

Justification for retention of the FSA’s requirements on the apportionment of responsibilities (“Provisions”) under Article 4 of Directive 2006/73/EC (“Level 2 Directive”) implementing Directive 2004/39/EC (“Level 1 Directive”).

1. The Provisions require a firm to take reasonable care to maintain a clear and appropriate apportionment of significant responsibilities among its directors and senior managers. They also require a firm to allocate to specific individuals the functions of dealing with this apportionment of responsibilities and of overseeing the establishment and maintenance of systems and controls. This paper explains how the Provisions satisfy the requirements of the Article 4 test. It is structured as follows:
 - An explanation of how the Provisions go beyond the requirements of the Level 2 Directive;
 - A description of the specific risks to investor protection and to market integrity addressed by the Provisions and explanation why they are not adequately addressed by the Level 2 Directive;
 - An explanation of why the Provisions are proportionate; and,
 - An explanation of why the Provisions do not restrict or otherwise affect the rights of investment firms under Articles 31 and 32 of the Level 1 Directive.
2. In addition to introducing new requirements that specifically implement Article 9 of the Level 2 Directive¹, the FSA proposes to retain the Provisions, with some minor modifications to reflect MiFID.

In what way are the Provisions additional to those in the Level 2 Directive?

3. The ways in which the Provisions are additional to those in the Directive are:
 - (a) The Provisions require a firm to take reasonable care to maintain a clear and appropriate apportionment of significant responsibilities among its senior management and certain other senior staff that report directly to senior management in such a way that:
 - (i) it is clear who has which of those responsibilities; and
 - (ii) the business and affairs of the firm can be adequately monitored and controlled by the senior management and relevant senior staff².

The provision described in (i) is more specific than Article 5(1)(a) of the Level 2 Directive, which deals with the allocation of functions more widely throughout the firm. The Provisions supplement the principle of collective senior management responsibility in Article 9(1) of the Level 2 Directive, by making it clear that individual members of the senior management and other senior staff should take the lead in relation to responsibilities that are significant.

¹ The FSA made its rules implementing Article 9 of the Level 1 Directive in the Senior Management Arrangements, Systems and Controls (Markets in Financial Instruments and Capital Requirements Directives) Instrument 2006 (http://fsahandbook.info/FSA/handbook/LI/2006/2006_50.pdf). These rules, which will apply from 1 November 2007, will be located at SYSC 4.3.

² SYSC 2.1.1R (<http://fsahandbook.info/FSA/html/handbook/SYSC/2/1>).

The provision described in (ii) reinforces the requirement in Article 9(2) of the Level 2 Directive, by emphasising the elements of monitoring that go beyond the receipt of reports and by also covering effective control.

(b) The Provisions require a firm to allocate to one or more individuals the functions of dealing with the apportionment of responsibilities as outlined in (a), and of overseeing the establishment and maintenance of systems and controls. The individual to whom these functions are allocated must be the chief executive (and all of them jointly, if more than one), or, in limited circumstances, a director or senior manager responsible for the overall management of the group; or a group division within which some, or all, of the firm's regulated activities fall. The Provisions add to and complement the requirements in Article 5(1)(a) and Article 9(1) of the Level 2 Directive as they prescribe the specific individuals who must carry forward the relevant functions.³

(c) The Provisions require a firm to record the arrangements it has made to satisfy the requirements outlined in (1) and (2) above and to maintain the record for 6 years.⁴

However, as the Provisions are concerned with the organisation and responsibilities of the governing body of UK firms, they may properly be regarded as dealing with questions of corporate governance and therefore outside of the scope of the Level 1 Directive and the notification obligation under Article 4 of the Level 2 Directive. We are therefore making this notification on a precautionary basis.

What are the specific risks to (i) investor protection or to (ii) market integrity that the requirements address that are not adequately addressed by the Level 2 Directive?

4. The specific risk to investor protection and to market integrity addressed by the Provisions that is not adequately addressed by the Directive is the risk of weakness in the organisation and compliance culture of a firm. This would arise if each individual senior manager sought to hide behind the collective responsibility of the firm's senior management team to reduce the risk that they will be personally called to account for specific failings in the firm's systems and controls. A failure in the compliance culture of a firm is likely to have a negative impact on consumers (for example, through increased mis-selling) and, depending on the significance of the firm, may also have an impact on market integrity.
5. The principle of collective responsibility of senior management in Article 9(1) of the Level 2 Directive is fundamental. However, on a practical level, individual members of the senior management may feel that they will be isolated from personal responsibility for failings because they were not individually assigned to take ownership of the relevant issue. This effect would be compounded if no individual in the senior management is required to take such ownership, for example, if senior management have collectively allocated conduct of the matter to relatively junior staff. This is particularly important because general UK company law does not require a company to assign particular roles to particular members of a firm's

³ SYSC 2.1.3R and SYSC 2.1.4R (<http://fsahandbook.info/FSA/html/handbook/SYSC/2/1>).

⁴ SYSC 2.2.1R (<http://fsahandbook.info/FSA/html/handbook/SYSC/2/2>).

governing body (such as a chief executive). In this regard, the Provisions can be seen as an enhancement of the general UK principles of corporate governance.

6. The requirements described in paragraph 3(a) ensure that a particular senior staff member is given ownership of each significant responsibility facing the senior management team collectively. There should therefore always be somebody at a senior level who knows that it is their responsibility to deal with the matter and that they can be called to account for failing to do so.
7. The requirements described in paragraph 3(b) ensure that the apportionment of responsibilities among senior staff and the establishment of systems and controls are seen as matters for the highest levels of the firm's executive management. This emphasises the central importance of these functions. Also, it is generally the case that, as an insider, the chief executive of a regulated firm is in a better position than regulators to detect acts of non-compliance within the firm. Acts of non-compliance can thus be more efficiently prevented by such individuals as they can exploit their position in, and their knowledge of, their companies to prevent such acts before they occur.
8. The day to day requirements imposed by the Provisions are largely in line with good practice. However, the incentives created by the Provisions are strengthened by the fact that the UK maintains a regime for the registration of certain individuals working in investment firms⁵. This allows the FSA to take a range of enforcement action against registered individuals within the firm as well as against the firm itself. In many cases, the individuals to whom functions are allocated under paragraph 3(a) will be registered under this regime. The functions described in paragraph 3(b) will always be allocated to a registered individual. The misconduct of a registered person in performing these functions can lead to the imposition of sanctions directly on the registered person.
9. This creates a strong incentive for senior staff to deal with significant issues and for the chief executive or equivalent to ensure the firm has proper systems and controls. If these functions were not so allocated, it is less likely in practice that a failure of the firm's systems and controls would lead to direct action against individual senior staff. This would reduce the incentive to deal with these issues. For these reasons, the Provisions can be seen, at least in part, as a supervisory tool rather than an organisational requirement.

In what way are the risks of particular importance in the circumstances of the market structure of the United Kingdom?

10. The risks described above are of particular importance in view of past failures of, and significant misconduct by UK firms⁶ and the complexity, size and international nature of a number of sectors of the UK market.

⁵ Recital 13 to the Level 2 Directive makes it clear that the organisational requirements under MiFID are without prejudice to systems established by national law for the registration of individuals working within investment firms.

⁶ Recital 10 to the Level 2 Directive clarifies that the market structure of the Member State in question includes the behaviour of firms and consumers in that market.

11. The background to the introduction of the Provisions and a specific example of the above risks is the collapse of Barings in 1995. This involved trading in very large quantities of derivatives in an overseas branch where the systems and controls maintained by the firm were inadequate to address the risks involved in that trading. The collapse had significant implications for both investors and the wider market. If the Provisions had been in force at the time, there would have been a much clearer allocation of responsibility for ensuring proper systems and controls to the senior executive. This would have created a strong incentive for the senior executive to improve the firm's systems and controls.
12. The risks addressed by the Provisions are also relevant to activities in the retail market. Past UK misselling episodes such as those relating to split capital investment trusts and precipice bonds have casued significant consumer detriment and undermined consumer confidence in the financial sector. The incentives placed on senior managers by the Provisions are crucial to minimising the likelihood of such scenarios in the future.
13. A number of UK markets involve particularly large volumes of business⁷. Such markets a relatively small lapse in controls can have a disproportionate impact on the firm's position. The UK is also the home Member State of a number of large firms with significant overseas operations, where effective systems and controls are particularly important because of the operational challenges posed by business ran out of multiple locations.

Why are the requirements proportionate?

14. A full public consultation was undertaken when the provisions were introduced in 1999 with general agreement to the Provisions. Feedback received provided valuable input, which was taken into account when devising the Provisions.
15. As part of our cost benefit analysis on the impact of retaining the Provisions in addition to Article 5(1)(a) and Article 9 of the Level 2 Directive, we sent a survey to a sample of firms. The preliminary results of this survey are that 13 of 14 firms sampled do not believe the Provisions impose additional costs relative to the MiFID requirements. This supports the fact that the Provisions can largely be seen as reflecting best practice.
16. A control failure (e.g. widespread misselling or a major bank failure) can impose billions of pounds of costs upon society. However, the requirements imposed by the

⁷ For example, average daily turnover in the global over the counter (OTC) derivatives market rose from \$764 billion to \$1,508 billion between April 2001 and April 2004. During this period, the UK's global share of turnover rose from 36% to 43%. France, with 10% of global turnover, had the next largest market share amongst EU member states in April 2004 (Derivatives, International Financial Services, London, March 2006). In the credit derivatives market, the UK had approximately a 45% market share of the global total of outstanding credit derivatives of \$3.5 trillion at year end 2003 (Credit Derivatives Report: Executive Summary, British Bankers Association, 2003/04). London is also Europe's leading centre for the management of hedge funds. At year end 2005, 75% of European hedge fund investments totalling \$300 billion were managed out of the UK. If funds of funds and investments from the US managed in Europe are taken into account, approximately 90% of European hedge fund assets are managed in the UK (Hedge Funds, International Financial Services, London, March 2006).

Provisions largely reflect good practice and are therefore likely to impose relatively small costs compared to the damage they may prevent. Thus, we believe that the benefits of the provisions outweigh their costs by a significant margin.

17. An alternative to the Provisions would be to increase the intensity of supervision of firms. However, the inside role of senior managers, which is discussed above, means that the Provisions provide a form of control that is difficult to replicate through supervision. Also greater levels of supervision would impose significant additional costs, which would ultimately be passed on to investors.

Do the requirements restrict or otherwise affect the rights of investment firms under Articles 31 and 32 of Directive 2004/39/EC.

18. The Provisions will not restrict or otherwise affect the rights of investment firms under Articles 31 and 32 of Directive 2004/39/EC as the FSA will not apply them to firms from other Member States where they are exercising rights under those Articles. This is because MiFID reserves such matters exclusively to the home Member State.

31 January 2007

APPENDIX

Reference material

FSA produced reports

Name of publication / report	Date published
Consultation Paper (CP26) – The Regulation of Approved Persons http://www.fsa.gov.uk/pubs/cp/cp26.pdf	July 1999
Consultation Paper (CP35) – Senior Management Arrangements, Systems and Controls http://www.fsa.gov.uk/pubs/cp/cp35.pdf	December 1999
Policy Statement (PS31) – High Level Standards for Firms and Individuals (Issues arising out of CP35 and CP26) http://www.fsa.gov.uk/pubs/policy/P31.pdf	June 2000
Consultation Paper (CP06/9) – Organisational Systems and Controls – Common Platform for Firms http://www.fsa.gov.uk/pubs/cp/cp06_09.pdf	May 2006

Other published reports

Name of publication / report	Date published
British Bankers Association Executive Summary: Credit Derivatives Report 2003/04 http://www.jmlsg.org.uk/bba/jsp/polopoly.jsp?d=127&a=6269	September 2005
Deloitte report The Cost of Regulation Study http://www.fsa.gov.uk/pubs/other/deloitte_cost_of_regulation_report.pdf	2006
Investment Management Association Asset Management Survey http://www.investmentfunds.org.uk/press/2006/20060704-01.pdf	July 2006
Lane, Clark & Peacock Accounting for Pensions UK and Europe Annual Survey 2006 http://www.lcp.uk.com/information/documents/AFPSurvey2006.pdf	2006
London Financial Services, London	March 2006

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Hedge Funds http://www.ifsl.org.uk/uploads/CBS_Hedge_Funds_2006.pdf	
London Financial Services, London Derivatives http://www.ifsl.org.uk/uploads/CBS_Derivatives_2006.pdf	March 2006