



Module Integrity of Financial Markets

Welcome to the module Integrity of Financial Markets of the MiFID II Stay Compliant Program of CFA Society VBA Netherlands. Your presenters today are Matthijs Bolkenstein, partner with Ploum Lawyers and Alwin Oerlemans, head of product management at APG Asset Management.

Ethics and integrity matter

Ethics and integrity matter in life and even more in the financial sector. Dealing with other people's money brings a huge responsibility with regard to ethical behaviour and integrity. The English word ethics is derived from the Ancient Greek word *ēthikós* (ἠθικός), meaning "relating to one's character", which itself comes from the root word *ēthos* (ἦθος) meaning "character, moral nature". Ethics can be defined as a set of moral principles or rules of conduct that provide guidance for our behaviour when it affects others (definition CFA Institute). It relates to good and evil and right and wrong. The word integrity evolved from the Latin adjective *integer*, meaning whole or complete. Integrity refers to the quality of being honest and having strong moral principles (American dictionary).

In the financial sector combatting misconduct is a continuing challenge. Cases of misconduct have often led to regulatory reforms. It is important to create a culture of integrity in the workplace. This concerns 1) Promoting ethical principles throughout the company; 2) the tone at top and 3) working in the best interest of clients.

This is important to promote a financial sector that is working to the ultimate benefit of society by having 1) trust of investors and 2) robust financial markets.

Wirecard example

The newspapers report almost daily on examples of lacking ethics and integrity in the financial sector. A recent example concerns Wirecard. Allegations of accounting malpractices have trailed Wirecard since the early days of its incorporation, reaching a peak in 2019 after the Financial Times published a series of investigations along with whistle-blower complaints and internal documents. On 25 June 2020, Wirecard filed for insolvency after revelations that €1.9 billion was "missing", the termination and arrest of its CEO Markus Braun. Questions are raised with regard to the regulatory failure on the part of BaFin, Germany's supervisor.

Integrity risks: examples

Integrity risks materialise in many ways as you can see on this slide. From money laundering to market manipulation to tax evasion, conflicts of interest and cybercrime.



Anti-money laundering

The prevention of anti-money laundering and financing of terrorism is a hot topic. ING has been fined an enormous amount and the debate on whether or not there should be consequences for senior management is still ongoing. ABN Amro appears to be next in line and this is probably only the top of the iceberg; more is yet to come! From ING we learned, amongst others, how difficult it is to build in proper AML procedures, including proper monitoring, reporting and adjustment procedures. Especially in international organisations where you have to deal with different cultures and (external) politics. The recent news about the possible AML violation at ING Poland and the Polish financial regulator being reluctant to cooperate with the Dutch Central Bank is a clear example of the difficulties international firms encounter if it comes to AML regulations. The European Banking Authority recently advocated for extending certain AML regulations not only to banks but also to investment firms and finds it important to further harmonize laws and regulations on an EU level. On the other hand there is an increasing concern within the European authorities about the effects of these measures as they will lead to financial institutions closing their doors for new business. For the financial industry it is balancing on a thin line.

The Dutch laws and regulations on AML are all based on the various European AML Directives and are incorporated in the Dutch Act on the prevention of money-laundering and terrorist financing. In addition certain provisions and obligations are laid down in amongst others the Dutch Financial Supervision Act and the Dutch Pension Act as well as international and national sanction regulations. A breach of AML regulations can result in the applicability of the Dutch Criminal Code and the Sanctions Act 1977.

Since a breach of AML and sanction regulations could lead to serious integrity issues for financial institutions and the financial markets as a whole, the focus of the Dutch financial supervisors, the Netherlands Authority for the Financial Markets and the Dutch Central Bank, is more and more on the compliance with AML regulations.

Firms are obliged to have policies and procedures in place that safeguard proper compliance with AML regulations. Firms need to identify their clients, understand the rationale of the proposed transactions and/or investments and should verify the background of the funding. Where institutional clients are involved, identification as well as the assessment of proposed transactions is often not that difficult. It could become more difficult in the event of family offices or funds being involved with opaque (trust) structures.

As a start firms should conduct customer due diligence during the onboarding process of a new client (and on a risk basis and ongoing monitoring basis). Client identification means that at least the client



and its ultimate beneficial owner (UBO) are identified. The customer due diligence should take place on a risk based approach. This depends on e.g. jurisdictions involved (sanction regulations), type of products and client structure.

On the basis of a customer due diligence a firm should be able to identify the client and its UBO, understand the corporate structure of the client and understand the nature of the transaction/relationship. On an ongoing basis the firm should verify whether the information received is still up to date (at least during the period transactions take place), whether authorizations of contact persons are up to date and whether the firm has a clear sight on who its acts for.

An important part of the compliance with AML regulations is recording of actions, findings and assessment of procedures. Although GDPR is outside the scope of this specific module, we would like to emphasize that, especially where it involves recording and recordkeeping, GDPR policies should be maintained and complied with.

Examples misconduct

AML is not only a hot topic in the Netherlands. Danske Bank has been in the news for various AML and other scam incidents recently. Events like this have a major impact on the trust people have in the financial sector, it is therefore that authorities are more and more looking into this. It is not just in the Netherlands, its international. It is therefore of the utmost importance to be familiar with international laws and regulations. As a firm you don't want to be in the news in this way.

Market Abuse

In early September Union Investment announced that one of its employees has been put on leave after regulators raided the Frankfurt-based company for evidence of insider-trading. The respective employee is suspected of making a "significant amount" by trading securities on private accounts, which trades are currently subject to investigation. One of the many examples where financial institutions and its employees are linked with market abuse offences.

For financial institutions it is key to maintain strict insider trading and market abuse policies and ensure that all relevant personnel is fully aware of the content of such policies and the consequences of non-compliance. Training is key!

The Dutch market abuse regulations are based on European directives and regulations and laid down in the Dutch financial Supervision Act and the Market Abuse Decree.

The main market abuse offences are insider trading and market manipulation. Firms are obliged to take sufficient measures to avoid any involvement in these type of offences. This means on the one



hand that it must prevent its 'own' market abuse and on the other hand it should prevent being involved in facilitating market abuse offences of its clients. Especially the latter is challenging and required a good understanding of the rules and regulations of the firm's staff.

On the insider trading side firms should ensure that insider trading lists are being used and updated when relevant. As soon as employees are aware of information that qualifies as inside information this person should be registered and subject to strict supervision when dealing. Inside information is considered information that can have an impact of the market and stock prices. Chinese walls between deal teams and analysts is one of the methods to avoid insider trading within a firm.

Market manipulation could take place in numerous ways. One of the most common ways is initiating manipulative transactions, misuse of stock positions or spreading of false information. All with a view to affect the stock market price.

Clients can also be involved in insider trading and market manipulation. It is therefore important to understand the reasons behind a trade or trade request. The employees involved should be able to determine themselves whether or not a specific trade or trade request of a client could be subject to either insider trading or market manipulation. When in doubt responsible (senior) management and compliance officers should be consulted before closing a transaction.

Misconduct examples

Market Abuse offences not only take place within smaller firms. Risks can be found and materialize throughout the entire financial sector. Recent examples show this once again.

Governance: a model

Enhancing financial integrity is an important element to safeguard good governance in organisations. Promoting good governance starts with a good set up. Professors Cools, Van de Loo and Winter have presented an excellent model for good governance. In this model they distinguish between Persons, Group and the System. The key question is to ask whether the Board does what it is supposed to do. Is the board on task as you can see in the middle of the triangle. Therefore, the 1) Persons, 2) Group and 3) System should be in order. This means respectively that 1) Individual Board members are fit for the job; 2) The Board acts as a strong collective and 3) The Board operates in a system that allows for good governance.

Individual and group decision-making biases

Being aware of individual and group decision-making biases is important. In practice, decision-making



may deviate from the plan, for instance by overriding existing controls, treating red flags as false alarms or accepting deviances and near misses. People have difficulty “staying on course” or may be “throwing good money after bad”.

Also group decision-making biases may occur, for instance in important decision-making processes individuals, still in doubt about a course of action that the majority has approved, decide to keep quiet and go along. Another example may concern an overconfident manager who wants to minimize conflict, delay, and challenges to his or her authority and the group accepting this behaviour.

Governance

Proper governance is one of the pillars used in safeguarding integrity in the financial sector. During the beginning of this century a lack of proper governance allowed financial institutions to take irresponsible risks leading to the credit crunch. The developments on institutionalizing proper governance (not only) in financial institution have been enhanced as a result of the credit crunch and are top of mind by regulators. MiFID sets clear rules on governance but also links governance with other ethical and integrity related matters such as remuneration and conflicts of interest.

Governance means oversight and checks and balances and forms an integral part of, and it is fair to say that it is the heart of, a firm's compliance. Everyone within a firm or working together with and on behalf of a firm should be subject to some form of oversight. Policies on procedures should be in place to. For example to prevent conflicts of interest within the firm and with clients to occur.

Conflicts of interest but also product development could adversely affect clients' interests and these should be avoided at all time.

One of the areas where governance aspects and requirements are not always sufficiently taken into account is in outsourcing arrangements whereby the firm outsources certain tasks to a third party. Notwithstanding outsourcing the firm remains responsible for a proper fulfilment of the outsourced tasks. It is therefore important that firms have sufficient control to monitor and influence the outsourced activities. In practice we often see that this is not the case and that supervision, thus governance, on the side of the firm has not been embedded in the firm's governance procedures.

Again, the level of governance and supervision should be determined on a risk basis.

Organizational requirements

Under MiFID II the senior management of a firm is responsible and accountable for the implementation and oversight of an effective governance system and that it should monitor, assess and improve the governance system when needed. Governance structures may vary based on the size of the firm and



the activities performed. It is important to recognize that there is no “one size fits all” approach. Governance is a dynamic aspect of a firm's organization and should therefore be subject to periodical review and adjustment.

What does this mean for clients?

Proper governance means management equipped and composed for its task by maintaining a diversified management team (age, gender, background), employee involvement and responsibility in order to create ownership.

Suitability: guidelines

The assessment of suitability is one of the key requirements for investor protection in the MiFID II framework. The importance of the suitability assessment for the protection of investors was already clear under MiFID I and has been confirmed under MiFID II. ESMA has given guidelines for the implementation of suitability. The guidelines concern 1) Information to clients about the purpose of the suitability assessment; 2) Know your client and your product; 3) Matching clients with suitable products and other requirements concerning qualification of staff and record-keeping.

Know your client and your product concerns 1) Arrangements necessary to understand the clients and to collect information from the clients; 2) Updating client information; 3) Client information for legal entities or groups; and 4) Arrangements necessary to understand investment products.

Matching clients with suitable products aims at 1) Arrangements necessary to ensure the suitability of an investment; and to take into account 2) Equivalent products (costs and complexity of equivalent products); and 3) Costs and benefits of switching investments.

Amendments are in preparation to also include “sustainability preferences”, “sustainability risks” and “sustainability factors” in MiFID II.

Whistleblowing – financial institutions (MiFID II)

A MiFID obligation that is still often underexposed is the requirement to maintain a whistleblowing policy and to ensure that everyone within a firm is familiar with the policy and its existence. Whistleblowing remains something too often considered to be not done. Whistleblowing is one of the most effective manners to discover potential integrity risks within a firm. The policy should allow and enable employees to report (on an anonymous basis) (potential) compliance breaches within the firm, also involving senior management members or compliance and risk officers.



Compliance function

Firms should establish, implement and maintain a compliance structure that contains adequate policies and procedures designed to detect any risk of failure by the firm to comply with its obligations under the MiFID II and other applicable laws and regulations, as well as the associated risks. Firms should put in place adequate measures and procedures designed to minimize such risk and to enable the competent authorities to exercise their powers effectively. This requirement is intended to be proportionate, meaning that for each firm different levels of compliance can apply. Investment firms are required to take into account the nature, scale and complexity of the business of the firm, and the nature and range of its investment services and activities.

Each firm should have a permanent and effective compliance function which operates independently, and which:

- monitors the adequacy and effectiveness of its measures, policies and procedures;
- advises the relevant persons responsible for carrying out investment services and activities to comply with the firm's obligations under the applicable laws and regulations;
- provides a report to the management board, on at least an annual basis (although it is advisable to do this more frequently, on the implementation and effectiveness of the overall control environment for investment services and activities, on the risks that have been identified, and on the complaints-handling reporting as well as remedies undertaken or to be undertaken;
- monitors the operations of the complaints-handling process and consider complaints as a source of relevant information.

For the compliance function to operate effectively and more importantly independently it is required that:

- it has the necessary authority, resources, expertise and access to relevant information;
- is appointed and replaced by the management board and is responsible for the compliance function and for any reporting as to compliance;
- the compliance function reports on an ad-hoc basis directly to the management board where it detects a significant risk of failure by the firm to comply with its regulatory obligations;
- the relevant persons involved in the compliance function are not involved in the performance of services or activities which they monitor; and
- the method of determining the remuneration of the relevant persons involved in the compliance function does not compromise their objectivity and is not likely to do so.



Complaints Handling

Complaints handling is one of the areas where integrity (and ethical) aspects could be at stake. Under MiFID strict rules in relation to complaint handling have been set:

- Firms should establish and maintain a complaints management policy. This should have clear, accurate and up-to-date information on the firm's complaints handling process and should be endorsed by the firm's management body.
- Firms should publish details of the process to be followed when handling a complaint, which should be provided on request or when acknowledging a complaint.
- Clients, and potential clients, should be able to submit complaints free of charge.
- Firms should have a complaints management function that enables complaints to be investigated. This role may be carried out by the compliance function.
- Firms should communicate to clients in plain language that is clearly understood and provide a response to the complaint without any unnecessary delay.
- Firms should explain to clients and potential clients the firm's position on the complaint and set out the client's options, where relevant, to refer to an alternative dispute resolution entity (KiFID), or for the client to take civil action.
- Firms should provide information on complaints and complaints handling to the relevant national competent authority ("NCA") or ADR entity.
- Firm's compliance functions should analyse complaints and complaints handling data to ensure that they identify and address any issues.

IORP II

In January 2017, the revised Institutions for Occupational Retirement Provision Directive came into force. The IORP II Directive is included in Dutch pension fund regulation and compliance is secured by the supervisor. The directive aims to ensure a high level of protection for future members and beneficiaries of pension funds while guaranteeing efficient investment. Important elements in the directive include 1) Strict prudential rules; 2) Investment rules adapted to the characteristics of IORPs and to the efficient management of savings and 3) Rules permitting IORPs' cross-border activity, enabling the creation of pan-European pension funds.

IORP II helps pension fund boards to be On Task in line with good governance as we discussed earlier in this course. Key tasks in implementing benefit schemes are: 1) Taking on pension liabilities; 2) Implementation of the pension scheme; 3) Services to participants and employers; 4) Maintaining reserves; 5) Management of the balance sheet, i.e. assets and liabilities (ALM); 6) and Investment



management, including taking into account Environmental, Social and Governance aspects of these investments.

Segregation of duties

An important element of IORP II concerns the Segregation of duties. To understand this let us go back in history to one of the first pension funds. The Chatham Chest was a fund set up in the UK in 1588 to pay pensions to disabled seamen from the Royal Navy. The Chest itself was a strong iron box with five locks as you can see on this picture. Keys for the Chest were held by five separate officials to reduce the risk of individual embezzlement. This examples shows the importance of the quality of individual board members and the board as a whole in decision making. The chest can only be opened by the collective.

IORP II: Key functions

This principle of the segregation of duties is also visible in the implementation of IORP II. Three key functions can be distinguished: the risk management function, the actuarial function and the internal audit function. In the Netherlands, the supervisor De Nederlandsche Bank sees to it that these functions are carried out independently. This has led to governance changes in the division of duties in Dutch pension fund boards and their executive offices.

The IORP II implementation in Dutch regulation also has clear requirements with regard to the three key functions. Key function holders must fulfil their role objectively, honestly and independently; and have access to relevant information. In addition, there should be an adequate separation of duties which include a direct reporting line to governance; and where appropriate to the internal supervisory body.

Given difference in sizes of pension funds and subsequently the size of the organisation, a principle of proportionality shall apply with any consequences for requirements for independence and explaining how the independence of key functions holders is (still) guaranteed in smaller organisations.

SIRA: Systematic Integrity Risk Analysis

An important instrument in risk management is the SIRA, the Systematic Integrity Risk Analysis. The SIRA is aimed at strengthening the risk management capability of financial organisations. It is a legal obligation for e.g. pension funds, insurance companies, bank, trust offices and accountants. It is required by law. The SIRA is a joint effort of management, compliance and risk management. It is not only the responsibility of the risk manager or the compliance officer. In the SIRA it is allowed to distinguish between client and services with potentially lower and higher risk profile. This will make



risk management more efficient. The SIRA consists of four activities: 1) risk identification; 2) risk analysis; 3) risk control and 4) risk monitoring and review. This is in line with risk management methodology as used by many financial institutions.

Do's and don'ts

Now that we have discussed legislation and implementation of this legislation for financial institutions, we will discuss consequences of violations of regulations and do's and don'ts.

Consequences of violations

The consequences of violations of duties by a firm vary and depend on the seriousness of the breach or offence. A distinction can be made between (a) consequences for the persons involved and (b) consequences for the firm itself.

A firm can impose disciplinary sanctions against its employees, including remuneration related sanctions and if the breach or offence is serious enough could lead to a termination of employment. Depending of the nature of the breach or offence supervisors can determine that the person(s) involved are no longer trustworthy and therefore not suitable for the function they fulfil. If trustworthiness is one of the requirements to fulfil a certain position, this would mean that the person involved will no longer qualify for that respective function and should step down.

Both persons involved and the firm itself can be exposed to (financial) penalties, both from an administrative and criminal perspective. For the firm such penalties could be connected to the firms turn-over, meaning that we are talking about serious numbers.

For the firm there is a high risk of reputational damage and the same applies to the financial sector as a whole (the credit crunch effect).

Do's

The most important thing to do is to be critical when dealing with clients comes to AML related tasks, but also if it involves compliance related matters in general. Ask clients questions (e.g. what would you like to achieve, did you consider other manners to achieve..., are these services for you or is it envisaged them to be beneficial to a wider group, is there a specific time element that we should take into account, is there a relationship with....). But also ask questions to colleagues, managers, risk officers and compliance officers in the event that you are in doubt whether or not transactions or certain behaviour could have an impact on integrity. Transactions and behaviour may be justified, but it is always better to know for sure.



Never hesitate to bring concerns to the attention of the compliance or risk officer. In case you find it difficult to openly report to the compliance and risk officer, make use of the firm's whistleblowing policy. In the unlikely event that there is no whistleblowing policy in place try to escalate it to the senior management or other designated officers within a firm. Ensure proper recording and record keeping.

Celebrate working in a diverse group of people and last but not least: walk the talk.

Don'ts

Although it often feels good to just ignore signals, this would be the wrong thing to do. Integrity issues may not only have an impact on your organization, it will most likely have an impact on yourself as well. Ignoring signals may even have consequences for your own position, depending on your role and duties. Therefore in case of any doubt or concern: never ignore and take proper actions.

Continue to facilitate trades, investments, transactions, etc. whilst it is obviously that by doing so the firm (and you) breaches applicable laws and regulations, even under the argument that you want to serve your clients interest, is an absolute no go, but in practise a mistake that is often made.

In case of AML: never inform the client about your doubt or notifications and reporting. This is not allowed under the applicable legislations and could lead to sanctions being imposed on the person(s) involved.

Given the crucial importance of IT: keep yourselves informed and make sure you do not postpone updates to protect your company for cybercrime.

Thank for taking part in the module Integrity of Financial Markets of the MiFID II Stay Compliant Program of CFA Society VBA Netherlands. You can now do the assessment to test your knowledge and understanding. Good luck!

Ethics and integrity matter

- Ethics can be defined as a **set of moral principles or rules of conduct** that provide **guidance for our behavior** when it affects others (definition CFA Institute)
- **Combatting misconduct** continuing struggle → regulatory reforms
- **Culture of integrity** in the workplace
 - Promote ethical principles throughout the company
 - Tone at top
 - Work in the best interest of clients
- Financial sector working **to the ultimate benefit of society**
 - Trust of investors
 - Robust financial markets



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Wirecard



Wirecard files for insolvency amid German accounting scandal

Move comes after former CEO at payments firm held on suspicion of falsifying accounts

Kalyeena Makortoff
11:30 Thursday, 25 June 2020

Source: The Guardian, June 2020



Wirecard asset freeze leaves vulnerable people without cash

Banking app customers and charities that use prepaid cards unable to access funds for three days

Hilary Osborne
15:58 Monday, 29 June 2020
Follow Hilary Osborne

Allegations of accounting malpractices have trailed Wirecard since the early days of its incorporation, reaching a peak in 2019 after the *Financial Times* published a series of investigations along with whistleblower complaints and internal documents. On 25 June 2020, Wirecard filed for insolvency after revelations that €1.9 billion was "missing", the termination and arrest of its CEO [Markus Braun](#). Questions are raised with regards to the regulatory failure on the part of [BaFin](#).

Source: Wiki, August 2020



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Integrity risks: examples

- Money laundering
 - Insider trading
 - Market manipulation
 - Investment fraud
 - Terrorism financing
 - Circumvention of economic and financial sanctions
 - Evasion or avoidance of tax regulations
- Scams
 - Forgery
 - Bribery
 - (Appearance of) conflicts of interest
 - Inducements
 - Independent advice
 - Cybercrime
 - ...



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Financial Integrity when delivering investment services to Institutional investors: some legislative examples and methods to enhance Financial integrity



Anti Money Laundering - AML

Applicable legislation (non exhaustive)

- European Anti-money laundering directives
- Act on prevention of money laundering and terrorism finance
- Criminal code
- Sanctions legislation
- Sector specific rules and regulations such as the Dutch Pension Act and the Dutch Financial Supervision Act

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Anti Money Laundering - AML

- Firms should be able to identify their client and need to understand the background of a transaction or investment and the nature of the funding
- Knowing your client involves research that involves the identification of the ultimate beneficial owner
- Assessment is risk based
- When: start of the relationship or in case client, jurisdiction or other circumstances require
- Recording is key: observe GDPR requirements

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Dutch bank ING fined \$900 million for failing to spot money laundering

Danske Bank: The Story Of Europe's Biggest Money Laundering Scandal



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Market Abuse

Applicable legislation (non exhaustive)

- European Market Abuse Directive
- Dutch Financial Supervision Act
- Market abuse decree
- Criminal code



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Market Abuse

- Firms should avoid facilitating transactions that lead to market abuse e.g. by means of insider trading or market manipulation
- When in doubt transactions should be postponed until clearance has been given by authorized officer/body within the firm
- Firms should maintain insider trading protocols and lists
- Chinese walls between deal team and analysts
- Assessment of service request



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MiFID II
Stay Compliant Program

UBS fined £27.6m by UK regulator for market abuse rule failings

Big fines for market manipulation – Should we panic now?

Suspected insider trading: Union Investment releases top managers

FINRA Fines Jefferies for Failure to Prevent Market Manipulation

Commerzbank fined by Cyprus regulators for market manipulation

Former Merrill Lynch broker fined £350,000 for 'serious market abuse'

Linear Investments loses appeal against £400k FCA fine for market abuse



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Enhancing financial integrity



Governance: a model



Bron: Cools, Van de Loo, Winter, 2010



Individual and group decision-making biases

- Individual decision-making biases.
 - "The new normal"
 - Override existing controls
 - Treat red flags as false alarms
 - Accept deviances and near misses
 - Escalate commitment to prior beliefs by "staying on course".
 - Incubate even more risk by "throwing good money after bad"
- Group decision-making biases
 - Individuals, still in doubt about a course of action that the majority has approved, decide to keep quiet and go along.
 - Overbearing, overconfident manager who wants to minimize conflict, delay, and challenges to his or her authority



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Governance

- Clearly a key focus for regulators globally in the wake of the credit crunch. Regulators are concerned about checks and balances and how risks are managed and controlled in firms.
- European Commission singles out corporate governance as a key contributory factor in the credit crunch.
- Conduct failures are linked with failures of corporate governance – failures in how firms deal with their customers indicate more systemic failures of internal governance.
- Corporate governance in MiFID is closely linked to other internal controls issues such as: product governance, remuneration, complaints handling and conflicts of interest.
- There are close links with the Senior Manager and Certification Regime



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Governance

- Firms to have adequate policies and procedures to ensure compliance of the firm (including managers, employees and tied agents) with MiFID obligations and personal transaction rules.
- Firms should operate effective organizational and administrative arrangements so as to take all reasonable steps to prevent conflicts of interests from adversely affecting the interests of its clients.
- Product review and approval processes should be in place (as per product governance sessions).
- Firms must ensure continuity in the performance of investment services and activities – employing appropriate and proportionate systems, resources and procedures.
- Outsourcing may be undertaken where firms ensure that they take reasonable steps to avoid undue additional operational risk. Outsourcing of important operational functions may not be undertaken in such a way as to materially impair the quality of its internal control and the ability of the supervisor to monitor the firm's compliance with all obligations.
- Firms need to have sound administrative and accounting procedures, internal control mechanisms, effective procedures for risk assessment, and effective control and safeguard arrangements for information processing systems.
- Firms need to have sound security mechanisms to guarantee the security and authentication of the means of transfer of information, minimize the risk of data corruption and unauthorized access and maintaining confidentiality of information.
- Firms must keep records sufficient for the competent authority to supervise and enforce.
- Firms must make appropriate arrangements to safeguard ownership of clients to client money / financial instruments.



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Organizational requirements

- MiFID II goes further than MiFID did in focusing on, and directing, the activities and responsibilities of the management of in-scope firms.
- Firm's management bodies must define, approve, oversee, and scrutinize the firm's organization for the provision of its investment services.
- Generally, management should take into account skills, knowledge, and experience required by personnel and the resources, procedures, and arrangements for the provision of the firm's services.
- Specific requirements attach to firms undertaking particular activities (e.g. firms providing independent advice or portfolio management are required to have policies as part of their organizational requirements to ensure proper treatment of third-party payments).
- MiFID II specifically states that the management body is responsible and "accountable" for the implementation of effective government arrangements.



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What does this mean for clients?



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Suitability: guidelines

- Information to clients about the purpose of the suitability assessment
- Know your client and your product
 - Arrangements necessary to understand the clients and to collect information from the clients
 - Updating client information
 - Client information for legal entities or groups
 - Arrangements necessary to understand investment products
- Matching clients with suitable products
 - Arrangements necessary to ensure the suitability of an investment
 - Equivalent products taken into account (costs and complexity of equivalent products)
 - Costs and benefits of switching investments
- Other related requirements
 - Qualification of staff
 - Record-keeping



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Whistleblowing – financial institutions (MiFID II)

- MiFID II (together with other EU legislation) requires whistleblowing mechanisms and obligations
- firms must have appropriate internal procedures in place allowing employees to whistleblow in respect of the firm's obligations under MiFID II
- Who: interdealer brokers, firms engaging in algorithmic and high frequency trading, trading venues including regulated markets, multilateral trading facilities, and prospective organized trading facilities, prospective data reporting service providers, investment managers, stockbrokers, investment advisers and corporate finance firms and venture capital firms

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Compliance function

Policies and Procedures

Firms are required to:

- establish, implement and maintain adequate policies and procedures designed to detect any risk of failure by the firm to comply with its obligations under the MiFID II Directive, as well as the associated risks and put in place adequate measures and procedures designed to minimize such risk and to enable the competent authorities to exercise their powers effectively under the directive.
- This requirement is intended to be proportionate. Investment firms are required to take into account the nature, scale and complexity of the business of the firm, and the nature and range of its investment services and activities (see Recital 37 guidance on proportionality).

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Compliance function

Establishment of Permanent and Effective Compliance Function

Firms are required to establish a permanent and effective compliance function which operates independently, and which:

- monitors the adequacy and effectiveness of its measures, policies and procedures;
- advises the relevant persons responsible for carrying out investment services and activities to comply with the firm's obligations under the MiFID II Directive;
- provides a report to the management body, on at least an annual basis, on the implementation and effectiveness of the overall control environment for investment services and activities, on the risks that have been identified and on the complaints-handling reporting as well as remedies undertaken or to be undertaken;
- monitors the operations of the complaints-handling process and consider complaints as a source of relevant information.

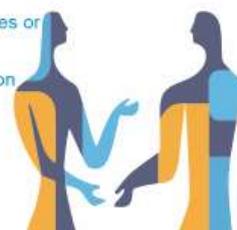


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Compliance function

Operation of the Compliance Function

- In order to enable the compliance function to discharge its responsibilities properly and independently firms must ensure:
- the compliance function has the necessary authority, resources, expertise and access to relevant information;
- a compliance officer is appointed and replaced by the management body and is responsible for the compliance function and for any reporting as to compliance;
- the compliance function reports on an ad-hoc basis directly to the management body where it detects a significant risk of failure by the firm to comply with its MiFID II obligations;
- the relevant persons involved in the compliance function are not involved in the performance of services or activities which they monitor; and
- the method of determining the remuneration of the relevant persons involved in the compliance function does not compromise their objectivity and is not likely to do so.



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Complaints Handling

According to MIFID Regulations :

- Firms should establish and maintain a complaints management policy. This should have clear, accurate and up-to-date information on the firm's complaints handling process and should be endorsed by the firm's management body.
- Firms should publish details of the process to be followed when handling a complaint, which should be provided on request or when acknowledging a complaint.
- Clients, and potential clients, should be able to submit complaints free of charge.
- Firms should have a complaints management function that enables complaints to be investigated. This role may be carried out by the compliance function.
- Firms should communicate to clients in plain language that is clearly understood and provide a response to the complaint without any unnecessary delay.
- Firms should explain to clients and potential clients the firm's position on the complaint and set out the client's options, where relevant, to refer to an alternative dispute resolution ("ADR") entity, or for the client to take civil action.
- Firms should provide information on complaints and complaints handling to the relevant national competent authority ("NCA") or ADR entity.
- Firm's compliance functions should analyze complaints and complaints handling data to ensure that they identify and address any issues.



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IORP II

The directive aims to ensure a high level of protection for future pensioners (members and beneficiaries of pension funds) while guaranteeing efficient investment by establishing the following rules:

1. Strict prudential rules, the specifics of which are to be determined by each EU country, to protect members and beneficiaries of IORPs who must have sufficient information about the rules of the pension scheme, the IORP's financial situation and their rights.
2. Investment rules adapted to the characteristics of IORPs and to the efficient management of savings. IORPs are long-term investors that have to deliver the best returns to their members and beneficiaries at the same time as keeping their investments safe. If each IORP is to establish the safest and most efficient investment policy, the investment rules, and in particular the rules for investing in shares, must not be too restrictive.
3. Rules permitting IORPs' cross-border activity, enabling the creation of pan-European pension funds. Cross-border management requires mutual recognition of supervisory methods in force in EU countries.



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On Task: IORP II

The **key tasks** in implementing benefit **schemes** are:

- Taking on pension liabilities;
- Implementation of the pension scheme;
- Services to participants and employers;
- Maintaining reserves;
- Management of assets and liabilities (ALM); and
- Investment management (including ESG).



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Segregation of duties

- The **Chatham Chest** was a fund set up in 1588 to pay pensions to disabled seamen from the Royal Navy.
- The Chest itself was a strong iron box with five locks,
- Keys for the Chest were held by five separate officials to reduce the risk of individual embezzlement.



Source: <http://collections.tmg.co.uk/collections/objects/3284.html>



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IORP II: Key functions

- **Risk management function**
 - designed to promote risk management
- **Actuarial function**
 - is responsible for actuarial activities, *including*
 - monitoring the calculation of technical provisions;
 - assessing the reliability and adequacy of the calculation of technical provisions
- **Internal audit function**
 - is responsible for the internal audit, *including*
 - evaluation whether the internal control mechanisms and other procedures and measures to ensure the integrity and management of the operations, including, where appropriate, the outsourced operations, are adequate and effective.



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Requirements key functions

Key function holders must:

- to fulfil their role objectively, honestly and independently; and
- have access to relevant information

In addition, there should be an **adequate separation of duties**:

- A direct reporting line to governance; and
- where appropriate to the internal supervisory body

A principle of **proportionality** shall apply:

- with any consequences for requirements for independence;
- explaining how the independence of key functions holders is (still) guaranteed



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SIRA: Systematic Integrity Risk Analysis

- Legal obligation for e.g. pension funds, insurance companies, bank, trust offices and accountants
- Necessary for compliance
- Joint effort of management, compliance and risk management
- Distinguish between client and services with potentially lower and higher risk profile
- Distinguish four activities:
 - risk identification
 - risk analysis
 - risk control
 - risk monitoring and review



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MiFID II
Stay Compliant Program

Do's and don't's



Consequences of violations

- Disciplinary sanctions
- Penalties both for financial institution and employee(s) and/or senior manager(s) involved
- Imprisonment employee(s) and/or senior manager(s) involved
- Reputational damage
- Suitability issues for (senior) management position and approvals
- Damage financial sector as a whole (credit crunch effect)

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Do's

- Ask questions (e.g. what would you like to achieve, did you consider other manners to achieve..., are these services for you or is it envisaged them to be beneficial to a wider group, is there a specific time element that we should take into account, is there a relationship with....)
- Report an/or escalate to compliance and risk officer
- Escalate to senior management or designated officers (whistleblowing) in case concerns are not taken seriously
- Record and store all documents and information
- In case of AML: never inform the client about your doubt or notifications and reportings
- Invest in permanent education and knowledge of regulation
- Celebrate diversity and take responsibility if diversity is an issue
- Walk the talk

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Don'ts

- Ignore signals
- Not taking actions
- Continue to facilitate trades, investments, transactions, etc.
- Informing client about AML related actions
- Postpone software updates to avoid cybercrime
- Leave confidential information unprotected

