

Internal  
Governance  
Requirements  
and the Hall of  
Mirrors in the  
CRD and MiFID

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## INTERNAL GOVERNANCE REQUIREMENTS AND THE HALL OF MIRRORS IN THE CRD AND MIFID

### Introduction

*With some overlapping between the Capital Requirements Directive (CRD) and the Markets in Financial Instruments Directive (MiFID) credit institutions and investment firms have the opportunity now to minimise duplication of compliance measures by identifying the common requirements, revising their internal governance framework accordingly and consequently improving their governance cohesion and reducing costs, write Paula Kelleher and Shane King.*

Next year credit institutions and investment firms which are subject to the Capital Requirements Directive (“CRD”) and the Markets in Financial Instruments Directive (“MiFID”) may be forgiven for feeling faint when they face two separate sets of internal governance requirements, many of which regulate the same matters. Credit institutions and investment firms have the opportunity now to minimise duplication of compliance measures by identifying the common requirements, revising their internal governance framework accordingly and consequently improving their governance cohesion and reducing costs.

The regulatory map for credit institutions and investment firms (“firms”) is currently undergoing significant reshaping in the Office of the Parliamentary Counsel to the Government as we wait for the signed national regulations to implement the CRD and MiFID. Public consultation on the CRD by the Financial Regulator is underway and most recently the Financial Regulator has written to firms requesting their views on its proposals for implementation of the CRD. In particular firms have been asked to notify the Financial Regulator when they plan to switch to the new regulatory requirements of the CRD.

Firms intending to switch to the new CRD regulatory regime on 1 January 2007 or 1 January 2008 must notify the Financial Regulator by 31 October 2006 and 31 December 2006 respectively. Prior to switchover various elements of the current ‘Capital Adequacy Directive’ e.g. calculation of regulatory capital, and the CRD will apply to firms. In particular the ‘internal governance obligations’ of the CRD will apply to firms from 1 January 2007. Under Article 22 of the CRD, firms are required to have in place an internal governance framework to include:

- ▣ A clear organisational structure with well defined, transparent and consistent lines of responsibility (new stated requirement)
- ▣ Effective processes to identify, manage, monitor and report risks (new stated requirement)
- ▣ Adequate internal control mechanisms – to include administrative and accounting procedures

Further detailed guidance regarding the implementation of these requirements is contained in Annex V of the CRD and the Committee of European Banking Supervisor's (CEBS) Guidelines including, 'Guidelines on the Application of the Supervisory Review Process under Pillar II' (2006) and the Basel Committee on Banking Supervision's (BIS) 'Sound Practices for the Management and Supervision of Operational Risk' (2003).

The internal governance requirements apply to firms which are carrying out MiFID activities e.g. a retail bank providing investment advice and concluding the sale of shares or a corporate finance firm accepting and transmitting orders between investors. The same firms will face separate but similar internal governance requirements under MiFID.

The MiFID requirements will be applied to firms from 1 November 2007 and these mirror the CRD requirements at a high level. The recently approved Commission Directive 2006/73/EC ("MiFID Implementing Directive") that implements the high level requirements of MiFID and the CEBS and BIS Guidelines in relation to the CRD equally have large areas of mutual compatibility. Significantly for smaller firms, both Directives provide that the Financial Regulator must take account of the nature, scale and complexity of each firm's business when deciding how to apply these requirements. Once firms know what the common requirements are, they can review their internal governance organisation and controls accordingly e.g. streamline their systems and align their management structure, to comply with both Directives.

The overlapping requirements fall under two broad categories of corporate structure and organisation and internal controls.

## Corporate Structure and Organisation

Both the CRD and MiFID require firms to have clearly defined organisational structures which specify consistent reporting lines and allocate functions and responsibilities. In particular, senior management is responsible for arranging the segregation of management and staff duties and in this regard both Directives require firms to establish and maintain

policies to prevent and manage conflicts of interest. The MiFID imposes more onerous obligations than the CRD, in that it requests that a conflict of interest policy should be made in writing and what it should contain, including identifying what circumstances may give rise to a conflict.

The CRD and MiFID require that firms must also have sound accounting procedures and establish, implement and maintain accounting policies and procedures, although MiFID goes further than CRD in expressly requiring firms to have the capacity to deliver financial reports which give a 'true and fair view of their financial position and which comply with all applicable accounting standards and rules'.

As regards business continuity the MiFID requires the establishment, implementation and maintenance of a business continuity policy to ensure continuity of a firm's investment services and activities in the case of an interruption to its systems and procedures and similarly the CRD requires a firm to have contingency and business continuity plans. Although the CRD requirement applies to severe business disruption and risks other than operations risks e.g. liquidity risk, it may be feasible for some firms to put a business continuity plan in place that covers as many disruptions as possible and applies to MiFID and CRD only activities.

Firms are also required to ensure they have effective internal reporting and communication of information in place. The MiFID requirements go further than the CRD by requiring firms to put in place effective safeguards to ensure security, integrity and confidentiality of information and information processing. If firms are outsourcing business functions, part of which includes the processing of information relating to MiFID and CRD-only business e.g. their backroom administration, then commercial difficulties may arise where dual regulatory standards have to be applied, unless of course the firm adjusts its procedures and controls to fulfil the higher standard. Firms may want to apply the higher MiFID standard to all services in order to avoid duplication, if for example they are introducing integrated communications systems for both types of business. The activity of outsourcing is also more heavily regulated under MiFID than the CRD, so firms may also want to consider if they can and want to apply the higher MiFID standard for outsourcing, to their CRD only business. The Financial Services Authority in the UK has stated that it intends to impose the higher standard to CRD only business but it remains to be seen if the Financial Regulator in Ireland intends to impose such super equivalent standards on CRD only business.

## Internal Controls

The CRD and MiFID oblige firms to establish, implement and maintain adequate risk control policies and also to regularly review and monitor these policies and also to establish a risk management function to implement an effective and comprehensive system of internal control. There is scope for firms to fulfil both sets of requirements and apply them to MiFID and non-MiFID business, however, when firms prepare their risk management strategy they will have to prepare separately regarding specific risks that must be provided for under the CRD e.g. credit and counterparty, residual, market liquidity and securitisation risk. The latter are quite separate from the scope of the risk that MiFID applies to i.e. the firm's operations.

The MiFID requires investment firms to have a permanent compliance function with responsibility for establishing policies and procedures to detect and minimise risk and monitor such procedures. It also requires investment firms to establish and maintain an independent internal audit function charged with detailed responsibilities e.g. establish and maintain an audit plan. While the CRD is not as explicit in stating such requirements, the CEBS Guidelines implementing the CRD describe these functions as necessary. For a firm that provides MiFID and CRD only services and that wants to put independent compliance and audit functions in place, it has an opportunity now to align such functions to cover both services and maximize economies of scale.

Finally, the Financial Regulator has previously stated to industry that it wishes to avoid imposing duplicate internal governance requirements on firms and in the most recent 'Consultation Paper on the Implementation of the CRD - 3 October 2006', the Financial Regulator directs firms to CEBS and BIS Guidelines to help them to define their regulatory requirements. At the moment it seems that it will be up to firms and not the Financial Regulator to decide how they comply with the common requirements and what standards they should apply to their MiFID and CRD only services. In any event, the initiative is with firms and any firm that takes the time now to review its internal governance framework in view of these common requirements, stands to benefit from improved governance efficiency and the likely reduction in costs that such improved efficiency brings.

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