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## Joint Trade Associations response to FSA Consultation Paper 06/9

### Organisational systems and controls Common platform for firms

*18 August*



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## **Joint Trade Associations response to FSA Consultation Paper 06/9**

### ***Organisational systems and controls: Common platform for firms***

#### **Summary of key points**

- (a) We support the common platform approach as a sensible and practical approach to the overlaps between CRD and MIFID in the relevant areas. Exceptionally, we agree with the superequivalence involved. We think that FSA should promote a similar approach to managing the overlaps between the Directives by other EU regulators. (Chapters 1 and 2)
- (b) We broadly agree that FSA has followed the intelligent copy-out approach, and support intelligent copy-out as the appropriate transposition method in all of the areas covered. (Chapters 1 and 2)
- (c) We think that FSA should apply the common platform approach to any business interruption. (Chapter 3, Q 8 – 10)
- (d) We oppose separate parallel standards for employees' awareness of procedures. (Chapter 4, Q11)
- (e) It is important for FSA to interpret provisions on compliance and the responsibilities of the compliance function and compliance officer in line with current practice. (Chapter 3, Q5; Chapter 5, Q15)
- (f) It is important for FSA to interpret internal audit requirements in accordance with accepted internal audit practice. (Chapter 5)
- (g) Liquidity risk provisions should not be amended until the Basel Committee of Banking Supervision has developed a global approach. (Chapter 6, Qq24 – 25)
- (h) FSA should adopt a practical approach to requirements to monitor outsourced service providers. (Chapter 7, SYSC 8)
- (i) FSA should adopt a proportionate approach to requirements to identify conflicts, and to the treatment of conflicts which are under the control of other group members, in line with the Directives requirements on the content of the firm's conflicts policy. (Chapter 9, paragraph 9.14)

- (j) FSA should adopt a consistent interpretation under which the conflict of interest provisions apply only where there is a material risk of damage to clients' interests. (Chapter 9, SYSC 10.1.2, 10.1.3, 10.1.8)
- (k) We suggest that the provisions on the circumstances in which a conflict of interest arises should be in the form of a rule, not guidance. (Chapter 9, SYSC 10.1.4)
- (l) FSA should avoid a restrictive interpretation of the provisions on disclosing conflicts that cannot be managed. (Chapter 9, Qq34 – 35)
- (m) FSA should clarify its plans for regulating the EEA branches of non-EEA firms. (Chapter 10)
- (n) FSA should make more precise the amendment to the definition of 'regulatory system'. (Amendments to glossary, Part 3)

## Chapter 1: Overview

### Paragraphs 1.5 – 1.7

We welcome and support the principles for implementing MIFID and other EU directives set out in paragraphs 1.5 and 1.6 of CP06/9. We agree that in general FSA has followed these principles in CP06/9.

### Paragraphs 1.8 – 1.14

FSA is right that, where there are overlaps between CRD and MIFID requirements, in general firms would prefer one set of requirements rather than two parallel sets. In general we support the common platform approach as a pragmatic and cost-efficient way of implementing these specific CRD and MIFID requirements where they overlap, despite the superequivalence involved. We comment specifically under each chapter below whether we agree with FSA's proposals on whether or not to apply the common platform approach in particular instances, whether we agree with the superequivalence proposed, and whether we agree with the cost-benefit analysis. Our support for superequivalence in these instances, where there is a clear justification for it, does not affect our general opposition to it in circumstances where it cannot be justified.

## Chapter 2: The Common Platform

We support the Common Platform approach as a sensible and practical approach to the overlaps between CRD and MIFID in the relevant areas. Exceptionally, we agree with the superequivalence involved. We think that FSA should promote a similar approach to managing the overlaps between the Directives by other EU regulators, through both CESR and CEBS, including as part of the planned 3L3 work referred to in CESR's MIFID Level 3 draft work programme. The statement for the minutes of the 26<sup>th</sup> June European Securities Committee meeting on the interaction between CRD and MIFID included technical problems which we understand have concerned the European Banking Committee. We think that the Common Platform approach represents a better treatment of the interaction between the two Directives. It would be helpful if a workable EU-wide resolution of the technical problems involved could be achieved by the end of 2006. However, even if this is not possible, we think that FSA should continue to pursue the Common Platform approach.

Under SYSC TP1.6, we note that firms do not have to notify the FSA that they are moving over to the new requirements, only to make a record of the date when they decide to do so.

It would help firms' implementation if FSA were to follow the precedent of CP06/3 Annex 4 by including alongside the final SYSC rules a table showing where superequivalences occur, which requirements apply to CRD firms, which to Common Platform firms, and which to MIFID firms.

**Q1:** *Will your firm transition to the common platform before 1 November 2007?*

This is a question for our Members to answer individually. Our Members welcome the common platform approach and the flexibility that it provides.

### Comments on SYSC 1

SYSC 1.3.8G. We support the draft guidance on the effect of provisions in SYSC4 to SYSC9 which take into account the activities of other members of a group. We draw FSA's attention to our comments under Chapter 9 and SYSC 10 below on the need for a practical approach to interpreting provisions on the effect of other members of a group on a firm's arrangements for identifying and managing conflicts of interest.

### Comments on SYSC 3

The amendments to SYSC 3 appear to represent an accurate copy-out of the relevant Directive articles.

### Comments on SYSC TP1

SYSC 1.7G. We assume that SYSC 1.7G means that if a firm decides to move to the common platform before 1<sup>st</sup> November 2007, it must do so at the same time for all of SYSC4 to SYSC10. However, we assume that because SYSC 1.6R and SYSC 1.7G apply to a firm, different members of a group may decide to move to the common platform on different dates.

## Chapter 3: General Organisational Requirements

### ***Governance, internal controls and organisation***

Whilst the directive requirements under the MIFID and CRD (MIFID Level 1 Article 13(5) and BCD Article 22) on governance, internal controls and organisation are relatively similar, they are not identical. We view the proposed common platform approach as the most straightforward manner of reconciling the different directive provisions for these organisational requirements.

Although the FSA's proposal to extend to common platform firms that are not subject to MIFID the requirement that a firm's systems and controls should take into account the nature, scale and complexity of its business is formally super-equivalent to the CRD, it is based on the principle of proportionality. We very much support this overarching principle and note that Guidance issued by CEBS has also emphasised the principle of proportionality very strongly.

**Q2:** *Do you agree with our proposal to create a unified standard by extending the Draft Implementing Measures requirements on governance, internal controls and organisation to CRD-only firms?*

Our members support this form of super equivalence as any additional burden on a CRD only firm ought (by reference to the principle of proportionality) to be limited.

**Q3:** *Do you agree that we should create two, parallel, standards in relation to the integrity of information (i.e. a separate standard for CRD-only firms)?*

We support the proposal to create parallel standards in the area of security, integrity and confidentiality of information on the grounds that the FSA's cost-benefit analysis indicates that costs might exceed benefits.

### ***Accounting***

SYSC 4.1.11R copies out MIFID provisions requiring a firm to be able to deliver in a timely manner, at FSA's request, financial statements which give a true and fair view of its financial positions and comply with all applicable accounting standards and rules.

We note, however, that the concept of true and fair has never been defined in UK legislation and a variety of meanings can be attributed to it. We fully support the principles underlying it - those of the going concern concept, the use of accruals accounting and the objectives of consistency and prudence - but note that the expectations of what 'true and fair' means in our Members' minds depends on the context in which the accounts are prepared. Full and half year statements will

be subject to the highest level of oversight and challenge including a full assessment of the level of provisions, for instance, that have been taken. FSA should recognise that a response to an ad hoc request for financial statements between full and half-year statements will require a suitable response time to be given to the firm if the “true and fair” standard is to be achieved. Hence it is essential that ‘in a timely manner’ is interpreted in a way which provides enough time to prepare financial statements to the relevant standard.

**Q4:** *Do you agree with our proposal to create a unified standard for accounting systems and controls?*

Yes.

### ***On-going monitoring***

We believe that this standard is implicit in SYSC 3.1.1R.

**Q5:** *Do you agree with our proposal to create a unified standard for ongoing monitoring?*

Yes.

### ***Verification of Compliance***

We note that the FSA plans to consider whether to expand the scope of the MIFID compliance verification requirement to encompass the whole ‘regulatory system’, in line with the existing SYSC 3.2.6R. On this issue, see our comments on Q15 under Chapter 5 below.

For the avoidance of doubt the word ‘guidance’ should not extend to CEBS guidance. (We do not believe that the current FSA definition of ‘guidance’ could be construed as including CEBS material.)

We understand that the FSA wishes to promote a compliance culture that applies to all firms in all their activities, but where the compliance burden remains proportionate to the nature and scale of their activities. Subject to our comments on Q15 below, we support this and recognise that were the FSA to fail to apply these standards comprehensively an inappropriate signal could be sent.

**Q6:** *Would you like us to create a unified standard by extending the requirement concerning verification of compliance to MIFID-only firms and to cover the regulatory system?*

Subject to our comments on Q15 below, we believe this is fair, but that the scope of the ‘regulatory system’ should be amended as set out in our comments under ‘Amendments to the Glossary of definitions’ below, and confined to FSA Rules

and Guidance made under FSMA as well as relevant directives and should not include CEBS guidance.

### ***Audit Committee***

We agree with the FSA's proposal to retain existing guidance that it may be appropriate for a firm to have an audit committee if it is proportionate to the nature/scale/activities of the firm's business in the common platform proposals.

**Q7:** *Do you agree with our proposal to retain this guidance concerning audit committees in the common platform?*

Yes we consider that this guidance, SYSC 3.2.15G, is useful to firms and permits the necessary flexibility for senior management to exercise judgment over whether or not to establish an audit committee.

### ***Business Continuity***

The FSA notes that the initial cost-benefit analysis did not support a common platform approach for business continuity requirements. However, the CBA contained in CP06/9 in the FSA view probably contains elements that are brought forward from examining the possibility of a common platform. Hence it is more difficult to interpret the CBA commentary.

As FSA recognises in paragraph 3.19 of CP06/9, firms typically approach business continuity planning with a common approach to both 'interruptions' and 'severe business disruptions'. We therefore question whether the FSA's proposal not to require common platform will be borne out by practice. If FSA does decide not to proceed with a common platform approach in this area, it will be important to ensure that FSA's rules are flexible enough to enable firms to adopt a common approach to 'interruptions' and 'severe business disruptions' if they wish to do so.

**Q8:** *Do you think the costs of the business continuity common platform approach outweigh the benefits?*

No. In undertaking their preparations for business continuity firms adopt a critical business line approach which transcends boundaries between Directives.

**Q9:** *Would you prefer the common platform approach to a parallel set of rules?*

Yes, we would support a common platform approach that permits a firm to utilise its BCM policy/planning to cover any business interruption. There should be reference to the Tripartite BCM team's Resilience Benchmarking Project and the resulting "Business Continuity Management Practice Guide" as an example of the scope to be covered.

**Q10:** *Do you agree that this guidance on what the business continuity policy might cover is sufficiently useful to have?*

No. We do not think it is useful to distinguish between “interruptions” and “severe business disruption”. Firms plan on the basis of being able to recover critical functions, howsoever the interruption or disruption is caused.

Comments on SYSC 4

We have assured ourselves that the material in SYSC 4 has been properly carried across from the relevant directives and IPRU (Bank). Subject to our comments above on accounting, verification of compliance, and except for our preference for a common platform approach to business continuity, we have no comment to make on this material.

The requirements outlined in SYSC 4.1.10G seem to us proportionate and appropriate.

## Chapter 4: Employees and Agents

**Q11:** *Do you agree that we should create two parallel standards in relation to employees' awareness of procedures (i.e. a separate standard for CRD-only firms)?*

No. We would not support the FSA's proposal in this area. The MIFID requirement that a firm must ensure that its 'relevant persons' are aware of the procedures to be followed to do their jobs properly should equally apply to those CRD only firms as to MIFID firms. The necessity of ensuring that a firm makes arrangements concerning segregating the duties of staff, which ensure that the performance of multiple functions by a 'relevant person' does not prevent them from discharging any particular function soundly, honestly, and professionally is one our members would support for all firms covered by the common platform under the aegis of clean and orderly markets.

Whilst we would agree the employee requirements under SYSC should take into account the nature, scale and complexity of a firm's business, having two separate parallel standards would both add unnecessarily to the size of the handbook and potentially create an uneven playing field for firms. FSA should adopt the common platform approach in this area.

**Q12:** *Do you agree with our proposal to create a unified standard concerning segregation of the duties of employees (rather than two parallel sets of requirements)?*

Yes, we would support the creation of a unified standard concerning segregation of the duties of employees. As outlined in our answer to the previous question having one set of rules for firms that can be achieved in a single transition is the optimal outcome for our member firms.

As outlined in the cost benefit analysis in Annex II on these proposals, the vast majority of firms will already be hiring employees with skills, knowledge and expertise to discharge their responsibilities appropriately. Therefore it is likely the impact of this proposal will be minimal.

It is stated in CP06/9 that the segregation of duties requirement is of itself not onerous in that it only imposes costs if it prevents the relevant person from carrying out multiple functions. The FSA should take a flexible approach in implementing this requirement as it may result in firms having to engage in significant training and/or hire new staff.

**Q13:** *Do you agree with our proposal to create a unified standard concerning employees' competence?*

Given this proposal is substantially the same as existing FSA Handbook requirements and, we would agree, is in line with existing industry good practice, we would support the imposition of a unified standard in this area.

However as is highlighted in the FSA's own cost benefit analysis, the area where some firms may need to invest further resource is that of multiple functionality of employees. It is possible that some firms may not currently have procedures which ensure that staff do not inappropriately perform multiple functions. We would suggest that where this has been identified by the firm that the FSA take a constructive engagement approach, that is to deal with the change in systems and controls through supervision taking into context the size and complexity of the firm. This is especially pertinent for smaller firms, where multiple functionality of staff is a requirement of cost efficiency. We would encourage the FSA to carefully consider the cost implications for small banks in implementing these conflicts of interest proposals.

**Q14:** *Is this guidance on a firm's employees useful to have in the common platform?*

We would support the carrying over of guidance from the existing FSA handbook into the new SYSC chapter 5.

#### Comments on SYSC 5

5.1.12R See our response to Q11 above.

## Chapter 5: Compliance (including internal audit)

### **Compliance**

**Q15:** *Do you agree with our proposal to create a unified standard for compliance as described above?*

Yes, subject to the proviso referred to in paragraph 5.3 that ‘standards should be applied in a way that is proportionate to the nature, scale, and complexity of a firm’s business’, and in paragraph 5.5 that there is no requirement for an independent compliance function if it would be disproportionate to the nature, scale, or complexity of the firm’s business.

There are also some issues regarding aspects of CP06/9’s proposed approach to implementing MIFID Level 2 Directive Article 6 and MIFID Level 1 Article 13.2 which we may need to discuss further with FSA. Whereas MIFID provisions are concerned with compliance with the obligations under that Directive, FSA’s proposals in SYSC 6.1, by building on the current SYSC 3.2.6R, have extended a firm’s duties to compliance ‘with obligations under the regulatory system’, the definition of which it also proposes to broaden. One result is that in areas not covered by MIFID but within the regulatory system definition, the current obligation to “take reasonable care to establish and maintain effective [compliance] systems and controls...” would become an obligation to “ensure compliance” – possibly a more onerous obligation, and one not required by MIFID. It is not clear to us, though, whether FSA considers that this change would lead to a material difference in practice. We are inclined to conclude that it would not. We would be grateful, though, to know if we have misunderstood the position. If FSA considers that the change is important in practice, it would be necessary to have a separate provision to cover the ‘non-Directive’ elements of the regulatory system in the absence of a cost-benefit analysis.

A related issue concerns the drafting of the proposed revision of the definition of “regulatory system”: see our comments under ‘Amendments to the glossary of definitions’ below.

A further point concerns the position of compliance officers. Currently, the compliance officer oversight function has responsibility for a firm’s compliance with COB, COLL, and CASS. Broadly, MIFID Level 2 Directive Article 6.2 does not seem to change this significantly, given the reference to MIFID Level 2 Directive Article 6.1 obligations (i.e. obligations under MIFID). However, given the reference to the regulatory system in proposed SYSC 6.1.2R (to which SYSC 6.1.3R, transposing Article 6.2, refers), there is a question about whether the proposed language in CP06/9 has the effect of increasing the breadth of the compliance officer’s responsibilities. We assume that this is not the intention, and in this regard we note that in SYSC 6.1.3R the compliance function is not a defined term, and that in SYSC 6.1.4R(2) the compliance officer’s reporting

responsibilities are limited to 'reporting as to compliance' (i.e. those matters covered under SYSC 6.1). In this connection we also note that, broadly, when regulators' requirements deal with the general role of the compliance function, they are making reference to the range of staff and departments within a firm with responsibilities for assisting senior management to identify and address the compliance risks faced by the firm, rather than to particular organisational structures: see most recently the Basel Committee on Banking Supervision's April 2005 paper "Compliance and the Compliance Function in Banks", which notes specifically, for example, the extent to which firms choose to have separate compliance and operational risk departments. It would be helpful if the policy statement on CP06/9 could clarify this aspect. Again, if FSA does not share our understanding it would be helpful if FSA would let us know as soon as possible.

Subject to these points, we agree with FSA's view in paragraph 5.6 that, taking into account the proportionality caveat, there should be no material impact arising from superequivalence.

### ***Internal audit***

There is some concern from our Members that the title of this chapter, and of SYSC 6.1, implies that internal audit is a subset of Compliance and conveys the wrong message especially to those firms that may be looking at the possibility of setting up an internal audit function. We suggest that any feedback statement, and the final rules, make clear the separateness of the two functions, for example by referring to "Compliance and Internal Audit".

Paragraph 5.9 notes that changes to the Handbook to implement MIFID provisions on internal audit will be in the form of rules replacing the current guidance and evidential provisions. We note that SYSC 6.2.1R is a copy out of MIFID Level 2 Directive Article 8 and refers to an "audit plan" in (1) and to "verifying" compliance in (3). "Audit plan" is imprecise and open to interpretation and "verification" is a more onerous task than the normal work of internal audit which is to provide assurance and follow up on the recommendations. In accordance with FSA's policy intention that the content of existing material remains the same, we would expect FSA to interpret such matters consistently with the current accepted practices of internal audit.

Paragraph 5.11 might be read as implying that internal audit is equivalent to an internal control mechanism when it is in fact (as Paragraph 5.8 states) an oversight of internal control functions. Firms without a separate internal audit function might need to utilise other means to oversee the adequacy of internal control mechanisms, but we do not consider that the Compliance function (which is a function of senior management) should be utilised in this role, given the need to segregate duties as described in paragraph 5.12, and to manage possible conflicts of interest.

Paragraph 5.12, first sentence, implies, confusingly, that the compliance function is not mandatory. See our comments under paragraph 5.9 on the need for

correct interpretation of MIFID terminology. We also note that SYSC 6.2.1R(2) accurately describes the relation of recommendations to the work of the internal audit function, whereas the reference to ‘issuing recommendations based on the audit plan’ does not. It is also important to interpret provisions relating to internal audit in a way which allows firms to retain flexibility in the methods that they use for internal model review under CRD Annex 7, Part 4, paragraph 5.3.

**Q16:** *Do you agree with our proposal to create a unified standard for internal audit?*

We agree with the proposal for a single unified standard, but have reservations as described elsewhere in this chapter about the drafting, usage and possible interpretations in the draft Handbook and explanatory text of the Consultation Paper. .

**Q17:** *For CRD-only firms what are the costs involved?*

We have no particular comments on this question.

**Q18:** *Do you agree with our proposal not to include any guidance on internal audit?*

Yes. There are a number of sources of information concerning the practice of internal audit freely available elsewhere, including from the Institute of Internal Auditors.

**Q19:** *Is there any guidance on internal audit in PRU, IPRU (BANK) or IPRU (BSOC) that you think is sufficiently important for us to retain and extend to all common platform firms? If so, please identify it and explain why.*

We do not think that the current guidance on internal audit needs to be retained.

### Comments on SYSC Chapter 6

Apart from the following points, we consider that the relevant parts of SYSC 6 represent an ‘intelligent copy out’ of MIFID provisions.

6.1.3R The final text of the Level 2 Directive requires firms to establish and maintain a compliance function.

6.2.1R See our comments on paragraph 5.9 above on the need for appropriate interpretation of the terms “audit plan” and “verify” consistently with common practice.

## Chapter 6: Risk Control (including CRD risk-specific material)

### Overview

We support the underlying approach to the drafting contained in SYSC 7 and SYSC 12, which is that risk control policies and procedures should be proportionate to the nature, scale and complexity of the firm, and their regulation, based on a small number of principles-based rules.

Like the FSA, we think that the common platform approach will promote good risk management practice, even though this will lead to a risk control regime which exceeds the minimum standards established by the Directives in some areas.

*Q20: Do you agreed with our proposals to create a unified standard concerning risk control?*

Whilst we generally believe that a firm need only meet and not be expected to exceed the minimum standards established by a Directive this useful approach is a pragmatic response to the way our members organise their business lines. Although we have no specific information on the incremental cost of establishing a unified standard for risk controls we agree with the FSA that the costs are likely to be small.

*Q21: Do you agree with our proposal to extend to MIFID-only firms the CRD requirements in relation to the documentation of the organisation and responsibilities of the risk assessment function?*

We believe the great majority of our Member firms already document the organisation and responsibilities of the risk assessment function and that the extension of this requirement to MIFID only firms is appropriate and unlikely to be burdensome from a cost point of view.

### **CRD risk-specific requirements**

*Q22: Do you agree that these CRD-based risk-specific proposals should not be extended to MIFID-only Firms?*

Yes, as there is no foreseeable market failure that might require regulation, we agree that there is no need to extend the CRD-based requirements on risk strategy to MIFID only firms.

**Q23:** *If you do not agree, please say which proposals should be extended to MIFID-only firms and why.*

None of the CRD risk-specific proposals should be extended to MIFID only firms.

### **Liquidity Risk**

We note that the FSA is currently reviewing the material currently in SYSC 5.1, and may consult on changes to it later in the year. We are aware of the Joint Forum's work on Liquidity and the likelihood that the Basel Committee for Banking Supervision (BCBS) and perhaps the International Association of Insurance Supervisors may undertake further work on Liquidity based on the Joint Forum findings. It is our strong belief that no work should be undertaken by the FSA, or in Europe more generally, on the quantitative aspects of supervisors' liquidity risk requirements until the direction of any such work by the BCBS becomes clearer. Neither should there be significant changes to the qualitative aspects of the existing UK liquidity regime. Internationally active firms typically prefer to take a centralised approach to liquidity risk management. They wish to avoid any sub-optimal trapping of regional pockets of liquidity and avoid to the greatest extent possible the difficulties that inevitably arise through different jurisdictional approaches.

**Q24:** *Do you agree that the CRD liquidity risk proposals should not be extended to MIFID only firms?*

Yes. Furthermore, liquidity risk proposals should not be amended until a global approach to the supervision of liquidity risk has been developed by the BCBS.

**Q25:** *If you do not agree please say why*

We do agree with the FSA's proposals to copy out the specific CRD liquidity risk requirements, but recommend that no further consultation on further changes to the liquidity risk regime be made until internationally developed standards have been agreed.

### **Group Risk**

**Q26:** *Do you agree with our 'minimum change' approach to implementing the group risk systems and controls requirements of the CRD?*

Yes. But we look forward to discussing with the FSA its approach to the supervision of groups later in the year as part of its fundamental review of the interaction between solo and group capital regimes for deposit-takers and investment firms.

**Q27:** *If you do not agree, what would you suggest instead? Do you think that our proposals achieve our intention of minimum change?*

Yes.

Comments on SYSC 7

7.1.12G We are unsure whether the last sentence in this paragraph is necessary and we recommend its deletion. The requirement for a bank to describe the systems it uses to determine that it is complying with CAD rules is somewhat circular as SYSC 4.1.3R could easily be interpreted as requiring this anyway.

Comments on SYSC 12

As far as we can tell SYSC 12 has been accurately copied across from PRU 8.1 apart from the addition of SYSC 12.1.13R and 12.1.14R and the small amendment to 12.1.8R. We agree with the wording of this new material.

## Chapter 7: Outsourcing

**Q28:** *Do you agree with our proposal to create a unified standard concerning outsourcing of critical or important operational functions?*

Yes. We would support the FSA's proposal in this area. Firms in general make no distinction on a Directive-related basis as to the type of business that is outsourced. In addition there is considerable scope for confusion in relation to the requirements in both the CRD and in MIFID. The mapping exercises carried out in relation to the requirements in MIFID and the CEBS Guidelines suggest that firms would benefit from greater clarity through a single set of requirements capturing both types of business. We think that FSA should promote a similar approach in the context of the planned 3L3 work on outsourcing referred to in CESR's MIFID Level 3 draft work programme. However, even if this is not achievable at EEA level, FSA should continue to pursue the Common Platform approach.

**Q29:** *Do you agree that our proposal for outsourcing of non-critical or important operational functions is proportionate?*

Yes. We believe the lighter touch proposed here is appropriate, giving firms the necessary flexibility, but not the obligation, to apply proportionately the relevant risks identified in outsourcing critical functions.

**Q30:** *If you do not agree, what approach should we take for outsourcing of non-critical or important operational functions?*

We agree.

**Q31:** *Do you agree that no further guidance is necessary on the meaning of a 'critical' or 'important' function?*

Yes. We believe these should be discussed on a bilateral basis between the firm and the FSA, since the impact of any one function will vary from one firm to another.

### Comments on SYSC8

While sub-paragraphs (1) and (4) of 8.1.8R:

(1) "the service provider must have the ability, capacity and any authorisation required by law to perform the outsourced functions, services or activities reliably and professionally";

(4) " appropriate action must be taken if it appears that the service provider may not be carrying out the functions effectively and in compliance with the laws and regulatory requirements",

are a copy out from MIFID, it will be important that the FSA makes clear that it will adopt a common sense and proportional approach when expecting firms to monitor service providers' compliance with applicable laws and regulatory requirements. A large firm may have arrangements with service providers in many different countries and it would be very difficult to fully monitor all applicable laws, authorisations etc on an ongoing and proactive basis although, of course, the firm would perform initial due diligence checks and act on information it has obtained. It would be vital for firms to understand what steps the FSA would require firms to undertake to gain comfort on this. The FSA should also focus on the reciprocal obligation of the service provider to disclose to the firm any development that would have an impact on its ability to carry out the outsourced function effectively and in compliance with applicable laws and regulatory requirements.

## Chapter 8: Record Keeping Requirements

As outlined in the FSA's consultation paper, changes to record keeping requirements as a result of MIFID will be reviewed in the FSA's Conduct of Business consultation paper in October 2006. We will respond to this CP in due course. In the interim we would highlight the transitional arrangements.

We support the FSA's proposal to amend the transitional provision so that the record-keeping requirements in SYSC Chapter 3 remain in force until 1 November 2007 for firms that adopt the common platform early. The ability for such firms to make only one set of changes for record-keeping while allowing them the full ten months to November 2007 to implement any changes they need to make would be an appropriate and flexible implementation of the MIFID and CRD common platform.

**Q32:** *Is there any guidance on record-keeping in IPRU (BANK) or IPRU (BSOC) that you think should be kept as part of the common platform?*

No.

**Q33:** *If you do, please identify it and explain why it should be extended to all common platform firms.*

We do not.

As a general point, we observe that firms find helpful the practice in the current rulebook of including in each chapter of the handbook a list of the relevant records that firms need to keep. It would be helpful if FSA continued this practice.

## Chapter 9: Conflicts of interest

Paragraph 9.4: We agree that regulatory standards should be clear, principles-based, and provide flexibility for firms according to their business model.

Paragraph 9.5: We agree that a ‘common platform’ approach is appropriate in this area, based on a requirement for an effective policy to manage conflicts which is appropriate to the size and organisation, and nature, scale and complexity of the firm’s business. However, we do not agree with footnote 2: CRD does not require a firm to have a conflict of interest policy in writing, and there should therefore be no obligation for a common platform firm to comply with SYSC 10.1.7R (1) from the time of entry into force of CRD. This would have the effect of requiring such firms to comply with a MIFID provision from 1<sup>st</sup> January 2007.

Paragraph 9.6: We agree with FSA’s proposal to carry forward MIFID requirements into the common platform, although we observe that not all aspects of them represent existing normal business practice for some smaller firms.

Paragraph 9.7: We strongly agree that a conflict arises only where there is a conflict between the firm’s interest and a duty owed to client, or between two clients to whom firm owes a duty, and not where the firm stands to gain if there is no associated disadvantage to client. This approach is consistent with MIFID (but is contradicted by FSA’s argumentation, with which we do not agree, in Chapter 3 of DP06/3, that a conflict exists in dealer markets simply because a dealer stands to make a profit by acting as such).

Paragraph 9.8: Although MIFID extends the coverage of conflict provisions over PRIN8, their application to different categories of client (including eligible counterparties) will differ depending on whether or not the firm provides a service, and therefore owes a duty.

**Q34:** *Do you agree with our view of the circumstances in which disclosure might or might not be appropriate as a means of managing conflicts of interest?*

*and*

**Q35:** *If you do not agree, in what circumstances might disclosure be, or not be, appropriate as a means of managing conflicts of interest?*

We agree with FSA’s comments in paragraph 9.10 that the proposals should not imply that disclosure cannot be an appropriate tool to accommodate conflicts. The pattern of considering whether other conflict prevention or management measures will be effective before the firm uses disclosure is consistent with current practice. However, we disagree with FSA’s assertion in paragraph 9.12 that disclosure alone is likely to be appropriate ‘in limited circumstances in

relation to conflicts which affect the interests of professional clients', and the implication in paragraph 9.13 that in other circumstances administrative or organisational measures would need to reduce the risk of damage to clients' interests to a 'low level' before disclosure could be used. The requirement in MIFID Level 1 Article 13.3 is to take all reasonable steps designed to prevent conflicts of interest from adversely affecting the interests of clients, and in MIFID Level 1 Article 18, where those arrangements are not sufficient, to disclose the nature and source of conflict *before undertaking* business on the client's behalf. MIFID Level 1 Article 18 therefore specifically contemplates that firms are free to undertake business subject to disclosure where conflict management is unavailing. This means that FSA should not seek to limit the proper application of MIFID's provisions on prior disclosure as a means of accommodating conflict where reasonable management measures do not eliminate the risk to clients. The anti-avoidance provisions in SYSC 10.1.11G (MIFID Level 2 Directive Recital 27) do not prevent the proper use of disclosure, regardless of the type of client, and regardless of whether organisational and administrative arrangements have reduced the risk of damage. However, we do not think that any change to the draft handbook provisions in SYSC 10 is needed for FSA to follow the right interpretation of this point.

Paragraph 9.14: It will be important to interpret the interaction between SYSC 10.1.2R, 10.1.3R, and 10.1.8R in a way that enables firms, where appropriate, to do no more than identify possible types of conflicts that might arise with other members of the group at a very general level, and to rely on the independence of operations or the existence of Chinese wall arrangements to mean that there is no conflict requiring active management.

Paragraph 9.16: We agree with FSA's proposal to retain COB 2.4.4R, COB 2.4.6R, and COB2.4.7G provisions on the legal effect of information barriers as SYSC 10.2. However, we also believe that the substance of COB 2.4.5G should be retained perhaps as part of SYSC 10.1.15G or as SYSC 10.1.16G. The guidance provides important comfort to our members, but the CP does not directly address COB 2.4.5G or offer a rationale for its deletion. Our view is that the substance of the guidance that firms should incur no liability as a result of effective Chinese wall type provisions remains sensible and coherent under MIFID, and we assume that the FSA will advise us if they hold a different view of the continued validity of the guidance.

**Q36:** *Do you agree with our proposal to create a unified standard for management of conflicts of interest?*

Yes.

**Q37:** *What would be the impact on your firm of the two aspects of superequivalence in the unified standard described in paragraph 9.19?*

We support the unified approach, and do not think that the additional impact of extending beyond MIFID business the requirements relating to the conflicts policy and the role of disclosure as a means of managing conflicts would be significant. As noted in our comments on paragraph 9.12 above, it is important not to overstate the extent to which MIFID will impose extensive new limitations on firms' ability to use disclosure to manage conflicts where the firm's reasonable steps do not avail to manage the conflict.

### Comments on SYSC Chapter 10

SYSC 10.1.2R and 10.1.3R require firms to identify conflicts between the firm or a person linked to it by control and the client, whereas SYSC 10.1.8R requires the conflicts policy to identify and manage only conflicts involving the firm itself. In many cases the relationship between a firm and persons linked directly or indirectly by control will mean that the firm is not in a position to be able to identify possible conflicts at a detailed level. It will therefore be important to interpret the interaction between these provisions in a way that enables firms to do no more than identify possible types of conflicts only at a very general level, and to rely on the independence of operations or the existence of Chinese wall arrangements to mean that there is no conflict requiring active management.

SYSC 10.1.3R's identification requirement should be brought into line with the wording of SYSC 10.1.8(1) (a) R requirements on the contents of the conflict policy, so that both relate to the same class of conflicts. SYSC 10.1.8(1)(a)R states that the conflict policy "must identify...the circumstances which constitute or may give rise to a conflict of interest entailing a *material risk of damage* to the interests of one or more clients", whereas SYSC 10.1.3R refers to "identifying the types of *conflict...whose existence may adversely affect* the interests of the client". The final text of MIFID Level 2 Directive Article 21, which corresponds to SYSC 10.1.3R, refers to conflicts: "*whose existence may damage...*". Amending SYSC 10.1.3R to refer to '*...types of conflict of interest that arise in the course of providing a service entailing a material risk of damage to the interests of one or more clients...*' would ensure that both provisions were targeted appropriately at the right class of conflicts, and also be consistent with the intelligent copy-out approach. Furthermore, in order to specify more precisely where a conflict arises that gives rise to an identification obligation, SYSC 10.1.3R should be linked to SYSC 10.1.4 by amending its first line to read: "For the purposes of identifying the types of conflict of interest, to which SYSC10.1.4R applies, that arise..."

SYSC 10.1.4G: The limitation of circumstances where a conflict arises to where the firm has a duty, and the provision that a conflict does not arise where a firm stands to make a gain unless there is a disadvantage to a client, is expressed as guidance. However, given its central role in the interpretation of the conflict of interest provisions, we think that FSA should frame this provision as a rule rather than guidance, even though it appears as a Recital rather than an Article in the EU legislation.

SYSC 10.1.8R (1) (a): For the sake of consistency with the record requirements in SYSC 10.1.12R and the identification requirements in SYSC 10.1.3R, SYSC 10.1.8R (1) (a) should require that the conflict policy should identify ‘...specific types of services and activities...’. We think that this change would be consistent with the intelligent copy-out approach.

SYSC 10.1.13 to 15: We think that this guidance is an improvement on COB5.10.5 because it allows a much broader flexibility for corporate finance firms to manage allocations of securities while treating all parties fairly and consistently.

SYSC 10.2 appears to be a direct copy-out of COB2.4.4R, COB2.4.6R, and COM2.4.7G. We support its retention. We also think that FSA should retain COM2.4.5G.

## Chapter 10: CAD/MIFID perimeter guidance

Paragraph 10.5. The position of the UK branches of non-EEA firms is not dealt with in any detail in CP06/9. The opening chapters (e.g. paragraph 1.19) make reference to FSA's plans to develop proposals for applying the common platform to firms outside the scope of MIFID/CRD over the next year and, in paragraph 2.21, FSA say that SYSC Chapter 3 will remain in force until that further work is completed. Paragraph 10.5 simply notes that MIFID does not apply to non-EEA firms' EEA branches

However, non-EEA branches are major City players and it is essential that FSA's plans for their regulation are clarified in the feedback statement to CP06/9 – if not before – and that FSA's approach is consistent with the arguments that HM Treasury has been adopting in the European Commission's transposition meetings as regards preventing a "subsidiarisation rule". HM Treasury's central argument, which we have supported, is that the position under MIFID is no different from that under the Investment Services Directive, albeit that it was not thought necessary to carry across the provisions of ISD Article 5. (MIFID Level 1 Recital 28 confirms that "the procedures for the authorisation within the Community of branches of investment firms authorised in third countries should continue to apply ..." and, for banks, Article 38 of the re-cast BCD continues to provide that Member States "shall not apply to branches of [non-EU] credit institutions ... provisions which result in more favourable treatment than that accorded to credit institutions having their head office in the Community ...".)

So, although we agree that MIFID does not apply to the UK branches of non-EEA firms, we believe that the only way to interpret the provisions of the Directives as regards the regulatory standards to be applied, is to conclude that such branches have to be subject to an equivalent regime for the investment activities they conduct that MIFID covers. FSA's consideration (as described in paragraph 1.19 of CP06/9) of the position of firms outside the scope of MIFID/CRD should, therefore, concentrate on the kinds of regulated activities that fall outside MIFID's scope. Clearly, if there is any doubt about the need to treat EEA branches on the same basis as UK incorporated entities undertaking the same kinds of investment business, the position will need to be discussed with the industry as a matter of urgency.

**Q39:** *Do you believe it is helpful for us to prepare perimeter guidance in relation to EU Directives?*

Yes. It will be helpful in particular for groups which need to ascertain whether their subsidiaries will be in-scope or not.

**Q40:** *Do you have any comments on the draft text of the guidance?*

Perimeter Guidance Q18. The analysis of the interaction between 'executing orders on behalf of clients' and 'dealing on own account' in the third paragraph Q18 in the draft Perimeter Guidance (What is dealing on own account?) is closely bound up with the interpretation of these terms and the way in which they are applied in MIFID, on which a number of the participating associations commented in their responses to FSA's DP06/3 "Implementing MIFID's best execution requirements". We will therefore need to comment on the wording of Q18 (some of which, we note, is replicated in paragraph 16.11 of CP06/14) in the light of the informal discussion paper on this subject which we understand that FSA is due to publish in late August 2006. .

**Q41:** *Do you think there are any issues not covered in the draft of the guidance that it should address?*

No.

## **Compatibility with FSA's objectives and principles of good regulation**

### FSA's statutory objectives

We have no particular comments on FSA's analysis of the compatibility of its proposals with its statutory objectives.

### Principles of good regulation

Paragraph 8. We agree that FSA's proposals are broadly conducive to the efficient and economic use of its resources.

Paragraph 10. We agree that FSA has, to the extent MIFID allows it to, left it to firms and their senior management to determine what they must do to meet the requirements.

Paragraph 11. We agree that in this particular instance, FSA's approach to superequivalence is a proportionate one, and, exceptionally, that superequivalence is appropriate. See our comments above on specific proposals.

Paragraph 12. We agree that FSA's proposals should not restrict innovation.

Paragraph 13. We agree that the competitive impact vis a vis other EEA jurisdictions is not measurable. In general we think that FSA's proposals should not affect the UK's competitive position in the rest of the world, although for this to be the case it will be essential for FSA to maintain a proportionate approach, for example regarding the ability of firms to provide services without new restrictions on the basis of disclosed unmanageable conflicts.

Paragraph 14. We agree that the proposed changes should not harm competition materially.

Paragraph 15. We agree that it is difficult to assess the effect on competition between in-scope and out-of-scope firms. Much will depend on how FSA interprets and applies the new requirements, as described in our comments above.

Paragraph 16. We agree that the proposals in CP06/9 are the most appropriate way of meeting FSA's statutory obligations in these areas.

## **SYSC 18: Guidance on the Public Interest Disclosure Act 1998**

On the assumption that SYSC 18 replicates the existing SYSC 4, we have no comments on it.

## Amendments to the glossary of definitions

### Part 3 – Existing definitions

‘Regulatory system’: In the context of our comments under Q15 above, we are concerned about the open-ended reference to “any relevant directly applicable provisions of a...Regulation”, given that the MIFID implementing Regulation is cited as just one example of such a measure. There needs to be greater clarity about the boundary between those EU measures that fall within the regulatory system definition and those that do not. In addition, we do not understand the inclusion of the reference to “directly applicable provisions of a Directive”, since we have understood that provisions of Directives are not directly applicable. We suggest an alternative formula along the following lines:

“...and including any *provisions that apply directly to a firm by virtue of an implementing measure under a Single Market Directive or under a Directive referred to in a Single Market Directive, and including also the provisions that apply directly to a firm by virtue of implementing measures under the Directives specified below: [list to be provided within Glossary].*”