



FSA publishes Consultation Paper on measures to introduce a common platform for MiFID and Capital Requirement Directive (CRD) Compliance

Introduction

The FSA has published a Consultation Paper setting out proposed rules and guidance to implement the organisational systems and controls requirements of the Markets in Financial Instruments Directive ("MiFID") and the Capital Requirements Directive ("CRD"). From 1st November 2007¹, the FSA will replace, for common platform firms, Chapter 3 of the Senior Management Systems and Controls Handbook with seven new chapters (referred to as the 'common platform'). However, from 1st January 2007 firms who are subject to the CRD will need to comply with the rules relating to systems and controls within the CRD – as a result, the FSA is proposing a transitional phase for common platform firms with the effect that common platform firms have to comply with the CRD requirements in respect of systems and controls from 1st January 2007 with the option of complying with the common platform rules from that date. The seven new chapters will cover the following specific areas:

- General Organisational Requirements (including business continuity);
- Employees and Agents;
- Compliance including internal audit;
- Risk Control;
- Outsourcing;
- Record keeping; and
- Conflicts of Interest.

The unified set of requirements may, in some cases, go beyond the strict Directive minimum requirements. For example, in the case of outsourcing, the unified standard for outsourcing will apply to common platform firms' outsourcing of critical or important functions related to a firm's MiFID business, non-MiFID regulated activity, listed activities under the Banking Consolidation Directive, and ancillary services under MiFID. This requirement goes beyond the MiFID minimum which is limited to regulating outsourcing of critical or important operational functions related to a firm's MiFID business (but is only super-equivalent to the extent that it goes beyond CRD requirements). In this bulletin, we have focused on the chapters on General Organisational Requirements (including business continuity) and Outsourcing.

General Organisational Requirements

SYSC Chapter 4 contains the proposed rules and guidance on the general organisation of a firm and covers:

- A firm's governance, internal controls and organisation;
- A firm's accounting procedures;
- A firm's audit committee;

¹ Or earlier if a common platform firm chooses to comply with the common platform prior to 1 November 2007



- Business continuity;
- The persons controlling a firm (the 'four eyes' requirement); and
- Senior management responsibility.

Given the broadly similar nature of the obligations in respect of business continuity within the CRD and MiFID, the FSA has explored the possibility of unified business continuity requirements that would require a firm to establish, implement and maintain an adequate business continuity policy aimed at ensuring that its essential data and functions are preserved, losses are limited and its regulated activities maintained in the case of an interruption to its systems and procedures. Where that is not possible, a firm would need to enable the timely recovery or resumption of such data, functions and activities.

This proposal involves two instances of super-equivalence:

- The CRD requires business continuity plans to be in place to cover the event of severe business interruption, whereas MiFID requires the plan to cover the wider case of an interruption to its systems and procedures. The FSA proposal would go beyond the minimum standards set out in the CRD and would mean all common platform firms meeting the broader standard (i.e. having plans in place to cover any interruption); and
- The CRD requirement applies to the whole of a firm's business whereas the MiFID requirement applies only to investment services and activities. A unified approach would go beyond MiFID's minimum requirements by requiring firms' business continuity plans to cover all regulated activities, not just MiFID activities.

In addition, the FSA proposes to include guidance which suggests that a firm's business continuity policy should include matters such as resource requirements, recovery priorities, communication arrangements, and regular testing where appropriate and proportionate.

Outsourcing

The FSA continues to view the operational risks posed by outsourcing arrangements as presenting a significant threat to three of the FSA's statutory objectives: (i) securing the appropriate degree of protection for consumers; (ii) maintaining confidence in the financial system; and (iii) reducing financial crime. In addition, the FSA concluded that a failure by a firm to have adequate arrangements regarding its outsourcing would be a failure to have robust governance arrangements or internal control mechanisms under Article 22 of the Banking Consolidation Directive. One conclusion the FSA has come to is that firms' outsourcing activities are unlikely to be segregated into MiFID or CRD business activities. As a consequence, the FSA has proposed a unified approach to outsourcing.

Extension of MiFID requirements

The FSA has decided to extend the detailed MiFID requirements relating to outsourcing of critical or important operational functions for all of a common platform firm's material outsourcing in relation to:

- Regulated activities whether MiFID business or not (e.g. deposit-taking activities and the safeguarding and administration of investments as well as MiFID investment services and activities);
- Listed activities under the Banking Consolidation Directive (e.g. lending activities); and



- Ancillary services under MiFID (e.g. the provision of investment research).

The FSA has taken the view that the rules on material outsourcing will not automatically apply to outsourcing of non-critical or non-important business functions but has issued guidance that the firm should take into account the rules on material outsourcing, as appropriate and proportionate, for its non-material outsourcing. This approach, as well as reflecting Article 22 of the Banking Consolidation Directive, is intended to give a firm and its management the flexibility needed to control the risks arising from non-material outsourcing in a manner appropriate and proportionate to the firm's needs.

The FSA has decided not to issue any further guidance as to what constitutes a 'critical' or 'important' function beyond what is set out in the Markets in Financial Instruments Directive (i.e. that an operational function will be regarded as critical or important if a defect or failure in its performance would materially impair the continuing compliance of an investment firm with the conditions and obligations of its authorisation or its other obligations under MiFID, or its financial performance, or the soundness or the continuity of its investment services and activities. However, the revised SYSC Handbook text does make it clear that the following functions will not be considered as critical or important:

- The provision of advisory services and other services which do not form part of the investment business of the firm, including the legal advice to the firm; and
- The purchase of standardised services, including market information services and the provision of price feeds.

Common Platform Firms

The revised SYSC Handbook text provides that common platform firms are required to exercise due skill and care and diligence when entering into, managing or terminating any outsourcing arrangement to a service provider of critical or important functions or of any regulated activities, listed activities or ancillary services (termed "relevant services and activities"). In particular, firms must ensure that the following conditions are satisfied:

- (a) 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;
- (b) the service provider must carry out the outsourced services effectively and to this end the firm must establish methods for assessing the standard of performance of the service provider;
- (c) the service provider must properly supervise the carrying out of the outsourced functions and adequately manage the risks associated with the outsourcing;
- (d) appropriate action must be taken if it appears that the service provider may not be carrying out the functions effectively and in compliance with applicable laws and regulatory requirements;
- (e) the firm must retain the necessary expertise to supervise the outsourced functions effectively and manage the risks associated with the outsourcing;
- (f) the service provider must disclose to the firm any development that may have an impact on its ability to carry out the outsourced functions effectively and in compliance with applicable laws and regulatory requirements;
- (g) the firm must be able to terminate the arrangement for outsourcing where necessary without detriment to the continuity and quality of its provision of services to clients;
- (h) the service provider must cooperate with the FSA and any other relevant MiFID competent authority in connection with the outsourced activities;
- (i) the firm, its auditors, the FSA and any other relevant MiFID competent authority must have effective access to data related to the outsourced activities and the business



- premises of the service provider; and the FSA and any other relevant MiFID competent authority must be able to exercise those rights of access;
- (j) the service provider must protect any confidential information belonging to the firm or relating to its clients; and
 - (k) where applicable, the firm and the service provider must establish, implement and maintain a contingency plan for disaster recovery and periodic testing of back up facilities.

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