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Re: CLLS Regulatory Law Committee Response to ESMA Consultation Paper (ESMA/2011/446) on Guidelines on certain aspects of the MiFID compliance function requirements

The City of London Law Society ("**CLLS**") represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

This response to ESMA's Consultation Paper (ESMA/2011/446) on Guidelines (the "**Guidelines**") on certain aspects of the MiFID compliance function requirements has been prepared by The City of London Law Society Regulatory Law Committee (the "**Committee**"). Members of the Committee advise a wide range of firms across Europe who operate in or use the services provided by the financial markets. European clients include banks, brokers, investment advisers, investment managers, custodians, private equity and other specialist fund managers as well as market infrastructure providers such as the operators of trading, clearing and settlement systems.

The CLLS is registered on the European Commission's Transparency Register, and its registration number is 24418535037-82.

We welcome ESMA's initiative to establish guidelines in respect of the compliance function requirements under MiFID, and its decision to consult on the contents of such guidelines. We are pleased to have this opportunity to comment on certain aspects of the guidelines that cause us concern or which we consider could be improved significantly.

Our comments may be summarised as follows:

- there is a need to expressly acknowledge senior management responsibility;
- we are concerned by the narrow focus of the guidelines;
- there is a need to anticipate equivalent guidelines in respect of other legislation;
- there is not sufficient attention paid to the need for a risk-based approach, whilst this is mentioned the tenor of the document seems to mandate a comprehensive (non-risk based) approach;

- there is inadequate flexibility, for example to cater for different corporate organisations and businesses: too many of the Guidelines are overly prescriptive;

- there is a need for better indication of the objectives sought to be achieved by requirements/suggestions, this is necessary when trying to assess the adequacy of alternative approaches;

- the compliance function responsibilities are described too broadly: all parts of the organisation have a responsibility to comply and to contribute to the firm's compliance in performing their functions.

GENERAL COMMENT

Executive summary, paragraph 3: Although we understand there would be difficulties in producing guidelines which are or purport to be comprehensive, we think much more could be done in at least two key respects:

- To provide much more guidance on the context and framework within which the compliance function operates in any organisation

    - The assumption seems to be that the compliance function itself is responsible for delivering compliance and, in doing so, must not be interfered with by senior management and business units or by senior management – who seem merely to be required to establish the organisation of the function and monitor its effectiveness (paragraph 45). We would strongly encourage acknowledgement of the key role and responsibility of senior management in establishing a compliance culture and supporting the function.

- To consider the function across the range of financial services regulatory requirements, including:

    - market abuse; and

    - the fact of forthcoming legislation, such as the Alternative Investment Fund Managers Directive (AIFMD), albeit that it might be premature to consider all the detail that will affect some firms.

DETAILED RESPONSES AND COMMENTS

Compliance risk assessment

Q1: Do you agree that investment firms should ensure that, where the compliance function takes a risk-based approach, a 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.

Yes, we agree. A comprehensive risk assessment is a key element in a risk-based approach. However, the question suggests that a risk-based approach is a choice whereas Section III.I seems to be expressed inflexibly.

Section III.I: Although a risk-based approach seems sensible for most organisations, what matters are the objectives of the function and the outcomes.

- Whereas assessment seems necessary to identify risks, the firm should have the choice to devote resources to eliminate certain risks so long as other material risks are properly resourced.

- Furthermore, the requirement for a "comprehensive scope" compliance function is inconsistent with a risk-based approach, because the latter implies that in practice non-material risks may receive minimal compliance attention.

- The Guidelines sit on the fence, acknowledging the sense of a risk-based approach, yet not accepting the inherent risk, namely that some issue, assessed as having minimal risk, will not be addressed: this is of little value to firms seeking (in the words of III.I) to allocate the function's resources efficiently.

Monitoring obligations

Q2: Please provide your comments (with reasons) on any or all aspects of this guideline on the monitoring obligations of the compliance function.

Section III.II: The requirement for comprehensive monitoring underscores the impression that the Guidelines do not really support a risk-based approach.

Paragraphs 13: the statement that "*responsibility for the compliance function rests with each investment firm in [a] group*" and the related comments do not really address the major issues to which such an approach, if rigidly followed, would cause. Supervisors know that this approach would and does present challenges to current models. However, it is also rather inconsistent with consolidated supervision, and risk compliance silos within a group, and gaps between these silos. Substantially more thought is required in this area, and more clarity is required as to the implications of the principle.

Reporting obligations

Q3: Please provide your comments (with reasons) on any or all aspects of this guideline on reporting obligations of the compliance function.

Section III.III: there are numerous issues with this overly prescriptive Guideline and the following paragraphs which develop it. It is important that senior management are made aware of key issues and, indeed, provide leadership on compliance matters as appropriate but it is also important that they not be provided with excess material concerning compliance, as the risk is then that they may not focus on the core concerns. In particular:

- The recommendations need to be more nuanced to allow firms to report an appropriate basis.

- The sense of the Guideline seems to be that long and detailed reports are required, comprehensively covering the aspects of compliance that are mentioned, unless the aspect is not relevant to the organisation. The Guideline needs to reflect a sense of materiality, and explain the objectives of the reporting obligations.

- Our concern is that senior management will receive long and descriptive reports that do not focus on the matters of which they should be aware, such as significant incidents which have occurred, risks which have been identified or grown, actions they need to take, etc. Senior management may not read such reports in detail, they may fail to identify the key points and their attention may be distracted from issues which require their attention.

- Without flexibility and focus the reports are likely to become ritualised and less valuable.

- This is exacerbated by the requirement in paragraph 20(b) and (c) that the (annual) written reports for management should address relevant changes in regulation and future changes.

    - In the current environment, this particular requirement would make such reports wholly unworkable: we suggest there should, as a minimum, be inserted the phrase "(where senior management has not previously been made aware of these through other channels)" and, preferably, a separate paragraph to the effect that the compliance function report to senior management, in the annual report or otherwise, with appropriate regularity on future regulatory changes which are likely to have a significant impact on the firm's business.

- There would be merit in including reporting to senior management on issues that have been dealt with.

Advisory obligations

Q4: Please provide your comments (with reasons) on any or all aspects of this guideline on the advisory obligations of the compliance function.

Section III.IV: This too is expressed in too prescriptive terms, particularly as regards training for staff.

- The implication that compliance should be involved in training on matters other than regulatory or compliance issues is inappropriate – of course, in some firms this may be appropriate but it should not required, in effect, by Guidelines;

- In any event, many firms will organise even compliance training separately from the compliance function, and the trainers may not be compliance staff.

- The Guidelines should recognise the different training models, and provide more flexible language, for example that compliance should monitor the processes for delivering compliance training and, to the extent appropriate, support the development and delivery of training, and language that indicates flexibility in different organisations.

Paragraph 29: A firm's policies and procedures go well beyond those required for compliance with MiFID and financial services regulation generally. It would not usually be the responsibility of the compliance function to make these assessments, but the function might check that there are processes to assess these matters, that such assessments are being carried out, and that appropriate steps are taken to address shortcomings.

Paragraph 33: this is too sweeping a generalisation and over-prescriptive and/or unclear.

- In many firms there are several functions that communicate with the competent authority, for example on such different areas as capital/liquidity, individual approvals of directors and other individuals (where this is required) and trading/conduct of business.

- The meaning of "regularly" and "relevant" is unclear. Where issues arise in a particular area that is not routinely handled by compliance it *may* be appropriate to involve the compliance function, and some guidance on this could be helpful, rather than a broad general statement.

Organisational requirements

Q5: Please provide your comments (with reasons) on any or all aspects of this guideline on the effectiveness of the compliance function.

Section IV.I: Although firms should "[take] into account the scale and types of investment services, activities and ancillary services" of the firm when allocating resources to the compliance function, this reference is misleading in suggesting that a firm should look separately at these MiFID elements, rather than at the firm's regulated business as a whole and, indeed, its related unregulated business. Many firms carry on business under a number of different regulatory regimes, and the compliance department must be organised to perform its functions appropriately under each and all, in relation to other legal/regulatory requirements (anti-money laundering and economic sanctions, for example) if and to the extent that those functions are allocated to the compliance department.

- We note that paragraph 46(a) and (b) reflect this approach better, and are in marked contrast to IV.I.

Paragraph 35: the word "similarly" is misleading in that the compliance resources required in relation to a particular business unit or the firm as a whole, may not be proportional to the scale of the activities. What matters here is that, as business grows and particularly as new business lines are developed and new offices and methods of conducting business (online for example) are established, the resources and organisation of the compliance function should be considered and appropriate changes made (including increased resources, if necessary).

Paragraph 38 is incorrect, in several respects.

- There are some databases to which compliance may need access on only 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;
    - be able to make decisions as to when they need access to data;
    - be able to obtain data they need to perform their function, at the appropriate level within the function;
    - know how to obtain that data quickly;
- Databases may be created for a particular investment banking transaction or project; although compliance should generally have the ability to obtain access, that does not mean they should routinely be given access.
- There may be good reasons why the compliance officer or particular members of the compliance team should be screened from certain information, in order for them to perform their functions properly, and this should be acknowledged.
- As regards access to meetings, putting the onus on the compliance officer to identify the meetings at which their attendance would be important could be extremely problematic, especially in a large firm or group.

- It can be inefficient and counter-productive in other ways to attend routine board/ management meetings, but at least those are identifiable;

- Ad hoc meetings are less easily identified, and in any case points may arise unexpectedly at meetings: what is important therefore is that (i) there are processes to involve compliance, (ii) compliance have access to meetings, and (iii) operational management and business units are sufficiently attuned to regulatory issues to recognise when such communication/involvement is needed and are required to communicate with and involve compliance as a matter of routine.

Paragraph 40:

- Numerous skills and types of knowledge are necessary and desirable for a designated compliance officer and the relative importance of these varies from one firm to another, driven not only by the nature of the organisation and its business, but also by its supervisory history and situation, the existing skill set of the compliance function and the way the function is organised. To require a higher level of MiFID expertise on the part of the designated compliance officer is inappropriate:

    - s/he can obtain this expertise after appointment and/or rely on the expertise of compliance staff and in-house/external counsel;

    - the requirement would restrict the pool of individuals who could be designated, which would not merely cause recruitment problems but also limit variation among compliance officers and their staff, leading in turn to dangerous group-think.

- Error: We believe the word “provision” should read “performance”.

Permanence of the compliance function

Q6: 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

(i) adequate stand-in arrangements for the responsibilities of the compliance officer which apply when the compliance officer is absent; and

(ii) arrangements to ensure that the responsibilities of the compliance function are performed on an ongoing basis?

Please also state the reasons for your answers.

Section IV.II: The principles here seem reasonable but we are concerned that the text is implying two requirements which will be disproportionate for many firms, especially smaller firms – and not just for firms who are exempt under Article 6(3) of the MiFID Implementing Directive[1] :

- The Guideline seems to imply that the stand-in must be part of the compliance function in the same way as the designated compliance officer;

[1] Where, in view of the nature, scale and complexity of its business, and the nature and range of investment services and activities , the compliance officer and staff may, for example, be involved in the performance of services or activities they monitor.

- The Guideline may also be construed as implying (in the last sentence of paragraph 42) that the stand-in must be qualified in compliance matters.

We agree that there should be stand-in arrangements but the requirement for them should be proportionate. There should be no suggestion that each firm must have (at least) two compliance staff.

Paragraph 43:

- There should be clear flexibility in addressing this requirement: for example, it should be clear that the work-plan and/or statement of reporting duties may be in one or more documents which are separate from the charter or other policies/internal rules.

- Although we agree in principle that "relevant amendments to regulatory provisions should be reflected promptly" in policies/rules, there are significant practical challenges of doing so. We consider that it is more important that the firm promptly implements the changes by complying with the amended provisions – there are various ways of achieving this before amending the formal policies/rules.

Independence of the compliance function

Q7: 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.

Q8: 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 in-dependently from any influence of the business units and that the compliance officer is appointed and replaced by senior management only?

Section IV.III: Again, we agree with the principles stated in the formal Guideline but disagree with:

- some of the comments and emphasis of the subsequent paragraphs;

- the suggestion (in Q8 and paragraph 45) that the compliance function should be free from all business unit influence.

Paragraph 45: In our "General comment" above we expressed concern at the limited role which the Guidelines acknowledge for senior management:

An example is the implication here that they are merely required to establish the organisation of the function and monitoring its effectiveness;

The Guidelines should express strongly and clearly that senior management have a key role and responsibility in:

- establishing a compliance culture across the firm, especially in business units, and

- supporting the compliance function.

Although we accept the principle that the compliance function should be free of day-to-day interference, this does not recognise the practical reality in many firms. For example:

- There is a need to ensure the compliance function's advisory role can be properly accessed by business;

- The compliance model may involve some compliance staff sitting with and supporting business units in a closer relationship, which may be considered by the firm or its compliance officer to be more effective in achieving compliance;

- Small firms, especially where the compliance officer has other functions which may include conducting business.

We therefore would encourage a more nuanced approach in this area of guidance. We recognise that many compliance officers might welcome a clear statement that independence means that business units should not issue instructions to compliance staff, but a requirement that they should not influence is too prescriptive and will place many compliance officers and staff in a difficult position.

We agree with the comment about senior management responsibility for appointing the compliance officer.

Exemptions

Q9: Please provide your comments (with reasons) on any or all aspects of this guideline on Article 6(3) exemptions.

Section IV.IV: We agree that firms relying on the exemption in Article 6(3) should assess whether the effectiveness of its compliance function is compromised, although it might be better to provide that they should take steps to minimise any adverse impact on that effectiveness.

Paragraph 46: we agree the approach of this paragraph, especially the breadth of (a) and (b), and would suggest that this be reflected elsewhere, particularly in the Guideline in IV.I.

Paragraph 50: this guideline against combining compliance with the functions mentioned, could be very challenging for smaller firms, and ESMA should consider providing some guidance on steps which firms could take to mitigate the concerns that might arise.

Combining the compliance function with other functions

Q10: Please provide your comments (with reasons) on any or all aspects of this guideline on combining the compliance function with other functions.

Paragraphs 52-54: Although we accept that combinations with internal audit and certain control functions should be discouraged, we think:

- the Guidelines should focus on ways to mitigate conflicts and avoid compromising effectiveness, and be less prescriptive in opposing combinations;

- As mentioned in response to Q9 and paragraph 50, the Guidelines should take into account the difficulties for smaller firms in resourcing separate functions

    - There are overlaps in skill sets as between internal audit and compliance, so even that combination should be countenanced subject to steps being taken to address the issues – and it would help if the Guidelines made suggestions in this area given that Article 8 of the MiFID Implementing Directive allows a proportionate approach.

- Paragraph 52: non-involvement of compliance staff in monitored activities may unnecessarily limit their advisory role, so a more nuanced approach would be desirable on this point, too.

There may even be positive benefits from some combinations, depending on the size and organisation of the firm and its business – risk management and anti-money laundering, for example.

Outsourcing of the compliance function

Q11: Please provide your comments (with reasons) on any or all aspects of this guideline on outsourcing of the compliance function.

IV.IV: There should be a clearer distinction made in the Guideline and the following paragraph between the compliance officer role (which we would expect to be retained within the firm, although the individual concerned would not have the usual expertise) and the performance of the tasks (which may be delegated/outsourced).

Paragraph 60: This is too prescriptive.

- It is unclear how monitoring will effectively assess compliance with Articles 6 and 14 of the MiFID Implementing Directive, and 6 – how is the monitor to have the "necessary expertise" if s/he is not a compliance officer.

- The Guidelines need to recognise that there are different ways to monitor the outsourced services

    - For example, although a director or other senior individual in the firm should be appointed with overall responsibility for supervising and monitoring the services, s/he may buy in some of the resources and expertise to do so, and may have other staff in the firm assist on certain aspects.

Competent authority review of the compliance function

Q12: 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.

Q13: Do you agree that 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?

We agree that competent authorities should have powers to review and assess these aspects of a firm, but they should not be required to do so, because:
- In many firms, these aspects may present a very low risk; and
- Supervisors who are deploying resources on a risk-based approach would not wish routinely to review these matters in every firm.

Although supervisors may assess whether changes in the organisation of the compliance function are required, they should not generally dictate the changes because:
- There may be alternative ways of meeting the concerns which have arisen; and

- Supervisors' independence is better served by assessing the firm's proposals for change than specifying detailed changes;

If ESMA would find it helpful to discuss any of these comments then we would be happy to do so. Please contact me in the first instance by telephone on +44 (0) 20 7295 3233 or by email at margaret.chamberlain@traverssmith.com.

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