instruments Directive
SMSG	Securities and Markets Stakeholder Group

## **I. Overview**

1. The European Securities and Markets Authority's (ESMA) Consultation Paper (CP) *Guidelines on certain aspects of the MiFID compliance function requirements* (ref: ESMA/2011/446) was published 22 December 2011. The consultation period closed 24 February 2012.
2. ESMA received 49 responses (including from asset managers, banks, investment firm associations, trade associations, investor groups) - of which 4 were confidential responses.
3. In addition, ESMA received the Securities and Markets Stakeholder Group's (SMSG) *Advice to ESMA* on that CP (dated 15 February 2012, ref: 2012/SMSG/12, and published on ESMA's website on 28 February 2012).
4. This final report sets out the feedback statement to the CP which provides an analysis of responses to the consultation (including the SMSG advice), describes any material changes to the technical proposals set out in Annex II (or confirms that there have been no material changes), and explains the reasons for this in the light of feedback received. This final report also includes the final guidelines.

### *Cost-benefit analysis (CBA)*

5. Several respondents noted that the proportionality principle was important for compliance with these guidelines. In particular, one respondent commenting on the CBA (Annex I of the CP) said that, depending on the firm's particular nature and circumstances (e.g. types of investment services, scope and volume of performed transactions, company structure, number of employees and offices), changes resulting from the guidelines could entail higher costs.
6. ESMA has drafted the guidelines with the proportionality principle in mind, and has emphasised where relevant that the principle should apply as appropriate. Further, while ESMA believes there is likely to be some small one-off cost in relation to the implementation of the ESMA guidelines by national competent authorities and European Union (EU) firms, ESMA considers that no changes need to be made to the CBA as set out in the CP.

## **Contents**

7. Section II sets out the feedback statement.
8. Annex I sets out the advice of the SMSG; and Annex II contains the full text of the near-final guidelines.

## **Next steps**

9. The guidelines in Annex II will be translated into the official languages of the EU, and the



final texts will be published on the ESMA website. The application and reporting requirement dates set out in Annex II will start to run from date of publication of the translations.

## II. Feedback Statement

### *General comments*

10. Some respondents (6 out of 49) noted that the proportionality principle should be set out more clearly and emphasised. In this regard, ESMA has inserted paragraph 13 into the guidelines to further clarify the topic, rather than create an extra guideline or principle on proportionality.
11. Respondents also noted that the guidelines should address more explicitly the role of senior management in ensuring that the business is run in a compliant manner and that the compliance function acts as 'a second line of defence'. ESMA has modified the guidelines in order to address this.
12. A few respondents (3 out of 49) noted their concern that the guidelines may not be compatible with MiFID 2. However, ESMA notes that the compliance function requirements are not a subject under the review of MiFID.
13. There were a few requests to clarify whether the guidelines address retail or professional clients. ESMA considers that the compliance function must be implemented and that all related requirements must be fulfilled no matter what the type of client. ESMA has set out the compliance function's responsibilities in the guidelines so that they apply to all firms irrespective of the type of client.

### *Guideline 1 (Question 1) - Compliance risk assessment*

14. **We asked: "Do you agree that investment firms should ensure that, where the compliance function takes a risk-based approach, any comprehensive risk assessment is performed to determine the focus and the scope of the monitoring, reporting and advisory activities of the compliance function? Please also state the reasons for your answers."**
15. 37 respondents answered this question.
16. The vast majority of respondents agree with ESMA's proposal. Respondents believe it is reasonable to acknowledge that investment firms and their compliance officers must find the necessary balance between resources and risks to determine the focus and the scope of the monitoring, reporting and advisory activities of the compliance function.
17. Some comments and suggestions made follow:
  - It is the firm's governing body, and not the compliance function, that is accountable for and manages compliance risk. Whilst this statement is true, ESMA considers that the compliance function should perform the risk assessment because it is the compliance function that is best placed to allocate its own resources to fulfil its responsibilities.

- The requirement for a ‘comprehensive scope’ compliance function is inconsistent with a risk-based approach, because a risk-based approach implies that in practice non-material risks may receive minimal compliance attention. ESMA has changed the wording of the guideline slightly (it now reads “taking into account the scope and nature of the investment firm’s investment services and activities”) so that the contradiction is less obvious, but there is still reference to the comprehensive scope of the compliance function.
- The risk assessment process, as well as the factors that should be considered in the risk assessment, should be outlined more clearly. This suggestion has been incorporated into the text of the supporting guidelines for Guideline 1.
- It should be made clear to all entities that the compliance risk assessment should be reviewed regularly, but with any updates made on an *ad hoc* basis should any new risks emerge. ESMA has clarified in the supporting guidelines for Guideline 1 that regular and ad-hoc reviews of the risk assessment are necessary.

#### *Guideline 2 (Question 2) - Monitoring obligations of the compliance function*

18. **We asked: “Please provide your comments (with reasons) on any or all aspects of this guideline on the monitoring obligations of the compliance function.”**
19. 39 respondents answered this question.
20. There was some criticism against the monitoring responsibilities of compliance and on-site reviews. ESMA considers that the supporting guidelines for Guideline 2 are sufficiently clear. Given that the compliance function needs to check how procedures work in practice, on-site inspections are listed as a possible way to carry out such controls, and the supporting guidelines clarify that the compliance function can also make use of other control function findings and reports.
21. Taking the proportionality principle into consideration, some respondents proposed clearly stating that in smaller firms compliance may use the reports produced by the risk management, rather than perform all controls itself. ESMA considers that the supporting guidelines already take proportionality into consideration. On-site inspections at small firms are easily accomplished and do not require an enormous amount of resource; also, the supporting guidelines do not state that compliance must perform all controls itself.
22. Some asset management respondents (3 out of 39 total responses) noted that in the area of asset management, within groups of investment firms, there are established organisational structures that require maintenance of a centralised compliance function at the group level. ESMA has inserted a clarifying remark that outsourcing of compliance tasks to one of the group’s entities is, of course, possible. However, it is not been possible to provide a general delegation of the compliance function to the group level - as recommended by a few respondents - as this is not in line with Article 6 of the MiFID Implementing Directive.

Article 6 requires every investment firm, i.e. every separate legal entity that is an investment firm, to implement a compliance function. This also applies to investment firms that are part of a group of entities with one or more investment firms.

23. Paragraph 22 of the supporting guidelines lists suitable tools used by the compliance function (targeted trade surveillance, observation and/or interviewing of relevant staff). Some respondents (5 out of 39) noted that such controls are performed by other control mechanisms, so it is not necessary that compliance uses these tools because the compliance function should not become a duplicate of internal audit or other control mechanisms. ESMA notes that these tools are listed only as possible suitable tools for the compliance function and also that the list is not meant to be exhaustive.
24. There was a request for more clarification on the topic of the ‘three lines of defence’. Compliance monitoring activities which are part of the ‘first line of defence’ should be clearly differentiated from those undertaken as the ‘second line of defence’. ESMA has adjusted the text of the guideline to better describe the topic, distinguishing between compliance controls, controls performed by the investment firm’s business areas and reviews by the risk management, internal control function, internal audit function or other control functions in the area of investment services.
25. With regard to paragraph 26 of the supporting guidelines to Guideline 2, there was the proposal to charge the compliance officer with the determination of the outcome of complaints. ESMA has changed the wording to state that “This does not require compliance functions to have a role in determining the outcome of complaints”. This will allow for more flexibility within firms.
26. Other comments highlighted that the compliance function should not be confused with customer complaint services since the compliance function only ensures that this service exists and works well (8 out of 39). The suggestion was to delete the obligation for compliance to oversee the complaints process. ESMA has amended this to clarify that the compliance function has a role in overseeing the operation of the complaints process as part of its monitoring responsibilities.
27. With regard to paragraph 24, where the text points out that it is the task of the compliance function to monitor first level controls by the firm’s business units (i.e. to perform second level controls), there was the request to emphasise and underline more clearly business units’ own responsibility to ensure that all legal requirements are met. ESMA has made this clarification.
28. There were some concerns with the text in the guideline which stated “Investment firms should ensure that the compliance function establishes a monitoring programme that covers all relevant areas of the investment firm’s investment services, activities and ancillary services”. Whilst the compliance function should evaluate all of the investment firm’s services, activities and ancillary services, the risk based assessment will drive what is relevant in terms of the actual monitoring plan. ESMA has adjusted the text to read “a



monitoring programme that takes into consideration all areas of the investment firm’s investment services, activities and any relevant ancillary services. The monitoring programme should establish priorities determined by the compliance risk assessment ensuring that compliance risk is comprehensively monitored”.

*Guideline 3 (Question 3) - Reporting obligations of compliance function*

29. **We asked for comments (with reasons) on any or all aspects of this guideline on reporting obligations of the compliance function.**
30. 39 respondents answered this question.
31. The second sentence of the guideline stated that the compliance report should contain “a description of the implementation and effectiveness of the firm’s compliance program” rather than a description of the overall control environment that it should contain. Respondents suggested that the latter is a more appropriate analysis as it looks beyond compliance controls only and considers also business controls so is more in line with Article 6 of the MiFID Implementing Directive. ESMA has revised the guideline accordingly.
32. Many respondents (18 out of 39) commented that the guideline seemed to suggest that compliance reports as a general rule are to be sent to both senior management and the competent authorities. ESMA has clarified in a footnote that: “This description of specific practices of competent authorities aims to provide the reader with additional information on differing approaches of competent authorities without setting up additional requirements for investment firms or competent authorities (and thereby triggering the obligation under Article 16(3) of the ESMA Regulation<sup>1</sup> to comply or explain).”
33. Respondents were also concerned that, under the suggested text of the guideline, senior management would receive long and descriptive reports that do not focus on the matters of which they should be aware, such as significant incidents that have occurred, risks that have been identified or grown, actions they need to take, etc. ESMA has amended the guideline, and added under paragraph 27: “(d) risks identified in the scope of the compliance function’s monitoring activities”.
34. Some respondents requested that ESMA define ‘senior management’ and ‘supervisory board’. However, ESMA considers that the definitions in MiFID are sufficient for these purposes.
35. Some respondents commented that:
  - Reporting on all outcomes of inspections and/or desk-based reviews to senior management, especially in larger firms, will not contribute to efficient and effective

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<sup>1</sup> Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC.

reporting and will hardly help senior management in carrying its responsibility in the area of compliance. ESMA has amended the wording to “summary of major findings”.

- Reporting on “future relevant regulatory changes which are likely to have a significant impact on the business” was outside the scope of MiFID. ESMA has deleted this.

*Guideline 4 (Question 4) - Advisory obligation of the compliance function*

**36. We asked for comments (with reasons) on any or all aspects of this guideline on the advisory obligations of the compliance function.**

37. 38 respondents answered this question.

38. The vast majority of respondents supported the advisory obligations of the compliance function. There was general agreement about the fact that management should promote and enhance a strong compliance culture within an investment firm. The general view was that improving the compliance culture is a responsibility of the business leadership, supported as necessary by the compliance function.

39. There was some criticism about requiring training to be performed on a regular basis – saying that this is too far reaching. ESMA considers that regular training is a sensible approach and that ad-hoc training only cannot be sufficient. Therefore, no changes were made in this regard.

40. Many respondents (14 out of 38) underlined that the guideline was too far-reaching as it stated that the compliance function is responsible for the training of the staff, even though business unit/management is responsible for the training of the staff; and that the role of the compliance function should be limited to advising and supporting the operational function in this area. ESMA has made amendments to the guideline to take these points into account.

41. Respondents also suggested the introduction of an escalation mechanism should compliance’s advice on new product approval processes, or other advice, be ignored. ESMA has added this under paragraph 40 of the guidelines.

42. Some respondents requested clarification on what is meant by “periodical assessment of whether staff hold the necessary level of awareness”. In order to leave room for the proportional application of this requirement, ESMA has chosen not to make this clarification.

43. Many respondents suggested that the guidelines should clarify that the inclusion of the compliance function in the relevant flows of information is an obligation of senior management and the operational functions and not of the compliance function itself. ESMA has made the amendments to paragraphs 40–42 of the guidelines.

44. Finally, some respondents noted that advisory/training scope of compliance tasks should

not be limited to MiFID subjects. ESMA has added the wording “in the area of investment services” where relevant.

*Guideline 5 (Question 5) - Effectiveness of the compliance function*

**45. We asked for comments (with reasons) on any or all aspects of this guideline on the effectiveness of the compliance function.**

46. 41 respondents answered this question.

47. Many respondents supported this guideline. However, the following issues were raised:

- Extending a firm’s business unit activities should not necessarily result in a proportionate extension of the compliance function. The appropriate compliance resource will depend on the inherent risks of the new business activity, with ‘riskier’ activities requiring proportionally a larger number of additional compliance staff. ESMA has amended paragraph 45 of the guideline to clarify this.
- Budget allocation is not common practice in investment firms (be it in the operational units or in compliance) - this is especially the case for small and medium sized investment firms. Mandatory budgets cannot be legislated top-down, at least not in cases where an investment firm does not allocate specific budgets to various units. ESMA has made the necessary amendment to paragraph 47 of the guidelines (that a budget is only necessary where the investment firm has set out budgets for specific functions or sections).
- In order to perform its activities it is not necessary for compliance to have access to all databases: there are some databases to which compliance may need access only on an ad hoc basis and others to which they would not (and generally should not) have access (such as private personnel data). What is important is that the compliance function should be aware of the information systems and types of databases in the firm. ESMA considers that only the compliance function itself can determine to which databases it needs access; this cannot be determined in advance.
- Investment firms should require and support compliance staff to be appropriately qualified and staff should be supported in their ongoing training and development. ESMA has made amendments to paragraph 50 of the guidelines accordingly.
- The fact that the compliance officer has the right to attend the entity’s management meetings goes beyond MiFID’s requirement and should not be specified as a general rule whose omission needs to be explained in writing. Each entity should be free to determine its specific organisation structures with regard to the compliance function’s involvement in management decisions. ESMA considers that this right is important in order for the compliance function to be effective and to be able to fulfil its role properly.

*Guideline 6 (Question 6) - Permanence of the compliance function*

48. **We asked: “Do you agree that, in order to ensure that the compliance function performs its tasks and responsibilities on an ongoing permanent basis, investment firms should provide:**

- **adequate stand-in arrangements for the responsibilities of the compliance officer which apply when the compliance officer is absent; and**
- **arrangements to ensure that the responsibilities of the compliance function are performed on an ongoing basis?**

49. 40 respondents answered this question.

50. The vast majority of respondents agreed with this guideline. In order to ensure that the compliance function performs its tasks and responsibilities, investment firms should provide adequate arrangements and ensure that the responsibilities of the compliance function are performed on an ongoing basis. Responsibilities and competences should generally be formalised in internal rules concerning governance of intermediaries.

51. There was also general agreement on the fact that there should be adequate stand-in arrangements. However, some respondents highlighted that this should not amount to the effective requirement of doubling the number of compliance staff or the compliance officer. Some also stated that planning for unforeseeable absences of the compliance officer is also difficult in practice. ESMA has deleted the sentence on foreseeable and unforeseeable absences. In addition, clarification has been made that stand-in arrangements can be ‘internal procedures’ in order to make clear that additional personnel is not required.

*Guideline 7 (Questions 7 and 8) - Independence of the compliance function*

52. **We asked: “Do you agree that investment firms should ensure that the compliance function holds a position in the organisational structure that ensures that the compliance officer and other compliance function staff are independent when performing their tasks? Please also state the reasons for your answer.”**

53. **And “Do you agree that investment firms should ensure that the organisation of the compliance function guarantees that the compliance officer’s daily decisions are taken independently from any influence of the business units and that the compliance officer is appointed and replaced by senior management only?”**

54. 40 respondents answered this question.

55. All respondents strongly believe that the independence of the compliance function is

crucial. It should be able to take decisions independently from the influence of other business units. The independence should be combined with proximity to transactions and operations. Independence and proximity can be achieved by a combination of a specific compliance position, and by requiring that the appointment and replacement of the compliance officer is approved by senior management or by the supervisory function. To discharge its duties effectively the compliance function must have the necessary authority to be able to operate independently. Moreover, the compliance function should ensure that there is:

- Adequate protection for employees who report breaches.
- Protection for both the whistleblower, the person who is allegedly responsible for the breach and any further witnesses.
- A procedure which gives access to legal assistance to the whistleblower and the allegedly responsible person.

56. However, some respondents (11 out of 40) pointed out that the statement that senior management may not interfere in the compliance function's activities is incompatible with the fact that senior management is ultimately responsible for compliance. At most, a policy could require the compliance officer to record (and potentially also present in the compliance report) whether the senior management deviates from crucial recommendations or assessments issued by the compliance officer. ESMA has deleted the following sentence from the final version of the guidelines: "Senior management's instructions to compliance staff should be general and should not interfere with the compliance function's day-to-day activities".
57. Finally a few respondents (3 out of 40) proposed that only a supervisory board (not senior management) should be able to appoint and replace the compliance officer. ESMA cannot accommodate this suggestion because of the different corporate legal structures in Member States.

#### *Guideline 8 (Question 9) - Exemptions*

58. **We asked for comments (with reasons) on any or all aspects of this guideline on Article 6(3) exemptions.**
59. 40 respondents answered this question.
60. The vast majority of the respondents supported ESMA's approach for proportionate compliance with the requirements set out in Article 6(3) of the MiFID Implementing Directive. Due to the wide range of firms operating in the investment services industry, proportionate compliance enables better adapting legal requirements with the characteristics of each firm.
61. Respondents suggested that it should be made clear that the combination of the compliance

function with the legal unit is not necessarily an unsound approach insofar as it does not impair the compliance function's independence, but, on the contrary, it can be an opportunity for the intermediary to improve co-operation and reciprocal support in the two fields that have several implications and related synergies. ESMA notes that this matter was discussed extensively at working group level when developing these guidelines, and notes that the combination does in fact yield many conflicts of interest. However, ESMA is aware that it may be disproportionate for a small investment firm to set up a separate compliance function. ESMA has modified the paragraph to specify that "an investment firm [...] may combine the legal and compliance function. However, an investment firm with more complex activities or greater size should generally avoid such combination, if it could undermine the compliance function's independence."

*Guideline 9 (Question 10) - Combining the compliance function with other functions*

**62. We asked for comments (with reasons) on any or all aspects of this guideline on combining the compliance function with other functions.**

63. 35 respondents answered this question.

64. The vast majority of respondents expressed general agreement with the proposal. However, to enhance clarity, it was suggested that:

- the title of ESMA's guidelines in this area be changed to "Combining the compliance function with other internal control functions" - ESMA has amended the title accordingly;
- the wording used in the guideline should be 'combination' instead of 'overlap' to clarify that the aim is to exploit synergies and not to cause duplication of effort - ESMA has changed the wording accordingly.

65. Regarding the possible combination of the compliance function with the internal audit function, a couple of respondents (2 out of 35) suggested that it must always be avoided (and not just 'should generally be avoided'). ESMA considers that this proposal would be disproportionate for very small firms. However, ESMA has clarified that "In this regard, firms should consider discussing the combination with the relevant supervisory authority. In addition, where this combination occurs, the firm must, of course, ensure that the responsibilities of each function are discharged properly (i.e. soundly, honestly and professionally)".

66. Regarding the possible combination of the compliance function with other control functions, 16 out of 35 respondents agreed with the proposed guideline stating that the combination does not necessarily undermine the independence of the compliance function, provided it does not create any conflicts of interest or impair the compliance function's independence. A few respondents (3 out of 35) nevertheless requested that it should be always avoided. Considering the results of the consultation, ESMA does not consider it

necessary to make significant changes to the wording of the guideline on this aspect.

67. Finally, some respondents (4 out of 35) suggested that investment firms should not be required to undertake a formal exercise to document their assessment as to why a particular combination is beneficial or to provide reasons why certain functions may overlap as this may be a lot of effort for firms. ESMA chose not to modify the wording because this information is useful for competent authorities. ESMA also believes it will not require excessive effort from firms.

#### *Guideline 10 (Question 11) - Outsourcing of the compliance function*

68. **We asked for comments (with reasons) on any or all aspects of this guideline on outsourcing of the compliance function.**

69. 36 respondents answered this question.

70. Respondents generally agreed with this guideline on outsourcing, believing it is in line with the MiFID requirements. However, a few respondents (3 out of 36) stated that the compliance function is not a critical or important function and that therefore outsourcing is not outsourcing of an important or critical function. ESMA is very concerned that some respondents do not consider the compliance function to be a critical or important function, and disagrees with this thinking. ESMA notes that firms are expected to undertake a due diligence assessment on the outsourcing service provider to ensure that the criteria in Articles 6 and 14 of the MiFID Implementing Directive are met.

71. On the topic of outsourcing, it was requested that the guideline should clarify that the extent of the required due diligence assessment should depend on the nature, scale, complexity and risk of the tasks and processes that are going to be outsourced. ESMA has modified paragraph 75 in the guidelines in order to clarify that: “the extent of the due diligence assessment is dependent on the nature, scale, complexity and risk of the tasks and processes that are outsourced.”

72. There was also the request to clarify that investment firms that outsource essential or important services or other operational tasks still continue to bear full liability for the fulfilment of all the obligations incumbent on them. ESMA has made this clarification.

73. A few respondents (2 out of 45) suggested that the guidelines make no distinction between group internal and external outsourcing, and that ESMA should clarify whether such a difference would have any impact in the conditions for outsourcing. ESMA does not believe this clarification is necessary, as paragraph 78 of the guidelines is sufficiently clear on this.

74. Respondents also requested that ESMA clarify that the guideline does not imply the need for a duplication of the compliance function. Some respondents noted it should be specified that the entity does not need to have, in-house, a person with the skill to perform the compliance function; rather, it should refer to somebody, e.g. a director, with the capacity to understand the significance of the compliance function and to interpret the reports



received from the outsourced compliance function so that the entity retains appropriate critical capacity to assess whether the function is being discharged properly or not. ESMA does not consider a change to the wording is necessary, because the wording of the guideline is sufficiently clear.

*Guideline 11 (Questions 12 and 13) - Review of the compliance function by competent authorities*

75. **We asked: “Do you agree that competent authorities should also review, as part of the ongoing supervisory process, whether measures implemented by investment firms for the compliance function are adequate and whether the compliance function fulfils its responsibilities appropriately? Please also state the reasons for your answer.”**
76. **And “Do you agree that the competent authorities should also assess whether amendments to the organisation of the compliance function are required due to changes in the scope of the business model of the investment firm and where such amendments are necessary, monitor whether these amendments have been implemented.”**
77. 40 respondents answered this question.
78. Respondents generally agreed that, as part of the supervisory process, competent authorities should review a firm’s arrangements for the compliance function to ensure that the compliance function fulfils its responsibilities appropriately. However, respondents highlighted that supervisors may not wish to routinely review these matters in every firm if resources are scarce and rather use a risk-based approach. The text has been amended by adding “following a risk-based approach”.
79. Some respondents (7 out of 40) underlined that when a firm’s business model changes, it is the responsibility of the firm itself to determine any amendments required to the organisation and resources of the compliance function and not the competent authority’s. This is then reviewed by the competent authority within its regular ongoing supervision. ESMA has made this clarification.
80. Finally, a few respondents (6 out of 40) stated that the guideline could be misinterpreted to mean that there is a requirement that internal changes by firms concerning the compliance function need to be submitted for approval or review to the supervisor before being implemented. ESMA notes that this was never the aim of this guideline, but has clarified this in the text of the guideline.



## Annex I

### Advice of the Securities and Markets Stakeholder Group<sup>2</sup>

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#### I. Executive summary

The Stakeholder Group supports the adoption of guidelines related to MiFID and the overall approach of ESMA with respect to the Guidelines on compliance reporting requirements. This issue is of high importance to ensure that rules designed to protect investors are effectively applied and do not remain « law on the books ». Therefore the adoption of the Guidelines should contribute effectively to enhance consumer protection, which is one of the ESMA's objectives.

While strongly supporting both the timing and the content of the Guidelines, the Group would like to call the attention of ESMA to a number of specific elements. In addition, the Group strongly supports the proportionality principle, which is included in Article 6 of the MiFID Implementing Directive, and even thinks that it should be strengthened.

In general, because of the high costs involved with compliance function requirements, the Group feels that ESMA should be mindful of the costs resulting from the proposed requirements. Therefore, some requirements included in the Guidelines, such as reports, staff-training and expertise, should be adapted in order not to prevent investment firms, and especially subject small and medium-sized ones, to enter in the market and to compete with larger firms.

The Group also feels that ESMA should allow more flexibility for small and medium-sized investment firms.

However, the Stakeholder Group would like to insist that irrespective of the size of the firm, the compliance function has to be performed adequately. The size of the firm is no excuse for poor compliance performance and outsourcing should be required when a firm does not have the internal resources to perform it internally.

As to the criteria used in the Guidelines, the Group feels that compliance is only a function of the nature of activities and instruments. Therefore, staff headcount should not be used as a justification for not having an adequate compliance function.

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#### II. Explanatory remarks

1. On December 22, 2011 ESMA published a consultation paper relating to proposed Guidelines regarding the implementation of certain requirements of the Markets in

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<sup>2</sup> This SMSG advice is available to view on ESMA's website at: <http://www.esma.europa.eu/node/57198>

Financial Instruments Directive (MiFID)<sup>3</sup> The purpose of the Guidelines is to enhance clarity and foster convergence in the implementation of certain aspects of the MiFID requirements.

2. The second set of Guidelines deals with the issue of compliance function requirements (ESMA/2011/446). Article 13 of MiFID and Article 6 of the MiFID Implementing Directive set out the regulatory provisions for the compliance function of investment firms. As mentioned in the Consultation Paper, “the financial crisis has highlighted the need for more clarification about the role of compliance, especially in view of the plethora of evolving legislation and increasing levels of scrutiny from both regulators and consumers. Also, compliance risk often takes second place to other areas of risk within a firm, and this can lead to the deficient implementation of appropriate compliance processes.”<sup>4</sup> Therefore, the purpose of these Guidelines is to enhance clarity and foster convergence in the implementation of the MiFID organisational requirements relating to certain aspects of the compliance function. The Guidelines are also aimed at reinforcing the importance of the compliance function.
3. The adoption of Guidelines by ESMA is subject to Article 16 of the ESMA Regulation<sup>5</sup> which provides that ESMA “shall, with a view to establishing consistent, efficient and effective supervisory practices within the ESFS (European System of Financial Supervisors), and to ensuring the common, uniform and consistent application of Union law, issue Guidelines and recommendations addressed to competent authorities or financial market participants”. Both Guidelines are addressed to competent authorities which are subject to the “comply or explain” approach imposed by Article 16(3) of the Regulation. The Guidelines are also addressed to financial market participants. However, participants are not under a duty report, “in a clear and detailed way, whether they comply with that Guideline...”<sup>6</sup>
4. These Guidelines constitute new developments at the EU level. They do not duplicate previous work by the Committee of European Securities Regulators (CESR). However, they build on existing requirements developed by national regulators. The Guidelines are divided between General Guidelines and Supporting Guidelines.

### **III. General comments of the Group on Guidelines on certain aspects of the MiFID compliance function requirements**

#### **III.I. Reporting obligations of the compliance function**

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<sup>3</sup> Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments.

<sup>4</sup> Compliance Draft Guidelines, p. 5.

<sup>5</sup> Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC.

<sup>6</sup> Art. 16(3) of the ESMA Regulation raises the possibility for this reporting requirement to apply.

5. The Group considers that there is no need to provide compliance function reports to competent authorities on a regular or periodic basis. Such reports can be always submitted to the supervisory authority on request or in the course of an on-site inspection. Such reports if submitted to the supervisory authority, taking into consideration all other types of regulated information that investment firms file with the regulator in the course of their activity, could put a stress on the capacity of the regulator to process and assess the information supplied and to employ a risk-based strategy of identifying firms violating the legal requirements applicable to their activity and the protection of clients.

### III.II. Advisory obligations of the compliance function

#### **Paragraph 26 (Staff training)**

6. As mentioned in the Guidelines, investment firms need to ensure that their staff are adequately trained.
7. However, this being said, the core essence of the compliance function is to monitor, assess on regular basis, advise and assist the relevant persons responsible for carrying out investment services and activities to comply with the firm's obligations under Directive 2004/39/EC. As these are very heavy and responsible obligations by themselves there is a need to be very careful when imposing another major obligation such as extensive staff training in order to prevent the effective compliance function from diluting and diverting its core essence.
8. The Group also feels that it could be expedient if competent authorities were charged with the function of providing training to compliance officers from the investment firms based on their supervisory experience and monitoring practices allowing them to gather information about typical and recurring violations of the relevant legislation. Business and trade associations could also be given role in that aspect provided they have the necessary resources and/or expertise to organize and conduct training courses for compliance staff. A certificate could even be issued by the competent authority. Otherwise, it could authorise private sector actors to deliver the certificate.

### III.III. Effectiveness of the compliance function

9. The very large majority of the Group thinks that all compliance staff should be subject to the same high level standards so as to their level of education, in order to ensure that the compliance function is performed appropriately. Compliance officers not directly engaged in the management of units should be subject to the same stringent formal rules in respect to their education, than heads of units. Irrespective of level, every employee of an investment firm involved in compliance needs to have an adequate and sufficient understanding of risks, behaviour and situations to be able to perform their respective tasks. Employees should not just rely on their superior.
10. However, some members of the Group think that the requirements applicable to the expertise of the compliance staff and officers should be structured in a graduated manner

such as to allow officers from the compliance staff who are not directly engaged in the management of units of the compliance office or the office itself to be subject to less stringent formal rules (as to e.g. education, work experience) than those applying to heads of units or the office itself.

#### III.IV. Exemptions

11. The Group supports the proportionality principle which is included in Article 6 of the MiFID Implementing Directive.<sup>7</sup> The principle of proportionality implies that “where an investment firm considers that it may not be proportionate for it to comply with the requirements set out in Article 6(3) of the MiFID Implementing Directive, it should assess whether the effectiveness of the compliance function is compromised by the proposed arrangements. This assessment should be reviewed regularly”.<sup>8</sup> Regarding the possibility to have exemptions from certain requirements based on this principle, the Group would like first to remind that a proportionate response to the compliance role function does not mean no compliance. Having said that, the Group would like to point some issues regarding exemptions.

#### **Paragraph 46 (Staff headcount)**

12. The Guidelines mention that, when deciding on measures that are best suited to the firm’s particular nature and circumstances, the staff headcount should be taken into account. Some members of the Group feel that too much importance should not be given to this criterion. The compliance is only a function of the nature of activities and instruments, and staff headcount should not be used as a justification for not having an adequate compliance function.

#### **Paragraph 49 (Exemption from appointment of a separate compliance officer)**

13. This principle of proportionality leads the Guidelines to allow a “smaller investment firm with a very narrow field of activities and/or limited human resources” not to appoint a separate compliance officer. As mentioned, this exemption to appoint a separate compliance officer does not constitute an exemption to apply the compliance requirements themselves. The Group considers this exemption to be justified in order not to prevent small and medium-sized investment firms from entering into existence and to promote competition in the financial sector. Nevertheless, small and medium-sized investment firms with no separate compliance officers present also higher compliance risks, be it only for the reason that the individual assuming the function of compliance officer might simply not be well trained in the area of law. Therefore, the Group considers that when such exemption is accepted, these firms should be subject to increased scrutiny and specific

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<sup>7</sup> Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive.

<sup>8</sup> Compliance Draft Guidelines (ESMA/2011/446), p. 13.

attention by the Competent Authority.

### III.V. Combining the compliance function with other functions

#### **Paragraphs 52-55**

14. The Group takes as the starting point that whoever is in charge of compliance should receive the same training and take the same exam, if there is one, as if she was full time. The fact that an individual is the CEO or CFO or CIO of a small firm is not sufficient to assume that she knows all the rules regarding compliance.
15. However, consistent with the principle of proportionality, the Group feels that in the case of small and medium-sized investment firms more freedom should be given to them to structure their compliance function with regard to organization and staff in order for them to minimize costs. The same approach should apply to the overlapping of functions. ESMA might consider that, for small and medium-sized investment firms, the overlapping of functions **could** become the rule rather than the exception. In order to promote this approach, Competent Authorities could also be allowed to issue Guidelines setting standards for categorization of investment firms based on the size and volume of their operations.
16. The Group also thinks that irrespective of the size of the firm, the compliance function has to be performed adequately. Therefore, smaller firms, which as a matter of fact need a certain flexibility, could be required to outsource their compliance function, when they do not have the internal resources to perform it internally.

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

Adopted on 15 February 2012

## Annex II

### Guidelines on certain aspects of the MiFID compliance function requirements

#### I. Scope

##### Who?

1. These guidelines apply to investment firms (as defined in Article 4(1)(1) of MiFID), including credit institutions that provide investment services, UCITS management companies<sup>9</sup>, and competent authorities.

##### What?

2. These guidelines apply in relation to the provision of the investment services and activities listed in Section A and the ancillary services listed in Section B of Annex I of the Markets in Financial Instruments Directive (MiFID).

##### When?

3. These guidelines apply from 60 calendar days after the reporting requirement date referred to in paragraph 10.

#### II. Definitions

4. Unless otherwise specified, terms used in the Markets in Financial Instruments Directive and the MiFID Implementing Directive have the same meaning in these guidelines. In addition, the following definitions apply:

*Markets in Financial Instruments Directive (MiFID)* Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, as subsequently amended.

*MiFID Implementing Directive* Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the

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<sup>9</sup> These guidelines only apply to UCITS management companies when they are providing the investment services of individual portfolio management or of investment advice (within the meaning of Article 6(3)(a) and (b) of the UCITS Directive).

purposes of that Directive.

*compliance function* The function within an investment firm responsible for identifying, assessing, advising, monitoring and reporting on the investment firm's compliance risk.

*compliance risk* The risk that an investment firm fails to comply with its obligations under MiFID and the respective national laws, as well as the applicable standards set out by ESMA and competent authorities on these provisions.

5. Guidelines do not reflect absolute obligations. For this reason, the word 'should' is often used. However, the words 'must' or 'are required' are used when describing a MiFID requirement.

### **III. Purpose**

6. The purpose of these guidelines is to clarify the application of certain aspects of the MiFID compliance function requirements in order to ensure the common, uniform and consistent application of Article 13 of the Markets in Financial Instruments Directive (MiFID), Article 6 of the MiFID Implementing Directive, and specified related provisions.
7. ESMA expects these guidelines to promote greater convergence in the interpretation of, and supervisory approaches to, the MiFID compliance function requirements by emphasising a number of important issues, and thereby enhancing the value of existing standards. By helping to ensure that firms comply with regulatory standards, ESMA anticipates a corresponding strengthening of investor protection.

### **IV. Compliance and reporting obligations**

#### **Status of the guidelines**

8. This document contains guidelines issued under Article 16 of the ESMA Regulation.<sup>10</sup> In accordance with Article 16(3) of the ESMA Regulation, competent authorities and financial market participants must make every effort to comply with guidelines.
9. Competent authorities to whom these guidelines apply should comply by incorporating them into their supervisory practices, including where particular guidelines are directed primarily at financial market participants.

#### **Reporting requirements**

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<sup>10</sup> Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC.

10. Competent authorities to which these guidelines apply must notify ESMA whether they comply or intend to comply with the guidelines, with reasons for any non-compliance. Competent authorities must notify ESMA within two months of publication of the translations by ESMA to ‘**compliance.388@esma.europa.eu**’. In the absence of a response by this deadline, competent authorities will be considered non-compliant. A template for notifications is available on the ESMA website.
11. Financial market participants are not required to report whether they comply with these guidelines.

## **V. Guidelines on certain aspects of the MiFID compliance function requirements**

12. As part of its responsibility for ensuring that the investment firm complies with its obligations under MiFID, senior management must ensure that the compliance function fulfils the requirements set out in Article 6 of the MiFID Implementing Directive.
13. The guidelines should be read together with the proportionality principle as set out in Article 6(1) of the MiFID Implementing Directive. The guidelines apply to investment firms taking into account the nature, scale and complexity of their respective businesses, and the nature and range of investment services and activities undertaken in the course of their business.

### **V.I. Guidelines on responsibilities of the compliance function**

#### **Compliance risk assessment**

#### **Relevant legislation: Article 6(1) of the MiFID Implementing Directive.**

##### *General guideline 1*

14. Investment firms should ensure that the compliance function takes a risk-based approach in order to allocate the function’s resources efficiently. A compliance risk assessment should be used to determine the focus of the monitoring and advisory activities of the compliance function. The compliance risk assessment should be performed regularly to ensure that the focus and the scope of compliance monitoring and advisory activities remain valid.

##### *Supporting guidelines*

15. MiFID requires investment firms to establish, implement and maintain adequate policies and procedures designed to detect any risk of failure by the investment firm to comply with its obligations under MiFID. As part of this, the compliance function should identify the level of compliance risk the investment firm faces, taking into account the investment services, activities and ancillary services provided by the investment firm, as well as the types of financial instruments traded and distributed.



16. The compliance risk assessment should take into account the applicable obligations under MiFID, national implementing regulation and the policies, procedures, systems and controls implemented within the firm in the area of investment services and activities. The assessment should also take into account the results of any monitoring activities and of any relevant internal or external audit findings.
17. The compliance function's objectives and work programme should be developed and set up on the basis of this compliance risk assessment. The identified risks should be reviewed on a regular basis as well as ad-hoc when necessary to ensure that any emerging risks are taken into consideration (for example, resulting from new business fields or other changes in the investment firm's structure).

### **Monitoring obligations of the compliance function**

#### **Relevant legislation: Article 6(2)(a) of the MiFID Implementing Directive.**

##### *General guideline 2*

18. Investment firms should ensure that the compliance function establishes a monitoring programme that takes into consideration all areas of the investment firm's investment services, activities and any relevant ancillary services. The monitoring programme should establish priorities determined by the compliance risk assessment ensuring that compliance risk is comprehensively monitored.

##### *Supporting guidelines*

19. The aim of a monitoring programme should be to evaluate whether the investment firm's business is conducted in compliance with its obligations under MiFID and whether its internal guidelines, organisation and control measures remain effective and appropriate.
20. Where an investment firm is part of a group, responsibility for the compliance function rests with each investment firm in that group. An investment firm should therefore ensure that its compliance function remains responsible for monitoring its own compliance risk. This includes where a firm outsources compliance tasks to another firm within the group. The compliance function within each investment firm should, however, take into account the group of which it is a part - for example, by working closely with audit, legal, regulatory and compliance staff in other parts of the group.
21. The risk-based approach to compliance should form the basis for determining the appropriate tools and methodologies used by the compliance function, as well as the extent of the monitoring programme and the frequency of monitoring activities performed by the compliance function (which may be recurring, ad-hoc and/or continuous). The compliance function should also ensure that its monitoring activities are not only desk-based, but that it also verifies how policies and procedures are implemented in practice, for example through on-site inspections at the operative business units. The compliance function should also consider the scope of reviews to be performed.

22. Suitable tools and methodologies for monitoring activities that could be used by the compliance function include (but are not limited to):
  - (a) the use of aggregated risk measurements (for example, risk indicators);
  - (b) the use of reports warranting management attention, documenting material deviations between actual occurrences and expectations (an exceptions report) or situations requiring resolution (an issues log);
  - (c) targeted trade surveillance, observation of procedures, desk reviews and/or interviewing relevant staff.
23. The monitoring programme should reflect changes to the investment firm's risk profile, which may arise, for example, from significant events such as corporate acquisitions, IT system changes, or re-organisation. It should also extend to the implementation and effectiveness of any remedial measures taken by the investment firm in response to breaches of MiFID.
24. Monitoring activities performed by the compliance function should also take into account:
  - (a) the business area's obligation to comply with regulatory requirements;
  - (b) the first level controls in the investment firm's business areas (i.e. controls by the operative units, as opposed to second level controls performed by compliance); and
  - (c) reviews by the risk management, internal control function, internal audit function or other control functions in the area of investment services and activities.
25. Reviews by other control functions should be coordinated with the monitoring activities performed by the compliance function while respecting the different functions' independence and mandate.
26. The compliance function should have a role in overseeing the operation of the complaints process and it should consider complaints as a source of relevant information in the context of its general monitoring responsibilities. This does not require compliance functions to have a role in determining the outcome of complaints. In this regard, investment firms should grant the compliance function access to all customer complaints received by the firm.

## **Reporting obligations of the compliance function**

**Relevant legislation: Article 6(3)(b) and 9 of the MiFID Implementing Directive.**

### *General guideline 3*

27. Investment firms should ensure that the regular written compliance reports are sent to senior management. The reports should contain a description of the implementation and effectiveness of the overall control environment for investment services and activities and a summary of the risks that have been identified as well as remedies undertaken or to be undertaken. Reports must be prepared at appropriate intervals and at least annually. Where the compliance function makes significant findings, the compliance officer should, in addition, report these promptly to senior management. The supervisory function, if any, should also receive the reports.

### *Supporting guidelines*

28. The written compliance report to senior management should cover all business units involved in the provision of investment services, activities and ancillary services. Where the report does not cover all of these activities of the investment firm, it should clearly state the reasons.
29. The following matters should be addressed in these written compliance reports, where relevant:
- (a) a description of the implementation and effectiveness of the overall control environment for investment services and activities;
  - (b) a summary of major findings of the review of the policies and procedures;
  - (c) a summary of on-site inspections or desk-based reviews performed by the compliance function including breaches and deficiencies in the investment firm's organisation and compliance processes that have been discovered and appropriate measures taken as a result;
  - (d) risks identified in the scope of the compliance function's monitoring activities;
  - (e) relevant changes and developments in regulatory requirements over the period covered by the report and the measures taken and to be taken to ensure compliance with the changed requirements (where senior management has not previously been made aware of these through other channels);
  - (f) other significant compliance issues that have occurred since the last report; and
  - (g) material correspondence with competent authorities (where senior management has not previously been made aware of these through other channels).

30. The compliance function should report to senior management, in a timely manner, on an ad-hoc basis when significant compliance matters have been discovered, such as material breaches of MiFID and the respective national requirements. The report should also contain advice on the necessary remedial steps.
31. The compliance function should consider the need for additional reporting lines to any group compliance function.
32. ESMA notes that some competent authorities require investment firms to provide them with compliance function reports on a regular or *ad hoc* basis. One competent authority also requires senior management to provide it with an annotated version of the report containing explanations of the compliance function's findings.<sup>11</sup> These practices provide competent authorities with first-hand insight into an investment firm's compliance activities, as well as any breaches of regulatory provisions.

### **Advisory obligations of the compliance function**

Relevant legislation: Article 6(2) of the MiFID Implementing Directive.

#### *General guideline 4*

33. Investment firms should ensure that the compliance function fulfils its advisory responsibilities including: providing support for staff training; providing day-to-day assistance for staff and participating in the establishment of new policies and procedures within the investment firm.

#### *Supporting guidelines*

34. Investment firms should promote and enhance a 'compliance culture' throughout the firm. The purpose of the compliance culture is not only to establish the overall environment in which compliance matters are treated, but also to engage staff with the principle of improving investor protection.
35. The investment firm needs to ensure that its staff are adequately trained. The compliance function should support the business units in the area of investment services and activities (i.e. all staff involved directly or indirectly in the provision of investment services and activities) in performing any training. Training and other support should focus particularly, but not exclusively, on:

- (a) the internal policies and procedures of the investment firm and its organisational structure in the area of investment services and activities; and

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<sup>11</sup> This description of specific practices of competent authorities aims to provide the reader with additional information on differing approaches of competent authorities without setting up additional requirements for investment firms or competent authorities (and thereby triggering the obligation under Article 16(3) of the ESMA Regulation to comply or explain).

- (b) MiFID, the relevant national laws, the applicable standards and guidelines set out by ESMA and competent authorities, and other supervisory and regulatory requirements that may be relevant, as well as any changes to these.
36. Training should be performed on a regular basis, and needs-based training should be performed where necessary. Training should be delivered as appropriate – for example, to the investment firm’s entire staff as a whole, to specific business units, or to a particular individual.
  37. Training should be developed on an on-going basis so that it takes into account all relevant changes (for example, new legislation, standards or guidelines issued by ESMA and competent authorities, and changes in the investment firm’s business model).
  38. The compliance function should periodically assess whether staff in the area of investment services and activities hold the necessary level of awareness and correctly apply the investment firm’s policies and procedures.
  39. Compliance staff should also provide assistance to staff from the operative units in their day-to-day business and be available to answer questions arising out of daily business activity.
  40. Investment firms should ensure that the compliance function is involved in the development of the relevant policies and procedures within the investment firm in the area of investment services, activities and ancillary services. In this context, the compliance function should be enabled, for example, to provide compliance expertise and advice to business units about all strategic decisions or new business models, or about the launch of a new advertising strategy in the area of investment services and activities. If the compliance function’s advice is not followed, the compliance function should document this accordingly and present it in its compliance reports.
  41. Investment firms should ensure that the compliance function is involved in all significant modifications of the organisation of the investment firm in the area of investment services, activities and ancillary services. This includes the decision-making process when new business lines or new financial products are being approved. In this context, the compliance function should be given the right to participate in the approval process for financial instruments to be taken up in the distribution process. Senior management should therefore encourage business units to consult with the compliance function regarding their operations.
  42. Investment firms should ensure that the compliance function is involved in all material non-routine correspondence with competent authorities in the area of investment services and activities.

## V.II. Guidelines on organisational requirements of the compliance function

### Effectiveness of the compliance function

#### **Relevant legislation: Article 6(3)(a) and 5(1)(d) of the MiFID Implementing Directive.**

##### *General guideline 5*

43. When ensuring that appropriate human and other resources are allocated to the compliance function, investment firms should take into account the scale and types of investment services, activities and ancillary services undertaken by the investment firm. They should also provide compliance staff with the authority necessary to exercise their duties effectively, as well as access to all relevant information concerning the investment services and activities as well as ancillary services undertaken.
44. The compliance officer should have sufficiently broad knowledge and experience and a sufficiently high level of expertise so as to be able to assume responsibility for the compliance function as a whole and ensure that it is effective.

##### *Supporting guidelines*

45. The number of staff required for the tasks of the compliance function depends to a large extent on the nature of the investment services, activities and ancillary services and other services provided by the investment firm. Where an investment firm's business unit activities are significantly extended, the investment firm should ensure that the compliance function is similarly extended as necessary in view of changes to the firm's compliance risk. Senior management should monitor regularly whether the number of staff is still adequate for the fulfilment of the duties of the compliance function.
46. In addition to human resources, sufficient IT resources should be allocated to the compliance function.
47. Where the investment firm establishes budgets for specific functions or units, the compliance function should be allocated a budget that is consistent with the level of compliance risk the firm is exposed to. The compliance officer should be consulted before the budget is determined. All decisions for significant cuts in the budget should be documented in writing and contain detailed explanations.
48. In ensuring compliance staff have access to the relevant information for their tasks at all times, investment firms should provide access to all relevant databases. In order to have a permanent overview of the areas of the investment firm where sensitive or relevant information might arise, the compliance officer should have access to all relevant information systems within the investment firm as well as any internal or external audit reports or other reporting to senior management or the supervisory function, if any. Where relevant, the compliance officer should also be able to attend meetings of senior

management or the supervisory function. Where this right is not granted, this should be documented and explained in writing. The compliance officer should have in-depth knowledge of the investment firm's organisation, corporate culture and decision-making processes in order to be able to identify which meetings are important to attend.

49. In order to ensure that compliance staff have the authority required for their duties, the senior management of the investment firm should support them in the exercise of these duties. Authority implies possessing adequate expertise and relevant personal skills, and may be enhanced by the investment firm's compliance policy explicitly acknowledging the specific authority of the compliance staff.
50. All compliance staff should have at least knowledge of MiFID and of the respective national laws and all applicable standards and guidelines issued by ESMA and competent authorities on these provisions, as far as these are relevant for the performance of their tasks. Compliance staff should be regularly trained in order to maintain their knowledge. A higher level of expertise is necessary for the designated compliance officer.
51. The compliance officer should demonstrate sufficient professional experience as is necessary to be able to assess the compliance risks and conflicts of interest inherent in the investment firm's business activities. The required professional experience may have, amongst others, been acquired in operational positions, in other control functions or in regulatory functions.
52. The compliance officer should have specific knowledge of the different business activities provided by the investment firm. The relevant expertise required may differ from one investment firm to another, as the nature of the main compliance risks that firms face will differ. In respect of Article 5(1)(d) of the MiFID Implementing Directive, a newly employed compliance officer may therefore need additional specialised knowledge focused on the specific business model of the investment firm even if the person has previously been the compliance officer for another investment firm.

## **Permanence of the compliance function**

### **Relevant legislation: Article 6(2)(a) of the MiFID Implementing Directive.**

#### *General guideline 6*

53. MiFID requires investment firms to ensure that the compliance function performs its tasks and responsibilities on a permanent basis. Investment firms should therefore establish adequate arrangements for ensuring the responsibilities of the compliance officer are fulfilled when the compliance officer is absent, and adequate arrangements to ensure that the responsibilities of the compliance function are performed on an ongoing basis. These arrangements should be in writing.

#### *Supporting guidelines*



54. The investment firm should ensure, e.g. through internal procedures and stand-in arrangements, that the responsibilities of the compliance function are fulfilled adequately during any absence of the compliance officer.
55. The responsibilities and competences as well as the authority of the compliance staff should be set out in a 'compliance policy' or other general policies or internal rules that take account of the scope and nature of the investment firm's investment services and activities. This should include information on the monitoring programme and the reporting duties of the compliance function as well as information on the compliance function's risk-based approach to monitoring activities. Relevant amendments to regulatory provisions should be reflected promptly by adapting these policies/rules.
56. The compliance function should perform its activities on a permanent basis and not only in specific circumstances. This requires regular monitoring on the basis of a monitoring schedule. The monitoring activities should regularly cover all key areas of investment services and activities taking into account the compliance risk associated with the business areas. The compliance function should be able to respond rapidly to unforeseen events, thereby changing the focus of its activities within a short timeframe if necessary.

### **Independence of the compliance function**

Relevant legislation: Article 6(3) MiFID Implementing Directive.

#### *General guideline 7*

57. Investment firms should ensure that the compliance function holds a position in the organisational structure that ensures that the compliance officer and other compliance staff act independently when performing their tasks. The compliance officer should be appointed and replaced by senior management or by the supervisory function.

#### *Supporting guidelines*

58. While senior management is responsible for establishing an appropriate compliance organisation and for monitoring the effectiveness of the organisation that has been implemented, the tasks performed by the compliance function should be carried out independently from senior management and other units of the investment firm. In particular, the investment firm's organisation should ensure that other business units may not issue instructions or otherwise influence compliance staff and their activities.
59. Where senior management deviates from important recommendations or assessments issued by the compliance function, the compliance officer should document this accordingly and present it in the compliance reports.



## Exemptions

### Relevant legislation: Article 6(3) of the MiFID Implementing Directive.

#### *General guideline 8*

60. Where an investment firm considers that it may not be proportionate for it to comply with the requirements set out in Article 6(3)(c) or (d) of the MiFID Implementing Directive, it should assess whether the effectiveness of the compliance function is compromised by the proposed arrangements. This assessment should be reviewed regularly.

#### *Supporting guidelines*

61. Investment firms should decide which measures, including organisational measures and the level of resources, are best suited to ensuring the effectiveness of the compliance function in the firm's particular circumstances. In deciding this, investment firms should take the following criteria (inter alia) into account:

- (a) the types of investment services, activities and ancillary services and other business activities provided by the investment firm (including those not related to investment services, activities and ancillary services);
- (b) the interaction between the investment services and activities and ancillary services and other business activities carried out by the investment firm;
- (c) the scope and volume of the investment services, activities and ancillary services carried out (absolute and relative to other business activities), balance sheet total and income of the investment firm from commissions and fees and other income in the context of the provision of investment services, activities and ancillary services;
- (d) the types of financial instruments offered to clients;
- (e) the types of clients targeted by the investment firm (professional, retail, eligible counterparties);
- (f) staff headcount;
- (g) whether the investment firm is part of an economic group within the meaning of Article 1 of the Seventh Council Directive of 13 June 1983 on consolidated accounts (Directive 83/349/EC);
- (h) services provided through a commercial network, such as tied agents, or branches;
- (i) cross-border activities provided by the investment firm;

(j) organisation and sophistication of the IT systems.

62. Competent authorities may also find these criteria useful in determining which types of investment firms may benefit from the proportionality exemption under Article 6(3) of the MiFID Implementing Directive.
63. An investment firm may fall, for example, under the proportionality exemption if the performance of the necessary compliance tasks does not require a full-time position due to the nature, scale and complexity of the firm's business, and the nature and range of the investment services, activities and ancillary services offered.
64. While a compliance officer must always be appointed, it may be disproportionate for a smaller investment firm with a very narrow field of activities to appoint a separate compliance officer (i.e. one that does not perform any other function). Where an investment firm makes use of the exemption, conflicts of interest between the tasks performed by the relevant persons should be minimised as much as possible.
65. An investment firm that does not need to comply with all the requirements set out in Article 6(3) of the MiFID Implementing Directive under the proportionality principle, may combine the legal and compliance function. However, an investment firm with more complex activities or greater size should generally avoid such combination, if it could undermine the compliance function's independence.
66. Where an investment firm makes use of the proportionality exemption, it should record how this is justified, so that the competent authority is able to assess this.

### **Combining the compliance function with other internal control functions**

#### **Relevant legislation: Article 6(3) of the MiFID Implementing Directive.**

##### *General guideline 9*

67. An investment firm should generally not combine the compliance function with the internal audit function. The combination of the compliance function with other control functions may be acceptable if this does not compromise the effectiveness and independence of the compliance function. Any such combination should be documented, including the reasons for the combination so that competent authorities are able to assess whether the combination of functions is appropriate in the circumstances.

##### *Supporting guidelines*

68. Compliance staff should generally not be involved in the activities they monitor. However, a combination of the compliance function with other control units at the same level (such as money laundering prevention) may be acceptable if this does not generate conflicts of interests or compromise the effectiveness of the compliance function.

69. Combining the compliance function with the internal audit function should generally be avoided as this is likely to undermine the independence of the compliance function because the internal audit function is charged with the oversight of the compliance function. However, for practical reasons (for example, decision making), and in certain circumstances (for example, in firms of only two persons), it may be more appropriate to have one person responsible for both functions. In this regard, firms should consider discussing the combination with the relevant supervisory authority. In addition, where this combination occurs, the firm must, of course, ensure that the responsibilities of each function are discharged properly (i.e. soundly, honestly and professionally).
70. Whether staff from other control functions also perform compliance tasks, should also be a relevant consideration in the determination of the relevant number of staff necessary for the compliance function.
71. Whether or not the compliance function is combined with other control functions, the compliance function should coordinate its activities with the second-level control activities performed by other units.

### **Outsourcing of the compliance function**

#### **Relevant legislation: Article 6 and 14 of the MiFID Implementing Directive.**

##### *General guideline 10*

72. Investment firms should ensure that all applicable compliance function requirements are fulfilled where all or part of the compliance function is outsourced.

##### *Supporting guidelines*

73. The MiFID outsourcing requirements for critical or important functions apply in full to the outsourcing of the compliance function.
74. The requirements that apply to the compliance function are the same whether or not any or all of the compliance function is outsourced; the responsibility for the fulfilment of the existing requirements rests with a firm's senior management.
75. The investment firm should perform a due diligence assessment before choosing a service provider in order to ensure that the criteria set out in Articles 6 and 14 of the MiFID Implementing Directive are met. The investment firm should ensure that the service provider has the necessary authority, resources, expertise and access to all relevant information in order to perform the outsourced compliance function tasks effectively. The extent of the due diligence assessment is dependent on the nature, scale, complexity and risk of the tasks and processes that are outsourced.
76. Investment firms should also ensure that when outsourced partially or fully, the compliance function remains permanent in nature, i.e. the service provider should be able to perform

the function on an ongoing basis and not only in specific circumstances.

77. Investment firms should monitor whether the service provider performs its duties adequately, which includes monitoring the quality and the quantity of the services provided. Senior management is responsible for supervising and monitoring the outsourced function on an ongoing basis, and should have the necessary resources and expertise to be able to fulfil this responsibility. Senior management may appoint a specific person to supervise and monitor the outsourced function on their behalf.
78. Outsourcing of the compliance function within a group does not lead to a lower level of responsibility for the senior management of the individual investment firms within the group. However, a centralised group compliance function may, in some cases, provide the compliance officer with better access to information, and lead to greater efficiency of the function, especially if the entities share the same premises.
79. If an investment firm, due to the nature, size and scope of its business activities, is unable to employ compliance staff who are independent of the performance of services they monitor, then outsourcing of the compliance function is likely to be an appropriate approach to take.

### V.III. **Guideline on competent authority review of the compliance function**

#### **Review of the compliance function by competent authorities**

##### **Relevant legislation: Articles 7 and 17 of MiFID.**

##### *General guideline 11*

80. Competent authorities should review how investment firms plan to meet, implement and maintain the MiFID compliance function requirements. This should apply in the context of the authorisation process, as well as, following a risk-based approach, in the course of ongoing supervision.

##### *Supporting guidelines*

81. Article 7 of MiFID states that a competent authority shall not grant authorisation to an investment firm unless and until such time as it is fully satisfied that the applicant complies with all requirements under the provisions adopted pursuant to MiFID. Accordingly, the competent authority should assess whether a firm's compliance function is adequately resourced and organised and whether adequate reporting lines have been established. It should require that any necessary amendments are made to the compliance function as a condition for authorisation.
82. Additionally, as part of the ongoing supervisory process, a competent authority should – following a risk-based approach – assess whether the measures implemented by the investment firm for the compliance function are adequate, and whether the compliance

function fulfils its responsibilities appropriately. Investment firms are responsible for determining whether amendments to the resources and organisation of the compliance function are required due to changes in the business model of the investment firm. Competent authorities should also, as part of their ongoing supervision and following a risk based approach, assess and monitor - where and if appropriate - whether such amendments are necessary and have been implemented. The competent authority should provide a reasonable timeframe for the firm to make amendments. However, investment firms' amendments are not necessarily subject to approval by the competent authorities.

83. Some competent authorities license or approve the nominated compliance officer following an assessment of the qualifications of the compliance officer. This assessment may include an analysis of the compliance officer's curriculum vitae, as well as an interview with the designated person. This sort of licensing process may help to strengthen the position of the compliance function within the investment firm and in relation to third parties.
84. Other regulatory approaches impose the responsibility for the assessment of the compliance officer's qualification solely on the senior management of the investment firm. Senior management assesses the prospective compliance officer's qualifications before appointment. Whether the investment firm properly complies with this requirement is then assessed within the general review of the firm's compliance with the relevant MiFID requirements.
85. Some Member States require investment firms to notify the competent authorities of the appointment and replacement of the compliance officer. In some jurisdictions, this notification must also be accompanied by a detailed statement on the grounds for the replacement. This can help competent authorities gain insight into possible tensions between the compliance officer and senior management which could be an indication of deficiencies in the compliance function's independence.
86. The above practices could be helpful to other competent authorities.<sup>12</sup>

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<sup>12</sup> This description of specific practices of competent authorities aims to provide the reader with additional information on differing approaches of competent authorities without setting up additional requirements for investment firms or competent authorities (and thereby triggering the obligation under Article 16(3) of the ESMA Regulation to comply or explain).