MAPLES GROUP

UPDATE

MiFID Firms – What is the Central Bank of Ireland's Focus for 2021?

This update examines some of the key regulatory developments which will impact firms engaged in MiFID activities in Ireland during 2021.

2021 Supervisory Priorities

On 8 February 2021, the Central Bank of Ireland (the "CBI") published its first Securities Markets Risk Outlook Report[1] (the "Report") informing regulated financial service providers, investors and market participants of what they consider to be the main conduct risks in the securities market. The following supervisory priorities for 2021 are highlighted:

- ***Market Abuse:*** The CBI will complete the supervisory reviews it commenced in 2020 on compliance with market abuse requirements for issuers (and those that act on their behalf) and take appropriate action on foot of its findings.

- ***Supervision of Conduct Risk****:* Enhancing international coordination in the supervision of conduct risk in wholesale securities markets, with a particular focus on improved EU supervisory convergence and continued cooperation under the IOSCO Multilateral Memorandum of Understanding.

- ***Focus on Data****:* Data quality will become an increasing area of focus and the European Securities and Markets Authority ("ESMA") has identified this as an EU strategic supervisory priority. During 2021 the CBI will conduct a series of actions on data quality in conjunction with ESMA and other national competent authorities.

- ***Sustainable Finance and SFDR:*** The development and implementation of the sustainable finance framework.

The CBI has also highlighted a number of areas which it expects firms to focus on during 2021, including:

- ***Ensuring Meaningful Transparency:*** It is essential that investors and market participants can make informed decisions based on available information, particularly with the clear and meaningful disclosure of costs and charges.

- ***Governance:*** Firms must meet the highest standard of governance by ensuring governance arrangements are fit for purpose and properly resourced, including as businesses expand or change.

- ***Increasing Complexity:*** Firms should be mindful of the increasing complexity of financial products in the market and manage new and emerging resulting risks.

[1] https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/securities-markets/risk-outlook-reports/securities-markets-risk-outlook-report-2021.pdf

Client Assets Regime Review

In December 2020 the CBI published Consultation Paper 133[2], focused on enhancements to the Central Bank Client Asset Requirements, as contained in the Central Bank Investment Firms Regulations.

Some of the key changes being proposed include new provisions on the establishment and termination of title transfer collateral arrangements; changes on client agreements, client disclosure, client consent, and client reporting; new reporting requirements for firms providing prime brokerage services; additional guidance on the client asset management plan and on segregation obligations; new provisions on evidencing client consent to the use of financial instruments; and bringing credit institutions undertaking MiFID activities into scope.

Revised Prudential Framework for Investment Firms

The Investment Firms Directive EU/2019/2034 ("IFD") and Investment Firms Regulation EU/2019/2033 ("IFR") introduce a new prudential framework for investment firms which will take effect from 26 June 2021 (subject to transposition of the IFD).

Investment firms will be re-categorised based on the nature, scale and complexity of their activities to drive a more proportionate regime:

- ***Class 1:*** Firms (i) dealing on own account (including matched principal trading) or placing financial instruments on a firm commitment basis; and (ii) meeting solo/consolidated asset threshold of ≥ €30bn. There is also CBI discretion to classify a firm as Class 1 based on factors such as systemic risk, clearing member status, economic importance or cross-border significance. These firms will be required to be re-authorised as credit institutions and be subject to CRR/CRD IV prudential requirements.

- ***Class 1 Minus:*** Firms (i) dealing on own account (including matched principal trading) or placing financial instruments on a firm commitment basis; and (ii) meeting solo/consolidated asset threshold of ≥ €15bn. However, the CBI will also have the discretion to categorise firms, which do not meet these criteria, as "class 1 minus", where they meet certain other conditions, such as carrying out activities on a scale that could lead to systemic risk and the total value of their solo/consolidated assets exceeding €5bn. These firms will be subject to CRR/CRD IV prudential requirements.

- ***Class 2:*** This is expected to be the default category for most investment firms which are not systemically important and will capture firms exceeding any of the "K-factor" and other thresholds for Class 3 categorisation (see below). These firms will be subject to IFD/IFR.

- ***Class 3:*** Small investment firms meeting specific K-factor criteria that are not involved in high-risk activities. These firms will be subject to lighter prudential requirements on the basis of proportionality.

The Irish Department of Finance[3] and the CBI[4] have published separate consultations on national discretions and competent authority discretions respectively, under this new

[2] https://www.centralbank.ie/docs/default-source/publications/consultation-papers/cp133/cp133---consultation-on-enhancements-to-the-central-bank-client-asset-requirements-as-contained-in-the-central-bank-investment-firms-regulations.pdf?sfvrsn=4

[3] https://www.gov.ie/en/consultation/0d2081-r/

[4] https://www.centralbank.ie/docs/default-source/publications/consultation-papers/cp135/cp135-consultation-on-competent-authority-discretions-in-the-ifd-and-ifr.pdf?sfvrsn=4

regime and firms will need to monitor these to understand how the regime will be applied in Ireland.

Each investment firm will need to consider the categories under the new regime and identify which category applies to the firm, and then engage with the CBI on this internal categorisation. The firm will then also need to assess the impact of the new categorisation on its prudential framework including from a capital, remuneration and operational perspective.

COVID-19 FAQs Update

The CBI updated its COVID-19 FAQs to list factors investment firms should consider when looking to pay dividends and variable remuneration, given the impact COVID-19 has had on the markets and the economy in recent months.

Firms must ensure that they can continue to meet their capital and liquidity requirements over an extended period of time and take a practical approach to paying dividends until they have a better understanding of their future costs and revenues. Firms subject to CRD IV/CRR and/or designated as Medium High under PRISM should be mindful of the need to engage with their relevant CBI supervisory teams in advance of proceeding with distributions (which includes creating a new obligations to pay variable remuneration to a material risk taker).

CBI 2020 Themed Inspections

The CBI's continued focus on MiFID compliance is no surprise given the extensive work undertaken in this area in 2020. We focus here on two of its 2020 thematic inspections and some of the remedial steps firms may need to take.

Appropriateness Assessment under MiFID II

On 29 June 2020 the CBI issued an industry letter (the "June Letter[5]") outlining key findings identified during its thematic inspection to assess firms' compliance with the MiFID II "appropriateness" requirements. MiFID II requires firms to complete a thorough and robust assessment of a client's knowledge and experience in order to determine whether the product or service is appropriate for that client.

The CBI focused on the practical application and implementation of appropriateness requirements in firms and record-keeping. Firms are required take all remedial action necessary to ensure they are acting in the best interests of consumers when selling complex products on an execution-only basis.

Key Findings

The June Letter identifies a number of weaknesses. Some firms adopted a generic blanket 'box-ticking' approach to demonstrate compliance without adequately considering the risks posed by the specific complex products they sell to retail clients on an execution-only basis, and without considering the differences in risks and complexity between different products. The CBI emphasised that it expects firms to comply "in spirt" as well as "by law" with the requirements and, at all times, to comply with their obligation to act in the best interests of clients.

The key findings include:

- ***Weak Processes, Systems and Controls:*** Some firms failed to adhere to

[5] https://www.centralbank.ie/docs/default-source/regulation/consumer-protection/compliance-monitoring/themed-inspections/stockbroking-investment-firms/thematic-inspection-of-appropriateness-under-mifid-ii.pdf?sfvrsn=4

their own appropriateness procedures in practice. Internal processes and controls must be sufficiently robust to ensure procedures are adhered to. A lack of assurance oversight was identified across appropriateness frameworks.

- ***Collection of Information Regarding Knowledge and Experience:*** The use of standardised questionnaires to gather information on the client's knowledge and experience which did not account for differences in risk and complexity among financial products and which, in certain instances, were not completed in full or correctly were identified. The use of defined scoring systems for which the underlying criteria was questionable and/or unclear was also highlighted as a concern.

- ***Unclear Rationale to Support Appropriateness Decisions:*** The rationale for concluding that a product is appropriate for a client and its link to the information collected not being clearly documented by firms and in line with their record keeping arrangements.

- ***Weak Warnings:*** Inadequate warnings were issued by firms where products were assessed as being ambiguous and inappropriate for clients, which did not act as an interruption to the process. The CBI stated that these warnings do not operate as disclaimers to override the firms' obligations to act in the best interests of the client.

The June Letter separately identifies certain positive practices adopted by firms' including:

- Separate business areas for the provision of advised and non-advised services.

- Use of automated questionnaires which reject certain applications where the required information is not provided.

- Use of product-specific procedures and guidance documents.

- Use of defined knowledge and experience thresholds based on the specific features, complexity and risk of a product.

- Clients required to demonstrate understanding of financial instruments and concepts by answering quiz questions relevant to the product or service in line with ESMA Guidance[6].

- Use of supporting narrative in relation to the determination of appropriateness.

- Layered approval and governance processes in place.

Firms were advised to review the June Letter and take all necessary remedial action.

Best Execution under MiFID II

The second MiFID focused CBI thematic review in 2020 related to investment firms' compliance with the best execution requirements. On 10 November 2020, the CBI issued a letter to industry outlining its key findings (the "November Letter[7]").

Firms have a responsibility to seek best execution for clients. When executing orders, firms must act in the best interest of clients at all times and should take all sufficient steps to obtain the best possible results for clients.

[6] https://www.esma.europa.eu/sites/default/files/library/2016-1165_qa_on_cfds_and_other_speculative_products_mifid.pdf

[7] https://www.centralbank.ie/docs/default-source/regulation/consumer-protection/compliance-monitoring/themed-inspections/stockbroking-investment-firms/industry-letter---mifid-ii-best-execution-thematic-inspection---10-november-2020.pdf

Firms are required to have robust best execution frameworks to verify on an on-going basis that their execution arrangements are and remain effective throughout the different stages of the order execution process.

The CBI's review focused on firms' best execution frameworks and, in particular, the firms' governance processes (including oversight and monitoring processes); policies and procedures; and reporting and record keeping. While they did identify some good practices, the CBI's primary concern was the failure of firms to demonstrate effective, oversight, monitoring and assurance as to their compliance with the best execution requirements. The CBI criticised firms' "tick-box" approach to compliance which was notably also raised in the June Letter.

Key Findings

- ***Policies and Procedures***: The November Letter emphasises the need for detailed execution policies that are reviewed at least annually to ensure alignment with the most recent regulatory developments, or whenever a material change occurs. Firms should incorporate version control to indicate when policies are being updated, who updated them and when it was approved by the board of directors (the "Board").

- ***Training:*** The CBI expects firms to implement training programmes to ensure that best execution processes are embedded into the firm and all staff are aware of their individual duties in this regard.

- ***Assurance Testing:*** The November Letter highlights the need for assurance testing on the end-to-end best execution process, noting the need for independent challenge in identifying gaps and weaknesses in firms' processes.

- ***Oversight and Challenge from Senior Management:*** The CBI also identified the lack of oversight and constructive challenge from the Board, relevant committees and/or the risk function. Importantly, the CBI notes that "the Board has responsibility for ensuring appropriate governance structures deliver sufficient oversight and monitoring capabilities at all levels of the organisation". To that end, the CBI expects the Board and senior management to have detailed knowledge of these MiFID II requirements, actively engage with policies and procedures updates together with effective challenge and discussion on the execution monitoring results.

The next steps for firms to address the November Letter findings include:

- Adopting policies and escalation procedures whereby results of ongoing monitoring are escalated to the Board/senior management with processes being updated following feedback.

- Reviewing policies at least annually which can be evidenced to the CBI if required. Polices should be subject to a four-eye review by the compliance function.

- Implementing sufficient training programmes so staff are aware of these requirements together with the policies and processes the firm has in place to ensure compliance. Training should be tailored to a firm's nature, scale and complexity.

- Providing evidence of oversight and monitoring of the best execution process, through assurance testing by Internal

Audit (or similar assurance testing programme).

Further Information

Further information on our Financial Services Regulatory Group, and the services we provide, is available on our website[8] and in our brochure[9].

If you would like further information, please liaise with your usual Maples Group contact or one of the members of our Irish Financial Services Regulatory Group:

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[8] https://maples.com/en/services/specialty-services/irish-financial-services-regulatory
[9] https://maples.com/-/media/files/pdfs/articles-and-chapters/financial-services-regulatory-group---core-services.pdf