



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

T +353 1 224 6000 F +353 1 671 6561

Bosca OP 559, Sráid an Dáma, Baile Átha Cliath 2, Éire.
PO Box No. 559 Dame Street, Dublin 2, Ireland.

www.centralbank.ie

25 February 2016

Dear Chairperson,

The Central Bank of Ireland (the “Central Bank”) carried out a themed inspection to examine the processes for the identification and management of conflicts of interest (“COI”) in investment firms¹ (the “Firms”). COI are inherent risks to clients and businesses alike. It is the Central Bank’s expectation that COI should be avoided, and managed appropriately where they cannot be avoided. The regulatory requirements under MIFID, UCITS and AIFMD² clearly oblige firms to establish and maintain an effective organisational model that actively monitors COI on a day-to-day basis so as to ensure that the best interests of clients are not negatively impacted. The purpose of this letter is to provide feedback on the Central Bank’s findings and to highlight a number of trends which you should consider in the context of your firm.

The themed inspection identified a number of failings around the management of COI. It identified a lack of board ownership in relation to the identification and management of COI. There is an onus on boards to engrain in the culture of their firm a duty to act in the best interest of the client in all instances. As the Chair of the Board, you are in an optimal position to take a holistic and objective approach to COI. Furthermore, as you are a key influencer, you are in a position to determine any change required.

As outlined in the Consumer Protection Outlook Report³, and as referred to in recent speeches⁴, the Central Bank sees culture as a key driver for the behaviour of firms and the individuals within them.

¹ MiFID and UCITS Managers with Individual Portfolio Management

² S.I. No.60 of 2007 European Communities (Markets in Financial Instruments) Regulations, 2007 (“MiFID”) Regulations 33, 39, 74, 75, 78.

S.I. 352/2011 - European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2011 Schedule 5 Paragraphs 65-73.

S.I. No. 257 of 2013 European Union (Alternative Investment Fund Managers) Regulations 2013 Regulation 15.

³ February 2015: <https://www.centralbank.ie/publications/Documents/Consumer%20Protection%20Outlook%20Report%202015.pdf>

Good firm culture is fundamental to ensuring good client outcomes. The Central Bank's thematic inspection confirmed that where firms have a strong compliance culture, COI are effectively managed.

Identification

The identification of COI is the first step in ensuring that no client detriment arises. If a firm cannot identify where a potential COI could exist, it will not be able to prevent a crystallised COI negatively impacting the client.

Firms are not operating in a Conflict Aware environment

The review clearly identified that the majority of the Firms reviewed were not operating in a COI-aware environment, and could not demonstrate that they had ensured that the best interest of the client was paramount in all instances. As opposed to demonstrating cultural awareness of COI, worst-in-class firms failed to realise the potential for COI that may occur in their firms. Many senior members of management had made the incorrect assumption that COI "do not arise" in their firms. On the contrary, COI arise in all firms. As the Firms in this review had similar regulatory permissions and provided similar services, there was an expectation that their similar business models would have similar COI. Many of the COI identified by the best-in-class firms did not appear on the COI logs of the worst-in-class firms. Whilst worst-in-class firms demonstrated that policies and procedures were in place, their ability to identify COI was poor.

Firms with a strong compliance culture identified more COI

Firms with a strong compliance culture succeeded in demonstrating a high level of COI awareness. These firms took a holistic approach to COI and had embedded a COI aware environment in the firm culture. These firms also maintained detailed COI logs, and as expected, identified the COI which arises due to an employee having a personal connection with another party. We had anticipated that all firms would have identified this potential COI.

In firms with a strong compliance culture, responsibility for the COI process was clearly allocated to accountable individuals and the identification of COI was seen as all employees' responsibility.

Appendix 1 highlights the key findings from the themed inspection. Appendix 2 outlines the good practices observed during the inspection, and also the poor practices which the Central Bank does not expect to see firms display in the future. This is not an exhaustive list of good and poor practices and firms should at all times be evaluating their own COI, how their COI are evolving and how they are best managed and mitigated.

⁴ Speeches by both Sylvia Cronin and Gerry Cross <http://www.centralbank.ie/press-area/speeches/Pages/default.aspx>

Action Required

The Central Bank requires your firm to:

1. Review all COI policies and procedures to ensure they meet the relevant requirements;
2. Consider all good and poor practices listed in Appendix 2 against your own COI procedures;
and
3. Review your current list of identified COI to ensure it remains up to date and relevant.

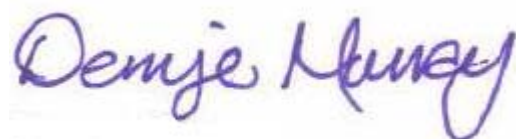
The Central Bank expects that this letter will be discussed, considered and minuted by the board before 30 June 2016.

Where the Central Bank identified risks to consumers, due to the issues outlined above, formal supervisory requirements have been imposed on the relevant firms.

Please be advised that, where there is non-compliance with the relevant regulatory requirements, the Central Bank will have regard to the consideration given by any firm to this letter, when exercising its regulatory and enforcement powers. Issues raised in this industry letter may be considered during the conduct of future inspections.

Should you have any queries regarding the content of this letter please contact iffs.mifid.conduct@centralbank.ie.

Yours sincerely



Denise Murray
Deputy Head, Investment Firms and Fund Services

Appendix 1: Summary of overall findings

The review identified the following key findings:

General trends

Although the Firms reviewed had policies and procedures in place in respect of COI, many of these fell short of meeting the COI requirements. In addition, some of the Firms failed to implement their policies and procedures in line with the requirements. The review also noted that certain Firms' COI logs were not live documents and some of the COI logs were blank.

Many of the Firms failed to demonstrate that they had considered, at a minimum, all of the different COI scenarios listed in the applicable regulations⁵. If these firms failed to embed the scenarios provided in the regulations, this raises greater concerns about the ability of the Firms to capture their firm specific COI.

A number of Firms also failed to clearly communicate with and train employees on their obligations around COI, in order to enable COI identification from the ground up.

Personal Account Dealing

The vast majority of the Firms reviewed permitted their employees to carry out personal account ("PA") dealing and had adequate PA dealing procedures in place. Supervisors were pleased to note that PA dealing rules applied to all staff members (including Executive Directors) and that pre trade checks on all PA deals was a common practice observed. However, Supervisors were concerned that only one firm carried out post trade analysis on PA deals. Post trade checks on PA deals can identify any trends or patterns such as front running client orders or front running investment research. Supervisors expected all firms to carry out such checks.

Gifts and Entertainment

Supervisors were surprised to find, that many of the Firms did not consider how the acceptance of gifts and entertainment could compromise their duty to act in the clients' best interest. Supervisors saw examples of expensive gifts received by staff that, if disclosed to clients, might have caused concern about the objectivity of decisions taken on the clients' behalf. These Firms failed to take into account how gifts/entertainment might be perceived by clients or influence the decision making of staff.

Half of the Firms reviewed did not have a control process around outgoing gifts. To comply with applicable regulations⁶ regarding non-monetary benefits, gifts and entertainment, firms are required to have a robust control process in place to record not only incoming gifts, but also all outgoing gifts.

Intragroup Relationships

In relation to the Firms' use of intragroup entities services/products, it was evident from the review that, overall, the Firms were cognisant of the possible COI these arrangements may present. Supervisors noted that intragroup relationships appear to be managed accordingly on an arm's

⁵ Regulation 75(1) of S.I. No.60 of 2007 European Communities (Markets in Financial Instruments) Regulations, 2007 and UCITS Regulations, Schedule 5 paragraph 65

⁶ Regulation 78 (1) and (2) of S.I. No.60 of 2007 European Communities (Markets in Financial Instruments) Regulations, 2007 and UCITS Regulations Schedule 5, 28

length basis and observed that the Firms are being mindful that the use of group entities may not be in the best interests of the client. The Firms however could improve their management of the COI that arises where management or a director propose to take on a role in another group entity. In such cases a firm's board should assess from a COI perspective any proposals for management/board members to take on a board/management position in another group entity.

Best in class approach to COI

All of the best in class firms demonstrated a common approach to the management of COI. These firms took a holistic approach to COI, considering COI from both a bottom up and top down approach and had embedded a COI aware environment in the firm culture.

Appendix 2: Good and Poor practice

General Trends
Good practices:
Operating in a conflict aware environment with an established framework for the identification and management of COI. Firm culture is central to identifying COI.
COI policies make it clear to employees that the clients' interests are paramount. COI training is provided on a regular basis, to remind staff of how COI may exist and it also encourages employees to identify COI.
For the purpose of COI identification, the firm utilises the COI scenarios outlined in the requirements as a starting point and then looks at: <ul style="list-style-type: none">• the type of COI which may arise, in light of the firms' business models (structural COI); and• the firm specific COI (i.e. personal connections of management etc.).
Business and compliance functions work together to monitor COI for more effective identification and management of COI.
COI documentation clearly sets out how each structural COI and firm specific COI is managed and mitigated.
COI are considered from both a bottom up and a top down basis, at least semi-annually, or at any time of a change to business model/new product. A COI committee was established, where it was proportionate to the nature, scale and complexity of the firm.
The use of internal audit or third parties to deliver enhanced COI identification and management.
Consideration has been given to the changing COI requirements under MiFID II.
Practices that should cause the board concern:
Not recognising any COI in the business, and believing the business model does not create any COI. This was demonstrated through blank COI logs and firms not having a mechanism in place to identify new COI as they arise, e.g. a new employee is taken on, or a new product is created.
Firms failing to: <ul style="list-style-type: none">• recognise that personal connections of employees may give rise to a COI;• have a process in place to identify this COI as it arises; and• place an obligation on employees to disclose such connections.

Gifts and Entertainment
Good practices:
All gifts/entertainment received and provided are recorded in the gifts log. The gift policy applies to all gifts, including frequent and low value gifts. A valid business reason is recorded for each gift. Requiring a business reason for each gift, led to the firm evaluating the intent of the offering party of the gift.
Reminders provided to employees regarding the gifts policy requirements, especially at relevant times i.e. the lead up to Christmas or major sporting events.
All gifts above a non-material amount (€50 for example) are required to go through an approval process and board/CEO approval is required for any high value gifts.
In order to identify trends, the cumulative value of gifts received or provided by/to a single

employee/from or to a single entity, over a specific time period, is considered.

Practices that should cause the board concern:

Incorrectly assuming that an inadequately documented gifts policy is in line with peer practice.

No consideration of how gifts may be perceived if they were disclosed to clients.

Inability to demonstrate compliance with the Regulations as there was no out-going gifts/entertainment log.

Declined gifts not recorded on the gifts log, in order to assist in the identification of trends.

PA Dealing

Good practices:

Post trade analysis completed on all PA deals. Post trade analysis would detect negative behavioural issues, should they occur (insider dealing, front running client orders or front running investment research).

PA rules and policies apply to all staff, without exception.

PA trading rules apply not only to employees, but also to any transaction from which the employee may benefit i.e. their spouse, or relative sharing their home etc.

PA rules requiring staff to trade only as long term investors and obliging employees to hold any position for a minimum holding period.

In order to eliminate confusion, for example where employees need to carve out transactions that do not require approval, the PA dealing approval process was applied to all securities.

Periodic reviews of broker confirmation statements against employees' relevant holding positions to ensure that only the pre-approved transactions have taken place.

Employees required to self-declare that they have no conflict regarding a proposed PA trade.

Practices that should cause the board concern:

A blanket ban on PA dealing which may lead to employees ignoring or circumnavigating the PA dealing ban.

Allowing retrospective compliance approval for PA deals that have already been executed.

Not demonstrating consideration as to whether additional controls are required for PA dealing in riskier, more sophisticated instruments such as options, futures or CFDs.

Intra Company Relationships

Good practices:

Intercompany relationships are managed at arm's length and with standard commercial terms.

When selecting a service provider, firms are able to justify the use of an intergroup entity over an external party.

Adequate separation of activities between group entities/business units engaging in potentially conflicting activity, including:

- the use of Chinese/Ethical walls;
- separate distinct reporting lines;

- physical separation of office locations between entities; and
- staff providing services to only one entity within the group and having defined roles.

Use of group products or services and any benefit accrued to the firm, are clearly disclosed to any impacted clients.

Employee systems access limited to relevant client information only, in order to eliminate the risk of a COI. This is particularly relevant where group entities are using a common platform/ IT systems.

Practices that should cause the board concern:

No formal board approval process prior to employees/board members taking a board/management position in another group entity. Failing to recognise the potential COI that arises where an employee is attempting to serve two masters.