MiFID Supervisory Briefings

Conflicts of Interest

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The Committee of European Securities Regulators

CESR is an independent Committee of European Securities Regulators. The role of the Committee is to:

- Improve co-ordination among securities regulators;
- Act as an advisory group to assist the European Commission, in particular in its preparation of draft implementing measures in the field of securities;
- Work to ensure more consistent and timely day-to-day implementation of community legislation in the Member States.

Promoting supervisory convergence

In the run-up to the implementation deadline for the Markets in Financial Instruments Directive (MiFID) on 1 November 2007, CESR devoted a lot of energy to setting recommendations and guidelines to help regulators take a consistent view of MiFID. With MiFID now in force, CESR's focus has shifted to matters of co-ordination and convergence of supervisory outcomes.

As part of its work to promote supervisory convergence, CESR has produced a series of supervisory briefings on the key elements of MiFID. They have been designed for supervisors, summarising the key elements of the rules and explaining the associated objectives and outcomes. The contents of these briefings are not exhaustive and do not constitute new CESR policy.

As well as an accessible introduction to the rules, the briefings also include indicative questions that supervisors could ask of themselves or a firm to assess a firm's approach to applying the rules. Naturally these questions are not intended to be exhaustive or to cover every possible situation, but can serve as a useful starting point when supervisors are deciding on areas of supervisory focus.

The briefings do not promote any particular way of supervising the rules, and are designed to be used in the way that best fits with a given supervisor's own methodology, whether this means distributing the briefings internally, or passing them to external bodies, such as auditors.

CESR believes that promoting convergence of supervisory outcomes can help promote market integrity and market confidence, whilst also minimizing the potential for client detriment and reputational risk, and has designed these briefings to support these goals.

Conflicts of interest

The MiFID Conflicts of Interest rules give firms flexibility to determine the appropriate approach for their business, depending on its size and complexity. This leaves scope for a high degree of supervisory judgement under the new rules; firms will have to put in place appropriate arrangements and supervisors will have to assess the adequacy of given arrangements.

This supervisory briefing is designed to help supervisors make these assesments, and is structured around three headings: (1) identifying of conflicts of interest; (2) managing conflicts of interest; (3) documentation: disclosure; policies and records. Each heading includes an overview of the outcomes that the rules promote, illustrates the potential risks, and provides examples of the sort of questions that supervisors could ask to test whether the outcomes are being met by firms.

1. Identifying conflicts of interest

Article 18 of the L1 Directive and Article 22(1) and (2) of the L2 Directive set out how firms should approach the **identification** of conflicts of interest.

When identifying conflicts a firm must take into account, as a minimum, whether the firm or its employees and tied agents:

- is likely to make a financial gain, or avoid a financial loss, at the expense of the client;
- has an interest in the outcome of a service provided to the client (or of a transaction carried out on behalf of the client) which is distinct from the client's interest in that outcome;
- has a financial or other incentive to favour the interest of another client (or group of clients) over the interests of the client;
- carries on the same business as the client; or
- receives an inducement in relation to a service provided to the client, in the form of monies, goods or services, other than the standard commission fee for that service.

In order to identify the situations that could give rise to conflicts of interest (for example, the sort of situations covered above) firms will have to undertake a **holistic review of their business**, looking within and across business lines, including non-investment activities and also considering the activities and structure of its wider group. Robust policies and procedures can aid in the identification process.

Firms should also be mindful that some services or combinations of services, such as investment research and advice, proprietary trading, portfolio management and corporate finance business carry a relatively high risk that a conflict of interest will result in material damage to clients' interests.

Example 1: An investment firm

An investment firm completed a one-off mapping exercise for conflicts of interest shortly after MiFID came into force. If the firm does not put in place arrangements to monitor existing conflicts and identify new ones, then there is a greater risk that a given conflict might not be effectively managed, and so lead to client detriment.

Questions

- What are the procedures for identifying, escalating and approving conflicts?
- What are the types of conflicts faced, providing examples of each?
- How does the firm monitor conflicts of interest on an ongoing basis?
- What information does senior management receive regarding conflicts of interest?

2. Managing conflicts of interest

Article 22(2)b of the L2 Directive requires firms to **manage** the conflicts of interest that they identify. There is no set way for firms to achieve the outcomes that the Directive is intended to achieve: conflicts management requires a tailored approach on the part of the firm, and an informed judgement on the part of the supervisor as to its adequacy.

Ensuring that staff act independently when they deal with clients is a key way of managing conflicts, and Article 22(3) of the L2 Directive sets out the measures that a firm should consider to achieve this:

- effective procedures to prevent or control the exchange of information, which could include a physical barrier, document classification, security and computer protections and/or confidentiality agreements;
- separate supervision of relevant persons;
- removal of direct remuneration links;
- measures to prevent or limit any person from exercising inappropriate influence; and
- measures to prevent or control the simultaneous or sequential involvement of a relevant person in separate services or activities.

With all of these – and indeed with any measure that a firm adopts – it is important that the procedure is appropriately designed: the firm should be clear about what it is intended to achieve and how, as well as being able to assess its effectiveness.

Questions

- How does the firm manage the conflicts that it faces? What procedures, systems and controls has it put in place? Who has developed these?
- How does it manage conflicts that arise from particular transactions?
- How does the firm review the effectiveness of its conflicts management arrangements? Has the firm ever conducted a review of particular arrangements, and with what conclusions?
- What HR policies does the firm have to manage conflicts, e.g. separate supervision?
- Does the firm have clearly defined reporting lines and areas of responsibility?
- How does the firm ensure that staff are aware of its procedures for identifying, managing, and escalating particular conflicts? What training does it provide?
- What information does the firm collect on breaches of its conflicts policy and how does it deal with such breaches?

Example 2: Investment Research

The production of research is an area that is particularly susceptible to conflicts of interest. This is because of the fact that while research is meant to help clients make investment decisions, it also impacts on other areas of business for the firm producing the research. For example, frequent research with clear buy or sell recommendations could generate order flow for the sales side of the firm. Equally, research could impact on the market value of an issuer to which the firm also provides other investment banking services. In other words it has the potential to serve the interests of the firm or the analyst or other clients of the firm (other than those receiving the research) as opposed to the interests of the recipient. Therefore, if the firm doesn't put in place measures to safeguard the independence of research analysts, then there is a risk that the impartiality of their recommendations could be compromised. [1]

Additional questions where conflicts arise from a particular combination of services…

- What conflicts arise because of the combination of services or activities that a firm is providing? What controls are put in place to protect the independence of particular functions (e.g. analysts producing investment research at an investment bank)?
- How does the firm ensure that there are no links between the remuneration of staff in a particular function and revenues generated by another?
- What are the situations in which staff from different functions are required to interact? How does the firm manage the risk arising from these situations?

Example 3: Connected parties

A small investment manager manages portfolios on behalf of family members as well as a handful of private clients. If the firm doesn't establish procedures to manage conflicts of interest, then there is a risk that the firm could favour the interests of certain clients over those of other clients.

Additional questions where conflicts arise from personal connections…

- Has the firm identified any conflicts that arise from personal connections?
- How does the firm manage such conflicts of interest?

3. Documentation: Disclosure, written policies and records

[1] MiFID sets specific requirements concerning the labelling and production of investment research which aren't covered in this briefing. Supervisors should also have regard to the provisions of Directive 2003/125/EC (which implements the provisions of the Market Abuse Directive regarding the fair presentation of investment recommendations and the disclosure of conflicts of interest). The MAD provisions are not covered in this briefing, given its primary focus on organisational rather than presentational issues.

Disclosure: Giving clients the opportunity to make an 'informed decision'

Where organisational or administrative arrangements made by the investment firm to manage conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented, the investment firm must disclose the general nature and/or sources of conflicts of interest to the client before undertaking business on its behalf (Article 18(2) of the L1 Directive).

The purpose of this disclosure is to give the client the information needed to make an informed decision about whether to proceed with the service. Hence the level of detail provided will depend on the business and the client involved.

- What are the firm's procedures for determining whether to disclose a conflict of interest?
- Has the firm ever disclosed conflicts of interest to clients because measures to manage those conflicts were not sufficient to mitigate the risk of damage to the client? What information did the firm provide?
- How does the firm ensure that disclosure covers all situations in which conflicts management arrangements do not prevent the interests of the client from being damaged?

In addition to disclosing conflicts that they cannot manage, firms sometimes make additional optional disclosures to clients, for example generic disclosures in marketing documentation. Although these are not always made because of an obligation to do so, the principle that the disclosure should be meaningful is just as relevant in this context in order for the rules to be effective.

Written conflicts policy and records

Article 22 of the L2 Directive requires firms to establish a written conflicts of interest policy. The policy should detail the circumstances that give rise to conflicts of interest and the procedures that will be adopted to manage such conflicts.

- How does the firm document its conflicts policy?
- Who is responsible for approving the firm's conflicts policy and how frequently is it updated?
- What records does the firm maintain for conflicts of interest (e.g. a conflicts register)?
- Does the policy detail conflicts management arrangements for the all the conflicts it identifies? How does the firm ensure these are adequate?

This note has been prepared by the CESR MiFID Level 3 Expert Group chaired by Mr Jean-Paul Servais, Chairman of the Executive Management Committee at the CBFA, and by its sub-Group on Intermediaries, chaired by Mrs María José Gómez Yubero, Director at the CNMV. For more information on this document or on CESR activities regarding intermediaries please contact Diego Escanero at descanero@cesr.eu.