

Organisational Systems and Controls

Overview

While firms need to comply with the CRD provisions of the common platform by 1 January 2007, MiFID provisions need to be complied with by no later than 1 November 2007. Many firms will be subject to the CRD and MiFID rules, therefore the FSA has introduced the concept of the 'common platform' to avoid imposing two sets of requirements on firms in respect of organisational systems and controls.

Existing rules are currently set out in Chapter 3 of Senior Management Arrangements, Systems and Controls (SYSC). The new rules and guidance to implement the organisational systems and controls requirements in MiFID and CRD will also be located in SYSC but, from 1 November 2007, the existing Chapter 3 of SYSC will, for common platform firms, be replaced with seven new chapters. These chapters will collectively be known as the 'common platform'. Chapter 3 of SYSC will remain in force for firms not subject to either MiFID or the CRD.

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Firms that are subject to both directives will be required to comply with the CRD from 1 January 2007 and with MiFID from 1 November 2007. Firms that are only subject to CRD will have to comply with the provisions of the common platform from 1 January 2007. Firms that are subject to MiFID but not CRD will not have to comply with the common platform until 1 November 2007. Until then they will remain subject to SYSC Chapter 3.

Firms not subject to either CRD or MiFID will continue to comply with SYSC Chapter 3 as they currently do. During the ten month period between 1 January 2007 to 1 November 2007 such firms have the right to choose at what point they come into line with the MiFID provisions of the common platform.

Transitional arrangements

Firms that are subject to both directives will be required to comply with the CRD from 1 January 2007 and with MiFID from 1 November 2007. Firms that are only subject to CRD will have to comply with the provisions of the common platform from 1 January 2007. Firms that are subject to MiFID but not CRD will not have to comply with the common platform until 1 November 2007. Until then they will remain subject to SYSC Chapter 3.

Firms not subject to either CRD or MiFID will continue to comply with SYSC Chapter 3 as they currently do. During the ten month period between 1 January 2007 to 1 November 2007 such firms have the right to choose at what point they come into line with the MiFID provisions of the common platform.

Conflicts of interest

The current rules and regulation for conflicts of interest are located within COB chapter 7.1, 5.10 and 2.4. For common platform firms, the requirements will be located within SYSC Chapter 10.

MiFID requires that a firm's conflicts policy:

- is in writing;
- identifies the circumstances which may give rise to a conflict of interest entailing material risk of damage to clients; and
- specifies the measures adopted to manage the conflicts.

They also include requirements for firms to insulate staff from conflicts where this is a proportionate approach.

MiFID will bring about changes to the current practice in the UK. For example under the current client classification, market counterparties are excluded from the PRIN 8 current conflicts management principle, but under MiFID and the new client classification, the type of client to whom duty is owed is not relevant.

Record keeping

The FSA's proposals to implement the MiFID record keeping requirements will be set out in the Reforming COB Regulation consultation paper, issued on 31 October 2006.

For investment firms, the FSA is proposing to maintain the rules and associated guidance on financial information and record, keeping the relevant chapters of IPRU(INV) until 1 November 2007.

Outsourcing

The MiFID requirements are extended under the common platform proposals (subject to proportionality) 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);
- ancillary services under MiFID (e.g. the provision of investment research).

The common platform proposal examines the circumstances in which a firm relies on a third party for the performance of operational functions that are critical or important for the provision of continuous and satisfactory service to clients. The firm is required to take reasonable steps to avoid undue operational risk and must not impair the quality of its internal control or the activities of its supervisor. The requirement is not absolute, but should focus on reasonable steps with regard to the processes and procedures a firm should take. The common platform proposals indicate that in taking reasonable steps a firm should be satisfied that:

- the service provider has the ability, capacity and necessary authorisation to perform the outsourced activities reliably and professionally;
- the firm can assess the standard of performance;
- the firm can supervise the third party appropriately and manage risks associated with the outsourcing.

The common platform proposals also require a firm to take appropriate action where it appears that the service provider is not carrying out the functions effectively or in compliance with applicable laws and regulatory requirements. Additional safeguards are that:

- the investment firm, its auditors and relevant competent authorities have effective access to data related to the outsourced activities, as well as to the business premises of the service provider;
- the service provider must protect confidential information belonging to the investment firm or its clients;
- the investment firm and the service provider must have a contingency plan that provides for disaster recovery;
- the outsourcing agreement must be in writing.

Risk control policies

Both MiFID and CRD stress the importance of firms establishing effective control policies and procedures. The FSA's proposals for risk control are not substantially different from the current hand book provisions.

A common platform firm will be required to establish, implement and maintain adequate risk management policies and procedures which identify and set the tolerable level of risk relating to its activities, including compliance with them. A firm should also have a separate risk control function reflecting the nature, scale and complexity of its business. This function will be responsible for assessing the risks the firm faces and for advising the firm's governing body and senior managers on those risks.

The common platform proposals incorporate the detailed MiFID requirements which give support to the high level standards. These include, for example, a requirement for a firm to monitor:

- the adequacy and effectiveness of its risk management policies and procedures;
- the level of compliance by the investment firm and its staff with its arrangements;
- the adequacy of measures taken to address any deficiencies.

The FSA's common platform proposals do go beyond the minimum requirements set by the directive.

The FSA also proposes that a number of requirements on risk control contained in CRD concerning credit and counterparty risk, market risk, residual risk, market risk, liquidity risk, operational risk and group risk are not applied as a unified standard. Such requirements are to be applied to 'CRD-only' firms.

Compliance (including internal audit)

The FSA believes that all firms should be subject to the same compliance standards, whilst recognising that those standards should be applied in a way that reflects the nature, scale and complexity of a firm's business.-

The FSA's proposals will require a firm to:

- establish and maintain policies and procedures aimed at ensuring effective compliance;
- establish procedures able to identify the risks associated with a failure by the firm to comply with its obligation;
- establish a monitoring programme to regularly assess and address any inadequacies or deficiencies arising from the firm's compliance and address any arising issues;

- have (subject to proportionality) an independent compliance function which has the necessary authority and is structured, resourced and operated in a manner which fosters integrity and efficient operation;
- appoint a compliance officer who has the necessary authority and responsibility for the compliance oversight function and who reports to the governing body.

The FSA also proposes a unified standard for internal audit in that, where appropriate, a firm must establish and maintain an internal audit function which is separate and independent from its other functions and activities. The FSA proposes that this requirement is to be a rule. Where it is not appropriate for a firm to have an independent internal audit function they will still need adequate internal control mechanisms.

Where a firm has an internal audit function, it must be separate from its compliance function and, if it exists, its risk management function.

The internal audit function will be responsible for establishing, implementing and maintaining an audit plan, issuing recommendations based on the audit plan, verifying compliance with those recommendations, and reporting to senior management and the supervisory function of the firm.

General organisational requirements

The FSA proposes a requirement that a firm has:

- robust governance standards;
- sound administrative and decision making procedures;
- an organisational structure which clearly, consistently and in writing specifies reporting lines and allocates functions and responsibilities;
- adequate safeguards for the security, integrity and confidentiality of information and for the firm's information processing.

For business continuity requirements, the FSA proposes to duplicate the MiFID and CRD requirements. CRD-only firms are to meet the CRD-based rule and MiFID-only firms will meet the MiFID-based rules. If subject to both directives, the firm should comply with the MiFID rules on business continuity for its investment services and activities and the CRD rules for all other activities.

Employees, agents and other relevant persons

The new rules clarify that firms have a responsibility to ensure their staff do their jobs properly, follow internal procedures, are competent to perform the tasks that they are given, and are not given conflicting roles that would compromise their ability to perform their tasks properly.

A firm must monitor and regularly evaluate the adequacy of its systems, internal control mechanisms and arrangements established to comply with the requirements concerning staff, and take appropriate measures to address any deficiencies.

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