

FSC Newsletter

Introduction

The Commission issues newsletters on an irregular basis. The purpose for each newsletter may vary, some may be updates on the Commission itself, whilst others provide feedback on issues of industry interest. This newsletter covers the generic findings from our risk assessment visits.

Newsletters are now being used exclusively to improve the Commission's communication, and therefore, unlike previously, they no longer form part of the regulatory framework. The failure to comply with any best practice recommendation will not result in disciplinary action. Whilst newsletters do contain guidance, they are not to be considered as "Guidance Notes" which will now be published separately.

The Commission will re issue previous "Newsletters" in the format of "Guidance Notes" in order to bring these in line with the new approach. Until this is done the previous Newsletters will still apply.

Risk Assessment Visits – Findings

Introduction

On 13 February 2004 the Commission announced the adoption of a risk based approach for supervising the financial services industry¹. This aims to focus resources on areas and firms where there is a possibility of a risk materialising and having adverse consequences on consumers and the stability and reputation of the jurisdiction. This approach establishes a high-level basis for the supervision of financial institutions in Gibraltar.

The FSC's risk-assessment visits are designed to evaluate the adequacy and effectiveness of authorised firms' risk-management techniques, as well as their adherence to the fundamental principles, obligations and requirements laid down by the various Ordinances, Regulations, Guidance Notes and best practice. A review may identify certain matters or shortcomings that may pose a risk to the firm's client-base or the jurisdiction as a whole. In such circumstances, firms may be required or recommended, depending on the nature and significance of a shortcoming, to address deficiencies identified.

A number of common themes have emerged from the reviews conducted to date. We have therefore issued this paper as a guide to the Commission's expectations concerning the operation of authorised firms. Firms are therefore asked to consider the contents of this Newsletter within the context of their operation. It is proposed that a formal guidance note will be issued once further visits have been conducted.

¹ Paper issued on 13 February 2004 titled 'The FSC's risk based framework for supervising the financial services industry'. Elements of the framework were updated on the 20 September 2005.

Corporate Governance

We have noted a low level of participation by some Boards of directors in actively leading and managing firms. The Commission has previously issued guidance in this respect in the form of FSC Newsletter 1 of 1998, which deals with the general duties and responsibilities of directors².

The heart of a firm's direction must come from an active Board. This is not to undermine the importance of a competent management team, within a clearly defined structure, prepared to take on responsibility and related accountability. In this regard the Board should ensure effective delegation and a relevant and timely reporting system commensurate with the level and extent of delegation. It might also be useful for the Board to seek the opinion of senior management who, ultimately, would be responsible for the day to day running of the business. This could be extended to seeking the opinion of the firm's auditors and others in a position to take a view on corporate governance.

Boards should actively consider undertaking a thorough risk assessment of the firm's business and taking into account external as well as internal factors. A relevant internal factor could be Board size and composition and whether this is appropriate for the firm's strategy.

Particular emphasis also needs to be placed on the fact that the Board must maintain a formal record of meetings, including that management keep records of its meetings, where policy, operational and strategic issues are discussed.

Know Your Client (KYC)

Stringent KYC policies and procedures minimise exposure to reputational risk. Such requirements do not simply entail obtaining copies of passports and utility bills but must enable the firm to understand the economic basis of its relationship with the client.

Firms need to understand the rationale behind robust and effective KYC procedures and are encouraged not to adopt a 'box-ticking' approach. Review teams have noted that a number of firms have not adopted a risk-based approach to KYC despite this being a requirement under the AMLGN's. There are a variety of methods available to firms for establishing KYC. Obtaining copies of passports and utility bills is simply one of them. These procedures cannot be applied equally to all clients as there will be different levels of documentary evidence to support KYC, including continuing KYC, across a client portfolio depending on the risk profile of the client.

The Commission requires firms to adopt a sensible risk assessment process to KYC, rather than the blanket approach adopted by some, particularly with respect to remediation programmes. Where necessary, firms are required to devote the necessary resources to address material deficiencies in KYC procedures and records.

Detailed due diligence should include:

- The close scrutiny of complex structures;
- Every effort to record source(s) of wealth to plausible verifiability (including the economic activity that created the wealth). For high risk cases this needs to be independently verified;
- Source of funds involved in the relationship;
- Development of a profile of expected activity of the business relationship so as to provide a basis for future monitoring;
- A review at senior management or Board level of the decision to commence the business relationships with high risk cases and 'Politically Exposed

² This will be replaced in 2006 by formal guidance notes

- Persons' ("PEP's"), and a regular review, at least annually, of the development of the relationship;
- Close scrutiny of unusual features.

Firms should make arrangements to record such facts either by way of a KYC Review Form or any other suitable fact-find questionnaire or file note³. Review teams usually find that whilst key individuals within a firm have full knowledge of a customer's business and transactions, including its principals, this is not always recorded on file. It is important for files to be as complete as possible with regard to information and documentation. This also ensures that effective continuity of service can be provided in the absence of any particular individual.

Care should also be taken when recording KYC information. Common shortcomings identified include recording source of funds as bank transfer, insufficient details regarding the nature of the client's activities or background, lack of cross-referencing, poor quality photocopies of key documents (e.g. passports), introducer of client unknown or not evident on file, or forms that are partially completed. If KYC records are maintained by a related party, firms must maintain copies of these records or have ready access to them.

Firms should also ensure that KYC information is obtained as soon as is reasonably practical. In a number of cases review teams have observed that an unacceptable time span has elapsed before due diligence information is collected on the relevant parties. There have been instances where review teams have observed that services have been provided to clients without any evidence of KYC having been conducted. This goes against the provisions of the Criminal Justice Ordinance 1995.

Once a firm has identified the relevant parties conducting business, it is essential that systems and procedures are adopted to ensure continual monitoring of higher risk customers. This aspect of KYC can only be effective if the firm has a thorough understanding of the business undertaken by the client. How else is the firm going to recognize if a transaction is suspicious?

It is therefore important that all relevant staff are adequately trained in the field of anti-money laundering, including refresher training at regular intervals.

Management of client relationships

Where an authorised firm provides financial services, relating to the following, to a customer, the firm must ensure that it enters into a contract/customer agreement with the customer such that it explains fairly and clearly the basis on which the services are provided⁴:

- Futures, options or contracts for differences;
- the discretionary management of a portfolio;
- the provision of non-discretionary portfolio management services;
- investments that are not readily realisable investments;
- any other type of business that is prescribed by the Commission.

It is imperative that firms ensure that such agreements be signed by clients.

³ Firms must ensure that whichever form is used complies with the requirements of the Gibraltar Anti-Money Laundering Guidance Notes 'KYC Review Form'.

⁴ This is a requirement for all firms licensed under the Financial Services Ordinance 1989 and authorised under the Financial Services Ordinance 1998 (Regulations 24 to 26 of the Financial Services (Conduct of Business) Regulations).

In other cases the firm should provide its terms of business to respective clients as a matter of course. The agreement should describe and govern the relationship between the parties by providing each with their respective functions, duties and responsibilities.

Whilst there is no requirement for the firm to ensure that the customer confirms they have received this, the Commission considers it good practice to do so. This would not only confirm compliance with the Regulations but also serve to protect the licence holder from a client's subsequent allegation of non receipt.

Agreements must not seek to exclude or restrict:

- any duty or liability to a customer which it has under the Ordinance, any subsidiary legislation made thereunder or under any rules made by the Commission ;
- any other duty to act with skill, care and diligence that is owed to a customer in connection with the provision of financial services ; and
- any liability owed to a customer for failure to exercise the degree of skill, care and diligence that may reasonably be expected in the provision of financial services.

Review teams have noted a number of firms providing financial services without an adequate agreement in place. Authorised firms must, therefore, ensure that a copy of the contract/management agreement, duly signed by the client (where appropriate), be kept on file.

Before a firm provides services to a client it must disclose the basis or amount of its charges for the provision of those services⁵. Such charges must not be unfair in their incidence or unreasonable in their amount, having regard to all relevant circumstances.

Likewise, firms need to obtain as much information about a client and seek to establish a client's financial standing, background (such as experience of the products being advised on) and investment/financial requirements (including attitude to risk) to assess whether a product is suitable. Firms must record this information in a manner that clearly explains the basis on which the firm recommended a particular product or course of action to the client. For example, a thorough 'fact-find' exercise enables firms to give the best advice and offer the product most suited to a client's needs. Good record keeping in this respect will also help the firm to defend itself against any claims of mis-selling.

A 'Reason Why' letter or suitability report should explain why it has been concluded that the recommended product is suitable for the customer having regard to the personal and financial circumstances of the client. Firms should endeavour to make the letter or report simple, concise and clear and above all use plain English. Technical terms must be clearly explained to ensure the customer's understanding of the product and its associated implications, including advantages and disadvantages.

• **Complaints handling**

Review teams have observed a lack of internal procedures to ensure the proper handling of complaints from customers. Firms should ensure that appropriate action is promptly taken regarding complaints. Complaints procedures should be adequately documented and made available to all relevant staff. It is, likewise, equally important for customers to be made aware of the existence of such a complaints handling procedure. This is usually contained within the contract/customer agreement.

⁵ Regulation 28, Financial Services (Conduct of Business) Regulations.

Authorised firms are also encouraged to enter in a written register a summary of all material complaints received and the manner in which they were handled. The register should be regularly reviewed by the board as an additional monitoring tool to improve quality of service and address recurring areas of weaknesses in procedures. This register must be open for inspection by the Financial Services Commission.

- **Record keeping requirements**

Client files should be sufficiently clear to substantiate the nature of the business relationship with the authorised firm. Review teams have, on occasions, found large gaps with regard to the information held on files. The nature of a firm's record keeping should be such that it allows a user not acquainted with the business relationship to understand the nature, extent and background of such a relationship with relative ease and free from ambiguity.

The use of file notes, for example, can help to record matters discussed with clients verbally for which no documentation or formal correspondence is available. This would also help an employee unfamiliar with a client to understand the nature of the relationship, thus ensuring continuity of service in the absence of the individual normally dealing with that particular client's affairs.

Care should also be taken to maintain accurate and up to date records which are material to the business relationship. These include such matters as, client instructions, business proposal forms, trading tickets, agreements, contracts, client profiles, statutory records (in the case of clients with corporate or trust structures this would mean registers, minute books), documents of title, account opening forms, account statements (bank or investment accounts), to name but a few.

Controls

As part of the risk assessment process, review teams will also test for evidence of the firm's internal controls of principle day-to-day scenarios. In this regard it is key for firms to have arrangements that evidence a review process consistent with sound internal control principles. This will be the case, for example, of processes such as client money/investment reconciliations, signing arrangements on client monies, client acceptance forms and checklists. In order to evidence the review process and maintain an appropriate audit trail, the Commission recommends firms adopt formal signing-off procedures. This in effect entails, for example, the persons undertaking a particular task to initial and date as having completed the task and a second person to initial and date as having checked the task.

Review teams have further observed that few firms have an adequate periodic review system in place in respect of client files, or the business relationship generally with a client, and that these are, at best, reviewed on an ad-hoc basis. The adoption of a periodic review system would assist firms in eliminating the deficiencies previously mentioned in respect of, for example, record keeping and general good house-keeping. Various errors and omissions noted during the course of the reviews would have otherwise been corrected with a periodic review system.

Review teams have also noted an absence of formal follow-up procedures with respect to matters outstanding in relation to clients. Whilst each firm may have its own system to deal with and chase outstanding matters, including varied approaches within a firm's staff, reviews have revealed various inconsistencies and anomalies. It is, therefore, recommended that firms adopt a standard and uniform procedure for the chasing of outstanding matters.

IT

Given the growing strategic importance of a firm's IT structure to effective service delivery we would recommend that firms review their IT arrangements in order to mitigate the risk of system failure and the obvious disruption this could bring to the business.

In particular, back-up procedures should be reviewed to assess reliability and effectiveness. The board together with senior management should actively consider factors such as; Frequency of back-ups, What is backed-up? Is the backed-up information mission critical? How quickly can lost data be restored? Which medium is used to back-up?

Another area of considerable significance is anti-virus protection. In the current climate of constant virus attacks, any safeguards or enhancements to procedures in this respect can only be seen as beneficial. Firms should therefore consider factors such as; Type of anti-virus software used? How often is this updated? How is it updated? What is virus-scanned? How often? Where are the scans performed? It should be noted that most of these measures have the potential of enhancing a firm's IT security procedures without unduly burdening the IT department's workload.

Review teams will also assess a firm's IT platform, to assess if functionality is commensurate with the size and nature of the business. Such a review will include items such as extent of manual data input, quality of management information systems, reporting functionalities, control processes and systems' capabilities generally.

Firms are also encouraged to provide staff with appropriate training and re-fresher courses on the use of IT and administration systems.

Firms are also advised to consider IT as a vital cornerstone of an effective 'Business Continuity Policy'.

The Commission is also aware that licensed firms have back up disaster recovery sites outside the jurisdiction. The Commission considers this to be a matter for the firm, however, firms should ensure that there are no regulatory or other implications in the jurisdiction concerned should these arrangements become active. Firms are therefore recommended to seek appropriate legal advice wherever the site is located. Firms should also consider data protection or other confidentiality issues that may arise in relation to client information.

General

• Procedures

Well documented procedures provide a foundation for firms to deliver a consistent quality of service. The procedures should be written at a level that everyone in the firm can understand. It must be useful, clear to the user and readily accessible. All relevant staff should be familiarised with its contents and substance. It is also advisable to include a section where personnel can "sign-off" when they have read and understood the process. An annual review by staff of the procedures manual would further enhance controls and understanding of the key processes.

Review teams have come across situations where staff are familiar with a process, yet the lack of documented procedures means that firms are not taking into account how the firm would operate should key members of staff suddenly leave. Likewise, in terms of training and succession planning, documented procedures provide a useful tool for new members of staff.

Firms should therefore document their procedures commensurate to their size and the nature of the business. These should include policies and procedures considered

material to the delivery of an efficient service and where necessary, provide key steps for performing a particular task. Written procedures should include, for example, complaints handling, all significant processes and general policies, including staff issues, disaster recovery and disciplinary procedures.