

Follow-up Report

to the peer review on certain aspects of the compliance function under MiFID I

List of Acronyms and Terms Used

AIF	Alternative Investment Funds
AML	Anti-Money Laundering
CFD	Contract for Differences
CRD	Capital Requirements Directive
CSA	Common Supervisory Action
EBA	European Banking Authority
ESMAR	Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC
EU	European Union
IRD	Investment Firm Directive
MiFID I	Markets in Financial Instruments Directive (Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC)

MiFID II	Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast)
NCA	National Competent Authority
SREP	Supervisory Review and Evaluation Process
UCITS	Undertakings for Collective Investment in Transferable Securities
VICA	Validated in Control Assessment

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1 Executive Summary

1. This follow-up peer review report updates on the actions that National Competent Authorities (NCAs) have undertaken to address the issues identified in the ESMA 2017 peer review on the Guidelines on certain aspects of the compliance function under MiFID I (the Guidelines)¹.
2. The compliance function acts as a key second line of defence and plays a crucial role within firms to identify, assess, monitor and report on the firm's compliance risk as set in MiFID.
3. In 2012, ESMA issued Guidelines to promote the effective and consistent performance of the compliance function and enhance the related NCAs' supervisory approach. These Guidelines were the basis of the peer review that ESMA conducted in 2017 covering all NCAs in their supervision of investment firms.² ESMA subsequently updated these Guidelines in 2020³. However, the relevant provisions assessed in the peer review and the follow-up remain valid.
4. The peer review identified that five NCAs (CY, EL, IS, NL, SI) needed to improve their practices when supervising certain aspects of the compliance function. With this follow-up, ESMA assesses whether these five NCAs improved their practices based on the peer review findings.
5. The follow-up peer review identifies that all NCAs have made progress since the peer review in addressing points of partial or insufficient compliance. NCAs have strengthened supervisory practices / framework, undertaken investigations and thematic reviews, introduced sample checks, and / or taken enforcement actions. For two NCAs (CY and IS) additional elements would still need to be considered.
6. In particular, while CY has conducted supervisory work on firms' compliance function since the peer review, it has introduced a more extensive focus only more recently. ESMA invites CY to consolidate its supervisory approach to ensure ongoing supervisory focus on firms' compliance function commensurate to the number, size and complexity of firms supervised. For IS, ESMA expects the NCA to (i) complement its supervision of the compliance function in relation to banks (based primarily on the EBA's Guidelines on internal governance and on the ECB's Supervisory Review and Evaluation Process) structurally considering all elements from the ESMA Guidelines, and (ii) increase its controls on the compliance function of non-banking investment firms.
7. As the compliance function remains a key element to promote sound and compliant behaviour by firms and a key source of information for supervisors, ESMA reiterates

to all NCAs the importance of continued and meaningful supervisory efforts in this area, with a view to ensuring that supervised entities maintain strong and effective compliance functions.

¹ The peer review report (ESMA42-111-4285) was published on 29 November 2017 and is available at: https://www.esma.europa.eu/sites/default/files/library/esma42-111-4285_peer_review_on_certain_aspects_of_the_compliance_function_under_mi-fid_i.pdf

² The Guidelines apply to competent authorities and to the following market participants (i) investment firms when carrying out investment services or investment activities or when selling or advising clients in relation to structured deposits; (ii) credit institutions when carrying out investment services or investment activities or when selling or advising clients in relation to structured deposits; (iii) undertakings for collective investment in transferable securities (UCITS) management companies when providing the services referred to in Article 6(3) of the UCITS Directive, in accordance with Article 6(4) of that Directive; and (iv) alternative investment fund managers (AIFMs) when providing the services referred to in Article 6(4) of the AIFMD, in accordance with Article 6(6) of that Directive. Unless otherwise specified, references in this report to the term 'investment firms' captures the types of firms listed in (i) to (iv).

³ These Guidelines came into effect on 5 August 2020 and are available at: https://www.esma.europa.eu/sites/default/files/library/esma35-36-1946_final_report_guidelines_on_certain_aspects_of_the_mifid_ii_compliance_function.pdf. The relevant provisions assessed in the peer review remain valid.

2 Introduction

8. This report provides an update on the actions certain NCAs have undertaken further to the 2017 peer review report on certain aspects of the compliance function under MiFID I (the peer review report).
9. The compliance function plays a key role in promoting the sound and compliant functioning of a firm. It acts as a second line of defence that identifies, assesses, advises, monitors and reports on the risk when a firm fails to comply with its obligations, as set out in MiFID. The compliance function can provide a key source of information to supervisors on the firm's compliance with its obligations.
10. Protection of investors is core to ESMA's mission. In 2012, ESMA published the Guidelines to clarify the application of certain aspects of the MiFID I compliance function requirements, in order to promote the effective and consistent performance of this function and enhance the related NCAs' supervisory approach. Since then, MiFID II was adopted and ESMA published updated Guidelines in 2020. While the objectives of the compliance function as well as the key principles underpinning the regulatory requirements have remained unchanged, the obligations have been further strengthened, broadened and detailed under MiFID II. The relevant provisions of the Guidelines for this follow-up remain valid under the new Guidelines.
11. The Guidelines cover key elements of the compliance function, such as its responsibilities, organisational requirements, and the competent authority's review of the compliance function.
12. Following the publication of the 2012 Guidelines, ESMA published the compliance table for these Guidelines, which indicated that all NCAs had communicated that they complied or intended to comply with them.
13. Given the importance of this topic, in 2017 ESMA carried out a peer review on NCAs' supervisory practices for investment firms in consideration of the Guidelines. Peer reviews are key tools to assess and further improve the effectiveness and consistency of NCAs' supervision.
14. The peer reviews focused on some key responsibilities of the compliance function, notably:
 - Guideline 1 (compliance risk assessment);
 - Guideline 2 (monitoring obligations);
 - Guideline 3 (reporting obligations); and
 - Guideline 4 (advisory obligations).

15. The peer review assessed the supervisory practices of all (31) NCAs in the EU/ EEA, looking at their authorisation and on-going supervisory processes of firms.
16. The peer review assessed whether NCAs were either compliant, partially compliant, or insufficiently compliant in supervising the Guidelines.
17. Overall, the peer review found a high level of compliance by most authorities. At the same time, it identified weaknesses and issued recommendations to some NCAs, in particular CY, EL, IS, NL, SI, determining that they were, for the most part, either insufficiently or partially compliant in supervising some or all Guidelines 1 – 4.⁴ This follow-up aims to consider developments and provide an update on how these five NCAs have taken on board the peer review’s findings and recommendations.

3 Follow-up process

18. The ESMA Board of Supervisors agreed on conducting this follow-up in the ESMA 2021-2022 Peer Review Work Plan.
19. ESMA carried out the assessment through a desk-based information gathering exercise to determine progress in addressing the weaknesses identified in the peer review. ESMA’s analysis did not cover the actual supervisory files produced by the NCAs nor exchanges between the NCAs and the supervised firms. The analysis therefore relies on and is based on the descriptions provided by NCAs on their supervisory practices and practical implementation.
20. The work was launched through letters by ESMA’s Chair and focused on areas for which findings have been identified in the peer review report, namely:
 - CY, IS, NL, SI in respect of Guideline 1 ‘Compliance risk assessment’;
 - CY, EL, IS, NL SI in respect of Guideline 2 ‘Monitoring obligations of the compliance function’;
 - CY, IS, NL, SI, in respect of Guideline 3 ‘Reporting obligations of the compliance function’ and
 - CY, EL, IS, NL, SI in respect of Guideline 4 ‘Advisory obligations of the compliance function’.

⁴ Some NCAs (DK, FR, MT, PT and SE) were also assessed as partially compliant in one or two assessment areas but overall had satisfactory findings. As such these NCAs were not included in this follow-up exercise.

Table 1 – Country codes and acronyms of Competent Authorities covered in ESMA's follow-up.

Country Code	Country	Competent Authority	Acronym
CY	Cyprus	Επιτροπή Κεφαλαιαγοράς Κύπρου	CySEC
EL	Greece	Ελληνική Επιτροπή Κεφαλαιαγοράς	HCMC
IS	Iceland	Seðlabanki Íslands	CBI
NL	Netherlands	Autoriteit Financiële Markten	AFM
SI	Slovenia	Agencija za trg vrednostnih papirjev	ATVP

3.1 Overview of the follow-up assessment

21. The following section presents the overview of the follow up assessment per NCA regarding their supervision of the compliance function in investment firms, in alphabetical order.

3.2 Cyprus

22. The peer review report identified insufficient application by CY of:

- Guideline 1 - checking that the compliance function at firms performs compliance risk assessments as part of their risk-based approach.
- Guideline 2a - checking that firms use the compliance risk-assessment to determine the compliance function's monitoring programme.
- Guideline 4b - checking that the compliance function provides training support for the staff of firms.

23. The peer review report also identified partial compliance by CY with:

- Guideline 2b - evaluating the content of the monitoring programme and the priorities it establishes.

- Guideline 2c - supervising whether the compliance function has access to all customer complaints received by the firm and whether these are used in the monitoring programme.
 - Guideline 2d - checking that the compliance monitoring programme is appropriately amended when there is an event that may influence the risk profile of the firm.
 - Guideline 3c - monitoring the content of the compliance report.
 - Guideline 4a - supervising the compliance function's advisory role.
24. The peer review report also identified in more general terms that it was a challenge for CY to conduct intensive supervision in high-risk and medium/high risk investment firms considering its resources. The peer review recommended increasing resources dedicated to the supervision of the over 200 firms supervised, and specifically training new staff to enhance on-site supervision of investment firms.

CY response

3.2.1 General

25. In response to the ESMA Chair's letter, CY noted that the supervision and further enhancement of the compliance function within supervised entities is one of their core objectives.
26. CY noted that when assessing a firm's application for authorisation, it assesses whether the applicant firm has procedures in place to carry out the compliance risk assessment. At this stage, CY also assesses the nominated head of the compliance function. CY stated that before granting a firm's authorisation, the NCA conducts an onsite inspection to ensure that the conditions for authorisation are fulfilled. At this stage, the NCA conducts an interview of the compliance officer to ensure that they possess the requisite knowledge and experience to carry out the role. CY reported that following authorisation, investment firms are required to notify the NCA of any proposed appointment of compliance officer and of the person responsible within the compliance function for complaints.
27. CY reported several supervisory actions regarding the compliance function of investment firms since the peer review as follows.
- a. Since 2017, CY conducted inspections of 38 investment firms to verify their compliance with the MiFID II obligations (both organisational requirements and conduct of business requirements). CY reported that in 32 cases, where it identified deficiencies, it also checked the effectiveness of the compliance function. CY also indicated that since 2017 they conduct sample checks on annual compliance reports. For example, in 2021 in addition, to the compliance reports reviewed in the scope of the inspections/reviews, nine more such

reports were reviewed.

- b. CY also reported that following the 38 inspections, it undertook 12 enforcement actions including withdrawal of license, suspension of authorisation, settlement. CY indicated that settlements reached also related to weaknesses identified with respect to the compliance function.

28. In 2020, CY conducted a thematic review dedicated to the compliance function of six firms, selecting them based on the size and level of risk⁵. CY stated that they assessed the firm's compliance with their obligations under MiFID II and specifically, the organisational requirements that relate to the compliance function⁶ as well as Guidelines 1 – 4. Further details on the scope of this review are provided below.

29. CY reported that following this thematic review, it published a Circular⁷ capturing the common deficiencies and good practices identified and requiring all firms to consider their level of compliance and, where appropriate, take corrective measures.

30. CY additionally reported that it addressed a *Dear CEO* letter in 2020 to all firms in Cyprus who offer investment services in relation to contracts for difference (CFDs). This letter highlights the key findings of a study into the non-compliance of a limited number of firms with their obligations in relation to the MiFID II requirements. A specific section dedicated to the compliance function calls upon firms to:

- a. Review their policies and procedures and ensure that they fully comply with their regulatory requirements. In doing so, firms are strongly encouraged to consider strengthening their compliance function (e.g. increase resources and expertise for enhanced monitoring, use of effective monitoring tools, etc.) and reevaluating the competence of staff.
- b. Take without any delay, immediate corrective measures, where necessary to comply with the regulatory requirements mentioned in the letter.

31. Overall, CY notes that further *Dear CEO* letters have been incorporated into its Supervision Action Plan for 2022-2023.

⁵ Notably, four out of the six firms selected were High/Medium-high risk and the remaining two firms were Low/Medium-low risk firms. It is noted that five out of the six firms provide services in relation to Contracts for Difference which are considered complex and risky products. In addition, these firms were selected after taking into consideration the number of complaints received from other NCAs in 2020. The sixth firm was selected considering its size and its risk categorisation as High and because of its status as traditional firm.

⁶ The regulatory provisions of Article 16(2) of MiFID II and Article 22 of the MiFID II Delegated Regulation

⁷ Circular C441 published on 7 April 2021 and available here <https://www.cysec.gov.cy/CMSPages/GetFile.aspx?guid=66cd3d5b-bf64-4bcc-99c7-a547cc30ca06>

32. Finally, while this follow-up peer review report was drafted, CY reported to ESMA that, under its new supervisory action plan 2022/23, the compliance function was reviewed or will be reviewed in at least 96 firms which are categorised as High/Medium High-risk firms (41% of all supervised investment firms).

2020 thematic review on the compliance function of six investment firms

33. As noted above, CY conducted a thematic desk-based review of six firms in 2020 aiming to identify relevant aspects of the Guidelines. Further details of this thematic review are set out below.

Guideline 1 – Supervision of regular performance of the compliance risk-assessment

34. CY assessed whether the firms perform compliance risk assessments as part of their risk-based approach to ensure that compliance risks are comprehensively monitored.
35. CY reported that based on the work conducted, it called for written representations⁸ of one firm and sent letters to three firms with suggestions / recommendations regarding matters that needed improvement⁹. For the remaining two firms, CY decided that no actions were necessary.

Guideline 2 - Monitoring obligations of the compliance function

36. CY sought to identify whether firms conduct their operations in accordance with their obligations and whether their organisational and control measures, including policies and procedures, are effective and appropriate to ensure that the firm's compliance function thoroughly monitors compliance risk.
37. CY reported that all firms submitted the annual assessments of the compliance function. In general, CY noted that firms relied on risk assessments to determine the tools and methodologies used in the permanent monitoring programme of the compliance function. CY additionally noted in some cases that the risk assessment was vague as it did not specify the monitoring methodologies/tools for each issue and the frequency of the compliance officer's monitoring/assessments. In such instances, CY carried out further supervisory action¹⁰.

Guideline 3 - Reporting obligations of the compliance function

⁸ This is a written statement prepared by a firm and submitted to the NCA.

⁹ In one case, the risks ratings were not specified, and it was not mentioned in the risk assessment section whether the types of financial instruments offered as well as the client categorisation of the client were taken into account by the firm when determining its compliance risk assessment. In a second case, the priorities were not based on the annual risk assessment. In addition, the risk model used by the firm did not illustrate what was taken into consideration and how the final risk rating was calculated.

¹⁰ In one case, the CySEC Board decided that a firm was in violation with the relevant requirements. However, in view of the corrective measures already taken, CY decided that no further action was necessary. In several other cases, the CySEC Board decided to send letters with deficiencies identified and recommendations regarding the matters that need improvement.

38. CY sought to verify the compliance of the six firms regarding the reporting obligations of the compliance function.
39. CY identified weaknesses, since the annual compliance report mainly focused on findings from evaluating the firm's written policies and procedures. Specifically, evaluations mainly focused on whether the firms' policies are up-to-date and in compliance with the regulatory framework, rather than including findings on the implementation of those policies by all employees in practice. Furthermore, CY reported that the different types of reviews conducted by the compliance function should be more accurately reflected in the firms' annual reports. CY stated that, wherever it identified weaknesses, it took supervisory action¹¹.

Guideline 4 - Advisory obligations of the compliance function

40. CY reported that it sought to verify adherence by the six firms regarding the advisory obligations of the compliance function and, in general, to ensure that all aspects of Guideline 4 are applied.
41. CY noted that in some cases, while the six firms had assessed staff's knowledge, they did not provide enough evidence or details regarding regular internal and external training, such as records of training logs. CY stated that they undertook supervisory action¹² wherever specific weaknesses were identified.

3.2.2 Assessment analysis and conclusion

42. ESMA notes CY has made progress since the peer review.
43. CY's approach to the supervision of the compliance function can be summarised as encompassing five elements: (i) assessing the compliance function during the authorisation stage, (ii) conducting inspections on a sample of firms to verify their compliance with MiFID II obligations (organisational and conduct of business requirements), which includes further checks on the compliance function where it identified deficiencies; (iii) reaching settlement; (iv) undertaking a dedicated thematic review on six firms' compliance with ESMA Guidelines on certain aspects of the compliance function; and (v) communicating publicly its expectations regarding the compliance function based on supervisory findings.

Assessing the compliance function during the authorisation stage

¹¹ Please see footnote 9.

¹² See also footnote 9.

44. ESMA views positively the practice of assessing the compliance function and the proposed compliance officer as part of authorising a firm. In ESMA's view, this should provide CY with an opportunity to rectify possible issues before the firm provides investment services and activities.

Regular inspections

45. CY supervises over 200 investment firms. ESMA notes that since 2017, CY carried out 38 inspections, and that as part of 32 it investigated further the compliance function, given shortcomings with MiFID II obligations were identified. CY also reported sample checks through or in addition to such inspections / reviews.
46. ESMA welcomes that NCAs undertake checks on the compliance reports and undertake a closer assessment of the compliance function when issues are identified. At the same time, ESMA notes that the latter is a type of reactive supervisory action, which should be complemented also with proactive supervision of the compliance function on a more regular basis and not just when deficiencies are identified. However, ESMA notes that as part of its supervisory action plan for 2022/2023 CY has introduced a more frequent and proactive assessment of the compliance function (see below).

Settlement

47. ESMA notes that CY reported that it reached in some cases settlements which related – among other matters – to compliance weaknesses. While ESMA cannot assess the extent of such actions, it notes that the use of enforcement can act as a deterrent to having poor systems and controls in firms regarding their compliance function and against a poor compliance culture that may exist within firms.

Thematic review

48. ESMA welcomes that CY conducted a specific thematic review in 2020 of ESMA Guidelines 1 – 4 of certain aspects of the compliance function. ESMA notes that the scope of the review looked closely at these four Guidelines and that CY followed up to this review, both specifically with the firms at stake, and with the wider regulatory community in Cyprus to raise awareness on CY's supervisory expectations regarding the compliance function of investment firms.

Communication to the public

49. ESMA notes that CY published a Circular that sets out the common deficiencies and good practices identified following the 2020 thematic review. ESMA also notes the publication of a Dear CEO letter in December 2020 to all investment firms in Cyprus

who offer CFDs, including a part devoted to the compliance function. ESMA also notes that further *Dear CEO* letters are expected as part of CY's Supervision Action Plan for 2022 – 2023.

50. ESMA welcomes these initiatives in that it is important for NCAs to use communication channels to set out their supervisory expectations, best practices and deficiencies identified through supervisory work. This can be an effective tool to reach those firms that were not included in the original supervisory activity.

General

51. While ESMA observes that CY has made progress following the peer review, two important and closely linked considerations are made:

52. First of all, considering the key importance of the role of the compliance function, and the number, size and complexity of supervised firms, many of which offering complex and risky products, and operating on a cross-border basis, ESMA would have expected CY to have undertaken between 2017 and 2022 more extensive and dynamic supervision on the matter. ESMA welcomes that CY undertook specific work on the compliance function of firms and used also settlement in relation to compliance functions and other failures. However, ESMA considers that CY covered overall in a five-year period a limited number of firms with a predominance of reactive work. The shortcomings identified show that there may be a wider structural issue with the compliance function of firms operating in Cyprus that deserves closer supervisory attention.

53. On a second point, ESMA notes that CY was included in the 2021 peer review on the supervision of cross border activities of investment firms.¹³ The peer review identified important issues regarding CY's supervision across the supervisory lifecycle and, as a result, issued two recommendations to CY under Article 16 of ESMAR. The first recommendation requires CY to increase to the resources directly dedicated to supervision.¹⁴ The second recommendation requires to put in place a revised annual supervisory plan, spanning ongoing supervision, investigations and – as applicable – enforcement, to increase the supervisory work performed on firms providing the peer-reviewed activities and aiming to improve the effectiveness of CY's supervision in

¹³ The majority of investment firms operating in Cyprus provide investment services and activities to clients across the EU. 2022 Peer review report on the cross border activities of investment firms available here: https://www.esma.europa.eu/sites/default/files/library/esma42-111-5534_report_peer_review_cross_border_activities_investment_firms.pdf

¹⁴ As indicated above, ESMA had already issued a similar recommendation to increase the number of supervisory resources through the 2017 peer review on the Guidelines. CY had indeed increased its resources following this peer review. At the same time, the cross-border peer review identified that the resource increase was overall not sufficient to ensure effective supervision, resulting in a renewed recommendation under Article 16 to increase the number of supervisory resources.

addressing supervisory risks at an earlier stage and responding more forcefully to problems identified.¹⁵ While this report was drafted, CY reported to ESMA that in the scope of its Supervisory Action Plan 2022/23 the compliance function was reviewed or will be reviewed in at least 96 firms which are categorised as High/Medium High risk firms (41% of all supervised investment firms). As the work under Article 16 recommendations is ongoing, ESMA refrains from commenting in this follow up on the work CY is undertaking as part of these. Given the key role of the compliance function, ESMA takes note that CY has been increasing its focus on the compliance functions. ESMA also notes that CY is increasing its supervisory resources, which should contribute to strengthening its supervisory work, including in relation to compliance.

Recommendations

54. ESMA notes that CY has made some progress since the 2017 peer review. However, in light of the (overall limited) coverage of supervisory work undertaken in 2017-2022 regarding the compliance function, and the reported issues observed, ESMA recommends that CY increases its focus to ensure that the supervision of the compliance function and the Guidelines are structurally and effectively included in the scope of CY's supervisory work. In doing so, CY should use different tools including enforcement to ensure a strong compliance function in investment firms. ESMA takes note that CY is currently in the process of increasing its supervisory resources and reviewing its supervisory practices and plans, and indicated, while this report was being finalised, that either it has, or it will carry out more investigations in 2022-2023 covering the compliance function. ESMA recommends CY to consolidate such more extensive and proactive work, in light of the observations above.

3.3 Greece

55. The peer review report identified insufficient application by EL regarding:

- Guideline 2a. - checking that firms use the compliance risk-assessment to determine the compliance function's monitoring programme.
- Guideline 2b. - evaluating the content of the compliance function's monitoring programme and priorities that it establishes.
- Guideline 4a. - supervising the compliance function's advisory responsibilities.

¹⁵ CY reported to ESMA in March 2023 that having noted the Article 16 Recommendations, it is in the process of further increasing its resources directly dedicated to the entire supervisory cycle (authorisations, ongoing supervision and enforcement). It is expected that a further thirty-four officers will join CySEC, in particular in the above mentioned three departments. This gradual increase in human resources will allow a broader scale of supervision in line with the ESMA Guidelines on certain aspects of the compliance function and CySEC's Risk Based Supervisory Framework ("RBS-F"). CySEC further reported that in addition to increasing and strengthening CySEC's human resources, the ability and capacity to perform early and meaningful supervision has been enhanced due to other factors, such as (a) the acquisition of a new monitoring/supervisory tool, (b) launching of infrastructure projects that would enhance supervisory capacity and, (c) taking enhanced administrative/enforcement actions.

- The peer review report identified partial application by EL of:
- Guideline 4b. - checking that the compliance function is engaged in training support for the staff of investment firms.

EL response

3.3.1 General

56. EL reported that following the peer review it revised its supervisory practices and undertook specific work. In particular, EL indicated that it now receives all compliance reports and undertakes a sample-based review to check that Guidelines 2 and 4 are being complied with. EL also reported that it undertakes a full review of all reports to identify any weaknesses, weaknesses could derive from non-compliance with ESMA's Guidelines. EL also reported investigations of investment firms which included, when needed, a review of the compliance functions and firms' adherence to the Guidelines. Finally, EL indicated that it took enforcement action against firms for failures regarding the compliance function.

Changes to the supervisory framework

57. EL reported that there are 62 firms operating in Greece to whom the Guidelines apply¹⁶.

58. EL stated in their response to the ESMA Chair that since 2017 they have been receiving, on annual basis, compliance reports from all supervised entities. These reports are prepared by the firm's compliance officer and cover the outcome of any inspection by the firm's compliance function.

59. EL stated that since the peer review, it has regularly been reviewing, on a sample basis, these compliance reports to ensure that they address the issues referred to in Guideline 2 and Guideline 4. The sample of compliance reports is identified on a risk-based approach taking into account the size of the firm. EL takes into account the size of the investment firm and the financial instruments distributed. EL indicated that in 2022 they reviewed five firms¹⁷. EL indicated that no follow-up was necessary as no significant findings were identified.

¹⁶ This figure is comprised of 47 investment firms, 13 UCITS management companies and two AIFMS with MiFID scope permissions.

¹⁷ EL indicated that this sample represented 52% of the total assets and 27% of the total revenue of Greek investment firms.

60. EL also stated that in addition to checking the specific inclusion of Guidelines 2 and 4 in a sample of compliance reports, it also reviews all the compliance reports to examine whether any important weakness or problem are disclosed.

General investigations

61. EL reported that it conducted investigations into firms falling within the scope of the MiFID compliance function requirements. EL noted that the overall framework including the ESMA Guidelines on certain aspects of the compliance function are assessed. EL stated that these investigations take into account the size of each firm and the risks arising from each activity.

62. EL reported that following the peer review it conducted inspections in seven investment firms which covered in their scope the assessment of the functioning of the compliance function¹⁸.

Undertaking enforcement action

63. Since 2018, EL has fined four investment firms for breaching the MiFID II compliance function requirements. EL reported that these fines resulted from the above investigations. The scope of the infringements included poor adherence to Guideline 1 (compliance risk assessment) and Guideline 3 regarding the reporting obligations of the compliance function.

3.3.2 Assessment analysis and conclusion

64. ESMA notes that EL has made progress since the peer review.

65. EL's approach to the supervision of the compliance function can be summarised as encompassing three elements: (i) reviewing all compliance reports to identify any weaknesses and undertaking a review of a sample of compliance reports to check that Guidelines 2 and 4 are complied with, (ii) investigations / inspections which may also cover in their scope the compliance function, and (iii) enforcement actions taken for failures regarding the compliance function.

Changes to the supervisory framework

¹⁸ EL did not provide ESMA with further details on the exact scope of these review.

66. In ESMA's view, the change introduced by EL to require firms to submit their compliance reports to the authority is a positive development. Additionally, it is noted that EL undertakes a desk-based sample of compliance reports to assess their adherence to Guidelines 2 and 4 and a full scope review of all reports to identify potential compliance weaknesses. All these changes are welcomed in that they should provide a holistic overview on how the compliance function, as a second line of defence, is adhering to its regulatory obligations.

Conducting investigations, which may include the compliance function.

67. EL informed ESMA that it conducted onsite inspections that included the compliance function and specifically the Guidelines, for seven investment firms. ESMA notes that assessing the compliance function through onsite inspections allows to assess more thoroughly the work and the adequacy of a firm's compliance function. EL did not provide to ESMA sufficient information on the volume and scope of these investigations / inspections, to enable ESMA to assess the work conducted in further detail. While overall the coverage may be limited considering the number of supervised firms, ESMA also notes that the nature, scale and complexity of these firms (including the products offered and the investor reach) may be narrower than that of other NCAs assessed in this work, and that EL took noticeable enforcement actions compared to the number of inspections conducted on the compliance function.

Undertaking enforcement action for failures regarding the compliance function

68. ESMA notes that since 2018, EL has taken several enforcement actions against firms for compliance function failures. It fined four investment firms for breaching the MiFID II compliance function requirements. In ESMA's view, the use of the enforcement tool can act as a credible deterrent to having poor systems and controls in firms regarding their compliance function and against a poor compliance culture that may exist within firms. It is indeed important that NCAs use the appropriate tools – including enforcement when needed - to drive up standards and ensure that firms have a robust, active, and well-functioning compliance function in accordance with the elements and objectives set out in the Guidelines are respected.

Recommendations

69. ESMA recommends EL to continue monitoring the compliance function of investment firms and ensure that they comply with the ESMA Guidelines. ESMA also recommends EL to continue considering the effectiveness of the supervisory actions developed to assess the compliance function and to use different tools including enforcement to ensure a strong compliance function in investment firms. ESMA invites EL to foster its supervisory work, including investigations / inspections, on firms' compliance function, considering the scale, type and complexity of supervised firms.

3.4 Iceland

70. The peer review report assessed that IS had not examined Guideline 1. In response to the questionnaire, IS did not provide any response on its work relating to Guidelines 2 – 4. The peer review therefore assessed IS as insufficiently compliant with Guidelines 1 – 4.

IS Response

3.4.1 General

71. IS stated in their response to the ESMA Chair's letter that MiFID II and the ESMA Guidelines on certain aspects of the compliance function under MiFID II did not enter into force in Iceland respectively until September and October 2021.

72. IS highlighted that, by applying a risk-based approach, they conducted dedicated supervisory work on ESMA's Guidelines for the four largest credit institutions operating in Iceland¹⁹. IS also informed ESMA that it receives an annual report of the compliance function for the four largest credit institutions in Iceland. The reports are reviewed regularly, and its contents and quality discussed in annual interviews with internal control functions, the CEO and the board.

73. For the largest four credit institutions, IS also stated that the assessment of the independence, roles and responsibilities of the compliance function are part of annual assessment of governance and internal controls in the SREP.²⁰ The SREP assessment includes but is not limited to reviewing the compliance officer's charter, compliance policies and their implementation and reports to the board and senior management. The compliance officer's charter outlines the role and responsibilities of the compliance officer, including reporting, advisory and training obligations. The annual report should include how these obligations are met. The assessment also includes annual interviews with compliance officers/heads of compliance of banks. Any deficiencies are communicated to the supervised entity. IS stated that credit institutions in Iceland are also required to comply with the EBA Guidelines on internal governance which includes a short chapter on the compliance function. Additionally, IS reported that elements from the ESMA Guidelines on certain aspects of the compliance function are examined in addition to the elements on the compliance function in the SREP and the EBA Guidelines for the four largest credit institutions.

¹⁹ These four credit institutions all have MiFID scope permissions.

²⁰ IS uses its national Guidelines for common procedures and methodologies for the SREP that are based on the EBA's Guidelines on the same topic.

74. In Iceland, in total there are 19 other (non-banking) investment firms. Regarding these firms, IS stated that it is in regular communication with them, including their compliance function departments. However, inspections are not carried out on a regular basis. IS rather conducts a periodic risk assessment through questionnaires to firms. These questionnaires concern, among other things, the compliance function of the firms. The responses are evaluated alongside data and information collected by the NCA. Thereafter, IS undertakes a risk assessment that sets out a supervisory plan for each entity. IS informed ESMA that since MiFID II and the ESMA Guidelines on certain aspects of the compliance function did not enter into force in Iceland up until 2021, a risk assessment has not yet been carried out for the other investment firms on these areas.

75. With regard to the scope of controls performed, IS indicated that these are based on the SREP methodology as set out below²¹.

Guideline 1 – Supervision of regular performance of the compliance risk-assessment

76. IS stated that the assessment of compliance risk and how it is managed is part of the SREP. The supervision includes desk-based reviews, on-site visits, thematic reviews and interviews. The compliance policy, the compliance risk assessments, and monitoring activities and reports of internal control functions are reviewed and discussed with the compliance officer in the annual review.

Guideline 2 - Monitoring obligations of the compliance function

77. IS stated that its supervisory approach in respect to the monitoring of the obligations of the compliance function includes reviewing compliance function's monitoring plans, reports of internal control functions and regular interviews with heads of control functions, senior management and the board. The compliance officer's annual report reflects the function's activities, including monitoring obligations through various tools (internal IT monitoring systems, trade surveillance, legal compliance, documenting conflict of interest etc).

Guideline 3 - Reporting obligations of the compliance function

78. IS stated that the SREP includes an assessment of the internal control functions' reporting to the senior management and the board. Part of that assessment is reviewing the data sets and meeting minutes of the board. The compliance officer's

²¹ Guidelines /GL/2021/05. These Guidelines entered into force on 31 December 2021 and IS notified the EBA of their compliance with the Guidelines on that date. Guidelines 21 relate to the Compliance Function.

independence, authority and stature are reviewed and assessed as part of the SREP process. The compliance officer's charter is reviewed and verified to check if the compliance officer reports directly to the CEO and has direct access to the board and its committees. The board of directors approves the compliance officer's employment and charter and must be notified in case of dismissal. The independence is discussed in the annual interview with the compliance officer.

Guideline 4 - Advisory obligations of the compliance function

79. IS stated that the compliance function's advisory role is outlined in the compliance officer's charter. The annual report on the compliance function includes if and how the compliance function fulfilled its advisory and training obligations. The compliance risk policy should include all applicable laws, rules, regulations, and standards.

3.4.2 Assessment analysis and conclusion

80. ESMA notes that following the peer review, MiFID II formally entered into force in IS (2021) and IS formally implemented the Guidelines in its national framework (end 2021). This constitutes an improvement as compared to the situation assessed in the peer review. At the same time, ESMA notes that the Guidelines have been only recently applied.

Credit institutions

81. ESMA notes that IS' work in relation to firms' compliance function, focuses, as part of its risk-based approach, on the four largest credit institutions operating in Iceland, which also have MiFID scope permissions. IS' supervisory approach regarding the compliance function is based predominately on compliance with the EBA's Guidelines on internal governance that contain one chapter devoted to the compliance function. Another element of IS' approach is carrying out a SREP on the four credit institutions with the EBA Guidelines on common procedures and methodologies for the SREP and supervisory stress testing under Directive 2013/36/EU. From the responses provided throughout the follow up peer review exercise, it appears that IS controls primarily focus on banking elements (EBA Guidelines and SREP) and to a lesser extent, on some elements from the ESMA Guidelines on certain aspects of the compliance function.
82. In ESMA's view, IS should strive to ensure that the ESMA's Guidelines are a feature of IS supervision for the four largest credit institutions. This is because one of MiFID's objectives is to strengthen investor protection whereas CRD, the IRD and the SREP are prudentially focused. The following provide further examples on elements where there are no analogous requirements in the EBA Guidelines / SREP. ESMA Guideline

2 contains granular details on the monitoring obligations of the compliance function and, requires that the compliance function should have a role in monitoring the operation of the complaints process and the need to consider complaints as a source of relevant information in the context of its general monitoring responsibilities. ESMA Guideline 3 sets out detailed and granular information that should be included in compliance reports to management including requirements relating to – among others - (i) general information such as the adequacy and effectiveness of the firm's policies and procedures and staff compliance with the obligations under MiFID, and (ii) details of actions taken to address any significant risk of failure by the firm or staff to comply with MiFID. ESMA Guideline 4 sets out the advisory and assistance obligations of the compliance function such as providing support for staff and management training and ensuring that the compliance function is involved in the development of relevant policies and procedures within the firm in the area of investment services and activities.

Investment firms

83. Based on the information provided, non-banking investment firms have not so far been subject to dedicated work to ensure their compliance with the ESMA Guidelines on certain aspects of the compliance function. ESMA shares IS' choice to adopt a risk-based approach to supervision and takes note that – while the peer review concluded in 2017 (during which IS emerged as insufficiently compliant with all the Guidelines), IS only adopted these Guidelines at the end of 2021, which may explain the limited focus to date. At the same time, ESMA expects that IS considers the calibration of its risk-based approach to ensure that going forward, also these firms are effectively assessed with regard their compliance function (in accordance with the ESMA Guidelines) in light of its key role for the sound functioning of investment firms.

Recommendations

84. ESMA recommends that IS incorporates all elements from the ESMA Guidelines on certain aspects of the compliance function into its supervisory approach for credit institutions that have MiFID scope permissions, so as to effectively reflect the Guidelines' provisions aiming to ensure strengthened investors protection under MiFID II, ensuring that all such elements are reviewed as closely and structurally as those included in the EBA Guidelines and SREP.
85. ESMA also recommends that IS considers the calibration of its risk-based approach to supervision and ensures that it assesses and promotes over time an effective compliance function also in non-banking investment firms. While IS may calibrate the supervisory activities undertaken based on the size, nature and complexity of firms, and resulting risks, it is key that it promotes that all investment firms have a sound and effective compliance function.

3.5 Netherlands

86. As NL did not actively supervise compliance with the Guidelines, the peer review report identified NL as insufficiently compliant with Guidelines 1 - 4 except for Guideline 3B in which NL was assessed as partially compliant.

NL response

3.5.1 General

87. NL responded to the ESMA Chair's letter with a detailed response of actions it took since the peer review. For the purposes of simplicity, these actions are broken down below into the following three areas: (i) NL's general approach to supervising the Guidelines on certain aspects of the compliance functions, (ii) a dedicated project called the 'Impact and Design of the Compliance Function' that ran from 2019 to 2022, and (iii) enforcement action relating to firms' compliance functions failings.

88. NL stated in the response that when reviewing an application for authorisation, NL checks whether the application contains a description of the compliance function. Then, NL checks the firm's application against Guideline 2 (compliance function monitoring). NL also initiates this check if there is a request to change or vary the permissions of a firm.

89. As part of NL's ongoing supervision of banks and large and complex asset managers (investment firms and management companies of AIF's and UCITS management companies that provide MiFID services and activities) NL has an ongoing supervisory programme that consists of regular, scheduled (mostly quarterly) meetings at board level in the presence of heads of compliance of supervised firms. Next to the regular meetings, there are ongoing contacts between NL and the compliance officers. NL stated that it requests the firms to regularly provide compliance reports, risk reports and incident reports. These reports are discussed during the consultations with senior management, but also with compliance and risk management.

90. NL indicated that the supervision of the compliance function is mainly carried out as part of ongoing supervision through the quarterly and annual meetings with the compliance functions of the largest firms.

91. In respect of smaller firms, NL stated that it prioritises supervisory actions based on complaints data, incidents and previous supervisory engagement and experience taking into account risks to consumers and the market.

92. NL reported that it carried out a thematic investigation (the VICA, see below) that will be followed up in 2023/24 to determine the rate of improvements made.
93. NL reported that, in 2021, it also conducted a market peer comparison review on compliance reports and discussed their findings with the compliance function of the five largest banks operating in the Netherlands. In this case, the market review entailed a comparison of the compliance reports of the eleven largest institutions. NL reported that it noted a wide variety of styles in the compliance reports, with regard to language, topics discussed and use of separate compliance reports or merged with risk reports. On the basis of this market review, NL stated that it outlined nine recommendations. NL reported that these recommendations are further built on the four building blocks of NL's compliance excel checklist, mostly used for larger firms, (i.e. regulatory compliance; the firm's ability to organise discussions where dissenting opinions are voiced; the firm's complaints and signal's function; and the firm's formatting of the compliance report). The recommendations from the market review are taken into account in NL's ongoing supervision²².
94. NL also reported that it carried out a deep-dive regarding the organisation of the compliance function within a large AIFM that is authorised to carry out MiFID services and activities.

Details of a dedicated project called the 'Impact and Design of the Compliance Function'

95. NL reported that during the period 2019-2022, NL initiated a project called the 'Impact and Design of the Compliance Function'. The aim of the project was to examine how the compliance function is designed within organisations, what impact the compliance function has and how mature the compliance function is. NL surveyed all firms providing retail services and then selected 15 investment firms and 7 banks to participate in this project²³. NL reported that it selected firms of different sizes, offering different services (portfolio management, advice, and execution services).
96. For its examination, NL explained that it implemented a research method called a 'Validated In-Control Assessment' (VICA) i.e. an inquiry consisting of supervisory expectations about the impact and design of the compliance function. These expectations were aligned with the ESMA Guidelines on certain aspect of the

²² NL reported these as: reports must be forward-looking and anticipating trends and developments; reporting on the quality of (Compliance function's advice); reporting on critical notes from the supervisor may also be designated as such (no veiled or exclusively positive language); reports on any problems experienced by the signalling function of the firm; report as completely and transparently as possible, even if this is difficult; add a clear own opinion of compliance where necessary and not just describe issues; avoid unambiguous language; include identified issues with preferably proposed mitigating measures and solutions; give attention to the way in which risks are weighed.

²³ The AFM reported that, as of 31 December 2020, it had authorised 244 MiFID investment firms.

compliance function under MiFID II, particularly 1, 2A, 2B, 2C, 2D, 3A, 3B, 4A, 4B and 4C²⁴.

97. For each expectation, the investment firms and the banks were asked to rate their own level of maturity.

98. NL benchmarked the firms against each expectation. In addition to the expectations, NL requested more 'factual' information e.g. staffing, dual-hatting, etc.

Follow up to the project

99. NL sent the 15 participating investment firms formal feedback on their self-assessment, and later asked what follow up actions / improvement plans the firms had undertaken, also clarifying – where needed – NL's expectations. NL is now following up on this through its ongoing supervision.

100. NL indicated that a project similar to the 'Impact and Design of the Compliance Function' could take place in the coming years, as one of the ways to address the compliance function in NL's supervision.

Enforcement action taken by NL relating to firms' compliance functions failings

101. NL reported that since 2018, it took several enforcement actions related to the compliance function of firms²⁵.

3.5.2 Assessment analysis and conclusion

102. NL's actions following the 2017 peer review are broken down below into the following three areas: (i) NL's general approach to supervising the Guidelines on

²⁴ For example, under Guideline 2B asking the firms to explain any medium or high risks that were excluded devising the content of the monitoring programme and under Guideline 3 asking the firms to deliver a list of regular and ad hoc reports that the compliance function draws up, including details with whom the reports are discussed.

²⁵ In particular NL noted: (i) an enforcement action against an investment firm regarding – amongst other areas – failures by the compliance function to systematically and continuously comply with Guidelines 1 and 2. (ii) an intended instruction to a firm, amongst other areas, to ensure the independence of the compliance function and that the compliance function is undertaking a compliance risk analysis to be used as the basis of the compliance monitoring program. (iii) a warning letter to an investment firm covering – amongst other areas – a lack of human resources in the compliance function to carry out its role effectively and (iv) a warning letter to another investment firm for compliance reporting failures.

certain aspects of the compliance functions, (ii) dedicated project called the 'Impact and Design of the Compliance Function' that ran from 2019 -2022 and (iii) enforcement actions taken by NL relating to firms' compliance functions failings. ESMA's analysis is set out below.

General approach

103. ESMA notes the progress made by NL regarding the supervision of the compliance report since the peer review.
104. ESMA notes that NL undertakes checks regarding the compliance function for a new applicant firm and when an existing firm seeks to vary its permissions. In ESMA's view, this should provide NL with an opportunity to rectify possible issues before the firms provides investment services and activities.
105. Based on the information provided, NL also seeks to have regular engagement with members of the compliance function for large firms. This should ensure that the importance of an independent, well-resourced, and active compliance function is understood by all staff members.
106. ESMA also welcomes that NL has used different tools to undertake checks on firms' compliance functions. These range from market reviews on compliance reports, thematic reviews looking at the functioning of a firm's compliance function and a deep dive regarding the organisation of the compliance function of a large asset manager providing MiFID services.

Dedicated project 'Impact and Design of the Compliance Function'

107. ESMA notes that, in addition to the thematic review mentioned above, between 2019-2022, NL carried out a dedicated project on the impact and design of the compliance function. ESMA welcomes the novelty and detailed scope of this project and the fact that it covered Guidelines 1, 2A, 2B, 2C, 2D, 3A, 3B, 4A and 4B, i.e. most of the guidelines in which the NL was assessed in the 2017 peer review to be either insufficiently or partially compliant. ESMA positively note that it covered a diversified population of 22 firms and that NL is following up on the findings of the dedicated project through ongoing supervision work across the affected firms.
108. ESMA also notes that NL published the findings from this project with the aim to provide guidance to firms that were not part of the project, to explain what NL expects at different maturity levels and to show how to improve the role of the compliance function within firms and overall compliance with the ESMA guidelines. It is indeed important for NCAs to use communication channels to set out their supervisory

expectations, best practices and deficiencies identified through supervisory work. This can be an effective tool to reach those firms that were not included in the original supervisory activity.

Enforcement action taken by NL relating to investment firms' compliance functions failings

109. ESMA notes that since 2018, NL has taken a number of enforcement actions against investment firms for compliance function failures. In ESMA's view, the use of the enforcement tool can act as a credible deterrent to having poor systems and controls in firms regarding their compliance function and against a poor compliance culture that may exist within firms. It is indeed important that NCAs use the appropriate tools – including enforcement when needed - to drive up standards and ensure that firms have a robust, active, and well-functioning compliance function in accordance with the elements and objectives set out in the Guidelines on certain aspects of the compliance function are respected.

Recommendations

110. ESMA recommends NL to continue monitoring the compliance function of investment firms and ensure that they comply with the ESMA Guidelines.

111. ESMA also recommends NL to continue considering the effectiveness of the supervisory actions developed to assess the compliance functions and to use different tools including enforcement to ensure a strong compliance function in investment firms.

3.6 Slovenia

112. The peer review report identified insufficient application by SI of:

- Guideline 1. - compliance function at supervised investment firms performs compliance risk assessments as part of their risk-based approach.
- Guideline 2a. - supervised investment firms use the compliance risk-assessment to determine the compliance function's monitoring programme.
- Guideline 3b. - independence of the compliance function
- Guideline 4b. - compliance function provides training support for the staff of investment firms
- Guideline 4c. - compliance function considers internal policies, procedures, organisational structure, MiFID and national laws, as well as guidelines and standards.

SI response

3.6.1 General

113. Following the peer review, SI took several steps to improve supervision of the compliance function of investment firms. These consisted of: (i) changes to its supervisory framework; (ii) thematic reviews to ensure that investment firms comply with the ESMA Guidelines on certain aspects of the compliance function; (iii) including the compliance function as part of an ESMA Common Supervisory Action (CSA) coordinated by ESMA since 2019; and (iv) taking an enforcement action.

Changes to the supervisory framework

114. SI stated that since 2016, because of a change to a bylaw, an investment firm must inform the NCA about the appointment or discharge of a firm's head of compliance function. SI explained that no formal pre-approval requirements are in place, but the action provides useful supervisory information. The same bylaw also established the independence of the compliance function and its unfettered and free reporting to the management board, supervisory board or the NCA.

115. Additionally, SI now requires a firm's compliance officer to take the role of coordinator in supervisory matters between the NCA and a firm. In practical terms, SI requires a compliance officer together with a firm's senior management to attend the close-out meeting of an onsite inspection with the NCA. SI suggested that this ensures that a compliance officer will know how best to eliminate any inconsistencies or deficiencies. SI additionally stated that they monitor the performance of the compliance function through the supervision of regular reporting, such as checking minutes of firms' supervisory board meetings.

116. In 2017, SI made the decision to require investment firms to fully comply with the Guidelines. SI informed ESMA that the Guidelines have been incorporated into their supervisory framework. In the same year, SI amended the requirements for UCITS management companies by requiring them to adopt a business compliance policy, by defining the tasks of the compliance function, and the introduction of a requirement that compliance function staff can report directly to their management board.

117. By way of background information, SI reported that it currently supervises eight firms that provide MiFID investment services and activities.

118. SI reported that since the peer review, it authorised two investment firms and checked both applicants' applications against Guidelines 1 – 4. SI confirmed that this is a standard practice for any new request for authorisation.

Thematic reviews since the peer review

119. SI reported 30 investigations / inspections which to a varying extent assessed specifically firms' compliance function, covering 11 firms between 2016²⁶ and 2022, and reported details as summarised below.
120. In 2016, SI also undertook a thematic onsite inspection in one UCITS management company in respect of Guideline 1, 2, 3b, 4b and 4c²⁷.
121. In 2017, SI also conducted a thematic onsite inspection of a UCITS management company and verified that the firm was complying with Guidelines 1 - 4.
122. In 2018, SI conducted thematic onsite inspections in two UCITS management companies and an onsite inspection in one investment firm. The UCITS management companies were assessed against Guidelines 1-4. In relation to the investment firm, SI stated that the compliance function was assessed against its risk assessment and a two-year working plan and Guidelines 1, 2a, 3b, 4b and 4c.
123. As part of the onsite inspections, SI undertook checks on the firms' compliance function. SI issued recommendations to two of these firms where inconsistencies and deficiencies regarding the firms' compliance function were identified.
124. In 2019, SI undertook onsite inspections in three investment firms checking as part of these, the firms' compliance function. SI reported that one investment firm was assessed against Guidelines 1 -4 while the other investment firms were assessed against Guidelines 3b and 4b (for one firm it was established that the investment firm was not compliant with Guidelines 4b and 4c. SI reported that it took enforcement action against this firm.

Including the compliance function as part of ESMA's Common Supervisory Actions

125. SI indicated that between 2019 and 2022 it undertook a review of some firms' compliance functions through ESMA's coordinated CSAs. These CSAs included: (i) dealing with the application of the MiFID II requirements on the assessment of appropriateness (2019); (ii) product governance requirements (2021); and (iii) costs and charges (2022). SI indicated that as part of these exercises it checked specific elements of the compliance function and the Guidelines, in particular:
- 2019 - SI reported that it checked in addition to Guidelines 3b and 4c, the role of the compliance function in seven investment firms *vis a vis* the compliance function's role in the process of developing and monitoring policies and procedures regarding the

²⁶ Some investigations carried out in 2016 had not been considered under the 2017 peer review.

²⁷ The thematic onsite inspection took place in June 2016. However, it was not included in the peer review report as conclusions from the onsite inspection were only made by the NCA in November 2016. The peer review's period under review was from 1 July 2014 – 30 June 2016. SI flagged that the population of supervised firms under MiFID II reduced in the period covered by this follow up peer review.

appropriateness assessment and how the compliance function incorporated the appropriateness assessment in their monitoring plan. SI also checked that the compliance function was involved in staff training on the appropriateness assessment and that it had access to client files.

- 2021 - SI checked the role of the compliance function in seven investment firms regarding the product governance process. SI stated that they checked the involvement of the compliance function in the process of developing and monitoring policies and procedures regarding product governance issues (Guideline 3.e). SI also established that the compliance function was involved in staff training (Guideline 4). These actions were complemented by two offsite inspections of UCITS management companies. The inspections were in relation to other supervisory matter. Nevertheless, SI incorporated a review of the role of the firms' compliance function as part of the visit.
- 2022 - SI checked in five investment firms the role of the compliance function in the costs and charges disclosure process (Guideline 4b). SI also established that the compliance function was involved in staff training (Guideline 4c) on ex-post costs and charges.

Enforcement action taken by SI relating to an investment firm's compliance function failings

126. In 2019, SI reported that it took enforcement action against a firm for failure to comply with Guidelines 4b and 4c.

3.6.2 Assessment analysis and conclusion

127. ESMA notes the positive pace of change regarding SI's supervision of the compliance function of investment firms. The changes made by SI since the peer review can be identified as follows: (i) making changes to the supervisory framework (ii) undertaking dedicated thematic reviews to ensure that investment firms comply with the Guidelines and (iii) including the compliance function as part of CSAs and (iv) taking enforcement action.

Changes to the supervisory framework

128. ESMA notes that SI improved its supervisory framework through the revision of bylaws, checking proposed compliance with the Guidelines when authorising a firm, establishing the independence of the compliance function and its free reporting to the management board, supervisory board or NCA, requiring a firm's compliance officer to take the role of coordinator in supervisory matters between the NCA and a firm, requiring to receive details

of the appointment or discharge of a firm's head of compliance. SI also introduced a requirement for management companies with MiFID scope permissions to regularly send their minutes of supervisory board meetings to the NCA.

129. ESMA views positively SI's changes to its practices as they go in the direction of empowering the compliance function and increasing SI's visibility on compliance-related issues discussed within the firms and changes undertaken.
130. ESMA also views the practice of reviewing an application for authorisation regarding the organisational structure of the compliance function against Guidelines 1 – 4 positively. In ESMA's view, this should provide SI with an opportunity to rectify possible issues before the firms provides any investment services and activities.

Thematic reviews

131. ESMA also notes that since 2016, SI has conducted a total of 30 investigations / inspections of firms regarding the supervision of the compliance function and ESMA Guidelines 1 – 4 on certain aspects of the compliance function. SI also sought to capture the role of the compliance function in so far as it relates to the theme of the CSA. ESMA views this positively and as an opportunity to include the compliance function as part of an EU coordinated action.
132. ESMA views that SI has undertaken specific actions to assess firm's culture, motivation and adherence to the ESMA Guidelines 1-4 on certain aspects of the compliance function rules with almost the totality of supervised investment firms.

Enforcement

133. ESMA also notes the use of the enforcement tool regarding a firm's adherence to the MiFID II requirements on the compliance function. In ESMA's view, the use of the enforcement tool can act as a credible deterrent to having poor systems and controls in firms regarding their compliance function and against a poor compliance culture that may exist within firms. It is indeed important that NCAs use the appropriate tools – including enforcement when needed - to drive up standards and ensure that firms have a robust, active, and well-functioning compliance function in accordance with the elements and objectives set out in the Guidelines. The use of enforcement powers by NCAs can act as a credible deterrent to poor behaviours by firms.

Recommendations

134. ESMA recommends SI continue monitoring the compliance function of investment firms and ensure that they comply with the ESMA Guidelines.
135. ESMA also recommends SI to continue considering the effectiveness of the supervisory actions developed to assess the compliance functions and to use different tools including enforcement to ensure a strong compliance function in investment firms.

4 Extract of Guidelines 1 - 4 on certain aspects of the MiFID II compliance function requirements

General guideline 1

14. Investment firms should ensure that the compliance function takes a risk-based approach in order to allocate the function's resources efficiently. A compliance risk assessment should be used to determine the focus of the monitoring and advisory activities of the compliance function. The compliance risk assessment should be performed regularly to ensure that the focus and the scope of compliance monitoring and advisory activities remain valid.

Supporting guidelines

15. MiFID requires investment firms to establish, implement and maintain adequate policies and procedures designed to detect any risk of failure by the investment firm to comply with its obligations under MiFID. As part of this, the compliance function should identify the level of compliance risk the investment firm faces, taking into account the investment services, activities and ancillary services provided by the investment firm, as well as the types of financial instruments traded and distributed.

16. The compliance risk assessment should take into account the applicable obligations under MiFID, national implementing regulation and the policies, procedures, systems and controls implemented within the firm in the area of investment services and activities. The assessment should also take into account the results of any monitoring activities and of any relevant internal or external audit findings.

17. The compliance function's objectives and work programme should be developed and set up on the basis of this compliance risk assessment. The identified risks should be reviewed on a regular basis as well as ad-hoc when necessary to ensure that any emerging risks are taken into consideration (for example, resulting from new business fields or other changes in the investment firm's structure).

General guideline 2

18. Investment firms should ensure that the compliance function establishes a monitoring programme that takes into consideration all areas of the investment firm's investment services, activities and any relevant ancillary services. The monitoring programme should establish priorities determined by the compliance risk assessment ensuring that compliance risk is comprehensively monitored.

Supporting guidelines

19. The aim of a monitoring programme should be to evaluate whether the investment firm's business is conducted in compliance with its obligations under MiFID and whether its internal guidelines, organisation and control measures remain effective and appropriate.

20. Where an investment firm is part of a group, responsibility for the compliance function rests with each investment firm in that group. An investment firm should therefore ensure that its compliance function remains responsible for monitoring its own compliance risk. This includes where a firm outsources compliance tasks to another firm within the group. The compliance function within each investment firm should, however, take into account the group of which it is a part - for example, by working closely with audit, legal, regulatory and compliance staff in other parts of the group.

21. The risk-based approach to compliance should form the basis for determining the appropriate tools and methodologies used by the compliance function, as well as the extent of the monitoring programme and the frequency of monitoring activities performed by the compliance function (which may be recurring, ad-hoc and/or continuous). The compliance function should also ensure that its monitoring activities are not only desk-based, but that it also verifies how policies and procedures are implemented in practice, for example through on-site inspections at the operative business units. The compliance function should also consider the scope of reviews to be performed.

22. Suitable tools and methodologies for monitoring activities that could be used by the compliance function include (but are not limited to):

- the use of aggregated risk measurements (for example, risk indicators);
- the use of reports warranting management attention, documenting material deviations between actual occurrences and expectations (an exceptions report) or situations requiring resolution (an issues log);
- targeted trade surveillance, observation of procedures, desk reviews and/or interviewing relevant staff.

23. The monitoring programme should reflect changes to the investment firm's risk profile, which may arise, for example, from significant events such as corporate acquisitions, IT system changes, or re-organisation. It should also extend to the implementation and effectiveness of any remedial measures taken by the investment firm in response to breaches of MiFID.

24. Monitoring activities performed by the compliance function should also take into account:

- a. the business area's obligation to comply with regulatory requirements;
 - b. the first level controls in the investment firm's business areas (i.e. controls by the operative units, as opposed to second level controls performed by compliance);
- and

- c. reviews by the risk management, internal control function, internal audit function or other control functions in the area of investment services and activities.

25. Reviews by other control functions should be coordinated with the monitoring activities performed by the compliance function while respecting the different functions' independence and mandate.

26. The compliance function should have a role in overseeing the operation of the complaints process and it should consider complaints as a source of relevant information in the context of its general monitoring responsibilities. This does not require compliance functions to have a role in determining the outcome of complaints. In this regard, investment firms should grant the compliance function access to all customer complaints received by the firm.

Reporting obligations of the compliance function

Relevant legislation: Article 6(3)(b) and 9 of the MiFID Implementing Directive.

General guideline 3

27. Investment firms should ensure that the regular written compliance reports are sent to senior management. The reports should contain a description of the implementation and effectiveness of the overall control environment for investment services and activities and a summary of the risks that have been identified as well as remedies undertaken or to be undertaken. Reports must be prepared at appropriate intervals and at least annually. Where the compliance function makes significant findings, the compliance officer should, in addition, report these promptly to senior management. The supervisory function, if any, should also receive the reports.

Supporting guidelines

28. The written compliance report to senior management should cover all business units involved in the provision of investment services, activities and ancillary services. Where the report does not cover all of these activities of the investment firm, it should clearly state the reasons.

29. The following matters should be addressed in these written compliance reports, where relevant:

- a. a description of the implementation and effectiveness of the overall control environment for investment services and activities;
- b. a summary of major findings of the review of the policies and procedures;
- c. a summary of on-site inspections or desk-based reviews performed by the compliance function including breaches and deficiencies in the investment firm's organisation and compliance processes that have been discovered and appropriate measures taken as a result;

- d. risks identified in the scope of the compliance function's monitoring activities;
- e. relevant changes and developments in regulatory requirements over the period covered by the report and the measures taken and to be taken to ensure compliance with the changed requirements (where senior management has not previously been made aware of these through other channels);
- f. other significant compliance issues that have occurred since the last report; and
- g. material correspondence with competent authorities (where senior management has not previously been made aware of these through other channels).

30. The compliance function should report to senior management, in a timely manner, on an ad-hoc basis when significant compliance matters have been discovered, such as material breaches of MiFID and the respective national requirements. The report should also contain advice on the necessary remedial steps.

31. The compliance function should consider the need for additional reporting lines to any group compliance function.

32. ESMA notes that some competent authorities require investment firms to provide them with compliance function reports on a regular or ad hoc basis. One competent authority also requires senior management to provide it with an annotated version of the report containing explanations of the compliance function's findings. These practices provide competent authorities with first-hand insight into an investment firm's compliance activities, as well as any breaches of regulatory provisions.

Advisory obligations of the compliance function

Relevant legislation: Article 6(2) of the MiFID Implementing Directive.

General guideline 4

33. Investment firms should ensure that the compliance function fulfils its advisory responsibilities including: providing support for staff training; providing day-to-day assistance for staff and participating in the establishment of new policies and procedures within the investment firm.

Supporting guidelines

34. Investment firms should promote and enhance a 'compliance culture' throughout the firm. The purpose of the compliance culture is not only to establish the overall environment in which compliance matters are treated, but also to engage staff with the principle of improving investor protection.

35. The investment firm needs to ensure that its staff are adequately trained. The compliance function should support the business units in the area of investment services and activities (i.e. all staff involved directly or indirectly in the provision of investment services and activities) in performing any training. Training and other support should focus particularly, but not exclusively, on:

- a. the internal policies and procedures of the investment firm and its organisational structure in the area of investment services and activities; and
- b. MiFID, the relevant national laws, the applicable standards and guidelines set out by ESMA and competent authorities, and other supervisory and regulatory requirements that may be relevant, as well as any changes to these.

36. Training should be performed on a regular basis, and needs-based training should be performed where necessary. Training should be delivered as appropriate – for example, to the investment firm’s entire staff as a whole, to specific business units, or to a particular individual.

37. Training should be developed on an on-going basis so that it takes into account all relevant changes (for example, new legislation, standards or guidelines issued by ESMA and competent authorities, and changes in the investment firm’s business model).

38. The compliance function should periodically assess whether staff in the area of investment services and activities hold the necessary level of awareness and correctly apply the investment firm’s policies and procedures.

39. Compliance staff should also provide assistance to staff from the operative units in their day-to-day business and be available to answer questions arising out of daily business activity.

40. Investment firms should ensure that the compliance function is involved in the development of the relevant policies and procedures within the investment firm in the area of investment services, activities and ancillary services. In this context, the compliance function should be enabled, for example, to provide compliance expertise and advice to business units about all strategic decisions or new business models, or about the launch of a new advertising strategy in the area of investment services and activities. If the compliance function’s advice is not followed, the compliance function should document this accordingly and present it in its compliance reports.

41. Investment firms should ensure that the compliance function is involved in all significant modifications of the organisation of the investment firm in the area of investment services, activities and ancillary services. This includes the decision-making process when new business lines or new financial products are being approved. In this context, the compliance function should be given the right to participate in the approval process for financial instruments to be

taken up in the distribution process. Senior management should therefore encourage business units to consult with the compliance function regarding their operations.

42. Investment firms should ensure that the compliance function is involved in all material non-routine correspondence with competent authorities in the area of investment services and activities.