



**ECSRC MARKET GUIDELINES (1 OF 2017)**

**COMPLIANCE AND INTERNAL CONTROL GUIDELINES  
FOR ENTITIES LICENSED UNDER THE SECURITIES ACT**

**OCTOBER 2017**

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### **COMPLIANCE AND INTERNAL CONTROL GUIDELINES FOR ENTITIES LICENSED UNDER THE SECURITIES ACT, 2001**

The Eastern Caribbean Securities Regulatory Commission (the Commission), in exercise of powers conferred on it pursuant to *Section 163 of the Securities Act, 2001* (the Act)<sup>1</sup>, and any statutory extensions, modification, amendment or re-enactment of the Act and subsidiary legislation made thereunder as amended from time to time, issues the following Market Guidelines to firms licensed to engage in securities business in the Eastern Caribbean Securities Market (ECSM).

#### **1.0 INTRODUCTION**

- 1.1 In safeguarding and protecting the interests of investors in securities in the ECSM, the Commission seeks to ensure that persons licensed or authorized to engage in securities business, comply with the necessary legislative requirements and act at all times, according to the principles of best practice. These Compliance and Internal Control Guidelines set forth minimum standards, in the absence of any particular consideration or circumstances, for all licensees in the conduct of the business in the ECSM.
- 1.2 The provisions of these Guidelines are also designed to assist licensees in developing and implementing internal policies and procedures to direct the conduct of securities business.

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<sup>1</sup> “Act” refers to the Securities Act, 2001 and its accompanying Regulations, and shall be deemed to include any amendment, replacement or re-enactment from time to time. The applicable Securities Acts and Regulations enforced throughout the ECCU are the: Securities Act Chapter S13 of Anguilla; the Securities Act No. 14 of 2001 of Antigua and Barbuda; Securities Act No. 21 of 2001 of the Commonwealth of Dominica, Securities Act No. 23 of 2001 of Grenada; Securities Act Chapter 11.01 of Montserrat, Securities Act Chapter 21.16 of St Kitts and Nevis; Securities Act Chapter 12.18 of Saint Lucia; and Securities Act Chapter 261 of Saint Vincent and The Grenadines.

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- 1.3 With the enactment of the Securities Act in 2001, “Standards of Conduct” were instituted for licensed market participants under *Section 71 of the Act* which prescribes:

*“In the conduct of securities business, a licensee shall at all times act according to the principles of best practice and, in particular, shall—*

- (a) observe a high standard of integrity and fair dealing;*
- (b) act with due skill, care and diligence;*
- (c) observe high standards of market conduct;*
- (d) seek from customers information about their circumstances and investment objectives which might reasonably be expected to be relevant in enabling the licensee to fulfil the licensee’s responsibilities to the customer;*
- (e) take reasonable steps to give every customer [which] the licensee advises, in a comprehensible way, any information needed to enable the customer to make a balanced and informed investment decision;*
- (f) avoid any conflict of interest with customers and, where such a conflict unavoidably arises, ensure fair treatment to the customer by complete disclosure or by declining to act;*
- (g) ensure that the interests of the licensee is not unfairly placed above those of the customer;*
- (h) protect by way of segregation and identification, those customer assets for which the licensee is responsible;*
- (i) maintain adequate financial resources to meet the securities business commitments of the licensee and withstand the risks to which the business is subject;*

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- (j) organise and control internal affairs in a responsible manner;*
- (k) keep proper records;*
- (l) have adequate arrangements to ensure that all staff employed are suitable, adequately trained and properly supervised, and establish and maintain well-defined compliance procedures; and*
- (m) deal with the Commission in an open and co-operative manner.*

1.4 The *Securities (Conduct of Business) Regulations* also provides a list of legislative requirements to govern various aspects of a licensee's operations, including but not limited to, handling customer money, safeguarding customer investments, suitability, compliance, supervision, insider dealing as well as compliance and supervision mechanisms to be implemented by licensed entities.

1.5 A licensed entity must structure and operate its businesses to ensure that there are adequate and satisfactory internal control and management systems to provide reasonable assurance that:

- a) the licensed securities business will be conducted in an orderly and efficient manner and in compliance with all applicable laws and supervisory requirements;
- b) the assets of the business, including clients' assets will be safeguarded;
- c) proper records will be maintained to promote the reliability of financial and other information used within and published by the business.

1.6 These Guidelines are not statutory but consistent with market conduct requirements and are not intended to override the provision of any applicable law, standards and codes or any other regulatory requirements. However, where the Commission finds evidence that a criminal offence has taken place, whether under the Companies Act,

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the Securities Act or any other applicable law, the matter will be referred to the appropriate authority.

- 1.7 Failure by any licensee to substantially follow these guidelines may reflect adversely on the fitness and propriety of the entity to continue to hold a license, and may also subject the licensee to private reprimand or public censure or, in a flagrant case, further action as the Commission deems fit, including actions designed to deprive the offender temporarily or permanently of its ability to use the facilities of the ECSM.

#### **2.0 SCOPE AND APPLICATION**

- 2.1 These Guidelines apply generally to persons licensed under PART II Securities Exchanges, PART III Clearing Agencies and Securities Registries, PART IV Conduct of Securities Business and PART IX Collective Investment Schemes and are subject to the nature and scope of securities business activities conducted by a licensee. However, these Guidelines are neither intended to, nor should be construed as, an exhaustive treatment of the subject matter.
- 2.2 Senior management (hereinafter referred to collectively as "Management" and which may include as the case may be a firm's Board of Directors, General Manager, Chief Executive Officer, Managing Director, or other Senior Management personnel) are ultimately responsible for the adequacy and effectiveness of the internal control system implemented by a licensee. Therefore, the system of compliance and internal controls implemented by a licensed entity should be determined following a thorough review of each firm's particular structure and level of operations.
- 2.3 These Guidelines set out some of the key controls and attributes of an adequate internal control system for a licensed entity, as well as some of the methods for effectively achieving those attributes. In assessing a licensee or authorized firm's

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achievement of the objectives identified in these Guidelines, the Commission will take into account each firm's particular circumstances when assessing the adequacy of a firm's internal controls and internal management systems (compliance, supervision and management functions).

## **3.0 GUIDELINES**

### **3.1 Board and Management Oversight**

#### Objective

The licensed entity must establish, document and maintain an effective board and management supervisory structure which ensures that the operations of the business are conducted in a sound, efficient and effective manner.

#### Guidance

- 3.1.1 The board of directors shall ensure that:
- a) all employees engaged in the conduct of the firm's licensed securities business<sup>2</sup>, business activities and securities transactions, particularly outside activities and transactions are effectively supervised and monitored;
  - b) securities business at every office location is conducted in accordance with the firm's written supervisory procedures (WSP's); and
  - c) the firm's procedures are consistent with industry best practices, regulatory requirements and the "Standards of Conduct", taking into account the circumstances of the firm.
- 3.1.2 Management assumes full responsibility for the firm's operations including ensuring that:

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<sup>2</sup> Employees include all individuals' licensed, registered and all other associated persons.

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- a) effective compliance systems are established, developed and implemented and the on-going effectiveness of the firm's internal controls and the adherence thereto by its employees.
- b) regular and effective communication occurs within the firm which ensures that Board and management are always fully apprised of the status of the firm's operations and financial position, including qualitative and quantitative risk exposures or weaknesses detected therein, areas of non-compliance with supervisory and regulatory requirements, and the overall adherence to the firm's defined business objectives.
- c) reporting lines are clearly identified with supervisory and reporting responsibilities assigned to appropriate staff member(s).
- d) detailed policies and procedures pertaining to authorisations and approvals, as well as the authority of key positions are clearly defined and communicated to all relevant employees and that these are adhered to.
- e) that management and supervisory functions are performed by qualified and experienced individuals who have in-depth knowledge of the “Standards of Conduct” and can effectively apply the standards in the discharge of all supervisory responsibilities.
- f) that supervisors promote compliance, including making reasonable efforts to prevent and detect violations of laws, rules, regulations, firm policies and the “Standards of Conduct”, by developing and implementing effective compliance tools within the firm structure, including but not limited to:

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- i) education and training programs on a recurring or regular basis for employees under their supervision
- ii) establishment and documentation of a code of ethics
- iii) compliance policies and procedures
- iv) an incentive structure that rewards ethical conduct; and
- v) the adoption of firm-wide best practice standards.

#### **3.2 Segregation of Duties and Functions**

##### Objective

Key duties and functions must be appropriately segregated, particularly those duties and functions which when performed by the same individual may result in undetected errors or may be susceptible to abuses which may expose the firm or its clients to inappropriate risks.

##### Guidance

3.2.1 Management must ensure that:

- a) where practicable, policy formulation, supervisory and other internal review or advisory functions, including compliance and internal audit, are effectively segregated from line operational duties. Such segregation will ensure the effectiveness of supervisory and other internal controls established by Management.
- b) operational functions including, but not limited to, sales, dealing, accounting and settlement are effectively segregated to minimize the potential for conflicts, errors or abuses which may expose the firm or its clients to inappropriate risks. Special care should be taken to ensure that the sales and dealing functions are segregated from the research function where the possibility of potential conflict of interest exists.

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- c) there is no overlap between personnel in the investment banking and the corporate finance areas of a brokerage firm and the sales and research departments at any time. The functions carried out by the sales, investment banking and corporate finance departments must be segregated to ensure the objectivity of the research function.
- d) the physical separation of departments and files to prevent the communication of sensitive information that should not be shared must be implemented to the greatest extent possible. For instance, the records of the investment banking and corporate finance departments of a brokerage firm should be maintained separately from the sales and research departments.
- e) the compliance and internal audit functions are effectively segregated from and independent of the operational and related supervisory functions, and report directly to the board and/or an appropriate committee of the board, with administrative reporting lines to the Chief Executive Officer or General Manager.

### **3.3 Personnel and Training**

#### **Objective**

Appropriate personnel recruitment and training policies must be established with adequate consideration given to training needs to ensure compliance with the firm's operational and internal control policies and procedures, and all applicable legal and regulatory requirements to which the firm and its employees are subject.

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#### Guidance

- 3.3.1 Employees who conduct securities business should possess appropriate educational or other qualifications or experience having regard to the nature of the securities business which the employee is expected to undertake. Such qualifications should include, where required, the satisfactory completion of any examination requirements prescribed by the Commission or other regulatory body and the attaining of any requisite licence and/or registration.
- 3.3.2 Management implements procedures to ensure that the firm only employs persons who are fit and proper to perform the duties for which they are employed and that such persons are duly licensed and registered with all applicable regulatory bodies as required.
- 3.3.3 All staff and other persons performing services on the firm's behalf are provided with adequate and up-to-date documentation regarding the firm's policies and procedures which should include those relating to internal controls and personal dealing.
- 3.3.4 Management ensures that adequate training suitable for the specific duties which staff members perform is provided both initially and on an ongoing basis. A firm's training programme should ensure that staff possess or acquire appropriate and practical experience through "on-the-job" training and where appropriate, attendance or participation in training courses or programmes that are organised or arranged by or through the company as management-initiated training workshops, conferences and seminars or may be employee-initiated self-development training programmes which the firm may or may not opt to sponsor the employee's participation, and the ECSM Certification Program and Examination (ECPE).

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#### **3.4 Information Management**

##### Objective

Policies and procedures must be established to ensure the integrity, security, availability, reliability and thoroughness of all information, including documentation and electronically stored data that are relevant to the firm's business operations.

##### Guidance

- 3.4.1 Management of information, both in physically and electronically stored form, is assigned to appropriately qualified and experienced staff member(s).
- 3.4.2 Management ensures that the firm's operating and information management systems (including electronic data processing ("EDP") systems) meet the firm's needs and are operated in a secure and adequately controlled environment.
- 3.4.3 Information management reporting requirements are clearly defined to ensure the adequacy and timeliness of production of the required internal and external reports including those required by relevant regulatory authorities and self-regulatory bodies.
- 3.4.4 Key components of the information management system design and implementation programme are adequately documented and regularly reviewed for effectiveness.
- 3.4.5 Appropriate and effective EDP and data security policies and procedures are implemented to prevent and detect the occurrence of errors, omissions

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or unauthorised insertion, alteration or deletion of, or intrusion into, the firm's data processing system (electronic or otherwise) and data covering all confidential information in the firm's possession, such as clients' personal and financial information and price sensitive information.

- 3.4.6 Management establishes and maintains effective record retention policies which ensure that all relevant legal and regulatory requirements are complied with, and which enable the firm, its auditors and regulators, e.g. the Eastern Caribbean Securities Exchange and its subsidiaries and the Commission, to carry out routine and ad hoc comprehensive reviews or investigations.

### **3.5 Compliance**

#### Objective

Policies and procedures must be established and maintained to ensure the firm's compliance with all applicable legal and regulatory requirements as well as with the firm's own internal policies and procedures. Compliance procedures should be commensurate with the characteristics of a firm, including its size and the nature of its business.

#### Guidance

- 3.5.1 Management must ensure that the firm complies with all regulations concerning annual certifications of compliance and supervisory processes and controls.
- 3.5.2 Management establishes and maintains an appropriate and effective compliance function within the firm which operates independently of all operational and business line functions and senior or supervisory management.

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- 3.5.3 The compliance function should report directly to executive management, the board and/or relevant board sub-committee(s) and should be organized and structured in a manner that ensures the efficient management and reporting of the firm's risk exposures and must be at a sufficiently senior level within the firm. Thus the compliance function must be organized to provide a holistic view of the firm's risk management framework.
- 3.5.4 The firm must clearly outline within its written procedures and policy manuals, appropriate reporting mechanisms for the compliance function that would address a broad audience of the board, management and/or relevant board sub-committee(s) in order to at a minimum, adequately monitor how risks exposures are being handled and to escalate significant issues associated with those risks.
- 3.5.5 The compliance function must have direct access to the board of directors via the relevant board sub-committee(s) to ensure that risks and areas of non-compliance are appropriately reported and addressed in a timely manner.
- 3.5.6 Reporting lines must be clearly articulated by the Board and included in the compliance procedures manual and mechanisms instituted within the organizational structure to ensure that these procedures are adhered to.
- 3.5.7 Management ensures that staff performing the compliance function possesses the necessary skills, qualifications and experience to enable them to effectively execute their duties.

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- 3.5.8 Management establishes and enforces clear policies to ensure that the compliance function covers all relevant aspects of the firm's operations, including the unfettered access to necessary records and documentation.
- 3.5.9 Multiservice brokerage firms must implement procedures to prevent the misuse of material non-public information, including procedures to review employee and proprietary trading, investment recommendations and the supervision of interdepartmental communications.
- 3.5.10 Staff performing the compliance function, must assist management in ensuring firm-wide adherence to established policies and procedures. These procedures should cover supervisory and regulatory requirements including, where applicable, registration/licensing and financial resources requirements; record-keeping (for management and regulatory reporting, audit and investigations); business practices (e.g. codes of conduct; commission rebates and soft dollar practices; and preparation, approval and dissemination of research reports); prevention of money laundering; internal control matters; and compliance with the relevant client, proprietary and staff dealing requirements.
- 3.5.11 Management establishes, maintains and enforces policies and procedures to ensure the proper handling of complaints from clients and appropriate remedial action is promptly taken. The complaints procedures should be documented and include procedures for complaints to be investigated by staff performing the compliance function who are not directly involved in the subject matter of the complaint, as may be required.
- 3.5.12 Staff performing the compliance function promptly reports to Management, the board and/or relevant board committee(s) all occurrences of material

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non-compliance by the firm or its staff with legal and regulatory requirements, as well as with the firm's own policies and procedures. The firm shall promptly notify the Commission, the Eastern Caribbean Securities Exchange and its subsidiaries as may be applicable of any incidents of material non-compliance by the firm or its staff with relevant legal and regulatory requirements.

- 3.5.13 The compliance staff should have a clear and thorough understanding of the “Standards of Conduct”, statutory and other regulatory requirements and be organized in such a manner that enables an institution to engage regulators in a satisfactory and effective manner.
- 3.5.14 The firm should foster on-going communication with regulators to assist in mitigating potential sanctions stemming from misrepresentation of any statutory requirements and to keep abreast of changing Rules and Guidelines. The firm should implement a central point of contact for managing its interactions and relationships with regulators. Where necessary, the firm may appoint more than one contact to address compliance or business-related issues with the regulator, provided that the regulator is informed when the appropriate contacts are identified and established. The Head of Compliance, the General Counsel, or appropriate senior officer may be the designated point of contact for communicating with regulators on regulatory and supervisory matters. The designated point of contact will be charged with monitoring compliance risks and effectively managing the relationship between the firm and its regulators.
- 3.5.15 The firm’s compliance manual should outline written policies and procedures for addressing regulatory matters with the relevant authorities. The procedures should, at a minimum, provide guidance to employees and

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designated personnel and the committee, where applicable, on initiating contact with regulators, assisting and or consulting with regulators during an investigation and responding to regulatory requests, orders etc. The process for managing and responding to issues emanating from internal and external audit reviews of the function and regulatory examinations must also be documented.

- 3.5.16 The firm must develop formalised processes for measuring the performance of the compliance function against a clearly devised vision of its compliance strategy so as to enable the firm to adapt to the nascent changes of the regulatory framework and safeguard the firm from potential sanctions of non-compliance. Performance assessments of the compliance function should include periodic reviews of the department by both the internal audit personnel and external auditors.

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#### **3.6 Anti-money Laundering (AML)**

##### Objective

Establish and implement an appropriate risk-based AML/CFT program to effectively combat money laundering and terrorist financing. The program will include *inter alia* policies or measures and operating procedures for information systems pertaining to AML/CFT that are adequate and compliant with international standards and regulatory rules.

##### Guidance

- 3.6.1 At a minimum establish internal policies, controls and written procedures that identify the person(s) responsible for carrying out the procedures, the frequency with which employees must perform the procedures, and the procedures for documenting and testing with respect to:
- (i) detecting and reporting unusual transactions and suspicious activity
  - (ii) designating and identifying to the relevant supervisory authority the name, title, mailing address, telephone number of individuals responsible for implementing and monitoring the day-to-day operations and internal controls of the program; and providing for prompt notification to the supervisor any change in designation;
  - (iii) providing for ongoing training of all employees; and
  - (iv) providing for independent testing of the AML/CFT compliance program by either firm personnel or a qualified outside party. At a minimum, the AML/CFT compliance programme should be subject to periodic reviews by both internal and external auditors. Where the brokerage unit operates within a larger institution the independent audit of the AML/CFT compliance programme for the brokerage operations can be included as part of the wider independent assessment for the institution.

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- 3.6.2 Regular review of AML procedures for effectiveness and update policies and procedures as necessary based on any regulatory, business, or operational requirements.
- 3.6.3 Establish and adhere to any AML recordkeeping requirements as mandated under the relevant AML laws to enable full compliance with information requests.
- 3.6.4 Undertake appropriate customer due diligence (CDD) measures in accordance with general AML laws and procedure requirements.
- 3.6.5 Designation of an AML Compliance Officer, with direct reporting obligations to the firm's senior Management and/or board of directors. Where the brokerage unit operates as a unit within an organisation where the AML compliance function has been centralised, the appointed AML compliance officer may also perform the role of AML compliance for the brokerage operations.
- 3.6.6 Establish and maintain written procedures to determine and facilitate on-going monitoring of any Politically Exposed Persons (PEPs), in particular those who may require greater regulatory scrutiny.
- 3.6.7 Implement policies, procedures and strict CDD measures to address money laundering or terrorist financing threats posed by non-face-to-face business relationships or transactions.

### **3.7 Internal Audit**

#### **Objective**

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An audit policy and related review function must be established and maintained which objectively examines, evaluates and reports on the adequacy, effectiveness and efficiency of the firm's management, operations and internal controls.

#### Guidance

- 3.7.1 Management establishes an independent and objective internal audit function, which is free of operating responsibilities. This function should have a direct line of communication to the board audit committee.
- 3.7.2 Clearly prescribed terms of reference must be developed which set out *inter alia* the scope, objectives, approach and reporting requirements for the internal audit function. The relative roles and responsibilities of, and the working relationship between, internal and external auditors should also be clearly defined.
- 3.7.3 Management ensures that the person(s) performing the audit function possess the necessary technical competence and experience.
- 3.7.4 The internal audit function must be subject to periodic reviews by an independent external auditor.
- 3.7.5 Management ensures that there is adequate planning, control and recording of all audit and review work performed; timely reporting of findings, conclusions and recommendations to Management; and matters or risks highlighted in the relevant reports are followed up and resolved satisfactorily and in a timely manner.

### **3.8 Operational Controls**

#### Objective

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Effective policies and operational procedures and controls in relation to the firm's daily business operations must be established, maintained and compliance with these policies, procedures and controls enforced. The effectiveness of such operational procedures and controls will be evaluated in the light of whether they serve to ensure:

- (i) an adequate exchange of information between the firm and its clients including information from and required disclosures of information to clients;
- (ii) the integrity of the firm's dealing practices, including the treatment of all clients in a fair, honest and professional manner;
- (iii) the safeguarding of both the firm's and its clients' assets;
- (iv) the maintenance of proper records and the reliability of the information contained therein and used within the firm or used for publication; and
- (v) the compliance by the firm and persons acting on the firm's behalf, with relevant legal and regulatory requirements.

#### Guidance

- 3.8.1 Management establishes and maintains processes to obtain and confirm the true identity of the client, the beneficial owner(s) and person(s) authorised to give instructions on the client's behalf; and the client's financial position, and investment experience and objectives prior to the establishment of an account.
- 3.8.2 Where the firm exercises discretionary authority over a client's account and procedures are used to ensure that the precise terms and conditions under which such authority may be exercised are effectively communicated to and agreed with the client, and that only transactions which are consistent with the investment strategies and objectives of the relevant client, are effected on the client's behalf.

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- 3.8.3 Where the firm is in the business of offering investment advice for remuneration, or has entered into a contractual advisory arrangement with a client, and in the course of such business, gives investment recommendations or advice, measures and procedures are adopted to ensure that such recommendations and advice are based on thorough analysis, taking into account available alternatives and that such recommendations and advice are appropriate for the relevant client. The firm documents and retains the reasons for the recommendations and advice given.
- 3.8.4 Specific policies and procedures are established to minimize the potential for the existence of conflicts of interest between the firm or its staff and clients. Further, in circumstances where actual or apparent conflicts of interest cannot reasonably be avoided, that clients are fully informed of the nature and possible ramifications of such conflicts and are in all cases treated fairly.
- 3.8.5 Management establishes and maintains policies and procedures which ensure that whenever the firm or its staff member(s) have a material interest in a transaction with a client, this fact is disclosed to the client prior to the execution of the relevant transaction.
- 3.8.6 Management establishes and maintains policies and procedures which ensure that client orders are handled in a fair and equitable manner and, in all cases comply with order handling requirements specified in the various Rules or regulations. In particular, clear and comprehensive audit trails are created to precisely record all orders (both client and internally generated) from the time of origination, including the time the order was received or initiated, through order execution and settlement, e.g. through use of

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sequential numbering on order tickets and the use of time stamping facilities.

- 3.8.7 Management establishes and enforces procedures which ensure that proper safeguards exist to prevent the firm or its staff from taking advantage of confidential price sensitive information, or executes transactions as or on behalf of insiders which may contravene the Insider Dealing and Other Market Abuses provisions prescribed under PART X of the Act.
- 3.8.8 Management establishes and maintains appropriate and effective procedures in relation to dealing and related review processes to prevent or detect errors, omissions, fraud and other unauthorised or improper activities, and which ensure the fair and timely allocation of trades effected on behalf of clients.
- 3.8.9 Appropriate and effective procedures are established and followed to protect the firm's and its clients' assets from theft, fraud and other acts of misappropriation. In particular, the authority of the firm and its staff to acquire, dispose of and otherwise move or utilise the firm's or its clients' assets is to be clearly defined and followed. All assets are properly safeguarded, while at the firm's premises and deposited into appropriate accounts at banks or with securities custodians promptly. Further, adequate and reliable audit trails are maintained which enable the firm to prevent, detect and investigate suspected improprieties.
- 3.8.10 Undertake regular reconciliation of the firm's internal records and reports with those issued by third parties, e.g. the ECSE, banks, custodians, and counterparties, to identify and highlight for action any errors, omissions or misplacement of assets. Such reconciliations are reviewed and approved by the Principal or other appropriate senior staff member(s).

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#### **3.9 Risk Management**

##### Objective

Effective policies and procedures shall be established and maintained to ensure the proper management of risks to which the firm and, if applicable, its clients are exposed, particularly with regard to their identification and quantification, whether financial or otherwise, and the provision of timely and adequate information to Board and Management to ensure that appropriate and timely action is taken to assess, mitigate and manage such risks.

##### Guidance

- 3.9.1 Appropriate and effective risk management policies are established and monitored by a risk management function which, depending upon the firm's size, complexity of operations and risk appetite, consist of a sufficient number of suitably qualified and experienced professionals.
- 3.9.2 Management clearly defines its risk policies and establishes and maintains risk measurements and reporting methodologies commensurate with the firm's business strategies, size, complexity of its operations and risk profile.
- 3.9.3 Appropriate and effective procedures are established and followed to ensure that the firm's risks of loss, financial or otherwise, as a consequence of client defaults or changing market conditions are maintained at acceptable and appropriate levels. The firm should only take on positions which it has the financial and managerial capacity to assume.
- 3.9.4 Where the firm carries out proprietary trading, appropriate trading limits and position limits are established and monitored at appropriate intervals depending on the level of activity and reviewed as part of the end-of-day

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processing routine. Applicable trading limits, position limits and other risk management measures should be checked and reviewed for effectiveness on a timely basis.

- 3.9.5 Comprehensive risk reviews are conducted at suitable intervals, and wherever there is significant change in the business, operation or key personnel, to ensure that the firm's risk of losses, whether financial or otherwise, as a result of fraud, errors and omissions, interruptions or other operational or control failures is maintained at acceptable and appropriate levels.
- 3.9.6 Appropriate risk exposure reports are submitted regularly to Management and any significant variances are reported promptly to Management.
- 3.9.7 The firm should have a clear underlying structure for assuming ownership of risks. Assigning ownership for all risks to appropriate departments and monitoring business performance against established levels of risk appetite so as to enhance the compliance culture within the firm.

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#### **Appendix**

#### **SUGGESTED CONTROL TECHNIQUES AND PROCEDURES**

This appendix outlines various internal control techniques and procedures commonly implemented by licensed securities firms in the financial industry. These techniques and procedures neither constitute nor should be construed as an exhaustive or comprehensive list of applicable or relevant internal control techniques and procedures. They represent suggested approaches, which when employed effectively, can serve to assist licensees in establishing sound internal control systems and enhance their ability to comply with relevant legal and regulatory requirements. Each licensee, however, must consider carefully the specific nature and particular needs of their business when designing and implementing an internal control system.

The control techniques and procedures described in this Appendix relate to the areas of Operational Controls and Risk Management set forth in Parts 10 and 11 respectively of the "Compliance and Internal Control Guidelines". Greater detail with respect to these areas is deemed appropriate inasmuch as it may generally be applicable to most licensees. Adoption of some or all of the suggested internal control techniques and procedures contained in this Appendix is neither a necessary condition nor a guarantee that a firm's internal controls are satisfactory.

#### **A. Operational Controls**

##### Opening and handling of client accounts

1. Mandatory account opening procedures are clearly defined and followed. Such procedures may include:
  - a) recording and retention for future reference of all relevant client information (such as the true identities of the client, the beneficial owner(s) and representatives who are authorised to issue instructions, as well as the financial

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- position and investment experience and objectives of the client), related specimen signatures, and supporting documentation
- b) reviewing and confirming client information gathered, using criteria approved by Management;
  - c) ensuring that the client is provided with adequate information about the firm and the services to be provided to the client, together with other relevant documents such as relevant risk disclosure statements (particularly where the firm possesses discretionary authority over the account or where derivative financial products will be transacted on the client's behalf), and the nature and scope of fees, penalties and other charges the firm may levy;
  - d) ensuring that the client is provided with adequate information regarding his rights;
  - e) procuring execution of applicable client account agreements as required under relevant law, rules, regulations and codes; and
  - f) review and approval of new account applications and amendments to existing accounts, along with related supporting documentation, by a licensed Principal, and or other designated senior /supervisory staff, as may be applicable.
2. In the case of discretionary accounts, special procedures are implemented and followed which may include:
- a. executing a discretionary account agreement which sets out the investment objectives and strategies of the client and the precise terms and conditions under which such discretion will be exercised;
  - b. regular reviews of the performance of the account conducted by the licensed Principal and or other designated senior or supervisory staff member(s) independent of the staff handling the account;

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- c. providing the client with regular statements and timely ad hoc reports on account balances and transaction details, especially when the account balance falls below agreed levels or when large orders for the account are pending or executed; and the dealing process: order tickets similar to those used for non-discretionary agency business are completed and time-stamped to record the actual time orders are initiated.

#### Providing Investment Advice

3. Where the firm is in the business of offering investment advice for remuneration, or has entered into a contractual advisory arrangement with a client, and in the course of such business, gives investment recommendations or advice, special procedures are implemented and followed which may include:
  - a. establishing clear requirements and procedures regarding adequacy of research work and preparation and retention of documentation supporting the recommendations and advice;
  - b. providing to the client, in writing, details of the fees, charges and penalties applicable to recommended investment products and services; and
  - c. documenting (and providing a copy to the client) the rationale underlying investment advice rendered or recommendations made. Such advice and recommendations must be suitable taking into account the client's particular investment experience and objectives and financial position.

#### Dealing practices

4. The firm puts in place procedures to ensure that its staff's trading activities are not prejudicial to the interests of its clients. Staff members are required to disclose to the firm, on joining and regularly afterwards (at least semi-annually or to the extent that such reporting is not already required by securities laws), details of holdings and trading activities in which they have an interest in relation to specific securities and other investment products in which the firm deals in or in respect of which the firm

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acts as an investment adviser or trading adviser. Staff members of a firm which is, or belongs to a group within which a group member is, a member of an exchange are required to trade through staff accounts in relation to products traded on that exchange. All transactions for staff and associated persons accounts must be separately recorded and diligently monitored by independent senior management or compliance personnel.

5. The firm clearly defines parameters in relation to the acceptance by staff member(s) or the firm of gifts, rebates, benefits-in-kind or "soft-dollar" benefits received from clients or other business contacts. These include the circumstances under which acceptance is permitted and approval required.
6. Effective procedures are established to ensure that whenever the firm or its staff member(s) and any associated persons have an interest in a transaction with a client (i.e. a direct/cross transaction), this fact is disclosed to the client prior to the execution of the relevant transaction. For example, the firm may maintain a register of direct and cross trades which also records the name of the client and the firm account involved, the person contacted and the time when the consent was received. The register is reviewed regularly (at least monthly) by designated staff member(s) performing the compliance function or a senior staff member in the dealing department.
7. Order handling procedures are clearly documented and followed. Such procedures may include:
  - a. Orders are recorded, using standard order forms, and time-stamped promptly upon initiation or receipt and are required to be transmitted to the dealer, representative or operators of terminals for automated trading systems within a reasonable time period, normally immediately. This applies to both agency orders and internally generated orders (e.g. orders for the proprietary accounts,

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staff accounts and funds managed by the firm). This recording procedure may be modified to take into account the different types of orders in different markets so long as it provides an audit trail.

- b. Prior to executing a client order, the following items are checked by designated staff:
  - i. the status of the account (active, closed or being on an internal watch list, etc.);
  - ii. the sufficiency of available funds or available credit in the relevant account;
  - iii. in the case of a sell order, the sufficiency and availability of securities or the existence of necessary securities borrowing arrangements, if applicable;
  - iv. the authority and applicable limitations thereon of the person placing the order;
  - v. where the order is received by facsimile or electronic mail such order is reviewed by senior staff (the Principal) and, if in doubt, the client is called to check the validity and authority of the order prior to execution;
  - vi. the services and products the account is authorised to use/trade; and
  - vii. any special conditions stated in the client agreement or reported by other operating departments within the firm.
  
- c. Clearly defined policies and procedures are followed regarding the permitted circumstances under which a client order is not required to be immediately exposed to the applicable market for execution (for example, stop loss orders, orders which give the dealer discretionary authority to decide the timing of putting "component" working orders to the market and the size of each working order). Such procedures may include the method used to determine the acceptable price(s) at which a transaction or part transaction(s) may be executed.

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- d. Management should establish criteria to cover the review of orders upon receipt or initiation to determine the execution methodology and timing of execution for each order. Clear audit trails indicating the time of transmission and reference to the originating order should be maintained.
- e. Effective procedures regarding the transmission of orders to the dealing room are established. Sufficient information should be given to enable client priority to be established.
- f. Where practicable, a licensed principal or designated senior staff member who is independent of the traders (accredited representatives) should be assigned to allocate trades executed in accordance with the client priority and sequence of order receipt.
- g. When establishing and documenting fair-dealing compliance procedures, which are procedures to ensure that the firm complies with and observes high standards of business integrity and fair and equitable principles of trade in conducting its business, licensees should consider matters relating to, but are not limited to the following:
  - i. Investment recommendations guidelines and policies:
  - i. Restrictions on the number of persons privy to the information or recommendation prior to dissemination
  - ii. Shorten the timeframe between the decision to make an investment recommendation and the time the actual recommendation is disseminated.
  - iii. Develop guidelines for pre-dissemination behavior so as to prohibit personnel who have prior knowledge of an investment recommendation from discussing or taking any action on pending recommendations

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- iv. Establishing procedures designed to enable simultaneous dissemination as far as possible. The timing of dissemination of investment recommendations should be arranged to ensure that all clients are treated fairly and are reasonably informed at approximately the same time so as to avoid placing any client or group of clients at an unfair advantage relative to others.
  - v. Maintaining a list of clients and their holdings at all times.
- h. Trade Allocation Procedures:
- i. Developing a set of guiding principles that ensure:
    - a) fairness to advisory clients, both in priority of execution of orders and in the allocation of the price obtained in execution of block orders or trades
    - b) timeliness and efficiency in the execution of orders, and
    - c) accuracy of the licensee's records as to trade orders and client account positions.
  - ii. Developing written allocation procedures for block trades and new issues that are fair and equitable:
    - a) Requiring orders and modifications or cancellations of orders to be documented and time stamped;
    - b) Processing and executing orders on a first-in, first-out basis with consideration of bundling orders for efficiency as appropriate for the asset class or the security;
    - c) Putting in place a policy to address the manner in which trades are allocated such as calculating execution prices and "partial fills" when trades are grouped, or in a block, for efficiency;
    - d) Giving all client accounts participating in a block trade the same execution price and charging the same commission;

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- e) When the full amount of the block order is not executed, allocating partially executed orders among the participating client accounts on a pro rata basis in relation to order size while not going below the established minimum lot size for certain securities, as may be established.
- f) When trades are allocated for new issues, obtaining advance notifications of interest, allocating securities by client (rather than portfolio manager), and providing a method for calculating allocations.

#### Conflicts of Interest

8. The firm avoids apparent and potential conflicts of interest by establishing and maintaining adequate "Chinese Walls", such as the separation of dealers handling client funds or discretionary orders from those handling proprietary or staff accounts.
9. Management establishes and maintains policies and procedures regarding "Chinese Walls" to ensure that price-sensitive information privy to the research staff or staff handling corporate finance matters like a takeover and merger should not be available to staff outside those departments, except on a "need to know" basis.
10. Create policies and procedures to prevent potential conflicts of interest, and even the appearance of a conflict of interest, with respect to personal transactions or investing.
11. Firms must have policies and procedures that manage covered employees'<sup>3</sup> "personal investments and trading activities"

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<sup>3</sup>A covered employee is a firm employee who 1) conducts research, writes research reports, and or makes investment recommendations; or assists in the research process; 2) takes investment action on behalf of clients or the firm or who comes in contact with investment recommendations or decisions during the decision-making process; or 3) may benefit, personally or professionally, from influencing research reports or recommendations.

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- a) Limit participation in equity IPOs so as to avoid the appearance of and possible clear breach of the duty of loyalty to clients. Reliable and systematic review procedures should be established to ensure that conflicts relating to IPOs are identified and appropriately dealt with by management and supervisors;
- b) Institute strict restrictions on investment personnel for acquiring securities in private placements. Supervisory and review procedures should be established to prevent non-compliance;
- c) Establish blackout or restricted periods prior to trades for clients so that managers/supervisors and other staff who are privy to the investment decision-making process may not take advantage of their knowledge of client activity by “front-running” client trades. Where applicable procedures should include restricted periods before (at least 30 calendar days) and after (at least 5 calendar days) issuing a research report. Procedures should also ensure that covered employees and members of their immediate families do not have the ability to trade in advance or otherwise disadvantage investing clients relative to themselves or the firm.
- d) Implement policies to prohibit covered employees and members of their immediate families from trading in a manner that is contrary to, or inconsistent with, the employees’ or the firm’s most recent, published recommendations or ratings, except in circumstances of extreme financial hardship (as may be defined by the firm).
- e) Institute reporting requirements and procedures for investment personnel, including:
  - i. Disclosure of holdings in which the employee has a beneficial interest;
  - ii. Providing duplicate confirmation of all personal securities transactions and copies of periodic statements for all securities accounts.

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- iii. Preclearance procedures to identify possible conflicts prior to the execution of trades

#### Sales Practices

- 12. The firm avoids advising customers to enter into transactions with such frequency or in such amounts that those transactions would be considered excessive trading, or churning, in customer accounts.
- 13. Management reviews and monitors all dealings and transactions with clients to ensure that no false statements, material misstatements or material information is omitted concerning any purchase or sale of a security
- 14. Securities intermediaries should have appropriate internal management systems which capture, monitor and control risks which can reasonably be expected to protect clients from financial loss and detect any misuse of customer funds or securities
- 15. The firm adequately supervises and reviews customer accounts and establishes policies and procedures to prevent unauthorized trading or exercised discretion without proper customer consent.
- 16. The firm must establish reasonable basis for recommending a particular security or strategy and may do so only where the recommendation is suitable for that customer considering that customer's investment objectives and risk tolerance; and any other requirements or relevant facts about that customer of which the firm is, or reasonably ought to be, aware, including but not limited to:
  - a. The customer's knowledge and understanding of the relevant investment and markets, and the risks involved;

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- b. The customer's financial standing, which will include an assessment of his net worth or the value of his portfolio;
  - c. The length of time the customer has been active in the markets, the frequency of dealings, and the extent to which he has relied on advice of the firm.
17. Implement appropriate internal management systems and internal controls to deter manipulative sales practices during the underwriting of a security or in the immediate aftermarket. Establish written procedures for delivering the appropriate prospectuses to clients and prospective clients.

#### Back office and accounting

18. Deal tickets are transmitted to the designated back office staff member(s) who enter the details into the firm's own in-house system (whether automated or otherwise). At the end of each business day, the firm's own record of trades is matched by the back office staff to the trading/clearing lists received from the exchange or clearing house and where applicable, to confirmation documents issued by counterparties. Exception reports identifying mis-matched and unusual trades are produced, reviewed and follow-up actions taken, where necessary.
19. All trades, including off-exchange trades, are confirmed promptly with the client on whose behalf the trade was executed.
20. All trade errors are reported to the person responsible for dealing and are allocated to an "error" or "suspense" account for prompt correction or closure of the position. The transactions in this account should be supported by clear documentation explaining the relevant circumstances and reviewed by the staff member(s) performing the compliance and internal audit functions. Any unusual circumstances or patterns should be investigated.

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#### Asset protection

21. Effective procedures are established and followed, when handling movements of firm and client assets. Such procedures may include:
- a. Clearly identifying staff member(s) and representatives of clients (for client assets) with authority to acquire, dispose of, lend, pledge or otherwise part with possession of, firm and client assets, and the parameters of such authority. The authority is checked with respect to each asset movement and client withdrawal request.
  - b. Use of standardised and sequentially numbered receipts and dispatch notes or other appropriate methods to acknowledge and account for asset movements.
  - c. Securely storing in fireproof cabinets, as far as possible and under dual control, the firm and client assets, other important documents and controlled forms such as cheque books, contract notes etc., while at the firm's premises; and promptly depositing cheques, cashier orders and other negotiable instruments and securities into the appropriate account(s) at banks or securities depositories.
  - d. Maintaining reliable and adequate audit trails which enable the firm to thoroughly investigate suspected improprieties.
22. Payment cheques to clients are crossed "Account Payee Only" and are made payable to the beneficial owner of the account or an authorised representative in conformity with applicable written standing client instructions. Similarly, the firm requires its clients to make payments to the firm by crossed cheques payable only to the firm.
23. Third party cheques are discouraged

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24. Management establishes and maintains policies and procedures to ensure that clients' requests not to mail them regular statements in respect of their accounts are genuine requests and such requests are in writing duly signed by the clients and regularly (at least annually) reconfirmed by clients.
25. Authorisation requirements and authorised cheque signatories and applicable authority parameters, are clearly defined and communicated to the relevant bank; e.g. two or more authorised signatures should be required. Under no circumstances are the firm's cheques to be signed unless the date, specified payee and amount portions of the cheques are properly filled in.
26. Appropriate controls exist with respect to access to computer systems, facsimile transmission and electronic mail devices, where such devices are used to transmit important information, e.g. funds transfer instructions, settlement instructions and trade confirmations. Clear policies regarding confidentiality of passwords are developed, e.g. passwords are regularly changed and relevant passwords disabled upon a staff member(s) leaving the firm.
27. Regular compliance reviews and audits are conducted to detect activities or conditions which may violate, or contribute to non-compliance by the firm and its staff with, legal and regulatory requirements, as well as with the firm's own policies and procedures.

#### **New Products and Services**

28. Establish and implement comprehensive internal controls to effectively manage the introduction of new products and services.
29. Complete regulatory and legal due diligence prior to transacting business in a new product.

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30. Establish, maintain and enforce adequate written supervisory procedures for each new product or service, and or for a significant variation of an existing product or service. The procedures must set effective standards for control and address attaining necessary management and regulatory approvals, identify regulatory and training issues and integrating new products and services into existing internal control processes.

#### **B. Risk Management**

##### Risk management policy and measurements

31. The firm's risk policies and measurements and reporting methodologies are subject to regular review, particularly prior to the commencement of the firm's provision of new services or products, or when there are significant changes to the products, services, or relevant legislation, rules or regulations that might impact the firm's risk exposure.

##### Credit risk

32. The firm establishes and maintains an effective internal credit rating system to evaluate client and counterparty creditworthiness. Clearly defined objective measures should be used to evaluate potential clients and determine/review the relevant credit ratings which are used to set appropriate credit limits for all clients, including existing clients. The ratings and applicable limits reflect, among other things:

- a. the client's credit rating by designated credit rating organisations, as may be prescribed by the Commission from time to time, if any;
- b. investment objectives, investment history, trading frequency and risk appetite;
- c. past payment records and defaults, if any;
- d. the client's capital base and the existence and amount of guarantees and by whom such guarantees are given, if any; and

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- e. any known events which may have an adverse impact on the client's financial status, potential for default or accuracy of information stored regarding the client.
33. The staff performing risk management function utilises appropriate quantitative risk measurement methodologies to effectively calculate and monitor the firm's credit exposure in relation to clients, including: pre-settlement credit exposures (e.g. marking –to-market of outstanding trades) and settlement risk (e.g. exposure caused by timing differences between delivery versus payment).
34. The staff performing risk management function ensures that credit risks posed by all clients belonging to the same group of companies are aggregated for purposes of measuring the firm's credit exposure. Particular attention is paid to netting arrangements which may serve to reduce the firm's exposure to credit risk. Care must be taken to ensure that credit exposures are netted only if supported by appropriate executed netting agreements, or other appropriate protections.
35. The staff performing risk management function specifies trading and position limits for each client based on their respective credit rating and trading needs. These limits are approved by the licensed Principal or member of Senior Management and enforced.
36. The firm's margin policy and procedures are clearly defined, documented and enforced. Matters to be covered in such margin policy include:
- a. the types of margin which may be called, the applicable margin rates and the method of calculating the margin;
  - b. the acceptable methods of margin payment and forms of collateral;
  - c. the circumstances under which a client may be required to provide margin and additional margin, and the consequence of a failure to meet a margin call, including the actions which the firm may be entitled to take; and

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- d. applicable escalation procedures where a client fails to meet successive margin calls.

#### Market risk

- 37. Management specifies authorised products and instruments the firm may deal in and enforces effective procedures to ensure compliance. Relevant control techniques may include regular review of the balance sheet and profit and loss accounts, and records of individual traders and trading units for unauthorised investments or transactions; and confirmation of outstanding transactions with the firm's trading partners.
  
- 38. The staff performing risk management function reviews and otherwise enforces on an on-going basis compliance with trading and position limits in relation to proprietary trading and open positions with respect to each authorised product the firm trades or invests in.
  
- 39. Management establishes and maintains effective risk management measures to quantify the impact on the firm (especially if it deals in derivative financial products) and, if applicable, its clients from changing market conditions. These measures should cover all risk elements associated with the products traded or services provided by the firm. Matters to be covered in such risk measures may include:
  - a. unspecified adverse market movements - using an appropriate value-at-risk or other methodology to estimate potential losses (this is particularly important for firms which take significant proprietary positions in derivative products);
  
  - b. individual market factors - measures the sensitivity of the firm's risk exposure to specific market risk factors e.g. interest rate yield curve shifting and changes in market volatility; and

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c. stress testing - determining the effect of abnormal and significant changes in market conditions on the firm using various quantitative and qualitative variable assumptions.

40. To discourage the firm's representative or traders from engaging in unauthorised trading, risk adjusted performance measures are used, which may impact a representative or traders remuneration where his/her activities expose the firm to especially high risks. Representative or traders who have exceeded in pre-approved limits are subject to appropriate action.

#### Liquidity risk

41. Management sets and enforces concentration limits with respect to particular products, markets and business counterparties, taking into account their respective liquidity profile and the firm's approved liquidity risk policies.

42. Measures of maturity mis-matches between sources and funding requirements and concentrations of individual products, markets and business counterparties, are established and regularly monitored.

43. Management establishes appropriate arrears and default procedures to alert staff member(s) responsible for liquidity management to potential problems and to provide them adequate time to take appropriate action to minimise the impact of client or counterparty liquidity problems.

#### Operational risk

44. Management regularly reviews the firm's operations to ensure that the firm's risk of losses, whether financial or otherwise, resulting from fraud, errors, omissions and other operational and compliance matters, are adequately managed. Operational matters covered may include:

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- a. physical and functional segregation of incompatible duties such as trade, settlement, risk management and accounting;
  - b. maintenance and timely production of proper and adequate accounting and other records, and the ability to detect fraud, errors, omissions and other non-compliance with external and internal requirements;
  - c. security and the reliability of accounting and other information, such as exception reports which should accurately highlight unusual activities and facilitate the detection of fraud, errors and significant trends; and
  - d. staffing adequacy including personnel with relevant and sufficient skills and experience to minimise the risk of loss due to the absence or departure of "key" staff member(s).
45. An effective business continuity plan appropriate to the size of the firm, is implemented to ensure that the firm is protected from the risk of interruption to its business continuity. Key processes in this area include: a business impact study, identification of likely scenarios involving interruptions (e.g. break down in its data processing systems) and documentation and regular testing of the firm's disaster recovery plan.
46. The firm has adequate insurance cover for different types of exposures, including but not limited to professional indemnity as prescribed under section 80 of the Act, fidelity insurance, and replacement of equipment and other business and data processing devices.