

MFSA

MALTA FINANCIAL SERVICES AUTHORITY

Circular regarding the EU Capital Requirements Directive ('CRD')

25th September, 2008

This Circular is being addressed to Investment Services Licence Holders ('Licence Holders') and the Malta Stock Exchange.

The Malta Financial Services Authority ('MFSA') hereby issues the following documents:

[A] Revised Part B of the Investment Services Rules for Investment Services Providers including a new sub-section in Section 7 entitled '*Risk Management and the Internal Capital Adequacy Assessment Process*'. The requirements in this new sub-section do not apply to: [i] credit institutions which are also Licence Holders – given that these will be subject to the requirements for credit institutions arising from the Banking Act, Cap. 371; [ii] Category 1 Licence Holders; and [iii] Licence Holders which only provide management services to collective investment schemes;

[B] Revised Financial Market Rules stipulating Financial Resources and Financial Reporting Requirements applicable to Regulated Markets and Central Securities Depositories including new rules dealing with risk management and capital adequacy; and

[C] Guidance Notes on Risk Management and Internal Capital Adequacy for Investment Services Licence Holders, Regulated Markets and Central Securities Depositories.

A copy of the above-mentioned documents is attached to this circular. The complete Rule books shall be available shortly on the MFSA's website in the area titled Securities.

The new requirements, which have the purpose of transposing the CRD Pillar II, shall be applicable as from 1st January, 2009. Accordingly, the first confirmation required in terms of SLC 7.46 of Part B of the Investment Services Rules and Rule 1.28 of the Financial Market Rules should be submitted to the Authority by the 31st January, 2009.

Please note that the above mentioned Rules and Guidance Notes were issued for consultation to the industry on the 20th August, 2008. No feedback/comments were received by the MFSA in this regard.

Contacts

Should you have any queries regarding the above or the attached documents, please do not hesitate to contact:

Mr. Christopher P. Buttigieg
Senior Manager
2548 5229
cbuttigieg@mfsa.com.mt

Mr. Konrad J. Farrugia
Manager
2548 5228
kfarrugia@mfsa.com.mt

INVESTMENT SERVICES RULES FOR INVESTMENT SERVICES PROVIDERS**PART B: STANDARD LICENCE CONDITIONS**

1. General Requirements

- 1.01 The Licence Holder shall commence its Investment Services business within twelve months of the date of issue of the Investment Services Licence.

If, for any reason the Licence Holder is not in a position to comply with this condition, it shall notify the MFSA in writing setting out the reason/s for such a delay together with an updated business plan indicating the proposed date of commencement of business. On the basis of the information provided and the circumstances of the case, the MFSA may decide to suspend or cancel the Licence in accordance with the relevant provisions of the Act.

- 1.02 The Licence Holder shall co-operate in an open and honest manner with the MFSA and inform it promptly of any relevant information. The Licence Holder shall supply the MFSA with such information and returns as the MFSA requires.

- 1.03 Where a Standard Licence Condition demands that a Licence Holder notifies the MFSA of an event, such notification shall be made to the MFSA formally, in a durable medium. The request to notify the MFSA of an event shall not be satisfied merely by the fact that the information which ought to be notified to the MFSA is included in a standard regulatory return.

- 1.04 The Licence Holder's Investment Services Business shall be effectively directed or managed by at least two individuals in satisfaction of the "dual control" principle. Such persons shall be of sufficiently good repute and sufficiently experienced so as to ensure the sound and prudent management of the Licence Holder.

Moreover, the Licence Holder shall take reasonable steps to ensure continuity and regularity in the performance of Investment and Ancillary Services. To this end, the Licence Holder shall employ appropriate and proportionate systems, resources and procedures.

- 1.05 By way of derogation from the requirements of SLC 1.04, where a Licence Holder is a natural person or a legal person managed by a single natural person, it shall provide, to the satisfaction of MFSA, alternative arrangements which ensure that it is soundly and prudently managed.

- 1.06 The Licence Holder shall notify the MFSA in writing of:
- a. a change in the Licence Holder's name or business name (if different) at least one month in advance of the change being made.
 - b. a change of address: at least one month in advance.
 - c. the departure of a Director or Senior Manager: within 14 days of the departure. The Licence Holder shall also request the Director or Senior Manager to confirm to MFSA that their departure had no regulatory implications or to provide relevant details, as appropriate. A copy of such request shall be provided to MFSA together with the Licence Holder's notification of departure.
 - d. the ultimate beneficial ownership of any party directly or indirectly controlling 10 per cent or more of the Licence Holder's share capital on becoming aware of the situation.
 - e. any acquisitions or disposals of shares which fall within the disclosure provisions of Article 10 of the Act – immediately upon becoming aware of the proposed acquisition or disposal. It should be noted that MFSA has the right to object to such an acquisition.
 - f. the provision of a related company loan, within 15 days of making the loan; provided that Licence Holder which falls under any one of the following categories need not comply with this requirements:
 - i. credit institutions licensed in terms of the Banking Act, 1994; or
 - ii. financial institutions licensed in terms of the Financial Institutions Act, 1994.
 - g. any proposed material change to its business (whether that business constitutes licensable activity under the Act or not) – at least one month before the change is to take effect (where a new or amended Investment Services Licence is required, the new business shall not begin until the new Investment Services Licence has been granted or the amendment has been approved).
 - h. any evidence of fraud or dishonesty by a member of the Licence Holder's staff immediately upon becoming aware of the matter.
 - i. a decision to make a material claim on any insurance policy held in relation to the Licence Holder's Investment Services business. Notification should be provided as soon as the decision is taken.

- j. any actual or intended legal proceedings of a material nature by or against the Licence Holder immediately after the decision has been taken or on becoming aware of the matter.
- k. any material changes in the information supplied to the MFSA – immediately upon becoming aware of the matter. This shall include the obligation to notify the MFSA on a continuous basis of any changes or circumstances which give rise to the existence of close links, as defined in Appendix 9, between the Licence Holder and any other person.
- l. the fact, where applicable, that it has not provided any Investment Service or carried out any investment activity for the preceding six months, setting out the reasons for such inactivity and providing a business plan for future activity.
- m. the relevant details required in terms of SLC 2.133 of these Rules pertaining to any introducers which may be appointed by the Licence Holder.
- n. the proposed appointment of a Tied Agent and of any information required in terms of these Rules, pertaining to a Licence Holder appointing tied agents.
- o. any other material information concerning the Licence Holder, its business or its staff in Malta or abroad – immediately upon becoming aware of the matter.

1.07 The Licence Holder shall obtain the written consent of the MFSA before:

- a. making any change to its share capital or the rights of its shareholders.
- b. establishing a branch in Malta or abroad.
- c. acquiring 10 per cent or more of the voting share capital of another company.
- d. taking any steps to cease its Investment Services business.
- e. agreeing to sell or merge the whole or any part of its undertaking.
- f. making application to a Regulator abroad to undertake any form of licensable activity outside Malta.
- g. the appointment of a Director or Senior Manager responsible for the Investment Services business of the Licence Holder or of the Licence Holder's Compliance Officer in terms of SLC 1.22(b) and/ or Money Laundering Reporting Officer, at least twenty one business days in advance. The request for consent of the appointment shall be accompanied by a Personal Questionnaire ("PQ"), in the form set out in Schedule F of these Rules – duly completed by the person proposed, which shall in the case of a proposed

Compliance Officer and/ or Money Laundering Reporting Officer, include sufficient details of the individual's background, training and/ or experience relevant to the post, to enable an adequate assessment by the MFSA. Where the person proposed had within the previous three years submitted a PQ to the MFSA in connection with some other role with the same Licence Holder, the request for consent need not be accompanied by a new PQ. In such instances, it shall be accompanied by a confirmation by the proposed person as to whether the information included in the PQ previously submitted is still current, and indicating any changes or up-dates thereto.

For the purposes of the above and (h) below, 'Senior Manager' should be interpreted as the person occupying the most senior role following that of Director, so that in the case where there are various management grades, it is the most senior manager who will require the MFSA's authorisation.

- h. the change in the responsibilities of a Director or Senior Manager at least twenty one business days in advance. The request for consent of the change in responsibilities of a Director or Senior Manager shall be accompanied by a PQ unless the individual concerned had within the previous three years submitted a PQ to the MFSA in connection with another role occupied by such individual with the same Licence Holder, in which case it shall be accompanied by a confirmation by the Director or Senior Manager as to whether the information included in the PQ previously submitted is still current, and indicating any changes or up-dates thereto.

A change in the responsibilities of a Director or Senior Manager should only be notified to the MFSA when such a change is material, which shall include a change in the status or seniority of the person concerned (upwards or downwards).

- i. any persons, whether Directors, Senior Managers or other employees are engaged in any of the following activities:
 - Portfolio or fund management
 - Investment advice

The request for authorisation shall include all relevant details in order to enable the MFSA to assess whether the persons concerned are sufficiently competent to undertake such activities. For this purpose, details of relevant experience, training and/or qualifications will be required. Applicants should also complete Sections 4, 5, 6 and 7 of the Application for an Investment Services Licence (Schedule A to these Rules).

1.08 The Licence Holder shall maintain sufficient records to be able to demonstrate

compliance with the conditions of its Investment Services Licence and as required by SLCs 2.83 to 2.85.

- 1.09 The Licence Holder shall co-operate fully with any inspection or other enquiry, or compliance testing carried out by the MFSA, or an inspector acting on its behalf.
- 1.10 Where, in the event of a dispute between a Licence Holder and a customer, it can be shown that unsuccessful efforts have been made to resolve the dispute, the MFSA may encourage the parties to submit the matter to arbitration. In such circumstances, the parties must in advance and in writing agree to:
- a. make all the necessary arrangements at their own cost;
 - b. appoint as Arbitrator(s), person(s) mutually acceptable; and
 - c. be bound by the decision of the Arbitrator(s) as if such decision was a judgment of the Court.

Alternatively, the matter may have to be referred to the Courts.

- 1.11 The Licence Holder shall pay promptly all amounts due to the MFSA.
- 1.12 The Licence Fee shall be payable by the Licence Holder on the day the Licence is first issued, and thereafter annually within one week from the anniversary of that date.
- 1.13 The Licence Holder shall notify the MFSA of any breach of the conditions of the Licence as soon as the Licence Holder becomes aware of the breach.
- 1.14 If so required by the MFSA, the Licence Holder shall do all in its power to delay the cessation of its Investment Services business, or the winding-up of such business so as to comply with conditions imposed by the MFSA, in order to protect the interests of customers.
- 1.15 A request for a variation of a Licence by the Licence Holder shall be submitted to the MFSA in writing, giving details of the variation requested and the reasons therefore.
- 1.16 A Licence Holder which is a sole trader or a small business shall make arrangements to ensure that customers' interests are safeguarded in the event of death, incapacity, sickness, holidays or other absence of the licensee.

General Organisational Requirements

- 1.17 The Licence Holder shall:

- a. establish, implement and maintain decision-making procedures and an organisational structure which clearly and in a documented manner specifies reporting lines and allocates functions and responsibilities;
- b. ensure that its relevant persons are aware of the procedures which must be followed for the proper discharge of their responsibilities;
- c. establish, implement and maintain adequate internal control mechanisms designed to secure compliance with decisions and procedures at all levels of the Licence Holder;
- d. employ personnel with the skills, knowledge and expertise necessary for the discharge of responsibilities allocated to them;
- e. establish, implement and maintain effective internal reporting and communication of information at all relevant levels of the Licence Holder;
- f. maintain adequate and orderly records of its business and internal organisation;
- g. ensure that the performance of multiple functions by its relevant persons does not and is not likely to prevent those persons from discharging any particular function soundly, honestly and professionally.

For these purposes, the Licence Holder shall take into account the nature, scale and complexity of its business, and the nature and range of Investment and Ancillary Services undertaken in the course of that business.

1.18 The Licence Holder shall establish, implement and maintain:

- a. systems and procedures that are adequate to safeguard the security, integrity and confidentiality of information, taking into account the nature of the information in question;
- b. an adequate business continuity policy aimed at ensuring, in the case of an interruption to its systems and procedures, the preservation of essential data and functions and the maintenance of Investment Services and activities, or, where that is not possible, the timely recovery of such data and functions and the timely resumption of its Investment Services and related activities;
- c. accounting policies and procedures that enable it to deliver in a timely manner to the MFSA upon request, financial reports which reflect a true and fair view of its financial position and which comply with all applicable accounting standards and rules.

1.19 The Licence Holder shall monitor and, on a regular basis evaluate, the adequacy and

effectiveness of its systems, internal control mechanisms and arrangements established in accordance with SLCs 1.17 and 1.18 above and take appropriate measures to address any deficiencies.

Compliance

- 1.20 The Licence Holder shall establish, implement and maintain adequate policies and procedures designed to detect any risk of failure by the Licence Holder to comply with its obligations under the Act, the Regulations issued thereunder and these Rules, as well as with its obligations under other applicable legislation, in particular the Prevention of Money Laundering Act, 1994, the Prevention of Financial Markets Abuse Act, 2005, and Regulations issued thereunder, as well as to detect the associated risks, and shall put in place adequate measures and procedures designed to minimize such risk and to enable the MFSA to exercise its powers effectively.

The Licence Holder shall, for this purpose, take into account the nature, scale and complexity of its business and the nature and range of Investment Services and activities undertaken in the course of that business

- 1.21 The Licence Holder shall establish and maintain a permanent and effective compliance function which operates independently and which has the following responsibilities:
- a. to monitor and, on a regular basis, to assess the adequacy and effectiveness of the measures and procedures put in place in accordance with the requirements of SLC 1.20, and the actions taken to address any deficiencies in the Licence Holder's compliance with its obligations;
 - b. to advise and assist the relevant persons responsible for carrying out Investment Services and activities to comply with the Licence Holder's legal and regulatory obligations.
- 1.22 In order to enable the compliance function to discharge its responsibilities properly, the Licence Holder shall ensure that the following conditions are satisfied:
- a. the compliance function shall have the necessary authority, resources, expertise and access to all relevant information;
 - b. a Compliance Officer shall be appointed and shall be responsible for the compliance function and for any reporting as to compliance required by these Rules;
 - c. the relevant persons involved in the compliance function shall not be involved in the performance of services or activities which they monitor;

- d. the method of determining the remuneration of the relevant persons involved in the compliance function shall not compromise their objectivity and shall not be likely to do so.

However, MFSA may exempt a Licence Holder from the requirements of points (c) or (d) if the Licence Holder is able to demonstrate to the satisfaction of the MFSA, that in view of the nature, scale and complexity of its business, and the nature and range of Investment Services and related activities, the requirement under that point is not proportionate and that its compliance function continues to be effective.

Moreover, with respect to (b) above, the appointment of an individual as Compliance Officer, is subject to MFSA's prior approval. Such person may also act as the Licence Holder's Money Laundering Reporting Officer. Reference should be made to SLC 1.07 (g) in this regard.

Risk Management

- 1.23 The Licence Holder shall take the following actions with a view to manage its risks:
 - a. establish, implement and maintain adequate risk management policies and procedures which identify the risks relating to the Licence Holder's activities, processes and systems, and where appropriate, set the level of risk tolerated by the Licence Holder;
 - b. adopt effective arrangements, processes and mechanisms to manage the risks relating to the Licence Holder's activities, processes and systems, in light of that level of risk tolerance;
 - c. monitor the following:
 - i. the adequacy and effectiveness of the Licence Holder's risk management policies and procedures;
 - ii. the level of compliance by the Licence Holder and its relevant persons with the arrangements, processes and mechanisms adopted in accordance with point (b) above;
 - iii. the adequacy and effectiveness of measures taken to address any deficiencies in those arrangements and procedures, including failures by the relevant persons to comply with such arrangements or follow such procedures.
- 1.24 The Licence Holder is required to establish and maintain a risk management function that operates independently and carries out the following tasks:

- a. the implementation of the policy and procedures referred to in SLC1.23; and
- b. the provision of reports and advice to senior management in accordance with SLC 1.26.

However, MFSA may allow the Licence Holder to establish and maintain a risk management function which does not operate independently if the Licence Holder, satisfies the MFSA that the establishment and maintenance of an independent risk management function is not appropriate and proportionate in view of the nature, scale and complexity of its business and the nature and range of the Investment Services and activities undertaken in the course of that business.

Where a Licence Holder is granted such a derogation, it must nevertheless be able to demonstrate that the policies and procedures which it has adopted in accordance with SLC 1.23, satisfy the requirements thereof and are consistently effective.

Responsibility of Senior Management

- 1.25 When allocating functions internally, the Licence Holder shall ensure that senior management, and where appropriate, the supervisory function, are responsible for ensuring that the Licence Holder complies with its obligations under these Rules.

In particular, senior management and where appropriate, the supervisory function shall be required to assess and periodically to review the effectiveness of the policies, arrangements and procedures put in place to comply with the obligations under these Rules and to take appropriate measures to address any deficiencies.

- 1.26 The Licence Holder shall ensure that its senior management receives on a frequent basis, and at least annually, written reports on the matters covered by SLCs 1.20 to 1.24 and SLC 1.28 indicating in particular whether the appropriate remedial measures have been taken in the event of any deficiencies.
- 1.27 The Licence Holder shall ensure that the supervisory function, if any, receives on a regular basis (at least annually) written reports on the same matters.

For the purposes of this Section, “supervisory function” means the function within a Licence Holder responsible for the supervision of its senior management.

Internal Audit

- 1.28 Where appropriate and proportionate in view of the nature, scale and complexity of its business and the nature and range of investments services and activities undertaken in the course of its business, the Licence Holder shall establish and maintain an internal audit function which is separate and independent from the other functions and activities of the Licence Holder and which has the following

responsibilities:

- a. to establish, implement and maintain an audit plan to examine and evaluate the adequacy and effectiveness of the Licence Holder's systems, internal control mechanisms and arrangements;
- b. to issue recommendations based on the result of work carried out in accordance with point (a);
- c. to verify compliance with those recommendations;
- d. to report in relation to internal audit matters in accordance with SLC1.26.

Enforcement

- 1.29 The Licence Holder shall at all times observe the Licence Conditions which are applicable to it, as well as all the relative requirements which emanate from the Act and regulations issued thereunder. In terms of the Act, the MFSA has various sanctioning powers which may be used against the Licence Holder which does not comply with its regulatory obligations. Such powers include the right to impose administrative penalties. Appendix 5 to these Rules refers to the factors which the MFSA takes into account when imposing administrative penalties and includes – for indicative purposes - non-exhaustive details of the penalties applicable for breaches of certain Licence Conditions and for late submission of documents and licence fees.

2. Conduct of Business Obligations

General

- 2.01 When providing Investment Services to clients, a Licence Holder shall act honestly, fairly and professionally in accordance with the best interests of its clients and shall comply with the relevant provisions of the Act, the Regulations issued thereunder, these Rules as well as with other relevant legal and regulatory requirements, in particular those set out in the Prevention of Money Laundering Act, 1994, and the Prevention of Financial Markets Abuse Act, 2005 and Regulations issued thereunder. The Licence Holder is also expected to take due account of any relevant Guidance Notes which may be issued by the MFSA or other relevant body to assist the Licence Holder in complying with its legal and regulatory obligations.
- 2.02 The Licence Holder shall not be regarded as acting honestly, fairly and professionally in accordance with the best interests of a client if, in relation to the provision of an investment or Ancillary Service to the client, it pays or is paid any fee or commission, or provides or is provided with any non-monetary benefit, other than the following:
- a. a fee, commission or non-monetary benefit paid or provided to or by the client or a person on behalf of the client;
 - b. a fee, commission or non-monetary benefit paid or provided to or by a third party or a person acting on behalf of a third party, where the following conditions are satisfied:
 - i. the existence, nature and amount of the fee, commission or benefit, or where the amount cannot be ascertained, the method of calculating that amount, must be clearly disclosed to the client, in a manner that is comprehensive, accurate and understandable, prior to the provision of the relevant Investment or Ancillary Service. The essential terms of the arrangements relating to the fee, commission or non-monetary benefit may be disclosed in summary form, provided that the Licence Holder undertakes to disclose further details at the request of the client and provided that it honours that undertaking;
 - ii. the payment of the fee or commission, or the provision of the non-monetary benefit must be designed to enhance the quality of the relevant Investment or Ancillary Service to the client and not impair compliance with the Licence Holder's duty to act in the best interests of the client;
 - c. proper fees which enable or are necessary for the provision of Investment Services such as custody costs, settlement and exchange fees, regulatory levies

or legal fees, and which, by their nature, cannot give rise to conflicts with the Licence Holder's duties to act honestly, fairly and professionally in accordance with the best interests of its clients.

Client Classification

2.03 Before providing an Investment Service, the Licence Holder shall classify the client or potential client to whom the service is to be offered as a Professional Client, Retail Client or an Eligible Counterparty in terms of the Glossary to these Rules and the following Rules.

Moreover, the Licence Holder shall notify new clients and existing clients which it has newly categorised, of their categorisation as a Retail Client, a Professional Client or Eligible Counterparty.

2.04 The Licence Holder shall implement appropriate written internal policies and procedures to categorise clients. Professional Clients are responsible for keeping the Licence Holder informed about any change, which could affect their current categorisation. Should the Licence Holder become aware however that the client no longer fulfils the initial conditions, which made him/her eligible for a professional treatment, the Licence Holder must take appropriate action.

2.05 The Licence Holder shall inform clients in a durable medium about any right that a client has to request a different categorisation and about any limitations to the level of client protection it would entail.

2.06 The Licence Holder may, either on its own initiative or at the request of the client concerned:

- a. treat as a professional or Retail Client, a client that might otherwise be classified as an Eligible Counterparty;
- b. treat as a Retail Client, a client that is considered as a Professional Client as defined in the Glossary to these Rules.

2.07 Where a client would ordinarily fall within the definition of a Professional Client, it may still elect to be treated as a Retail Client and the Licence Holder may agree to provide a higher level of protection. In this case, the Licence Holder must:

- a. warn the client, prior to any provision of services, that, on the basis of the information available to it, the client is deemed to be a Professional Client, and will be treated as such unless Licence Holder and the client agree otherwise;
- b. inform the client that he can request a variation of the terms of the agreement in order to secure a higher degree of protection.

Although it is the responsibility of the client, considered to be a Professional Client, to ask for a higher level of protection when he/she deems he/she is unable to properly assess or manage the risks involved, such higher level of protection will only be provided on the basis of a written agreement with the Licence Holder to the effect that the client shall not be treated as a Professional Client for the purposes of the applicable Conduct of Business Rules. Such agreement should specify whether this applies to one or more particular services or transactions, or to one or more types of product or transaction.

- 2.08 The Licence Holder shall treat clients which do not fall under the definition of a Professional Client in terms of the Glossary to these Rules, including public sector bodies and private individual investors, as Retail Clients, unless they have clearly elected not to be so treated. Such an option would mean that the client has chosen to waive some of the protections afforded by the Conduct of Business Rules and the Licence Holder shall only uphold such a request provided the relevant criteria and procedure mentioned below in SLC 2.09 to 2.12, are fulfilled.
- 2.09 Such clients referred to in SLC 2.08 which have opted not to be treated as Retail Clients, should not be presumed to possess market knowledge and experience comparable to that of the categories mentioned in the definition of Professional Clients. Any waiver of the protection afforded by the standard Conduct of Business Rules shall be considered valid only if an adequate assessment of the expertise, experience and knowledge of the client, undertaken by the Licence Holder, gives reasonable assurance, in the light of the nature of the transactions or services envisaged, that the client is capable of making his own investment decisions and of understanding the risks involved.
- 2.10 In the course of the above assessment required in terms of SLC 2.09, as a minimum, two of the following criteria should be satisfied:
- a. the client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter of the previous four quarters;
 - b. The size of the client's Instrument portfolio, defined as including cash deposits and Instruments exceeds EUR 500 000;
 - c. The client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged.
- 2.11 Clients referred to in SLC 2.08, may waive the benefit of the Conduct of Business Rules only where the following procedure is followed:
- a. they must state in writing to the Licence Holder that they wish to be treated as

- a Professional Client, either generally or in respect of a particular Investment Service or transaction or type of transaction or product
 - b. the Licence Holder must give them a clear written warning of the protections and investor compensation rights they may lose
 - c. they must state in writing in a separate document from the contract, that they are aware of the consequences of losing such protections.
- 2.12 Before deciding to accept any request for waiver, the Licence Holder is required to take all reasonable steps to ensure that the client requesting to be treated as a Professional Client meets the relevant requirements stated in SLC 2.10 above. However, if clients have already been categorised as professionals under parameters and procedures similar to those above, it is not intended that their relationships with the Licence Holder should be affected by any new procedures adopted under these Rules.

Client Profile Requirements

Assessment of Suitability and Appropriateness

- 2.13 When providing investment advice or portfolio management services, the Licence Holder shall obtain the necessary information, in accordance with SLCs 2.16 to 2.20 and SLC 2.22 to 2.24 regarding the client's or potential client's knowledge and experience in the investment field relevant to the specific type of product or service, his financial situation and his investment objectives so as to enable the Licence Holder to recommend to or, in the case of portfolio management, to effect for the client or potential client, the Investment Services and Instruments that are suitable for him.
- 2.14 When providing Investment Services other than investment advice or portfolio management services, the Licence Holder shall ask the client or potential client to provide information in accordance with SLCs 2.21 and SLC 2.22 to 2.24 regarding his knowledge and experience in the investment field relevant to the specific type of product or service offered or demanded so as to enable the Licence Holder to assess whether the Investment Service or product envisaged is appropriate for the client.

In case the Licence Holder considers, on the basis of the information received under the above paragraph, that the product or service is not appropriate to the client or potential client, the Licence Holder shall warn the client or potential client. This warning may be provided in a standardised format.

In case where the client or potential client elects not to provide the information referred in this SLC or where he provides insufficient information regarding his knowledge and experience, the Licence Holder shall warn the client or potential

client that such a decision will not allow the Licence Holder to determine whether the service or product envisaged is appropriate for him. This warning may be provided in standardised format.

- 2.15 In cases where an Investment Service is offered as part of a financial product which is already subject to other provisions of Community legislation or common European standards related to credit institutions and consumer credits with respect to risk assessment of clients and/or information requirements, this service shall not be additionally subject to the obligations set out in this Section.

Assessment of Suitability

- 2.16 The Licence Holder shall obtain from clients or potential clients, such information as is necessary for the Licence Holder to understand the essential facts about the client and to have a reasonable basis for believing, giving due consideration to the nature and extent of the service provided, that the specific transaction to be recommended, or entered into in the course of providing a portfolio management service, satisfies the following criteria:

- a. it meets the investment objectives of the client in question;
- b. it is such that the client is able financially to bear any related investment risks consistent with his investment objectives;
- c. it is such that the client has the necessary experience and knowledge in order to understand the risks involved in the transaction or in the management of his portfolio.

- 2.17 Where a Licence Holder provides an Investment Service to a Professional Client, it shall be entitled to assume that, in relation to the products, transactions and services for which it is so classified, the client has the necessary level of experience and knowledge for the purposes of SLC 2.16.

Where that Investment Service consists in the provision of investment advice to a Professional Client, the Licence Holder shall be entitled to assume for the purposes of SLC 2.16 that the client is able financially to bear any related investment risks consistent with the investment objectives of that client.

- 2.18 The information regarding the financial situation of the client or potential client shall include, where relevant, information on the source and extent of his regular income, his assets, including liquid assets investments and real property, and his regular financial commitments.

- 2.19 The information regarding the investment objectives of the client or potential client shall include, where relevant, information on the length of time for which the client

wishes to hold the investment, his preferences regarding risk taking, his risk profile and the purposes of the investment.

- 2.20 Where, when providing the Investment Service of investment advice or portfolio management, a Licence Holder does not obtain the information required under SLC 2.13, the Licence Holder shall refrain from providing the above mentioned services to the client or potential client.

Assessment of appropriateness

- 2.21 When assessing whether an Investment Service, other than investment advice or portfolio management, is appropriate for a client, the Licence Holder shall be required to determine whether that client has the necessary experience and knowledge in order to understand the risks involved in relation to the product or Investment Service offered or demanded.

For these purposes, a Licence Holder shall be entitled to assume that a Professional Client has the necessary experience and knowledge in order to understand the risks involved in relation to those particular Investment Services or transactions, or types of transaction or product, for which the client is classified as a Professional Client.

Provisions common to the assessment of suitability and appropriateness.

- 2.22 Information regarding the client's or potential client's knowledge and experience in the investment field includes the following, to the extent appropriate to the nature of the client, the nature and extent of the service to be provided and the type of product or transaction envisaged, including their complexity and the risks involved:
- a. the types of service, transaction and Instrument with which the client is familiar;
 - b. the nature, volume, frequency of the client's transactions in Instruments and the period over which they have been carried out;
 - c. the level of education, profession or relevant former profession of the client or potential client.
- 2.23 A Licence Holder shall not encourage a client or potential client not to provide information required for the purposes of SLCs 2.13 and 2.14.
- 2.24 A Licence Holder shall be entitled to rely on the information provided by its clients or potential clients unless it is aware or ought to be aware that the information is manifestly out of date, inaccurate or incomplete.

Exemption from the Appropriateness Test

2.25 When providing Investment Services that only consist of the execution and/or reception and transmission of client orders with or without Ancillary Services, the Licence Holder need not obtain the information referred to in SLC 2.14 above where all of the following conditions are met:

- a. the above services relate to shares admitted to trading on a regulated market or in an equivalent third country market, money market Instruments, bonds or other forms of securitised debt (excluding those bonds or securitised debt that embed a derivative), UCITS and other non-complex Instruments. A market established in a country which is not an EU or EEA Member State shall be considered as equivalent to a regulated market if it complies with equivalent requirements to those established in terms of the MIFID;
- b. the service is provided at the initiative of the client or potential client;
- c. the client or potential client has been clearly informed that in the provision of this service the Licence Holder is not required to assess the suitability of the Instrument or service provided or offered and that therefore, he does not benefit from the corresponding protection of the relevant Conduct of Business Rules. This warning may be provided in standardised format;
- d. the Licence Holder complies with its obligations relating to the management of conflicts of interests as set out in SLC 2.94 to 2.100. below.

2.26 An Instrument which is not specified in SLC 2.25(a) above shall be considered as non-complex if it satisfies the following criteria:

- a. It does not fall under paragraph (c) of the definition of “transferable securities” in the Glossary to these Rules or under paragraphs (4) to (10) of the Second Schedule to the Act;
- b. there are frequent opportunities to dispose of, redeem, or otherwise realise that Instrument at prices that are publicly available to market participants and that are either market prices or prices made available, or validated, by valuation systems independent of the issuer;
- c. it does not involve any actual or potential liability for the client that exceeds the cost of acquiring the Instrument;
- d. adequately comprehensive information on its characteristics is publicly available and is likely to be readily understood so as to enable the average Retail Client to make an informed judgment as to whether to enter into a transaction in that Instrument.

Client Disclosure Requirements

- 2.27 The Licence Holder shall provide appropriate information, in a comprehensible form to its clients or potential clients such that they are reasonably able to understand the nature and risks of the Investment Service to be provided by the Licence Holder and of the specific type of Instrument that is being offered, and consequently to take investment decisions on an informed basis. This information may be provided in standardized format and should include details about:
- a. the Licence Holder and its services;
 - b. Instruments and proposed investment strategies. This should include appropriate guidance on and warnings of the risks associated with investments in those Instruments or in respect of particular investment strategies;
 - c. execution venues;
 - d. costs and associated charges.
- 2.28 The Licence Holder shall provide Retail Clients or potential Retail Clients with the following general information, where relevant:
- a. the name and address of the Licence Holder, and the contact details necessary to enable clients to communicate effectively with the Licence Holder;
 - b. the languages in which the client may communicate with the Licence Holder, and receive documents and other information from the Licence Holder;
 - c. the methods of communication to be used between the Licence Holder and the client including, where relevant, those for the sending and reception of orders;
 - d. a statement of the fact that the Licence Holder is licensed by the MFSA, together with the address of the MFSA;
 - e. the nature, frequency and timing of the reports on the performance of the service to be provided by the Licence Holder to the client in accordance with SLC 2.40;
 - f. if the Licence Holder holds client Instruments or client money, a summary description of the steps which it takes to ensure their protection, including summary details of any relevant investor compensation or deposit guarantee scheme which applies to the Licence Holder by virtue of its activities in a Member State;

- g. a description, which may be provided in summary form, of the conflicts of interest policy maintained by the Licence Holder in accordance with SLC 2.98 to 2.100;
 - h. at any time that the client requests it, further details of that conflicts of interest policy in a durable medium or by means of a website (where that does not constitute a durable medium) provided that the conditions specified in SLC 2.115 are satisfied.
- 2.29 When providing the services of portfolio management, the Licence Holder shall establish an appropriate method of evaluation and comparison such as a meaningful benchmark, based on the investment objectives of the client and types of Instruments included in the client portfolio, so as to enable the client for whom the service is provided to assess the Licence Holder's performance.
- 2.30 The following information shall also be provided, where applicable, in addition to that required under SLC 2.28 to Retail Clients or potential Retail Clients by the Licence Holder proposing to provide portfolio management services:
- a. information on the method and frequency of valuation of the Instruments in the client portfolio;
 - b. details of any delegation of the discretionary management of all or part of the Instruments or money in the client's portfolio;
 - c. a specification of any benchmark against which the performance of the client portfolio will be compared;
 - d. the types of Instrument that may be included in the client's portfolio and types of transaction that may be carried out in such Instruments, including any limits;
 - e. the management objectives, the level of risk to be reflected in the Licence Holder's exercise of discretion, and any specific constraints on that discretion.
- 2.31 The Licence Holder shall, in good time before a Retail Client or potential Retail Client is bound by any agreement for the provision of Investment Services or Ancillary Services or before the provision of those services whichever is the earlier, to provide that client or potential client with the following information:
- a. the terms of any such agreement;
 - b. the information required in SLC 2.28 to 2.30 relating to that agreement or to those Investment or Ancillary Services.
- 2.32 The Licence Holder, shall, in good time before the provision of Investment Services

or Ancillary Services to Retail Clients or potential Retail Clients, provide the information required under SLCs 2.28 to 2.30 and SLCs 3.10 to 3.22.

- 2.33 The Licence Holder shall provide Professional Clients with the information referred to in SLCs 3.19 to 3.20 in good time before the provision of the service concerned.
- 2.34 The information referred to in SLCs 2.31 to 2.33 shall be provided in a durable medium or by means of a website (where that does not constitute a durable medium) provided that the conditions in SLC 2.115 are satisfied¹.
- 2.35 By way of exception from SLCs 2.31 and 2.32, the Licence Holder may, in the following circumstances provide the information required under SLC 2.31 to a Retail Client immediately after that client is bound by any agreement for the provision of Investment Services or Ancillary Services, and the information required under SLC 2.32 immediately after starting to provide the service:
- a. the Licence Holder was unable to comply with the time-limits specified in SLCs 2.31 and 2.32 because, at the request of the client, the agreement was concluded using a means of distance communication which prevents the Licence Holder from providing the information required in the aforementioned SLCs;
 - b. in any case where Article 3(3) of Directive 2002/65/EC on the distance marketing of consumer financial services does not otherwise apply, the Licence Holder complies with the requirement in relation to the retail investor or potential retail investor, as if that client or potential client were a “consumer” and the Licence Holder were a “supplier” within the meaning of that Directive.
- 2.36 The Licence Holder shall notify a client in good time about any material change to the information provided under SLCs 2.28 to 2.30 and 3.10 to 3.22 which is relevant to the service being provided to that client. That notification shall be given in a durable medium if the information to which it relates is given in a durable medium.
- 2.37 The Licence Holder shall ensure that information contained in a marketing communication, is consistent with any information the Licence Holder provides to clients in the course of carrying on Investment or Ancillary Services.

Retail Client Agreement

- 2.38 The Licence Holder shall establish a record that includes the document or documents agreed between it and the client and which set out the rights and obligations of the parties, and the other terms on which the Licence Holder will provide services to the

¹ Amended 16th November, 2007

client. The rights and duties of the parties to the contract may be incorporated by reference to other documents or legal texts.

- 2.39 The Licence Holder which provides an Investment Service other than investment advice to a new Retail Client, shall enter into a written basic agreement with the client, in paper or another durable medium, setting out the essential rights and obligations of the Licence Holder and the client.

The rights and duties of the parties to the agreement may be incorporated by reference to other documents or legal texts.

Client Reporting

General

- 2.40 The client must receive from the Licence Holder, adequate reports on the service provided to him. These reports shall include, where applicable, the costs associated with the transactions and services undertaken on behalf of the client.

Reporting Obligations in Respect of Execution of Orders Other Than For Portfolio Management

- 2.41 Where a Licence Holder has carried out an order, other than for portfolio management, on behalf of a client, it is required to take the following action in respect of that order:
- a. it must promptly provide the client, in a durable medium, with the essential information concerning the execution of that order;
 - b. in the case of a Retail Client, it must send the client a notice in a durable medium confirming execution of the order as soon as possible and no later than the first business day following execution or, if the confirmation is received by the Licence Holder from a third party, no later than the first business day following receipt of the confirmation from the third party;

Point (b) shall not apply where the confirmation would contain the same information as a confirmation that is to be promptly dispatched to the Retail Client by another person.

Points (a) and (b) shall not apply where orders executed on behalf of clients relate to bonds funding mortgage loan agreements with the said clients, in which case the report on the transaction shall be made together with the consolidated terms of the mortgage loan, but no later than one month after the execution of the order.

- 2.42 In addition to the requirements set out above, the Licence Holder shall supply the

client, on request, with information about the status of his order.

- 2.43 In the case of orders for a Retail Client relating to units or shares in a collective investment scheme which are executed periodically, the Licence Holder shall either take the action specified in point (b) of SLC 2.41 or provide the Retail Client, at least once every six months, with the information listed in SLC 2.44 in respect of those transactions.
- 2.44 The notice referred to in point (b) of SLC 2.41 shall include such of the following information as is applicable, and where relevant, in accordance with Table 1 of Annex I to the Commission Regulation:
- a. the reporting Licence Holder's identification;
 - b. the name or designation of the client;
 - c. the trading day;
 - d. the trading time;
 - e. the type of the order;
 - f. the venue identification;
 - g. the Instrument identification;
 - h. the buy/sell indicator;
 - i. the nature of the order if other than buy/sell
 - j. the quantity;
 - k. the unit price;
 - l. the total consideration;
 - m. a total sum of the commissions and expenses charged and, where the Retail Client so requests, an itemised breakdown;
 - n. the client's responsibilities in relation to the settlement of the transaction including the time limit for payment or delivery as well as the appropriate account details where these details and responsibilities have not previously been notified to the client;
 - o. if the client's counterparty was the Licence Holder itself or any person in the

Licence Holder's group or another client of the Licence Holder, the fact that this was the case unless the order was executed through a trading system that facilitates anonymous trading.

For the purposes of (k) above, where the order is executed in tranches, the Licence Holder may supply the client with information about the price of each tranche or the average price. Where the average price is provided, the Licence Holder shall supply the Retail Client with information about the price of each tranche upon request.

- 2.45 The Licence Holder may provide the client with the information referred to in SLC 2.44 using standard codes if it also provides an explanation of the codes used.

Reporting Obligations In Respect of Portfolio Management Services.

- 2.46 The Licence Holder which provide the service of portfolio management to clients shall provide each such client with a periodic statement in a durable medium of the portfolio management activities carried out on behalf of that client unless such a statement is provided by another person.

- 2.47 In the case of Retail Clients, the periodic statement required above shall include wherever relevant, the following information:

- a. the name of the Licence Holder;
- b. the name or other designation of the Retail Client's account;
- c. a statement of the contents and the valuation of the portfolio, including details of each Instrument held, its market value, or fair value if market value is unavailable and the cash balance at the beginning and the end of the reporting period, and the performance of the portfolio during the reporting period;
- d. the total amount of fees and charges incurred during the reporting period, itemising at least total management fees and total costs associated with execution, and including where relevant, a statement that a more detailed breakdown will be provided on request;
- e. a comparison of performance during the period covered by the statement with the investment performance benchmark (if any) agreed between the Licence Holder and the client;
- f. the total amount of dividends, interest and other payments received during the reporting period in relation to the client's portfolio;
- g. Information about other corporate actions giving rights in relation to Instruments held in the portfolio;

- h. For each transaction executed during the period, the information referred in SLC 2.44 where relevant, unless the client elects to receive information about executed transactions on a transaction – by- transaction basis, in which case SLC 2.49 shall apply.

2.48 In the case of Retail Clients, the periodic statement referred to in SLC 2.46 shall be provided once every six months, except in the following cases:

- a. where the client so requests, the periodic statement must be provided every 3 months;
- b. in cases where SLC 2.49 applies, the periodic statement must be provided at least once every 12 months;
- c. where the agreement between a Licence Holder and a Retail Client for a portfolio management service authorises a leveraged portfolio, the periodic statement must be provided at least once a month.

The Licence Holder shall inform Retail Clients that they have the right to make requests for the purposes of point (a).

However the exception provided for in point (b) shall not apply in case of transactions in securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures or in Instruments included in points (4) to (10) of the Second Schedule to the Act.

2.49 The Licence Holder shall, in cases where the client elects to receive information about executed transactions on a transaction-by-transaction basis, provide promptly to the client, on the execution of a transaction by the portfolio manager, the essential information concerning that transaction in a durable medium.

Where the client concerned is a Retail Client, the Licence Holder must send him a notice confirming the transaction and containing the information referred to in SLC 2.44 no later than the first business day following that execution or, if the confirmation is received by the Licence Holder from third party, no later than the first business day following sub-paragraph shall not apply where the confirmation would contain the same information as a confirmation that is to be promptly dispatched to the Retail Client by another person.

Additional Reporting Obligations For Portfolio Management or Contingent Liability Transactions.

- 2.50 Where a Licence Holder provides portfolio management transactions for Retail Clients or operates Retail Client accounts that include an uncovered open position in a contingent liability transaction, it is also required to report to the Retail Client any losses exceeding any predetermined threshold, agreed between the Licence Holder and the client, no later than the end of the business day in which the threshold is exceeded or, in a case where the threshold is exceeded on a non-business day, the close of the next business day.

Statement of Client Instruments or Client Money.

- 2.51 A Licence Holder that holds client Instruments or client money is required to send at least once a year, to each client for whom it holds Instruments or money, a statement in a durable medium of those Instruments or money unless such a statement has been provided in any other periodic statement.

Provided that this SLC shall not apply to a credit institution authorised under Directive 2000/12/EC, relating to the taking up and pursuit of the business of credit institutions, in respect of deposits within the meaning of that Directive held by that institution.

- 2.52 The statement of client assets referred to above, shall include the following information:
- a. details of all the Instruments or money held by the Licence Holder for the client at the end of the period covered by the statement;
 - b. the extent to which any client Instruments or client money have been the subject of securities financing transactions;
 - c. the extent of any benefit that has accrued to the clients by virtue of participation in any securities financing transactions, and the basis on which that benefit has accrued.

In cases where the portfolio of a client includes the proceeds of one or more unsettled transactions, the information referred to in point (a) may be based either on the trade date or the settlement date, provided that the same basis is applied consistently to all such information in the statement.

- 2.53 A Licence Holder which holds Instruments or money and which carries out the service of portfolio management for a client, may include the statement of client assets referred to in SLC 2.52, in the periodic statement it provides to that client pursuant to SLC 2.46.

Best Execution Requirements

General

- 2.54 The Licence Holder shall take all reasonable steps to obtain, when executing orders, the best possible result for its clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. Nevertheless, whenever there is a specific instruction from the client, the Licence Holder shall execute the order following the specific instruction.
- 2.55 The Licence Holder shall establish and implement effective arrangements for complying with SLC 2.54. In particular, the Licence Holder shall establish and implement an order execution policy to allow it to obtain, for its client orders, the best possible result in accordance with SLC 2.54.
- 2.56 The order execution policy shall include in respect of each class of Instruments, information on the different venues where the Licence Holder executes its client orders and the factors affecting the choice of execution venue. It shall at least include those venues that enable the Licence Holder to obtain on a consistent basis the best possible result for the execution of client orders.

The Licence Holder shall provide appropriate information to its clients on its order execution policy and shall obtain the prior consent of its clients to the execution policy.

Where the order execution policy provides for the possibility that client orders may be executed outside a regulated market or a MTF, the Licence Holder shall, in particular, inform its clients about this possibility. The Licence Holder shall obtain the prior express consent of its clients before proceeding to execute their orders outside a regulated market or an MTF. The Licence Holder may obtain this consent either in the form of a general agreement or in respect of individual transactions.

- 2.57 The Licence Holder shall monitor the effectiveness of its order execution arrangements and execution policy in order to identify and, where appropriate, correct any deficiencies. In particular, it shall assess, on a regular basis, whether the execution venues included in the order execution policy provide for the best possible result for the client or whether it needs to make changes to its execution arrangements. The Licence Holder shall notify clients of any material changes to its order execution arrangements or execution policy.
- 2.58 The Licence Holder shall be able to demonstrate to its clients, at their request, that it has executed their orders in accordance with the Licence Holder's execution policy.

Best Execution Criteria

2.59 When executing client orders, the Licence Holder shall take into account the following criteria for determining the relative importance of the factors referred to in SLC 2.54:

- a. the characteristics of the client including the categorisation of the client as retail or professional;
- b. the characteristics of the client order;
- c. the characteristics of Instruments that are the subject of that order;
- d. the characteristics of the execution venues to which that order can be directed.

For the purpose of this SLC and SLCs 2.70 and 2.71, “execution venue” means a regulated market, an MTF, a systematic internaliser, or a market maker or other liquidity provider or an entity that performs a similar function in a third country to the functions performed by any of the foregoing.

2.60 A Licence Holder would satisfy its obligation under SLC 2.54 to take all reasonable steps to obtain the best possible result for a client to the extent that it executes an order or a specific aspect of the order following specific instructions from a client relating to the order or the specific aspect of the order.

2.61 Where a Licence Holder executes an order on behalf of a Retail Client, the best possible result shall be determined in terms of the total consideration, representing the price of the Instrument and the costs related to execution, which shall include all expenses incurred by the client which are directly related to the execution of the order, including execution venue fees, clearing and settlement fees and any other fees paid to third parties involved in the execution of the order.

For the purposes of delivering best execution where there is more than one competing venue to execute an order for an Instrument, in order to assess and compare the results for the client that would be achieved by executing the order on each of the execution venues listed in the Licence Holder’s order execution policy that is capable of executing that order, the Licence Holder’s own commissions and costs for executing the order on each of the eligible execution venues shall be taken into account in that assessment.

2.62 The Licence Holder shall not structure or charge its commission in such a way as to discriminate unfairly between execution venues.

Special Provisions Applicable to a Licence Holder Carrying Out Portfolio Management Services and Reception and Transmission of Orders.

- 2.63 When providing the service of portfolio management, the Licence Holder shall act in accordance with the best interests of its clients when placing orders with other entities for execution that result from decisions by the Licence Holder to deal in Instruments on behalf of its clients.
- 2.64 When providing the services of transmission and reception of orders (arranging deals), the Licence Holder shall comply with the obligation to act in accordance with the best interests of its clients when transmitting client orders, to other entities for execution.
- 2.65 In complying with SLCs 2.63 and 2.64 above, the Licence Holder shall comply with the requirements of SLC 2.66 to SLC 2.69.
- 2.66 The Licence Holder shall take all reasonable steps to obtain the best possible result for its clients taking into account the factors referred to in SLC 2.54 . The relative importance of these factors shall be determined by reference to the criteria set out in SLC 2.59 and, for Retail Clients, to the requirement under SLC 2.61.

A Licence Holder satisfies its obligations under SLC 2.63 or SLC 2.64, and is not required to take the steps mentioned in this Licence Condition, to the extent that it follows specific instructions from its client when placing an order with, or transmitting an order to, another entity for execution.

- 2.67 The Licence Holder shall establish and implement a policy to enable it to comply with the obligation in SLC 2.66. The policy shall identify, in respect of each class of Instruments, the entities with which the orders are placed or to which the Licence Holder transmits orders for execution. The entities identified must have execution arrangements that enable the Licence Holder to comply with its obligations under SLCs 2.63 to 2.69 when it places or transmits orders to that entity for execution.

The Licence Holder shall provide appropriate information to its clients on the policy established in accordance with this SLC.

- 2.68 The Licence Holder shall monitor on a regular basis the effectiveness of the policy established in accordance with SLC 2.67 and, in particular, the execution quality of the entities identified in that policy and, where appropriate, correct any deficiencies

In addition, the Licence Holder shall review the policy annually. Such a review shall also be carried out whenever a material change occurs that affects the Licence Holder's ability to continue to obtain the best possible result for its clients.

- 2.69 SLCs 2.63 to 2.68 shall not apply when the Licence Holder that provides the service of portfolio management and/or reception and transmission of orders also executes the orders received or the decisions to deal on behalf of its client's portfolio. In those cases, SLCs 2.54 to 2.58 shall apply.

Execution Policy

- 2.70 The Licence Holder shall review annually the execution policy established pursuant to SLC 2.55 as well as its order execution arrangements.

Such a review shall also be carried out whenever a material change occurs that affects the Licence Holder's ability to continue to obtain the best possible result of the execution of its clients orders on a consistent basis using the venues included in its execution policy.

- 2.71 The Licence Holder shall provide Retail Clients with the following details on their execution policy in good time prior to the provision of the service:
- a. an account of the relative importance the Licence Holder assigns, in accordance with the criteria specified in SLC 2.59, to the factors referred to in SLC 2.54, or the process by which the Licence Holder determines the relative importance of those factors;
 - b. a list of the execution venues on which the Licence Holder places significant reliance in meeting its obligation to take all reasonable steps to obtain on a consistent basis the best possible result for the execution of client orders;
 - c. a clear and prominent warning that any specific instructions from a client may prevent the Licence Holder from taking the steps that it has designed and implemented in its execution policy to obtain the best possible result for the execution of those orders in respect of the elements covered by those instructions;

This information shall be provided in a durable medium, or by means of a website (where that does not constitute a durable medium) provided that the conditions specified in SLC 2.115 are satisfied.

Client Order Handling Rules

General

- 2.72 The Licence Holder which is licensed to execute orders on behalf of clients (deal as agent) shall implement procedures and arrangements which provide for the prompt, fair and expeditious execution of client orders, relative to other client orders or the trading interests of the Licence Holder . These procedures or arrangements shall

allow for the execution of otherwise comparable client orders in accordance with the time of their reception by the Licence Holder.

- 2.73 In the case of a client limit order in respect of shares admitted to trading on a regulated market which are not immediately executed under prevailing market conditions, the Licence Holder is, unless the client expressly instructs otherwise, to take measures to facilitate the earliest possible execution of that order by making public immediately that client limit order in a manner which is easily accessible to other market participants.

The Licence Holder is deemed to comply with this requirement by transmitting the client limit order to a regulated market and/or MTF. MFSA may waive the obligation to make public a limit order that is large in scale compared with normal market size as determined in terms of the Financial Markets Act (Transparency) Regulations, 2007.

- 2.74 When carrying out client orders, the Licence Holder shall satisfy the following conditions:
- a. it must ensure that orders executed on behalf of clients are promptly and accurately recorded and allocated;
 - b. it must carry out otherwise comparable client orders sequentially and promptly unless the characteristics of the order or prevailing market conditions make it impracticable, or the interests of the client require otherwise;
 - c. it must inform a Retail Client about any material difficulty relevant to the proper carrying out of orders promptly upon becoming aware of the difficulty.

- 2.75 Where a Licence Holder is responsible for overseeing or arranging the settlement of an executed order, it shall take all reasonable steps to ensure that any client Instruments or client money received in settlement of that executed order are promptly and correctly delivered to the account of the appropriate client.

- 2.76 A Licence Holder shall not misuse information relating to pending client orders, and shall take all reasonable steps to prevent the misuse of such information by any of its relevant persons.

Aggregation and allocation of orders.

- 2.77 A Licence Holder shall not carry out a client order or a transaction for own account in aggregation with another client order unless the following conditions are met:
- a. it must be unlikely that the aggregation of orders and transactions will work overall to the disadvantage of a client whose order is to be aggregated;

- b. it must be disclosed to each client whose order is to be aggregated that the effect of aggregation may work to its disadvantage in relation to a particular order;
- c. an order allocation policy must be established and effectively implemented, provided in sufficiently precise terms for the fair allocation of aggregated orders and transactions, including how the volume and price of orders determines allocations and the treatment of partial executions.

2.78 Where a Licence Holder aggregates an order with one or more other client orders and the aggregated order is partially executed, it is expected to allocate the related trades in accordance with its order allocation policy.

Aggregation and allocation of transactions for own account.

2.79 The Licence Holder which aggregates transactions for own account and with one or more client orders shall not allocate the related trades in a way that is detrimental to a client.

2.80 Where a Licence Holder aggregates a client order with a transaction for own account and the aggregated order is partially executed, the Licence Holder is expected to allocate the related trades to the client in priority to itself.

However, if the Licence Holder is able to demonstrate on reasonable grounds that without the combination it would not have been able to carry out the order on such advantageous terms, or at all, it may allocate the transaction for own account proportionally, in accordance with its order allocation policy referred to in SLC 2.77(c).

2.81 The Licence Holder shall, as part of the order allocation policy referred to in SLC 2.77(c), put in place procedures designed to prevent the reallocation, in a way that is detrimental to the client, of transactions for own account which are executed in combination with client orders.

Transactions Executed with Eligible Counterparties

2.82 A Licence Holder authorised to execute orders on behalf of clients and/or deal on its own account and/or to receive and transmit orders, may bring about or enter into transactions with Eligible Counterparties without being obliged to comply with the obligations under these Rules which fall under the following sub-sections of the Conduct of Business Obligations: ‘General’, ‘Client Profile Requirements’, ‘Client Disclosure Requirements’, ‘Client Reporting’, ‘Best Execution Requirements’ and SLC 2.72 in respect of ‘Client Order Handling’ – in respect to those transactions or in respect of any Ancillary Service directly related to those transactions.

Record Keeping

- 2.83 The Licence Holder shall arrange for records to be kept of all services and transactions undertaken by it which shall be sufficient to enable MFSA to monitor compliance with the requirements under these Rules, and in particular to ascertain that the Licence Holder has complied with all obligations with respect to clients or potential clients. In this regard, MFSA reserves the right to require a Licence Holder to record telephone conversations and/or electronic communications involving client orders.

In complying with this SLC, the Licence Holder shall refer to Articles 7 and 8 of the Commission Regulation.

Moreover, the Licence Holder shall also keep at the disposal of the MFSA, for at least five years, the relevant data relating to all transactions in Instruments which it has carried out, whether on own account or on behalf of a client. In the case of transactions carried out on behalf of clients, the records shall contain all the information and details of the identity of the client, and the information required under the Prevention of Money Laundering Act, 1994 and Regulations issued thereunder.

A summary of the records which the Licence Holder is expected to retain for the purposes of this SLC are found in Appendix 7 to these Rules.

- 2.84 The Licence Holder shall retain all the records required under these Rules and the Commission Regulation for a period of at least 5 years.

Additionally records which set out the respective rights and obligations of the Licence Holder and the client under an agreement to provide services, or the terms on which the Licence Holder provides services to the client, shall be retained for at least the duration of the relationship with the client.

However, MFSA, may, in exceptional circumstances, require the Licence Holder to retain any or all of those records for such longer period as is justified by the nature of the Instrument or transaction, if that is necessary to enable MFSA to exercise its supervisory functions.

- 2.85 The records shall be retained in a medium that allows the storage of information in a way accessible for future reference by the MFSA and in such a form and manner that the following conditions are met:
- a. MFSA must be able to access them readily and to reconstitute each key stage of the processing of each transaction;

- b. it must be possible for any corrections or other amendments, and the contents of the records prior to such corrections or amendments, to be easily ascertained;
- c. it must not be possible for the records otherwise to be manipulated or altered.

Safeguarding of Client Assets

Note: *the Licence Holder holding or controlling Client Assets shall be required to comply with the SLCs in this Section in addition to the relevant provisions of the Investment Services Act (Control of Assets) Regulations, 1998 as amended.*

For the purposes of these Rules, the term “Client Assets” shall mean Instruments and money belonging to the client.

General

- 2.86 For the purposes of safeguarding client’s rights in relation to Instruments and money belonging to them which are held or controlled by the Licence Holder, the latter shall comply with the following requirements:
- a. they must keep such records and accounts as are necessary to enable them at any time and without delay to distinguish assets held for one client from assets held for another client, and from their own assets;
 - b. they must maintain their records and accounts in a way that ensures their accuracy, and in particular their correspondence to the Instruments and money held for clients;
 - c. they must conduct, on a regular basis, reconciliations between their internal accounts and records and those of any third parties by whom those assets are held;
 - d. they must take the necessary steps to ensure that any client Instruments deposited with a third party, in accordance with SLCs 2.87 to 2.89 are identifiable from the Instruments belonging to the Licence Holder and from the Instruments belonging to that third party, by means of differently titled accounts on the books of the third party or other equivalent measures that achieve the same level of protection;
 - e. they must take the necessary steps to ensure that the client money deposited in accordance with SLC 2.90 to 2.91 with a central bank, an EEA credit institution or a bank authorized in a third country or a qualifying money market fund, are held in an account or accounts identified separately from any accounts used to hold money belonging to the Licence Holder;

- f. they must introduce adequate organisational arrangements to minimise the risk of the loss or diminution of client assets, or of rights in connection with those assets, as a result of misuse of the assets, fraud, poor administration, inadequate record-keeping or negligence.

Depositing Client Instruments

- 2.87 A Licence Holder is permitted to deposit Instruments held by it on behalf of its clients into an account or accounts opened with a third party provided that the Licence Holder exercises all due skill, care and diligence in the selection, appointment and periodic review of the third party and of the arrangements for the holding and safekeeping of those Instruments.

In particular, the Licence Holder, shall take into account the expertise and market reputation of the third party as well as any legal requirements or market practices related to the holding of those Instruments that could adversely affect clients' rights.

- 2.88 If the safekeeping of Instruments for the account of another person is subject to specific regulation and supervision in a jurisdiction where a Licence Holder proposes to deposit client Instruments with a third party, the Licence Holder shall not deposit those Instruments in that jurisdiction with a third party which is not subject to such regulation and supervision.
- 2.89 The Licence Holder shall not deposit Instruments held on behalf of clients with a third party in a third country that does not regulate the holding and safekeeping of Instruments for the account of another person unless one of the following conditions are met:
- a. the nature of the Instruments or of the Investment Services connected with those Instruments requires them to be deposited with a third party in that third country;
 - b. where the Instruments are held on behalf of a Professional Client, that client requests the Licence Holder to deposit them with a third party in that third country.

Depositing Client Money

- 2.90 Licence Holder, on receiving any client money, shall promptly place that money into one or more accounts opened with any of the following:
- a. a central bank;
 - b. a credit institution authorised in accordance with Directive 2006/48/EC;

- c. a bank authorised in a third country;
- d. a qualifying money market fund.

Point (a) above shall not apply to a credit institution authorised under Directive 2006/48/EC in relation to deposits within the meaning of that Directive held by that institution.

- 2.91 Where the Licence Holder does not deposit client money with a central bank, it shall exercise all due skill, care and diligence in the selection, appointment and periodic review of the credit institution, bank or money market fund where the money is placed and of the arrangements for the holding of that money.

In particular, the Licence Holder shall take into account the expertise and market reputation of such institutions or money market funds with a view to ensuring the protection of clients' rights as well as any legal or regulatory requirements or market practices related to the holding of client money that could adversely affect client's rights.

Clients shall have the right to oppose the placement of their money in a qualifying money market fund.

Use of Clients' Instruments

- 2.92 A Licence Holder shall not enter into arrangements for securities financing transactions in respect of Instruments which it holds on behalf of a client, or otherwise use such Instruments for its own account or the account of another client of the Licence Holder, unless the following conditions are met:

- a. the client must have given his prior express consent to the use of the Instruments on specified terms, as evidenced, in the case of a Retail Client, by his signature or equivalent alternative mechanism;
- b. the use of that client's Instrument must be restricted to the specific terms to which the client consents.

- 2.93 The Licence Holder shall not enter into arrangements for securities financing transactions in respect of Instruments which are held on behalf of a client in a Nominee account maintained by a third party, or otherwise use Instruments held in such an account for their own account or for the account of another client unless, in addition to the conditions set out in SLC 2.92, at least one of the following conditions are met:

- a. each client whose Instruments are held together in a Nominee account must have given prior express consent in accordance with point (a) of SLC 2.92;

- b. the Licence Holder must have in place systems and controls which ensure that only Instruments belonging to clients who have given prior express consent in accordance with point (a) of SLC 2.92 are so used.

The records of the Licence Holder shall include details of the client on whose instructions the use of the Instruments has been effected, as well as the number of Instruments used belonging to each client who has given his consent, so as to enable the correct allocation of any loss.

Conflicts of Interest

General

- 2.94 The Licence Holder shall maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest as defined in this Section from adversely affecting the interests of its clients.
- 2.95 The Licence Holder shall take all steps to identify conflicts of interests between themselves, including their managers, employees or any person directly or indirectly linked to them by control and their clients or between one client and another that arise in the course of providing any investment and Ancillary Services, or combinations thereof.
- 2.96 Where the organisational or administrative arrangements made by the Licence Holder in accordance with SLC 2.94 to manage conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented, the Licence Holder shall clearly disclose the nature and/or sources of conflicts of interest to the client before undertaking business on its behalf.

Such disclosure shall be made in a durable medium and shall include sufficient detail, taking into account the nature of the client, to enable that client to take an informed decision with respect to the Investment or Ancillary Service in the context of which the conflict of interest arises.

- 2.97 For the purposes of identifying the types of conflict of interest that arise in the course of providing investment and Ancillary Services or a combination thereof and whose existence may damage the interests of a client, the Licence Holder shall take into account, by way of minimum criteria, the question of whether itself or a relevant person, or a person directly or indirectly linked by control to the Licence Holder, is in any of the following situations, whether as a result of providing Investment or Ancillary Services or investment activities or otherwise:
 - a. the Licence Holder or that person is likely to make a financial gain, or avoid a

financial loss at the expense of the client;

- b. the Licence Holder or that person has an interest in the outcome of a service provided to the client or of a transaction carried out on behalf of the client, which is distinct from the client's interest in that outcome;
- c. the Licence Holder or that person has a financial or other incentive to favour the interests of another client or group of clients over the interests of the client;
- d. the Licence Holder or that person carries on the same business as the client;
- e. the Licence Holder or that person receives or will receive from a person other than the client, an inducement in relation to a service provided to the client, in the form of monies, goods or services, other than the standard commission or fee for that service.

Conflicts of Interest Policy.

2.98 The Licence Holder shall establish, implement and maintain an effective conflicts of interest policy set out in writing and appropriate to the size and organisation of the Licence Holder and the nature, scale and complexity of its business.

Where the Licence Holder is a member of a group, the policy must also take into account any circumstances, of which the Licence Holder is or should be aware, which may give rise to a conflict of interest arising as a result of the structure and business activities of other members of the group.

2.99 The conflicts of interest policy established in accordance with SLC 2.98, shall include the following content:

- a. it must identify, with reference to the specific Investment Services and activities and Ancillary Services carried out by or on behalf of the Licence Holder, the circumstances which constituted or may give rise to a conflict of interest entailing a material risk of damage to the interests of one or more clients;
- b. it must specify procedures to be followed and measures to be adopted in order to manage such conflicts.

2.100 The procedures and measures provided for in SLC 2.99(b) are to be designed to ensure that relevant persons engaged in different business activities involving a conflict of interest of the kind specified in SLC 2.99(a), carry on those activities at a level of independence appropriate to the size and activities of the Licence Holder and of the group to which it belongs, and to the materiality of the risk of damage to the interests of clients.

For the purposes of SLC 2.99(b), the procedures to be followed and measures to be adopted shall include such of the following as are necessary and appropriate for the Licence Holder to ensure the requisite degree of independence:

- a. effective procedures to prevent or control the exchange of information between relevant persons engaged in activities involving a risk of a conflict of interest where the exchange of that information may harm the interests of one or more clients;
- b. the separate supervision of relevant persons whose principal functions involve carrying out activities on behalf of, or providing services to, clients whose interests may conflict, or who otherwise represent different interests that may conflict, including those of the Licence Holder;
- c. the removal of any direct link between the remuneration of relevant persons principally engaged in one activity and the remuneration of, or revenues generated by, different relevant persons principally engaged in another activity, where a conflict of interest may arise in relation to those activities;
- d. measures to prevent or limit any person from exercising inappropriate influence over the way in which a relevant person carries out Investment or Ancillary Services or activities;
- e. measures to prevent or control the simultaneous or sequential involvement of a relevant person in separate Investment or Ancillary Services or activities where such involvement may impair the proper management of conflicts of interests.

If the adoption or the practice of one or more of those measures and procedures does not ensure the requisite degree of independence, the Licence Holder shall adopt such alternative or additional measures and procedures as are necessary and appropriate for those purposes.

Record Keeping

- 2.101 A Licence Holder shall keep and regularly update a record of the kinds of Investment or Ancillary Service or investment activity carried out by or on behalf of the Licence Holder in which a conflict of interest entailing a material risk of damage to the interests of one or more clients has arisen or, in the case of an ongoing service or activity, may arise.

Staff Dealing

General

2.102 A Licence Holder shall establish adequate policies and procedures sufficient to ensure compliance of the Licence Holder, including its managers and employees, with its obligations under these Rules as well as appropriate rules governing personal transactions by such persons.

Personal Transactions

2.103 A Licence Holder shall establish, implement and maintain adequate arrangements aimed at preventing the activities listed in (a) to (c) below in the case of any relevant person who is involved in activities that may give rise to a conflict of interest, or who has access to inside information within the meaning of Article 2(1) of the Prevention of Financial Markets Abuse Act, 2005 or to other confidential information relating to clients or transactions with or for clients by virtue of an activity carried out by him on behalf of the Licence Holder:

- a. entering into a transaction which meets at least one of the following criteria:
 - i. that person is prohibited from entering into it under the Prevention of Financial Markets Abuse Act, 2005;
 - ii. it involves the misuse of improper disclosure of that confidential information;
 - iii. it conflicts or is likely to conflict with an obligation of the Licence Holder under these Rules.
- b. advising or procuring, other than in the proper course of his employment or contract for services, any other person to enter into a transaction in Instruments which, if a personal transaction of the relevant person, would be covered by point (a) above or by SLC 2.112 (a) or (b) or SLC 2.76.
- c. Without prejudice to Article 6(2) of the Prevention of Financial Markets Abuse Act, 2005, disclosing, other than in the normal course of his employment or contract for services, any information or opinion to any other person if the relevant person knows, or reasonably ought to know, that as a result of that disclosure, that other person will or would be likely to take either of the following steps:
 - i. to enter into a transaction in Instruments which, if a personal transaction of the relevant person, would be covered by point (a) above or SLC 2.112 (a) or (b) or SLC 2.76;

- ii. to advise or procure another person to enter into such a transaction.

2.104 The arrangements required under SLC 2.103 must be designed in particular to ensure that:

- a. each relevant person covered by SLC 2.103 is aware of the restrictions on personal transactions, and of the measures established by the Licence Holder in connection with personal transactions and disclosure, in accordance with SLC 2.103;
- b. the Licence Holder is informed promptly of any personal transaction entered into by a relevant person, either by notification of that transaction or by other procedures enabling the Licence Holder to identify such transactions;

In the case of outsourcing arrangements, the Licence Holder must ensure that the Licence Holder to which the activity is outsourced, maintains a record of personal transactions entered into by any relevant person and provides that information to the Licence Holder promptly on request;

- c. a record is kept of the personal transaction notified to the Licence Holder or identified by it, including any authorisation or prohibition in connection with such a transaction.

2.105 SLC 2.103 and SLC 2.104 shall not apply to the following kinds of personal transactions:

- a. personal transactions effected under a discretionary portfolio management service where there is no prior communication in connection with the transaction between the portfolio manager and the relevant person or other person for whose account the transaction is executed;
- b. personal transactions in units in collective undertakings that comply with the conditions necessary to enjoy the rights conferred by the UCITS Directive or are subject to supervision under the law of a Member State which requires an equivalent level of risk spreading in their assets, where the relevant person and any other person for whose account the transactions are effected, are not involved in the management of that undertaking.

Provision of services through the medium of another Licence Holder

2.106 A Licence Holder receiving an instruction to perform Investment or Ancillary Services on behalf of a client through the medium of another investment firm, shall be able to rely on client information transmitted by the latter. The investment firm which mediates the instructions will remain responsible for the completeness and

accuracy of the information transmitted.

- 2.107 The Licence Holder which receives an instruction to undertake services on behalf of a client through the medium of another investment firm, shall also be able to rely on any recommendations in respect of the service or transaction that have been provided to the client by another investment firm. The investment firm which mediates the instructions will remain responsible for the appropriateness for the client of the recommendations or advice provided.
- 2.108 The Licence Holder which receives client instructions or orders through the medium of another Licence Holder, shall remain responsible for concluding the service or transaction, based on any such information or recommendations, in accordance with the relevant provisions of these Rules².

Conduct of Business Rules for a Licence Holder Producing and Disseminating Investment Research

- 2.109 For the purposes of this Section, “investment research” means research or other information recommending or suggesting an investment strategy, explicitly or implicitly, concerning one or several Instruments or the issuers of Instruments, including any opinion as to the present or future value or price of such Instruments, intended for distribution channels or for the public, and in relation to which the following conditions are met:
- a. it is labelled or described as investment research or in similar terms, or is otherwise presented as an objective or independent explanation of the matters contained in the recommendation;
 - b. if the recommendation in question were made by a Licence Holder to a client, it would not constitute the provision of investment advice for the purposes of the Act.
- 2.110 A recommendation of the type covered by Regulation 2(1) of the Prevention of Financial Markets Abuse (Fair Presentation of Investment Recommendations and Disclosure of Conflicts of Interest) Regulations, 2005 (Legal Notice 106 of 2005), but relating to Instruments as defined in the Act, that does not meet the conditions set out in SLC2.109, shall be treated as a marketing communication for the purposes of these Rules, and any Licence Holder which produces or disseminates the recommendation shall ensure that it is clearly identified as such

Additionally, the Licence Holder shall ensure that any such recommendation contains a clear and prominent statement that (or, in the case of an oral recommendation to the effect that) it has not been prepared in accordance with legal

² Inserted on 16th November, 2007

requirements designed to promote the independence of investment research and that it is not subject to any prohibition on dealing ahead of the dissemination of investment research

- 2.111 A Licence Holder which produces, or arranges for the production of investment research that is intended or likely to be subsequently disseminated to clients of the Licence Holder or to the public, under its own responsibility or that of a member in its group (if the Licence Holder is a member of a group), shall ensure that the implementation of all the measures set out in SLC 2.100 in relation to the financial analysts involved in the production of the investment research and other relevant persons whose responsibilities or business interests may conflict with the interests of the persons to whom the investment research is disseminated.
- 2.112 The Licence Holder which is covered under SLC 2.111 shall have in place arrangements designed to ensure that the following conditions are satisfied:
- a. financial analysts and other relevant persons must not undertake personal transactions or trade other than as market makers acting in good faith and in the ordinary course of market making or in the execution of an unsolicited client order, on behalf of any other person, including the Licence Holder, in Instruments to which investment research relates, or in any related Instruments, with knowledge of the likely timing or content of that investment research which is not publicly available or available to clients and cannot readily be inferred from information that is so available, until the recipients of the investment research have had a reasonable opportunity to act on it;
 - b. in circumstances not covered by point (a), financial analysts and any other relevant persons involved in the production of investment research must not undertake personal transactions in Instruments to which the investment research relates, or in any related Instruments, contrary to current recommendations, except in exceptional circumstances and with the prior approval of a member of the Licence Holder's legal or compliance function;
 - c. the Licence Holder itself, financial analysts and other relevant persons involved in the production of investment research must not accept inducements from those with a material interest in the subject matter of the investment research;
 - d. the Licence Holder itself, financial analysts, and other relevant persons involved in the production of the investment research must not promise issuers favourable research coverage;
 - e. issuers, relevant persons other than financial analysts, and any other persons must not before the dissemination of investment research be permitted to review a draft of the investment research for the purpose of verifying the

accuracy of factual statements made in that research, or for any other purpose other than verifying compliance with the Licence Holder's legal obligations, if the draft includes a recommendation or a target price.

For the purposes of this SLC, "related Instrument" means an Instrument the price of which is closely affected by price movements in another Instrument which is the subject of investment research, and includes a derivative on that other Instrument.

- 2.113 The Licence Holder which disseminates investment research produced by another person to the public or to clients shall be exempted from complying with the requirements of SLC 2.112 if the following criteria are met:
- a. the person that produces the investment research is not a member of the group to which the Licence Holder belongs;
 - b. the Licence Holder does not substantially alter the recommendations within the investment research;
 - c. the Licence Holder does not present the investment research as having been produced by it;
 - d. the Licence Holder verifies that the producer of the research is subject to requirements equivalent to the requirements under these Rules in relation to the production of that research, or has established a policy setting such requirements.

Conditions Applicable to the Provision of Information

- 2.114 Where, for the purposes of these Rules, information is required to be provided in a durable medium, the Licence Holder may provide that information in a durable medium other than on paper only if:
- a. the provision of that information in that medium is appropriate to the context in which the business between the Licence Holder and the client is, or is to be, carried on; and
 - b. the person to whom the information is to be provided, when offered the choice between information on paper or in that other durable medium, specifically chooses the provision of the information in that other medium.
- 2.115 Where the Licence Holder provides the information it is bound to provide in terms of these Rules to a client, by means of a website and that information is not addressed personally to the client, the following conditions shall be satisfied:
- a. the provision of that information in that medium is appropriate to the context in

which the business between the Licence Holder and the client is, or is to be, carried on;

- b. the client must specifically consent to the provision of that information in that form;
- c. the client must be notified electronically of the address of the website, and the place on the website where the information may be accessed;
- d. the information must be up to date;
- e. the information must be accessible continuously by means of that website for such period of time that the client may reasonably need to inspect it.

2.116 For the purposes of SLCs 2.114 and 2.115, the provision of information by means of electronic communications shall be treated as appropriate to the context in which the business between the Licence Holder and the client is, or is to be, carried on if there is evidence that the client has regular access to the internet. The provision by the client of an email address for the purposes of the carrying on of that business shall be treated as such evidence.

Complaints Handling

2.117 The Licence Holder is required to establish, implement and maintain effective and transparent procedures for the reasonable and prompt handling of complaints received from Retail Clients or potential Retail Clients, and to keep a record of each complaint and the measures taken for its resolution. The Licence Holder is also required to inform complainants that they may refer their complaint to the MFSA if they are not satisfied with the manner in which it has been handled by the Licence Holder.

Provisions Applicable to a Licence Holder whose Staff promote and Sell Investment Products

Note: *For the purposes of the following SLCs, reference to 'promote and sell' should be interpreted as the practice whereby the Licence Holder's staff explain the features of a particular product to a client or prospective client without actually providing investment advice with respect to that product, such that it is the client who ultimately decides for himself/herself whether to invest in the particular product or not.*

2.118 The Licence Holder may allow its staff to promote and sell investment products subject to:

- a. appropriate internal controls and internal compliance checks being in place to ensure that:
 - i. no investment recommendations are made or investment advice is provided by staff members who are not authorized to provide advice in terms of SLC 1.07(i);
 - ii. the relevant Rules on disclosure to clients particularly SLC 2.27, 2.28, 2.37, 3.10 to 3.14 and 3.22 and SLC 2.119 below are observed by staff members promoting and selling investment products provided that for the purposes of SLC 3.10, all clients may be treated as retail and staff need not carry out a client classification exercise in terms of SLC 2.03 prior to explaining the features of an investment product. Such client classification exercise should be made once a client decides to submit an order for execution with respect to the investment product being promoted.
 - iii. an appropriateness test as per SLC 2.14 is carried out by staff members before receiving and transmitting any orders for investment in the products concerned unless all the conditions indicated in SLC 2.25 are met
- b. staff being required to follow documented procedures which should be drawn up by the Licence Holder to ensure that its staff promoting and selling investment products are aware of the relevant procedures, including regulatory requirements they are to follow when promoting and selling investment products.

2.119 Staff involved in the promotion and sale of investment products must also clearly disclose to clients:

- a. that they are only in a position to offer information on one or a limited range of investment products; that the information provided does not constitute investment advice and that should clients require advice, they will be referred to an authorized advisor. Except for non face to face communications with clients, this disclosure should be provided in writing and be countersigned by the client;
- b. any connections which the Licence Holder may have with the product provider; and
- c. the nature of the Licence Holder's interest in promoting and selling the particular products, taking account of the relevant requirements of SLC 2.02.

2.120 The Licence Holder must, at all times, maintain adequate records pertaining to staff

who are not authorized advisors but who provide information to clients and who promote and sell investment products. Such records should include:

- a. an up-dated list of the names of staff members who are authorized by the Licence Holder to promote and sell investment products, together with details of the training provided to such persons as per SLC 2.122 below;
- b. evidence of internal compliance checks undertaken by the Licence Holder and
- c. details of any disciplinary action taken against staff involved in the selling and promoting of investment products.

2.121 The records referred to in SLC 2.120 above should be available for inspection by MFSA officials during Compliance Visits.

2.122 The details of training provided to the Licence Holder's staff which the Licence Holder must retain in terms of SLC 2.120 (a) include:

- a. a description of the training provided, including details of the course content;
- b. details of the identity and experience of the trainer/s; and
- c. a declaration that the trainer is satisfied that the persons who attended the training have achieved a standard of competence that indicates that they are capable of clearly explaining the features of the product in question.

Provisions Applicable to a Licence Holder Appointing Tied Agents

Note: *For the purposes of these Rules reference to tied agents shall also include persons employed by a legal person which is registered as a tied agent of a Licence Holder, in terms the Investment Services (Tied Agents) Regulations, 2007 (hereinafter referred to as "the Regulations") and which are directly involved in carrying out tied agency activities.*

These Rules are additional and without prejudice to the obligations of the Licence Holder set out in the Regulations.

2.123 A Licence Holder may appoint a tied agent which is:

- a. established in Malta , provided that such tied agent is registered by the MFSA
or

- b. established in an EU or EEA Member State provided that such tied agent is either:
 - i. registered as a tied agent in such EU or EEA Member State or
 - ii. registered in Malta if the EU or EEA Member State in which such tied agent is established does not provide for the registration of tied agents within its jurisdiction.

2.124 The responsibility for the control and monitoring of the activities of tied agents rests with the senior management of the Licence Holder. In this regard, the Licence Holder shall ensure that the tied agents it appoints:

- a. report to it on a regular basis with respect to the activities carried out by the tied agent;
- b. pass on to the Licence Holder all the necessary documentation for processing and/or record keeping purposes, promptly;
- c. continue to satisfy the registration requirements and the eligibility criteria referred in Part A of these Rules on an on-going basis;
- d. do not hold or control clients' money or assets;
- e. comply with the requirements of the Investment Services Rules which are relevant to the activities they carry out on behalf of the Licence Holder. Particular attention should be given by the Licence Holder to ensuring compliance, by the tied agent, with the relevant requirements in this Section entitled "Conduct of Business Obligations" and in Section 3 entitled "Disclosure Requirements for Information to Clients, including Marketing Communications".

2.125 The Licence Holder shall ensure that the tied agents it appoints, shall, where appropriate make a prior appointment to call clients or potential clients. Unsolicited or unarranged calls shall be made between 9.00 a.m., and 7.00 p.m. Monday to Friday (excluding public holidays and Saturday) from 9.00a.m. to 5.00 p.m., unless otherwise requested by an existing or potential client.

2.126 The Licence Holder shall look into any concerns that may arise at any time regarding its tied agents' fit and proper status and take the necessary action. The necessary action may include, for example, increased monitoring or, if appropriate, suspension or termination of the appointment. In all cases, the Licence Holder should report any concerns it may have in this regard, to the MFSA, without delay.

- 2.127 The Licence Holder shall take reasonable steps to ensure that each of its tied agents:
- a. carry on only those activities which are permissible in terms of the definition of “tied agent” in regulation 2 of the Regulations and provided such activities are in line with the terms of the terms of the tied agent’s appointment by the Licence Holder.
 - b. carries on the activity for which the Licence Holder has accepted responsibility in a way which is, and is held out as being, clearly distinct from any of the tied agent’s other business, irrespective of whether such other business is regulated or not.
- 2.128 The Licence Holder will be held responsible for any breaches of the Rules committed by any of the tied agents it appoints.
- 2.129 When carrying out tied agent activities from a place of business or from any other place accessible to the public, the Licence Holder shall require the tied agent to display in a prominent position in that place, or in a part thereof to which the public has access, the certificate of registration or an official copy thereof issued by the Authority.
- 2.130 The Licence Holder shall maintain all records, including those relating to the “Know Your Client” procedures and evidence that the tied agent has carried out the necessary suitability and/or appropriateness tests in terms of SLCs 2.23 to 2.26, pertaining to the activities performed by the tied agents on the Licence Holder’s behalf, as are necessary to demonstrate compliance by the tied agent with the relevant provision of these Rules. Such records shall be made available to MFSA officials during Compliance Visits.
- 2.131 The Licence Holder shall ensure that its tied agents:
- a. do not act as such for other Licence Holders and
 - b. are not involved in any activities which may give rise to a conflict of interest which could be detrimental to the Licence Holder’s clients
- 2.132 The Licence Holder is to inform the MFSA of any decision to terminate a tied agent’s appointment and shall confirm whether such a decision was taken due to any issues of a regulatory nature or concern.

Provisions Applicable to a Licence Holder Appointing Introducers

- 2.133 The MFSA is to be advised by the Licence Holder of the names and addresses of the

Introducers.

- 2.134 The Licence Holder is responsible for “Know Your Customer” checks and cannot rely on the Introducer’s opinion.
- 2.135 The Introducer is bound by confidentiality as to the means and resources of the customer if s(he) is made aware of them.
- 2.136 In no circumstances can the Introducer give investment advice, promote a certain product or undertake any Investment Services licensable activity.
- 2.137 The Introducer will not be permitted to pass on any documentation, promoting any particular product or service on behalf of the Licence Holder, to the client/ or to assist the client in the completion of any relevant documentation.
- 2.138 The Introducer will not be permitted to receive any funds from clients or give any commitments on behalf of the Licence Holder.
- 2.139 The Introducer’s involvement will be limited to arranging a meeting between the Licence Holder and the customer, but can also attend the meeting if required.
- 2.140 The Introducer should not hold himself out to the general public as acting as Introducer and should not actively promote its “introducing services”.
- 2.141 Charges which the client/ investor will incur should not differ irrespective of whether the client approached the Licence Holder direct or through an Introducer.
- 2.142 Insurance companies authorised under the Insurance Business Act, 1998 (“the IBA”) and insurance agents and insurance brokers enrolled under the Insurance Intermediaries Act, 2006 (“the IIA”) cannot act as Introducers. In accordance with article 8(b) of the IBA, the objects of insurance companies are to be limited to business of insurance, as defined in the said Act. In the case of enrolled agents and brokers, in terms of article 10(1)(a)(i) of the IIA the business of such persons is to be limited to insurance intermediaries activities as defined in the said Act. Insurance agents and insurance brokers enrolled under the IIA are permitted in accordance with Insurance Intermediaries Rule 11 of 2007, to carry on Investment Services activities provided that the insurance intermediaries concerned are granted an Investment Services licence under the Investment Services Act, 1994.
- 2.143 Insurance sub-agents are permitted to act as Introducers for authorised companies in whose Sub-agents Company Register they are registered and on whose behalf they are enrolled in terms of the IIA or for wholly-owned Investment Services subsidiaries of such authorised companies.
- 2.144 A record is to be retained, for inspection by the MFSA’s Compliance Officers, of

commissions paid to each introducer.

2.145 Introducers may only act as such for one Licence Holder.

3. Disclosure Requirements for Information to Clients, including Marketing Communications

General

3.01 All information, including marketing communications addressed by the Licence Holder to clients or potential clients shall be fair, clear and not misleading by complying with the conditions set out below. Marketing communications (which include ‘investment advertisements’ as defined in Article 2(1) of the Act) shall:

- i. be clearly identifiable as such.
- ii. be considered to be fair, clear and not misleading if they comply with the conditions set out in SLC 3.02 - 3.09.

For the avoidance of doubt the following are not subject to the rules contained in SLCs 3.02 – 3.23 but are still subject to the requirements of this SLC, requiring them to be “fair clear and not misleading”:

- a. marketing communications which falls within the definition of “advertorial” as defined in the Glossary to these Rules; and
- b. marketing communications which consist only of one or more of the following: the name of the Licence Holder, a logo or other image associated with the Licence Holder, a contact point, a reference to the types of Investment Services offered by the Licence Holder or to its fees and commissions.

3.01A The Licence Holder shall ensure that appropriate records of all issued and/or approved marketing communications are maintained and made available for inspection by the MFSA within 24 hours of its request, for not less than five years from the date of publication or broadcast. Such records should include:

- a. the name of the individual who approved the communications;
- b. the date of approval of the information;
- c. the publication/s in which the marketing communication was included; and
- d. evidence to support any statement made in the information and which is not a statement of fact.

Marketing Information and other Information for Retail Clients and Potential Retail Clients

- 3.02 The Licence Holder shall ensure that all information it addresses to, or disseminates in such a way that it is likely to be received by Retail Clients or potential Retail Clients, including marketing communications, satisfies the following conditions. It shall:
- a. include the name of the Licence Holder;
 - b. be accurate, and in particular shall not emphasise any potential benefits of an Investment Service or Instrument without also giving a fair and prominent indication of any relevant risks;
 - c. be sufficient for, and presented in a way that is likely to be understood by, the average member of the group to whom it is directed, or by whom it is likely to be received;
 - d. not disguise, diminish or obscure important items, statements or warnings.
- 3.03 Where the information compares Investment or Ancillary Services, Instruments, or persons providing Investment or Ancillary Services, the following conditions shall be satisfied:
- a. the comparison must be meaningful and presented in a fair and balanced way;
 - b. the sources of the information used for the comparison must be specified;
 - c. the key facts and assumptions used to make the comparison must be included.
- 3.04 Where the information contains an indication of past performance of an Instrument, a financial index or an Investment Service, the following conditions shall be satisfied:
- a. that indication must not be the most prominent feature of the communication;
 - b. the information must include appropriate performance information which covers the immediately preceding 5 years, or the whole period for which the Instrument has been offered, the financial index has been established, or the Investment Service has been provided if less than 5 years, or such longer period as the Licence Holder may decide, and in
 - c. every case that performance information must be based on complete 12 month periods;
 - d. the reference period and the source of information must be clearly stated;

- e. the information must contain a prominent warning that the figures refer to the past and that past performance is not a reliable indicator of future results;
 - f. where the indication relies on figures denominated in a currency other than that of the country in which the Retail Client or potential Retail Client is resident, the currency must be clearly stated, together with a warning that the return may increase or decrease as a result of currency fluctuations;
 - g. where the indication is based on gross performance, the effect of commissions, fees or other charges must be disclosed.
- 3.05 Where the information relates to future performance, the following conditions shall be satisfied:
- a. the information must not be based on or refer to simulated past performance ;
 - b. it must be based on reasonable assumptions supported by objective dated;
 - c. where the indication is based on gross performance, the effect of commissions, fees or other charges must be disclosed;
 - d. it must contain a prominent warning that such forecasts are not a reliable indicator of future performance.
- 3.06 Where the information includes or refers to simulated past performance, it must relate to an Instrument or a financial index, and the following conditions shall be satisfied:
- a. the simulated past performance must be based on the actual past performance of one or more Instruments or financial indices which are the same as, or underlie, the Instrument concerned;
 - b. in respect of the actual past performance referred in point (a), the conditions set out in points (a) to (c), (e) and (f) of SLC 3.04 must be complied with;
 - c. the information must contain a prominent warning that the figures refer to simulated past performance and that past performance is not a reliable indicator of future performance.
- 3.07 Where the information refers to a particular tax treatment, it shall prominently state that the tax treatment depends on the individual circumstances of each client may be subject to change in the future.
- 3.08 The information shall not use the name of the MFSA or other competent authority in

such a way that would indicate or suggest endorsement or approval by that authority of the products or services of the Licence Holder.

- 3.09 Where a marketing communication contains an offer or invitation of the following nature and specifies the manner of response or includes a form by which any response may be made, it shall include such of the information referred in SLCs 2.28 to 2.30 and SLC 3.10 to 3.22 as is relevant to the offer or invitation:
- a. an offer to enter into an agreement in relation to an Instrument or Investment Service or Ancillary Service with any person who responds to the communication;
 - b. an invitation to any person who responds to the communication to make an offer to enter into an agreement in relation to an Instrument or Investment Service or Ancillary Service.

However, paragraph (a) shall not apply if, in order to respond to an offer or invitation contained in the marketing communication, the potential Retail Client must refer to another document or documents, which, alone or in combination, contain that information.

Information about Instruments.

- 3.10 The Licence Holder shall provide clients or potential clients with a general description of the nature and risks of Instruments, taking into account, in particular, the client's categorisation as either a Retail Client or a Professional Client. That description must explain the nature of the specific type of Instrument concerned, as well as the risks particular to that specific type of Instrument in sufficient detail to enable the client to take investment decisions on an informed basis.
- 3.11 The description of risks shall include, where relevant to the specific type of Instrument concerned and the status and level of knowledge of the client, the following elements:
- a. the risks associated with that type of Instrument including an explanation of leverage and its effects and the risk of losing the entire investment;
 - b. the volatility of the price of such Instruments and any limitations on the available market for such Instruments;
 - c. the fact that an investor might assume as a result of transactions in such Instruments, financial commitments and other additional obligations, including contingent liabilities, additional to the cost of acquiring Instruments;
 - d. any margin requirements or similar obligations, applicable to Instruments of

that type.

- 3.12 If a Licence Holder provides a Retail Client or potential Retail Client with information about an Instrument that is the subject of a current offer to the public and a prospectus has been published in connection with that offer in accordance with Directive 2003/71/EC (“the Prospectus Directive”), that Licence Holder shall inform the client or potential client where that prospectus is made available to the public.
- 3.13 Where the risks associated with an Instrument composed of two or more different Instruments or services are likely to be greater than the risks associated with any of the components, the Licence Holder shall provide an adequate description of the components of that Instrument and the way in which its interaction increases the risks.
- 3.14 In the case of Instruments that incorporate a guarantee by a third party, the information about the guarantee shall include sufficient detail about the guarantor and the guarantee to enable the Retail Client or potential Retail Client to make a fair assessment of the guarantee.

Disclosure Requirements applicable to a Licence Holder holding or controlling Client Assets.

- 3.15 Where the Licence Holder holds or controls Instruments or money belonging to Retail Clients, the Licence Holder shall provide those Retail Clients or potential Retail Clients with the information specified in SLCs 3.16 to 3.21 as is relevant.
- 3.16 The Licence Holder shall inform the Retail Client or potential Retail Client where the Instrument or money of that client may be held by a third party on behalf of the Licence Holder and of the responsibility of the Licence Holder for any acts or omissions of the third party and the consequences for the client of the insolvency of the third party.
- 3.17 Where Instruments of the Retail Client or potential Retail Client may, be held in a Nominee account by a third party, the Licence Holder shall inform the client of this fact and shall provide a prominent warning of the resulting risks.
- 3.18 The Licence Holder shall inform the Retail Client or potential Retail Client where it is not possible for client Instruments held with a third party to be separately identifiable from the proprietary Instruments of that third party or of the Licence Holder and shall provide a prominent warning of the resulting risks.
- 3.19 The Licence Holder shall inform the client or potential client where accounts that contain Instruments or money belonging to that client or potential client are or will be subject to the law of a jurisdiction other than that of a Member State and shall indicate that the rights of the client or potential client relating to those Instruments or

money may differ accordingly.

- 3.20 A Licence Holder shall inform the client about the existence and the terms of any security interest or lien which the Licence Holder has or may have over the client's Instruments or money, or any right of set-off it holds in relation to those Instruments or money. Where applicable, it shall also inform the client of the fact that a depository may have a security interest or lien over, or right of set-off in relation to those Instruments or money.
- 3.21 A Licence Holder, before entering into securities financing transactions in relation to Instruments held by it on behalf of a Retail Client, or otherwise to use such Instruments for its own account or on the account of another client, shall in good time before the use of those Instruments provide the Retail Client, in a durable medium, with clear, full and accurate information on the obligations and responsibilities of the Licence Holder with respect to the use of those Instruments, including the terms for their restitution, and on the risks involved.

Information about Costs and Associated Charges.

- 3.22 The Licence Holder shall provide its Retail Clients with information on costs and associated charges that includes such of the following elements as are relevant:
- a. the total price to be paid by the client in connection with the Instrument or the Investment Service or Ancillary Service, including all related fees, commission, charges and expenses, and all taxes applicable via the Licence Holder or, if an exact price cannot be indicated, the basis for the calculation of the total price so that the client can verify it. Commissions charged by the Licence Holder shall be itemised separately in every case;
 - b. where any part of the total price referred to in point (a) is to be paid in or represents an amount of foreign currency, an indication of the currency involved and the applicable currency conversion rates and costs;
 - c. notice of the possibility that other costs, including taxes, related to transactions in connection with the Instrument or the Investment Service may arise for the client that are not paid via the Licence Holder or imposed by it;
 - d. the arrangements for payment or other performance.

Information Drawn up in accordance with Directive 85/611/EEC (the UCITS Directive)

- 3.23 In respect of units in a collective investment scheme which qualifies as a UCITS under Directive 85/11/EEC, a simplified prospectus complying with Article 28 of that Directive is regarded as appropriate information for the purposes of:

- a. the provision of information about Instruments and proposed investment strategies including appropriate guidance on and warnings of the risks associated with investments in those Instrument or in respect of particular investment strategies;
- b. costs and associated charges related to the UCITS itself including the exit and entry commissions.

4. Outsourcing

General

- 4.01 A Licence Holder shall ensure, when relying on a third party for the performance of operational functions which are critical for the provision of continuous and satisfactory service to clients and the performance of investment activities on a continuous and satisfactory basis, that it takes reasonable steps to avoid undue additional operational risk. Outsourcing of important operational functions may not be undertaken in such a way as to impair materially the quality of its internal control and the ability of the MFSA to monitor the Licence Holder's compliance with all obligations.
- 4.02 An operational function of a Licence Holder shall be regarded as critical or important if a defect or failure in its performance would materially impair the continuing compliance of a Licence Holder with the conditions and obligations of its authorisation or its other obligations under these Rules, or its financial performance, or the soundness or the continuity of its Investment Services and activities.
- 4.03 Without prejudice to the status of any other function, the following functions shall not be considered as critical or important for the purposes of SLC 4.02:
- a. the provision to the Licence Holder of advisory services, and other services which do not form part of the investment business of the Licence Holder, including the provision of legal advice to the Licence Holder, the training of the Licence Holder's personnel, billing services and the security of the Licence Holder's premises and personnel;
 - b. the purchase of standardised services, including market information services and the provision of price feeds.

Conditions for Outsourcing Critical or Important Operational Functions or Investment Services or Activities.

- 4.04 When the Licence Holder outsources critical or important operational functions or any Investment Services or activities, the Licence Holder remain fully responsible for discharging all of their obligations under these Rules and are required to comply, in particular with the following conditions:
- a. the outsourcing must not result in the delegation by senior management of its responsibility;
 - b. the relationship and obligations of the Licence Holder towards its clients under these Rules must not be altered;

- c. the compliance with the Licence Holder's applicable licence conditions must not be undermined;
- d. none of the other conditions subject to which the Licence Holder was granted a licence must be removed or modified.

4.05 The Licence Holder shall exercise due skill, care and diligence when entering into, managing or terminating any arrangement for the outsourcing to a service provider of critical or important operational functions or of any Investment Services or activities.

The Licence Holder shall in particular take the necessary steps to ensure that the following conditions are satisfied:

- a. the service provider must have the ability, capacity and any authorisation required by law to perform the outsourced functions, services or activities reliably and professionally;
- b. the service provider must carry out the outsourced services effectively, and to this end the Licence Holder must establish methods for assessing the standard of performance of the service provider;
- c. the service provider must properly supervise the carrying out of the outsourced functions, and adequately manage the risks associated with the outsourcing;
- d. appropriate action must be taken if it appears that the service provider may not be carrying out the functions effectively and in compliance with applicable laws and regulatory requirements;
- e. the Licence Holder must retain the necessary expertise to supervise the outsourced functions effectively and manage the risks associated with the outsourcing and must supervise those functions and manage those risks;
- f. the service provider must disclose to the Licence Holder any development that may have a material impact on its ability to carry out the outsourced functions effectively and in compliance with applicable laws and regulatory requirements;
- g. the Licence Holder must be able to terminate the arrangement for outsourcing where necessary without detriment to the continuity and quality of its provision of services to clients;
- h. the service provider must cooperate with the MFSA in connection with the outsourced activities;

- i. the Licence Holder, its auditors and the MFSA must have effective access to data related to the outsourced activities, as well as to the business premises of the service provider; and the MFSA must be able to exercise those rights of access;
 - j. the service provider must protect any confidential information relating to the Licence Holder and its clients;
 - k. the Licence Holder and the service provider must establish, implement and maintain a contingency plan for disaster recovery and periodic testing of backup facilities, where that is necessary having regard to the function, service or activity that has been outsourced.
- 4.06 The respective rights and obligations of the Licence Holder and of the service provider must be clearly allocated and set out in a written agreement.
- 4.07 Where the Licence Holder and the service provider are members of the same group, the Licence Holder may, for the purposes of complying with this Section, take into account the extent to which the Licence Holder controls the service provider or has the ability to influence its actions.
- 4.08 The Licence Holder shall make available to the MFSA, on request, all information necessary to enable the MFSA to supervise the compliance of the performance of the outsourced activities with the requirements of these Rules.

Service Providers Located in Third Countries.

- 4.09 In addition to the requirements of SLCs 4.04 to 4.08, where a Licence Holder outsources the Investment Service of portfolio management provided to Retail Clients to a service provider located in a third country, that Licence Holder shall ensure that the following conditions are satisfied:
- a. the service provider must be authorised or registered in its home country to provide that service and must be subject to prudential supervision;
 - b. there must be an appropriate cooperation agreement between the MFSA and the supervisory authority of the service provider.
- 4.10 When one or both of the conditions referred to in SLC 4.09 are not satisfied, a Licence Holder may outsource Investment Services to a service provider located in a third country only if the Licence Holder gives prior notification to MFSA about the outsourcing arrangement and the MFSA does not object to that arrangement within a reasonable time following receipt of that notification.

- 4.11 The Licence Holder shall still be required to comply with the requirements of SLCs 4.04 to 4.08.

5. Supplementary Conditions for Operators of Multilateral Trading Systems

- 5.01 The operator of an MTF, shall establish transparent and non-discretionary rules and procedures for fair and orderly trading and shall establish objective criteria for the efficient execution of orders.
- 5.02 The operator of an MTF shall:
- a. establish transparent rules regarding the criteria for determining the Instruments that can be traded under its systems; and
 - b. where applicable, provide or ensure that there is access to sufficient publicly available information to enable its users to form an investment judgement, taking into account both the nature of the users and the types of Instruments traded.
- 5.03 SLCs 2.02 to 2.81 are not applicable to the transactions concluded under the rules governing an MTF between its members or participants or between the MTF and its members or participants in relation to the use of the MTF. Provided that members of or participants in the MTF shall comply with the obligations provided for in the above-mentioned SLCs with respect to their clients when, acting on behalf of their clients, they execute their orders through the systems of an MTF.
- 5.04 The operator of an MTF shall establish and maintain transparent rules, based on objective criteria, governing access to its facility. These rules shall provide that the MTF may admit as members or participants Licence Holders, credit institutions authorised under Directive 2000/12/EC and other persons who:
- a. are fit and proper;
 - b. have a sufficient level of trading ability and competence;
 - c. have, where applicable, adequate organisational arrangements; and
 - d. have sufficient resources for the role they are to perform, taking into account the different financial arrangements that the MTF may have established in order to guarantee the adequate settlement of transactions.
- 5.05 The operator of an MTF shall:
- a. clearly inform its users of their respective responsibilities for the settlement of the transactions executed on that facility;
 - b. have in place the necessary arrangements to facilitate the efficient settlement of

the transactions concluded under the systems of the MTF.

- 5.06 Where a transferable security, which has been admitted to trading on a regulated market, is also traded on an MTF without the consent of the issuer, the MTF shall not make such issuers subject to any obligation relating to initial, ongoing or ad hoc financial disclosure.
- 5.07 The operator of an MTF shall comply immediately with any instruction from the MFSA to suspend or remove an Instrument from trading.

Compliance Arrangements

- 5.08 The operator of an MTF shall:
- a. establish and maintain effective arrangements and procedures, relevant to the MTF, for the regular monitoring of the compliance by its users with its rules;
 - b. monitor the transactions undertaken by its users under their systems in order to identify breaches of its rules, disorderly trading conditions or conduct that may involve market abuse.
- 5.09 The operator of an MTF shall:
- a. notify the MFSA of any significant breaches of its rules or disorderly trading conditions or conduct that may involve market abuse;
 - b. supply the relevant information without delay to the MFSA for the investigation and prosecution of market abuse and shall provide the MFSA with full assistance in investigating and prosecuting market abuse occurring on or through its systems.

Pre-trade transparency requirements for MTFs

- 5.10 The operator of an MTF shall make public current bid and offer prices and the depth of trading interests at those prices which are advertised through its systems in respect of shares admitted to trading on a regulated market. This information shall be made available to the public on reasonable commercial terms and on a continuous basis during normal trading hours.
- 5.11 Depending on the market model or the type and size of orders in the cases defined in the Commission Regulation, the MFSA may waive the obligation for the operator of an MTF to make public the information referred to in SLC 5.10. In particular, the MFSA may waive the obligation in respect of transactions that are large in scale compared with normal market size for the share or type of share in question. Such waiver may be granted by the MFSA following a written request from the MTF

operator to the MFSA which request should include relevant details as necessary.

- 5.12 In complying with the provisions of this Section of these rules the operators of an MTF shall also comply with the applicable provisions of the Commission Regulation.

Post-trade transparency requirements for MTFs

- 5.13 The operator of an MTF shall make public the price, volume and time of the transactions executed under its systems in respect of shares which are admitted to trading on a regulated market. The details of all such transactions shall be made public, on a reasonable commercial basis, as close to real-time as possible. Provided that this SLC shall not apply to details of trades executed on an MTF that are made public under the systems of a regulated market.
- 5.14 The MFSA may authorise, subject to the applicable provisions of the Commission Regulation, the operator of an MTF to provide for deferred publication of the details of transactions based on their type or size. In particular, the MFSA may authorise the deferred publication in respect of transactions that are large in scale compared with the normal market size for that share or that class of shares.

MTFs shall obtain the MFSA's prior approval to proposed arrangements for deferred trade-publication. These arrangements shall be clearly disclosed to market participants and the investing public.

- 5.15 In complying with the provisions of this Section of the Rules the operator of an MTF shall also comply with the applicable provisions of the Commission Regulation.

Transaction Reporting

- 5.16 An MTF shall submit to the MFSA a daily report of all the transactions carried out in Instruments which are traded on the MTF ('the Transaction Report'). Such a Transaction Report shall contain the information as specified from time to time by the MFSA and shall be submitted in the format specified by the MFSA. Transaction Reports are to be submitted by the MTF to reach the Authority by the end of the business day following that on which the said trades were executed. The MTF will immediately notify the Authority in writing of any circumstance which prevents it from complying with this requirement.

Provisions regarding central counterparty, clearing and settlement arrangements in respect of MTFs

- 5.17 The operator of an MTF may enter into appropriate arrangements with a central counterparty or clearing house and a settlement system of another Member State with a view to providing for the clearing and/or settlement of some or all trades concluded

by market participants under their systems.

Provided that the MFSA may oppose the use of central counterparty, clearing houses and/or settlement systems in another Member State where this is demonstrably necessary in order to maintain the orderly functioning of that MTF and taking into account the conditions for settlement systems established in Article 34(2) of the MIFID.

6. Supplementary Conditions for a Licence Holder which Qualifies as Systematic Internaliser and for a Licence Holder which execute Off-Market Deals.

6.01 Systematic internalisers in shares shall publish a firm quote in those shares admitted to trading on a regulated market for which they are systematic internalisers and for which there is a liquid market. In the case of shares for which there is not a liquid market, systematic internalisers shall disclose quotes to their clients on request.

Provided that the provisions of this Section of the Rules shall be applicable to systematic internalisers when dealing for sizes up to standard market size. Systematic internalisers that only deal in sizes above standard market size shall not be subject to the provisions of this Section.

6.02 Systematic internalisers may decide the size or sizes at which they will quote. For a particular share, each quote shall include a firm bid and/or offer price or prices for a size or sizes which could be up to standard market size for the class of shares to which the share belongs. The price or prices shall be updated regularly by the systematic internaliser and shall also reflect the prevailing market conditions for that share.

6.03 Shares shall be grouped in classes on the basis of the arithmetic average value of the orders executed in the market for that share. The standard market size for each class of shares shall be a size representative of the arithmetic average value of the orders executed in the market for the shares included in each class of shares.

Provided that the market for each share shall be comprised of all orders executed in the European Union in respect of that share excluding those large in scale compared to normal market size for that share.

6.04 Systematic internalisers shall make public their quotes on a regular and continuous basis during normal trading hours.

Provided that they shall be entitled to update their quotes at any time. Provided further that, under exceptional market conditions, to withdraw their quotes.

6.05 Quotes shall be made public in a manner which is easily accessible to other market participants on a reasonable commercial basis.

6.06 Systematic internalisers shall, in complying with the SLCs 2.54 to 2.71 execute the orders they receive from their Retail Clients in relation to the shares for which they are systematic internalisers at the quoted prices at the time of reception of the order

6.07 Systematic internalisers shall execute the orders they receive from their Professional

Clients in relation to the shares for which they are systematic internalisers at the quoted price at the time of reception of the order. This notwithstanding, they may execute those orders at a better price in justified cases provided that this price falls within a public range close to market conditions and provided that the orders are of a size bigger than the size customarily undertaken by a retail investor.

- 6.08 Systematic internalisers may execute orders they receive from their Professional Clients at prices different than their quoted ones without having to comply with SLC 6.07 in respect of transactions where execution in several securities is part of one transaction or in respect of orders that are subject to conditions other than the current market price.
- 6.09 Where a systematic internaliser who quotes only one quote or whose highest quote is lower than the standard market size receives an order from a client of a size bigger than its quotation size, but lower than the standard market size, it may decide to execute that part of the order which exceeds its quotation size, provided that it is executed at the quoted price, except where otherwise permitted under the conditions of SLCs 6.07 and 6.08.
- 6.10 Where the systematic internaliser is quoting in different sizes and receives an order between those sizes, which it chooses to execute, it shall execute the order at one of the quoted prices in compliance with SLCs 2.72 to 2.81 except where otherwise permitted under the conditions of SLCs 6.07 and 6.08.
- 6.11 Systematic internalisers may decide, on the basis of their commercial policy and in an objective non-discriminatory way, the investors to whom they give access to their quotes. To that end, there shall be clear standards for governing access to their quotes. Systematic internalisers may refuse to enter into or discontinue business relationships with investors on the basis of commercial considerations such as the investor credit status, the counterparty risk and the final settlement of the transaction.
- 6.12 In order to limit the risk of being exposed to multiple transactions from the same client, systematic internalisers may limit in a non-discriminatory way the number of transactions from the same client which they undertake to enter at the published conditions. Systematic Internalisers may also in a non-discriminatory way, and in accordance with SLCs 2.72 to 2.81, limit the total number of transactions from different clients at the same time provided that this is allowable only where the number and/or volume of orders sought by clients considerably exceeds the norm.
- 6.13 The Licence Holder which, either on own account or on behalf of clients, concludes off-market deals, shall make public the volume and price of those transactions and the time at which they were concluded. This information shall be made public as close to real-time as possible, on a reasonable commercial basis, and in a manner which is easily accessible to other market participants.

Provided that where the off-market deal is in Instruments traded on a Regulated Market authorised in terms of article 4 the of Financial Markets Act, 1990, the Licence Holder shall be deemed as having complied with this SLC if it satisfies the requirements set in the Financial Markets Act (Off-Market Deals) Regulations, 2007.

Provided further that the MFSA, subject to the applicable provisions of the Commission Regulation, may authorise the Licence Holder to provide for deferred publication of the details of transactions based on their type or size. In particular, the MFSA may authorise the deferred publication in respect of transactions that are large in scale compared with the normal market size for that shares or those classes of shares. The Licence Holder shall obtain the MFSA's prior approval of proposed arrangements for deferred trade-publication, and shall clearly disclose these arrangements to market participants and the investing public.

- 6.14 In complying with the provisions of this Section of the Rules, the Licence Holder shall also refer and comply with the applicable provisions of the Commission Regulation

7. Financial Resources Requirements, Accounting and Record Keeping

General

7.01 The Licence Holder shall at all times maintain own funds equal to or in excess of its capital resources requirement. This shall constitute the Licence Holder's Financial Resources Requirement.

Provided that the Licence Holder which is a credit institutions licensed in terms of the Banking Act, 1994 or a branch established in Malta of a credit institutions authorised in a EU Member State or EEA State, or of an overseas credit institutions which is subject to prudential requirements at least equivalent to the requirements applicable to Maltese credit institutions, is not subject to the above-mentioned financial resources requirement and needs not prepare and submit any Interim or Annual Financial Return referred to in the SLCs which follow.

7.02 The meaning of own funds and the capital resources requirement applicable to the different categories of Licence Holders, as well as the methodology for calculating a Licence Holder's satisfaction of its Financial Resources Requirement, are set out in Appendix 1.

7.03 The Licence Holder shall comply with any further financial resources requirements set by the MFSA. If the MFSA so determines, the Licence Holder will be given due notice in writing of the additional financial resources requirements which shall be applied.

7.04 The Licence Holder shall immediately advise the MFSA if at any time it is in breach of its Financial Resources Requirement. In this case, the MFSA may, if the circumstances justify it, allow the Licence Holder a limited period within which to restore its financial resources to the required level.

7.04A The Licence Holder shall ensure compliance with this section of the Investment Services Rules for Investment Services Providers and Appendix 1 to these Rules. A Licence Holder which is found to be in breach of these requirements may be subject to regulatory action in terms of Article 136 of Directive 2006/48/EC of the European Parliament and the Council relating to the taking up and pursuit of the business of credit institutions.

Professional Indemnity Insurance Requirement

7.05 The Licence Holder shall take out and maintain such insurance cover as it considers appropriate. The following mandatory requirements shall however apply to:

i. Licence Holders (except for Category 1) shall be required to maintain such

insurance policies of such classes and types to provide (unless otherwise agreed with the MFSA), at least the minimum level of protection set out in Section 2 of Appendix 6 to these Rules);

- ii. A Category 1b Licence Holder having chosen the option to maintain professional indemnity insurance (instead of the option to comply with the financial resources and reporting requirements applicable to Category 1a Licence Holders) shall take out and maintain professional indemnity insurance to provide at least the minimum level of protection set out in Section 1 of Appendix 6 of these Rules.

A Category 1b Licence Holder subject to the professional indemnity insurance requirement, shall submit a copy of its policy to the MFSA for approval, whilst a licence holder falling under (a) above, shall submit a copy of its money policy to the MFSA for its approval.

For the purposes of demonstrating to the satisfaction of the MFSA that the requirements in (a) to (b) above are being complied with on an on-going basis, the Licence Holder shall within one month from the date of renewal of the policy submit to the MFSA, a copy of the renewal cover note or such other written evidence as the MFSA may require to establish compliance with these Rules.

A Licence Holder shall within two working days from the date it becomes aware of any of the circumstances specified in (a) to (g) below, inform the MFSA in writing where:

- a. during the currency of a policy, the Licence Holder has notified insurers of an incident which may give rise to a claim under the policy;
- b. during the currency of a policy, the insurer has cancelled the policy or has notified its intention of doing so;
- c. the policy has not been renewed or has been cancelled and another policy satisfying the requirements of Appendix 6 has not been taken out from the day on which the previous policy lapsed or was cancelled;
- d. during the currency of a policy, the terms or conditions are altered in any manner so that the policy no longer satisfies the requirements of Appendix 6;
- e. the insurer has intimated that it intends to decline to indemnify the insured in respect of a claim under the policy;
- f. the insurer has given notice that the policy will not be renewed or will not be renewed in a form which will enable the policy to satisfy the requirements of Appendix 6;

- g. during the currency of a policy, the risks covered by the policy, or the conditions or terms relating thereto, are altered in any manner.

An Investment Services Licence Holder which is also licensed in terms of the Banking Act, 1994 and its subsidiaries, need not comply with the requirements of this Licence Condition, but instead shall provide MFSA with a brief summary of the nature and amount of its insurance cover.

Accounting / Record Keeping

7.06 The Licence Holder shall maintain proper accounting records to show and explain the Licence Holder's own transactions, assets and liabilities.

7.07 The accounting records shall:

- a. disclose with reasonable accuracy, at all times, the financial position of the Licence Holder; and
- b. enable the financial statements required by the MFSA to be prepared within the time limits specified in the conditions of the Investment Services Licence.

7.08 In particular, the financial records shall contain:

- a. entries from day to day of all sums of money received and expended and the matters to which they relate;
- b. a record of all income and expenses, explaining their nature;
- c. a record of all assets and liabilities, including any guarantees, contingent liabilities or other financial commitments; and
- d. entries from day to day of all transactions on the Licence Holder's own account.

7.09 The Licence Holder shall retain accounting records for a minimum period of ten years. During the first two years they shall be kept in a place from which they can be produced within 24 hours of their being requested.

7.10 The Licence Holder shall agree with the MFSA its Accounting Reference Date (financial year end).

Customers' Accounting Records

7.11 The Licence Holder shall ensure that proper accounting records are kept to show and

explain transactions processed by the Licence Holder on behalf of its customers.

7.12 The records shall:

- a. record all purchases and sales of Customers' Assets processed by the Licence Holder;
- b. record all receipts and payments of money belonging to customers which arise from transactions processed by the Licence Holder;
- c. disclose the assets and liabilities of a Licence Holder's customers individually and collectively, to the extent that they are managed by the Licence Holder;
- d. record all Customers' Assets (including title documents) in the possession of the Licence Holder or of another person who is holding such assets for, or to the order of the Licence Holder, showing the location of the assets, their beneficial owner and the extent to which they are subject to any charge of which the Licence Holder has been notified.

7.13 Customers' accounting records shall be retained for a minimum period of ten years.

During the first two years they shall be kept in a place from which they can be produced within 24 hours of their being requested.

7.14 The Licence Holder shall arrange for records to be kept of all services and transactions undertaken by it which shall be sufficient to enable MFSA to monitor compliance with the requirements of these rules, and in particular to ascertain that the Licence Holder has complied with all obligations with respect to clients or potential clients.

Reporting Requirements

7.15 The Licence Holder shall have internal control mechanisms and administrative and accounting procedures which permit the verification of their compliance with these Rules as well as effective procedures for risk assessment and effective control and safeguard arrangements for information processing systems,

The Licence Holder shall in each year prepare an Annual Financial Return in the form set out in Appendix 2 signed by the proprietor where the Licence Holder is a sole trader, or otherwise by at least two directors or partners or any other persons authorised to sign by way of a Board Resolution. In the latter case, the Licence Holder is expected to provide a certified true copy of such Board Resolution to the MFSA.

7.16 The Annual Financial Return shall be submitted to the MFSA within one month of

the Accounting Reference Date.

- 7.17 Audited annual financial statements prepared in accordance with International Financial Reporting Standards, together with a copy of the auditors' management letter and the auditors' report required by SLC 7.32, shall be submitted to the MFSA within four months of the Accounting Reference Date.
- 7.18 In addition to the Annual Financial Return and the audited annual financial statements, a Category 1 Licence Holder shall prepare an Interim Financial Return, in the form set out in Appendix 2, at a date six months after the Accounting Reference Date. In the event of a change to the Accounting Reference Date, the date for the preparation of the Interim Financial Return shall be agreed with the MFSA.
- 7.19 In addition to the Annual Financial Return and audited annual financial statements, Category 2 and Category 4 Licence Holders shall prepare an Interim Financial Return, in the form set out in Appendix 2, at dates three, six and nine months after the Accounting Reference Date. The first Interim Financial Return should cover the three months immediately following the Accounting Reference Date, the second Interim Financial Return should cover the six months immediately following the Accounting Reference Date and the third Interim Financial Return should cover the nine months immediately following the Accounting Reference Date. In the event of a change to the Accounting Reference Date, the dates for the preparation of the Interim Financial Returns shall be agreed with the MFSA.
- 7.20 In addition to the Annual Financial Return and audited annual financial statements, a Category 3 Licence Holder shall prepare an Interim Financial Return, in the form set out in Appendix 2, on a monthly basis. The first Interim Financial Return should cover the first month after the Accounting Reference Date, the second Interim Financial Return should cover first two months after the Accounting Reference Date and so on. In the event of a change to the Accounting Reference Date, the dates for the preparation of the Interim Financial Returns shall be agreed with the MFSA.
- 7.21 The Interim Financial Return shall be submitted to the MFSA within one month of the date up to which it has been prepared. It shall be signed by the proprietor where the Licence Holder is a sole trader, or otherwise by at least two directors or partners or any other persons authorised to sign by way of a Board Resolution. In the latter case, the Licence Holder is expected to provide a certified true copy of such Board Resolution to the MFSA.
- 7.22 The Licence Holder shall prepare and submit such additional financial returns as the MFSA may require.
- 7.23 The Licence Holder shall be responsible for the correct compilation of the Financial Returns. The nature and content of the financial returns shall be as follows:

- a. they shall be in the form set out in Appendix 2;
 - b. they shall be in agreement with the underlying accounting records;
 - c. accounting policies shall be consistent with those adopted in the audited annual financial statements and shall be consistently applied. These accounting policies should adequately cater for the following:
 - i. amounts in respect of items representing assets or income may not be offset against amounts in respect of items representing liabilities or expenditure, as the case may be, or vice versa, unless duly authorised by the MFSA; and
 - ii. balances representing clients' money and/ or assets held/ controlled by the Licence Holder must not form part of the Licence Holder's Balance Sheet;
 - d. information to be included in the financial returns shall be prepared in accordance with International Financial Reporting Standards;
 - e. investments shall be included in the balance sheet at valuations arrived at in accordance with the provisions of International Financial Reporting Standards;
 - f. financial returns shall not be misleading as a result of the misrepresentation or omission or miscalculation of any material item;
 - g. where the Annual Financial Return has been submitted before the relevant audited annual financial statements have been produced it shall be updated to reflect the information in the audited financial statements and submitted to the MFSA together with the audited annual financial statements;
 - h. in the case of an individual or individuals in partnership or association, financial returns shall be prepared to show relevant figures for the Investment Services business exclusively. If required by the MFSA to do so, the individual (or individuals) shall submit, in addition, a statement of personal assets and liabilities.
- 7.24 If so notified in writing by the MFSA, the Licence Holder shall be required to prepare and submit additional financial information for the purposes of consolidated supervision.
- 7.25 The Licence Holder shall notify the MFSA immediately it becomes aware:
- a. that it is in breach of the requirements in respect of financial resources, records, reporting or procedures and controls;

- b. (b) that it will be unable to submit an Annual or Interim Financial Return on the due date.

The notice shall give reasons and shall explain what action is being taken to rectify matters.

7.26 The Licence Holder shall notify the MFSA immediately if:

- a. it is notified that its auditor intends to qualify the audit report;
- b. it becomes aware of actual or intended legal proceedings against it;
- c. it decides to claim on a professional indemnity or other policy relating to its Investment Services business;
- d. the Licence Holder's counterparties in repurchase and reverse repurchase agreements or securities and commodities-lending and securities and commodities-borrowing transactions default on their obligations.

Audit

7.27 The Licence Holder shall appoint an auditor approved by the MFSA. The Licence Holder shall replace its auditor if requested to do so by the MFSA. The MFSA's consent shall be sought prior to the appointment or replacement of an auditor.

The Licence Holder shall make available to its auditor the information and explanations he needs to discharge his responsibilities as an auditor and in order to meet the MFSA's requirements.

7.28 The Licence Holder shall not appoint an individual as an auditor, nor appoint an audit firm where the individual directly responsible for the audit, or his firm is:

- a. a director, partner, qualifying shareholder, officer, representative or employee of the Licence Holder;
- b. a partner of, or in the employment of, any person in (a) above;
- c. a spouse, parent, step-parent, child, step-child or other close relative of any person in (a) above;
- d. a person who is not otherwise independent of the Licence Holder;
- e. person disqualified by the MFSA from acting as an auditor of a Licence Holder.

For this purpose, an auditor shall not be regarded as an officer or an employee of the Licence Holder solely by reason of being auditor of that Licence Holder.

- 7.29 The Licence Holder shall obtain from its auditor a signed letter of engagement defining clearly the extent of the auditor's responsibilities and the terms of his appointment. The Licence Holder shall confirm in writing to its auditor its agreement to the terms in the letter of engagement. The auditor shall provide the MFSA with a letter of confirmation in the form set out in Annex II to the Application Form for an Investment Services Licence (whether the Applicant is a Corporate entity or a Sole Trader).
- 7.30 The letter of engagement shall include terms requiring the auditor:
- a. to provide such information or verification to the MFSA as the MFSA may request;
 - b. to afford another auditor all such assistance as he may require;
 - c. to vacate his office if he becomes disqualified to act as auditor for any reason;
 - d. if he resigns, or is removed or not reappointed, to advise the MFSA of that fact and of the reasons for his ceasing to hold office. The auditor shall also be required to advise the MFSA if there are matters he considers should be brought to the attention of the MFSA;
 - e. in accordance with article 18 of the Act, to report immediately to the MFSA any fact or decision of which he becomes aware in his capacity as auditor of the Licence Holder which:
 - i. is likely to lead to a serious qualification or refusal of his audit report on the accounts of the Licence Holder; or
 - ii. constitutes or is likely to constitute a material breach of the legal and regulatory requirements applicable to the Licence Holder in or under the Act;
 - iii. gravely impairs the ability of the Licence Holder to continue as a going concern; or
 - iv. relates to any other matter which has been prescribed.
 - f. in accordance with article 18 of the Act, to report to the MFSA any facts or decision as specified in (e) above of any person having close links, as defined in Appendix 9, with the Licence Holder, of which the auditor becomes aware

in his capacity as auditor of the Licence Holder or of the person having such close links.

- 7.31 If at any time the Licence Holder fails to have an auditor in office for a period exceeding four weeks the MFSA shall be entitled to appoint a person to fill the vacancy; the fees and charges so incurred being payable by the Licence Holder.
- 7.32 In respect of each annual accounting period, the Licence Holder shall require its auditor to prepare a management letter in accordance with International Standards on Auditing. The auditor must also confirm to the MFSA that the audit has been conducted in accordance with International Standards on Auditing and whether, in the auditor's opinion:
- a. the Annual Financial Return together with the audited annual financial statements are in agreement with the Licence Holder's accounting records;
 - b. the Annual Financial Return has been prepared in accordance with the MFSA's requirements and is consistent with the audited annual financial statements;
 - c. the Licence Holder's Financial Resources have been properly calculated in accordance with the MFSA's requirements and exceed the Licence Holder's Financial Resources Requirement as at the Accounting Reference Date;
 - d. proper accounting records have been kept, and adequate systems for their control have been maintained, as required by the MFSA, during the period covered by the Annual Financial Return;
 - e.
 - i. the Licence Holder has maintained throughout the period covered by the Annual Financial Return, systems adequate to safeguard Customers' Assets and Clients' Money; or
 - ii. based on review procedures performed, nothing has come to the auditor's attention that causes the auditor to believe that the Licence Holder held Customers' Assets or Clients' Money during the period covered by the Annual Financial Return.
 - f. all information and explanations necessary for the purpose of the audit have been obtained.
- 7.33 Where, in the auditor's opinion, one or more of the requirements have not been met, the auditor shall be required to include in his report a statement specifying the relevant requirements and the respects in which they have not been met. Where the auditor is unable to form an opinion as to whether the requirements have been met, the auditor shall be required to specify the relevant requirements and the reasons why he has been unable to form an opinion.

- 7.34 The Licence Holder in receipt of a management letter from its auditor which contains recommendations to remedy any weaknesses identified during the course of the audit, is required to submit to the MFSA by not later than six months from the end of the financial period to which the management letter relates, a statement setting out in detail the manner in which the auditor's recommendations have been/ are being implemented. In the instance where the Licence Holder has not taken / is not taking any action in respect of any one or more recommendations in the auditor's management letter, the reasons are to be included.
- 7.35 The Licence Holder is required to include in the Directors' Report (which should form part of the annual report to members of the company), a statement regarding breaches of SLCs or other regulatory requirements which occurred during the reporting period, and which were subject to an administrative penalty or other regulatory sanction.

Where there have been no breaches, it is sufficient merely to say so. However, if there have been breaches, a summary must be provided of the breach(es) committed and regulatory sanction imposed.

Supplementary conditions for a Licence Holder subject to the Investor Compensation Scheme Regulations ("the Regulations") issued in terms of the Act.

- 7.36 The Licence Holder is required to contribute to the Investor Compensation Scheme ("ICS"), in such manner and within such time limits stipulated in the Regulations, as may be amended from time to time. The Regulations require the Licence Holder to make a Fixed and Variable Contribution.

The Variable Contribution must be computed at every accounting reference date of the Licence Holder. Transfers to the Investor Compensation Scheme Reserve which may be required in terms of the Regulations, are to be made by the Licence Holder when drawing up the annual financial statements, and are to be reflected in the Annual Financial Return. The Licence Holder is not required to make any transfers to the Investor Compensation Scheme Reserve in the Interim Financial Returns.

- 7.37 The Licence Holder must insert a suitable note in its annual audited financial statements, outlining the market value of the Instruments in which the Investor Compensation Scheme Reserve has been invested, together with a maturity schedule according to the type of Instrument, as appropriate.
- 7.38 The process leading to a possible claim for compensation payable by the ICS is triggered by a determination which the MFSA shall make to the ICS in accordance with the terms stipulated in the Regulations. The MFSA may consider the following circumstances in arriving at a decision as to whether to make a determination to the ICS in terms of the Regulations. These should be interpreted as merely indicative,

rather than an exhaustive list of such circumstances:

- a. a prolonged and recurrent material deficit of the Licence Holder's Financial Resources, where the MFSA is of the opinion that the shareholders are unable to financially support the Licence Holder; or
- b. the MFSA is informed of a voluntary winding up of the Licence Holder; or
- c. the MFSA has received a complaint from one or more investors to the extent that the Licence Holder was unable to fulfill its obligations arising from claims by such investor(s).

Conditions applicable to a Licence Holder which forms part of an Investment Services Consolidation Group.

- 7.39 The Licence Holder shall, by not later than the end of one month from its accounting reference date, assess whether it forms part of an Investment Services Consolidation Group, as defined in Appendix 3 A to these Rules, and provide the Authority with an explanation to this effect.
- 7.40 Where the Licence Holder considers that it forms part of an Investment Services Consolidation Group, it shall in turn request its auditor's opinion in this regard, in terms of the definition of an Investment Services Consolidation Group in the Glossary to these Rules. The Licence Holder's auditor shall, in its annual report made in terms of SLC 7.32, provide the MFSA with an opinion as to whether:
- a. the Licence Holder forms part of an Investment Services Consolidations Group as defined in the Glossary to these Rules; and
 - b. the Investment Services Consolidated Group is in surplus or otherwise of the consolidated financial resources requirement.
- 7.41 The Licence Holder which forms part of an Investment Services Consolidation Group shall ensure that the Investment Services Consolidation Group at all times maintains consolidated own funds which are equal to or in excess of the consolidated capital resources requirement. This shall constitute the Investment Services Consolidation Group's consolidated financial resources requirement.
- 7.42 The Licence Holder which forms part of an Investment Services Consolidation Group shall prepare an Annual Consolidated Financial Return in the form set out in Appendix 3 B to these Rules. This shall be signed by at least two directors or any other persons authorised to sign by way of a Board Resolution. In the latter case, the Licence Holder is expected to provide a certified true copy of such Board Resolution to the MFSA. The Consolidated Annual Financial Return shall be submitted to the MFSA within one month of the Accounting Reference Date.

- 7.43 In addition to the Consolidated Annual Financial Return, a Category 2 Licence Holder and a Category 3 Licence Holder which form part of an Investment Services Consolidation Group shall, at a date six months after the Accounting Reference Date, prepare an Interim Consolidated Financial Return. The Consolidated Interim Financial Return shall be submitted to the MFSA within one month of the date up to which it has been prepared. In the event of a change in the Accounting Reference Date, the date for the preparation of the Consolidated Interim Financial Return shall be agreed with the MFSA.
- 7.44 The Licence Holder shall, where applicable ensure compliance with this section of these Rules and Appendix 3 A thereof. A Licence Holder which is found to be in breach of these requirements may be subject to regulatory action in terms of Article 136 of Directive 2006/48/EC of the European Parliament and the Council relating to the taking up and pursuit of the business of credit institutions.

Risk Management and the Internal Capital Adequacy Assessment Process

- 7.45 In terms of SLC 1.23 a Licence Holder is *inter alia* required to have in place a risk management process to:
- a. identify the risks to which the Licence Holder is/could be exposed; and
 - b. manage those risks, in the light of the level of risk tolerance set by the Licence Holder.

In addition to the above, the Licence Holder shall have in place sound, effective and complete strategies and processes to assess and maintain on an ongoing basis the amounts, types and distribution of internal capital that it considers adequate to cover the nature and level of the risks to which it is or might be exposed. This is hereinafter referred to as the Licence Holder's Internal Capital Adequacy Assessment Process.

The Licence Holder shall, on yearly basis, review its Risk Management and Internal Capital Adequacy Assessment Process ('RMICAAP') with the aim of ensuring that this process remains comprehensive and proportionate to the nature, scale and complexity of the activities of the Licence Holder concerned.

In preparing, reviewing and updating its RMICAAP, a Licence Holder shall refer to the Guidance Notes on Risk Management and Internal Capital Adequacy Assessment for Investment Services Licence Holders, Regulated Markets and Central Securities Depositories.

This SLC and the subsequent SLCs in section 7 of these Rules shall not apply to:

- a. credit institutions which are also Licence Holders

- b. Category 1 Licence Holders; and
- c. Licence Holders which only provide management services to collective investment schemes.

7.46 As at the 31st January of every calendar year, the Licence Holder shall confirm to the MFSA that it has a RMICAAP in place and that this is comprehensive and proportionate to the nature, scale and complexity of the activities of the Licence Holder concerned. Such confirmation shall be signed by two directors of the Licence Holder.

7.47 The Licence Holder may from time to time be requested by the MFSA to submit an RMICAAP Report, outlining the arrangements, strategies, processes and mechanisms implemented by the Licence Holder to comply with SLC 7.45. The report shall *inter alia* indicate:

- a. the risks to which the Licence Holder is/could be exposed; and
- b. the manner in which the Licence Holder is managing/intends to manage these risks.

Such report shall be signed by two directors of the Licence Holder.

7.48 Taking into account the technical criteria set out in the Guidance Notes on Risk Management and Internal Capital Adequacy Assessment for Investment Services Licence Holders, Regulated Markets and Central Securities Depositories, the MFSA shall review the RMICAAP Report submitted by a Licence Holder in terms of SLC 7.47 and evaluate the extent to which the Licence Holder has arrangements, strategies, processes and mechanisms in place which ensure a sound management and coverage of all material risks.

8. Transaction Reporting

8.01 The Licence Holder which executes transactions in any Reportable Instrument shall report the details of such transactions to the MFSA. This obligation shall apply whether or not such transactions were carried out on a regulated market. For the avoidance of doubt, such reporting requirement does not apply to the following categories of Investment Services Licence Holders:

- i. Licence Holders who merely “ receive and transmit orders” by transmitting client’s orders to a third party for execution, and who therefore do not actually execute transactions for clients themselves (i.e. they do not deal as agent);
- ii. Category 1a, 1b, or 4 Investment Services Licence Holders;
- iii. Where the Licence Holder is already subject to a transaction reporting requirement by a Regulated Market or an MTF, in respect of the trade and/or where the Regulated Market or MTF has been entrusted by the MFSA to act as reporting channel;
- iv. Where the Licence Holder has a branch in another Member State and carries out the transaction through the said branch on a Regulated Market or MTF in another EU or EEA Member State (“its host State”).

Reference to Appendix 8 of these Rules should be made. This contains guidance as to:

- a. the applicability of the reporting requirement in different scenarios;
- b. the information which such transaction reports shall contain; and
- c. the system through which such transaction reports shall be made.

8.02 Transaction Reports shall be submitted as soon as practicable after the execution of the trade as and in any event not later than the close of the following working day. The Licence Holder must notify the MFSA in writing and without delay, of any circumstances which prevent a transaction report being made within the period specified above. This obligation shall apply whether or not such transactions were carried out on a regulated market.

8.03 The Licence Holder shall report such details relating to off-exchange trades which it may execute on behalf of or with clients in relation to Instruments listed and traded on a regulated market or an MTF, as the Regulated Market or MTF may request.

8.04 The Licence Holder shall keep at the disposal of the MFSA, for at least five years, the

relevant data relating to all transactions in Instruments which it has carried out, whether on own account or on behalf of clients. In the case of transactions carried out on behalf of clients, the records shall contain all the information and details of the identity of the client, and the information required under Council Directive 91/308/EEC of 10 June 1991 on prevention of the use of the financial system for the purposes of money laundering.

- 8.05 In complying with the provisions of this Section of the Investment Services Rules, the Licence Holder shall also refer and comply with the applicable provisions of Chapter III of the Commission Regulation.

9. Supplementary Conditions for a Custodian of a Collective Investment Scheme.

9.01 The Licence Holder shall be a separate person from the Manager of a Scheme for which it acts as Custodian, and shall act independently of each other and solely in the interests of the Unit Holders. Since independence may be compromised in a variety of ways, any facts, relationships, arrangements, or circumstances which may at any stage bring that independence into question shall be declared to the MFSA as soon as the Licence Holder becomes aware of any such matter.

9.02 The Licence Holder shall have an established place of business in Malta and shall be:

- a. a credit institution, constituted and licensed under the laws of Malta; or
- b. a branch established in Malta, of a credit institution authorised in a EU Member State or EEA State; or
- c. a branch established in Malta of an overseas credit institution which is subject to prudential requirements at least equivalent to the requirements applicable to Maltese credit institutions; or
- d. a company incorporated in Malta which is wholly owned by a credit institution, provided that the liabilities of the Licence Holder are guaranteed by the credit institution and the credit institution is either a Maltese credit institution or is an overseas credit institution which is subject to prudential requirements at least equivalent to the requirements applicable to Maltese credit institutions; or
- e. a company incorporated in Malta which is wholly owned by a Maltese or foreign institution or company which is deemed by the MFSA to be an institution or company which provides unit-holders with protection equivalent to that provided by a Licence Holder fulfilling the requirements of (a), (b), (c) or (d) above and provided the liabilities of the company acting as Custodian are guaranteed by the institution or company and the institution or company has paid-up share capital of EUR5 million or its equivalent in foreign currency.

In the case of (d) and (e) above, the Licence Holder shall be required to have a minimum of one Director on its Board who is resident in Malta

9.03 The Licence Holder shall have the business organization, systems, and appropriate expertise and experience deemed necessary by the MFSA for it to carry out its functions.

9.04 Neither the Licence Holder nor any of its associates shall deal with the Scheme as a Principal unless the terms of the transaction or arrangement are on an arm's length basis.

- 9.05 The Licence Holder shall ensure that the sale, issue, repurchase, redemption and cancellation of Units effected by or on behalf of the Scheme are carried out in accordance with MFSA requirements, if any, applicable to the Scheme and with the Scheme's Constitutional Documents and most recent Prospectus.
- 9.06 The Licence Holder shall, where applicable, supervise the operation of a Scheme to ensure that the Manager complies with the investment restrictions of the Scheme.
- 9.07 The Licence Holder shall ensure that the value of Units is calculated in accordance with the provisions of the Constitutional Documents and the most recent Prospectus of the Scheme.
- 9.08 The Licence Holder shall carry out the instructions of the Manager, or the Scheme as applicable, unless they conflict with the MFSA requirements, if any, applicable to the Scheme and with the Scheme's Constitutional Documents and most recent Prospectus.
- 9.09 The Licence Holder shall ensure that in transactions involving a Scheme's assets, consideration is remitted to it within time limits which are in accordance with accepted market practice in the context of a particular transaction.
- 9.10 The Licence Holder shall ensure that a Scheme's income is applied in accordance with the Scheme's Constitutional Documents and most recent Prospectus.
- 9.11 The Licence Holder shall enquire into the conduct of the Manager or the Scheme in each annual accounting period and report thereon to the holders of Units in accordance with MFSA's requirements, if any, applicable to the Scheme and with any applicable provisions of its Agreement with the Scheme or (in the case of a Scheme constituted as a Unit Trust or Common Contractual Fund) its Manager.
- 9.12 The custodian agreement shall state that the Licence Holder will be liable to the Manager, the Scheme, and to the holders of Units for any loss suffered by them as a result of the Licence Holder's fraud, wilful default or negligence including the unjustifiable failure to perform in whole or in part its obligations.
- 9.13 The liability of the Licence Holder shall not be diminished if it has entrusted to a third party some or all of the assets in its safe-keeping. This shall be stated in the custodian agreement.
- 9.14 The Licence Holder shall not enter into a contract for the sale of assets when such assets are not in the ownership of the Scheme
- 9.15 When servicing a Scheme formed in accordance with or existing under the laws of Malta duly licensed by the MFSA, the Licence Holder shall:

- a. advise the MFSA if the value of the Scheme falls below Lm1 million (Euros 2,329,373); and
 - b. notify the MFSA of any breach of the Scheme's Licence Conditions or of any of the provisions of the Constitutional Documents of the Scheme as soon it becomes aware of the breach.
- 9.16 The Licence Holder shall notify the MFSA of the intended termination of its appointment to act as custodian of a Scheme.
- 9.17 The Licence Holder shall comply with the requirements laid out in the Investment Services Act (Control of Assets) Regulations, 1998 as may be amended from time to time.

10. Supplementary Conditions for a Manager of a Collective Investment Scheme**General Conditions applicable to the Licence Holder which qualifies as a Maltese Management Company and to Managers of Non UCITS Schemes**

- 10.01 The Licence Holder shall be a separate person from the Custodian of a Scheme for which it acts as Manager and shall act independently of each other and solely in the interests of the Unit holders. Since independence may be compromised in various ways, any facts, relationships, arrangements or circumstances which arise which may at any stage bring that independence into question shall be declared to the MFSA as soon as the Licence Holder becomes aware of any such matter.
- 10.02 The Licence Holder shall have an established place of business in Malta. It shall have sufficient financial resources at its disposal to enable it to conduct its business effectively and to meet its liabilities.
- 10.03 Neither the Licence Holder nor any of its associates shall deal with the Scheme as a Principal unless the terms of the transaction or arrangement are on an arm's length basis.
- 10.04 The Licence Holder and the Scheme, taking into account all of the Schemes which the former manages, shall not acquire sufficient Instruments to give it the right to exercise control over 20 per cent or more of the share capital or votes of a company, or sufficient Instruments to enable it to exercise significant influence over the management of the issuer.
- 10.05 The Licence Holder shall comply with directions given by the Custodian, being directions designed to ensure that the Scheme is properly managed and administered in accordance with MFSA requirements, if any, applicable to the Scheme and with the Scheme's Constitutional Documents and most recent Prospectus.
- 10.06 The Licence Holder shall keep a daily record of its box dealings and the Units held by it. The records shall be available to the Custodian and to the MFSA.
- 10.07 The Licence Holder shall comply with the External Transactions Act, 2003, in respect of the Scheme and its own operations.
- 10.08 When servicing a Scheme formed in accordance with or existing under the laws of Malta duly licensed by the MFSA, the Licence Holder shall:
- a. advise the MFSA if the value of the Scheme falls below Lm1 million (Euros 2,329,373); and
 - b. notify the MFSA of any breach of the Scheme's Licence Conditions or of any

of the provisions of the Constitutional Documents of the Scheme as soon it becomes aware of the breach.

- c. inform the MFSA immediately, and in any event within the working day, of the temporary suspension of the re-purchase or redemption of the Units of the Scheme.

10.09 The Licence Holder shall be liable to the Scheme and to the holders of Units for any loss suffered by them as a result of the Licence Holder's fraud, wilful default or negligence including the unjustifiable failure to perform in whole or in part its obligations.

10.10 Where the Licence Holder has the responsibility for doing so, the Licence Holder shall issue registered certificates or bearer securities representing one or more portions of the Scheme, or alternatively written confirmation of entry in the register of Units or fractions of Units.

10.11 Where a Scheme invests in the Units of another Scheme managed by the same Licence Holder, the Licence Holder shall waive all charges which it is entitled to charge for its own account in relation to the acquisition or disposal of Units in the Scheme into which investment is made. As far as is practicable, it shall avoid management charges being incurred in respect both of the Scheme and of the underlying Scheme or Schemes.

10.12 Where the Licence Holder receives a commission by virtue of an investment by a Scheme in the Units of another Scheme, that commission shall be paid into the property of the Scheme.

Supplementary Conditions for Managers of Non-UCITS Schemes

10.13 The activities of the Licence Holder shall ordinarily be limited to the management of collective investment schemes. However, the Licence Holder may also, with the approval of the Authority, be allowed to provide other Investment Services.

If the Licence Holder is also authorised to provide investment advice and/or portfolio management services to retail and/or Professional Clients and/or to Eligible Counterparties shall:

- a. disclose its interest in any collective investment scheme(s) in respect of which it provides investment advice;
- b. in the course of the provision of portfolio management services, not be permitted to invest all or part of the investor's portfolio in units of collective investment schemes it manages or in which it has an interest, unless it receives prior general written consent from the client following disclosure of its interest;

- c. not be permitted to provide portfolio management services to any Custodian which performs custodial duties for collective investment schemes in respect of which it acts as Manager.

The Management Company shall not use the Scheme's assets for its own purposes.

- 10.14 A Collective Investment Scheme may appoint a Manager or a Manager and an Administrator. Where only the Licence Holder is appointed, it shall be responsible for all management and administration functions. Where an Administrator is appointed, the Licence Holder will be responsible for management functions only and the Administrator for administrative functions only.

If an Administrator is not appointed by the Scheme, the Licence Holder may sub-contract the provision of administration services to an Administrator although, responsibility for administration services will in this case be retained by the Licence Holder.

A Licence Holder which sub-contracts the provision of administration services to an Administrator shall remain responsible, on a continuing basis for:

- a. the choice and the performance of the Administrator;
- b. ensuring that the Administrator is competent and suitable and able to undertake the proposed functions;
- c. monitoring the services being provided by the Administrator.

The appointment of an Administrator by the Licence Holder and any change thereto, requires MFSA's prior approval

- 10.15 In the event that the Manager wishes to delegate to third parties the carrying out on its behalf of one or more of its functions, it shall first notify MFSA. Such notification shall include details of the nature of functions to be delegated and of the entity or entities to whom the Licence Holder proposes to delegate such functions. The Licence Holder will be required to comply with SLCs 4.01 to 4.11.

Supplementary Conditions for a Licence Holder which qualifies as a Maltese Management Company

- 10.16 The activities of the Licence Holder shall ordinarily be limited to the management of collective investment schemes, which may include the following functions:

- Investment management;

- Administration:
- Legal and fund management accounting services;
- Customer inquiries;
- Valuation and pricing (including tax returns);
- Regulatory compliance monitoring;
- Maintenance of unit-holder register;
- Distribution of income;
- Unit issues and redemptions;
- Contract settlements (including certificate dispatch);
- Record-keeping
- Marketing

However, the Licence Holder, may, with the approval of the MFSA, be allowed to provide the following additional services:

- i. discretionary portfolio management services on a client-by-client basis, in relation to one or more Instruments as defined in the Act;
- ii. investment advice in relation to one or more Instruments as defined in the Act;
- iii. Safekeeping and administration in relation to units of collective investment schemes.

A Licence Holder authorised to provide the advisory and/ or portfolio management services to Retail and/ or Professional Clients and/ or to Eligible Counterparties shall:

- a. disclose its interest in any collective investment scheme(s) in respect of which it provides investment advice;
- b. in the course of the provision of discretionary portfolio management services, not be permitted to invest all or part of the investor's portfolio in units of collective investment schemes it manages or in which it has an interest, unless it receives prior general written consent from the client following disclosure of its interest;

- c. not be permitted to provide discretionary portfolio management services to any Custodian which performs custodial duties for collective investment schemes in respect of which it acts as Manager;
- d. comply with the capital adequacy requirements applicable to Licence Holders providing similar Investment Services; and
- e. be subject, with regard to the services mentioned above, to the provisions laid down in Directive 97/9/EC 1997 on investor compensation schemes

10.17 The Licence Holder shall at all times maintain own funds equal to or in excess of its capital resources requirement. This shall constitute the Manager's financial resources requirement, in accordance with the relevant requirements set out in Appendix 1.

10.18 The Licence Holder's head office and registered office shall both be located in Malta.

10.19 In the event that the Licence Holder wishes to delegate to third parties the carrying out on its behalf of one or more functions, it shall comply with with SLCs 4.01 to 4.11 and with the following requirements:

- a. the Licence Holder shall obtain MFSA's prior consent to the outsourcing or delegation of any of its functions following submission of appropriate details as may be required by the MFSA;
- b. the mandate shall not prevent the effectiveness of supervision over the delegate, and in particular it shall not prevent the Licence Holder from acting, or the Scheme from being managed, in the best interests of investors;
- c. when the delegation concerns the investment management, the mandate may only be given to undertakings which are authorised or licensed for the purpose of asset management and subject to prudential supervision, and such delegation shall be in accordance with investment-allocation criteria periodically laid down by the Licence Holder;
- d. a mandate with regard to the core function of investment management shall not be given to the Custodian or to any undertaking whose interests may conflict with those of the Licence Holder or the unit-holders;
- e. measures shall exist which enable the Licence Holder to monitor effectively at any time the activity of the undertaking to which the mandate is given;
- f. the mandate shall not prevent the Licence Holder from giving at any time, further instructions to the undertaking to which functions are delegated and to withdraw the mandate with immediate effect when this is in the interest of

investors;

- g. having regard to the nature of the functions to be delegated, the undertaking to which functions will be delegated shall be qualified and capable of performing the functions in question; and

In no case shall the liability of the Licence Holder be affected by the fact that it delegated any functions to third parties, nor shall the Licence Holder delegate functions to the extent that it becomes a “letter box/ brass plate” entity.

PART I – ACCOUNTING, AUDITING, FINANCIAL REPORTING, AND RECORD KEEPING REQUIREMENTS

For the purpose of these Financial Market Rules:

“Authorised Person” shall mean either a Regulated Market or a Central Securities Depository or where applicable an operator of a Regulated Market and a Central Securities Depository

“Central Securities Depository” means a person authorised in terms of Part IV of the Financial Markets Act, 1990 (henceforth referred to as “the Act”) to provide one or more of the functions stipulated in article 26 of the Act.

“Regulated Market” means a person in respect of whom the Competent Authority has issued an authorisation in terms of article 4 of the Act.

1.0 Accounting / Record Keeping

1.01 An Authorised Person shall maintain proper accounting records to show and explain the Authorised Person's own transactions, assets and liabilities.

1.02 The accounting records shall:

- a. disclose with reasonable accuracy, at all times, the financial position of the Authorised Person; and
- b. enable the financial statements required by the MFSA to be prepared within the time limits specified in these Rules.

1.03 In particular, the financial records shall contain:

- a. entries from day to day of all sums of money received and expended and the matters to which they relate;
- b. a record of all income and expenses, explaining their nature;
- c. a record of all assets and liabilities, including any guarantees, contingent liabilities or other financial commitments; and
- d. entries from day to day of all transactions on the Authorised Person's own account.

- 1.04 The Authorised Person shall retain accounting records for a minimum period of ten years. During the first two years they shall be kept in a place from which they can be produced within 24 hours of their being requested.
- 1.05 The Authorised Person shall agree with the MFSA its Accounting Reference Date (financial year end).

Reporting Requirements

- 1.06 Authorised Persons shall have internal control mechanisms and administrative and accounting procedures which permit the verification of their compliance with these Rules as well as effective procedures for risk assessment and effective control and safeguard arrangements for information processing systems.
- 1.07 Authorised Persons shall in each year prepare an Annual Financial Return in the form set out in Appendix I of these Rules. The Annual Financial Return shall be submitted to the MFSA within one month of the Accounting Reference Date.
- 1.08 An Annual Financial Return reflecting the figures of the audited annual financial statement and confirmed by the auditors shall be submitted to the MFSA within four months of the Accounting Reference Date.
- 1.09 Audited annual financial statements prepared in accordance with International Financial Reporting Standards, together with a copy of the auditors' management letter and the auditors' report required by Rule 1.22, shall be submitted to the MFSA within four months of the Accounting Reference Date.
- 1.10 In addition to the Annual Financial Return and audited annual financial statements, Authorised Persons shall prepare an Interim Financial Return, in the form set out in Appendix I to these Rules, at dates three, six and nine months after the Accounting Reference Date. The first Interim Financial Return should cover the three months immediately following the Accounting Reference Date, the second Interim Financial Return should cover the six months immediately following the Accounting Reference Date and the third Interim Financial Return should cover the nine months immediately following the Accounting Reference Date. In the event of a change to the Accounting Reference Date, the dates for the preparation of the Interim Financial Returns shall be agreed with the MFSA. The Interim Financial Return shall be submitted to the MFSA within one month of the date up to which it has been prepared.

- 1.11 Financial Returns shall be signed by at least two directors or partners or any other persons authorised to sign by way of a Board Resolution. In the latter case, the Authorised Person is expected to provide a certified true copy of such Board Resolution to the MFSA.
- 1.12 The Authorised Person shall prepare and submit such additional financial returns as the MFSA may require.
- 1.13 The Authorised Person shall be responsible for the correct compilation of the Financial Returns. The nature and content of the financial returns shall be as follows:
- a. they shall be in the form set out in Appendix I of these Rules;
 - b. they shall be in agreement with the underlying accounting records;
 - c. accounting policies shall be consistent with those adopted in the audited annual financial statements and shall be consistently applied. These accounting policies should adequately cater for amounts in respect of items representing assets or income may not be offset against amounts in respect of items representing liabilities or expenditure, as the case may be, or vice versa, unless duly authorised by the MFSA;
 - d. information to be included in the financial returns shall be prepared in accordance with International Financial Reporting Standards;
 - e. investments shall be included in the balance sheet at valuations arrived at in accordance with the provisions of International Financial Reporting Standards;
 - f. financial returns shall not be misleading as a result of the misrepresentation or omission or miscalculation of any material item;
- 1.14 If so notified in writing by the MFSA, the Authorised Person shall be required to prepare and submit additional financial information for the purposes of consolidated supervision.
- 1.15 The Authorised Person shall notify the MFSA immediately if it becomes aware:
- a. that it is in breach of the requirements in respect of financial resources, records, reporting or procedures and controls;

- b. that it will be unable to submit an Annual or Interim Financial Return on the due date.

The notice shall give reasons and shall explain what action is being taken to rectify matters.

1.16 The Authorised Person shall notify the MFSA immediately if:

- a. it is notified that its auditor intends to qualify the audit report;
- b. it becomes aware of actual or intended legal proceedings against it;
- c. the Authorised Person's counterparties in repurchase and reverse repurchase agreements or securities and commodities-lending and securities and commodities-borrowing transactions default on their obligations.

Audit

1.17 The Authorised Person shall appoint an auditor approved by the MFSA. The Authorised Person shall replace its auditor if requested to do so by the MFSA. The MFSA's consent shall be sought prior to the appointment or replacement of an auditor.

The Authorised Person shall make available to its auditor the information and explanations he needs to discharge his responsibilities as an auditor and in order to meet the MFSA's requirements.

1.18 The Authorised Person shall not appoint an individual as an auditor, nor appoint an audit firm where the individual directly responsible for the audit, or his firm is:

- a. a director, partner, qualifying shareholder, officer, representative or employee of the Authorised Person;
- b. a partner of, or in the employment of, any person in (a) above;
- c. a spouse, parent, step-parent, child, step-child or other close relative of any person in (a) above;
- d. a person who is not otherwise independent of the Authorised Person;
- e. a person disqualified by the MFSA from acting as an auditor of an

Authorised Person.

For this purpose, an auditor shall not be regarded as an officer or an employee of the Authorised Person solely by reason of being auditor of that Authorised Person.

- 1.19 The Authorised Person shall obtain from its auditor a signed letter of engagement defining clearly the extent of the auditor's responsibilities and the terms of his appointment. The Authorised Person shall confirm in writing to its auditor its agreement to the terms in the letter of engagement. The auditor shall provide the MFSA with a letter of confirmation in the form set out in Appendix II to these Rules.
- 1.20 The letter of engagement shall include terms requiring the auditor:
- a. to provide such information or verification to the MFSA as the MFSA may request;
 - b. to afford another auditor all such assistance as he may require;
 - c. to vacate his office if he becomes disqualified to act as auditor for any reason;
 - d. if he resigns, or is removed or not reappointed, to advise the MFSA of that fact and of the reasons for his ceasing to hold office. The auditor shall also be required to advise the MFSA if there are matters he/she considers should be brought to the attention of the MFSA;
 - e. to report immediately to the MFSA any fact or decision of which he becomes aware in his capacity as auditor of the Authorised Person which:
 - i. is likely to lead to a serious qualification or refusal of his audit report on the accounts of the Authorised Person; or
 - ii. constitutes or is likely to constitute a material breach of the legal and regulatory requirements applicable to the Authorised Person in or under the Act;
 - iii. gravely impairs the ability of the Authorised Person to continue as a going concern; or
 - iv. relates to any other matter which has been prescribed.

- 1.21 If at any time the Authorised Person fails to have an auditor in office for a period exceeding four weeks the MFSA shall be entitled to appoint a person to fill the vacancy; the fees and charges so incurred being payable by the Authorised Person.
- 1.22 In respect of each annual accounting period, the Authorised Person shall require its auditor to prepare a management letter in accordance with International Standards on Auditing. The auditor must also confirm to the MFSA that the audit has been conducted in accordance with International Standards on Auditing and whether, in the auditor's opinion:
- a. the Annual Financial Return together with the audited annual financial statements are in agreement with the Authorised Person's accounting records;
 - b. the Annual Financial Return has been prepared in accordance with the MFSA's requirements and is consistent with the audited annual financial statements;
 - c. the Authorised Person's Financial Resources have been properly calculated in accordance with the MFSA's requirements and exceed the Authorised Person's Financial Resources Requirement [as set out in the next section of these Rules] as at the Accounting Reference Date;
 - d. proper accounting records have been kept, and adequate systems for their control have been maintained, as required by the MFSA, during the period covered by the Annual Financial Return;
 - e. all information and explanations necessary for the purpose of the audit have been obtained.
- 1.23 Where, in the auditor's opinion, one or more of the requirements have not been met, the auditor shall be required to include in his report a statement specifying the relevant requirements and the respects in which they have not been met. Where the auditor is unable to form an opinion as to whether the requirements have been met, the auditor shall be required to specify the relevant requirements and the reasons why he has been unable to form an opinion.
- 1.24 Authorised Persons in receipt of a management letter from their auditor which contains recommendations to remedy any weaknesses identified during the course of the audit, are required to submit to the MFSA by not later than six months from the end of the financial period to which the management letter relates, a statement setting out in detail the manner in

which the auditor's recommendations have been/ are being implemented. In the instance where Authorised Persons have not taken / are not taking any action in respect of any one or more recommendations in the auditor's management letter, the reasons are to be included.

- 1.26 Authorised Persons are required to include in the Directors' Report (which should form part of the annual audited financial statements to members of the company), a statement regarding breaches of the Financial Market Rules or other regulatory requirements which occurred during the reporting period, and which were subject to an administrative penalty or other regulatory sanction.

Where there have been no breaches, it is sufficient merely to say so. However, if there have been breaches, a summary must be provided of the breach(es) committed and regulatory sanction imposed.

Risk Management and the Internal Capital Adequacy Assessment Process

- 1.27 The Authorised Person shall have in place an effective risk management process by taking the following actions with a view to manage its risks:

[a] establish, implement and maintain adequate risk management policies and procedures which identify the risks, including, particularly operational risk relating to the Authorised Person's activities, processes and systems, and where appropriate, set the level of risk tolerated by the Authorised Person;

[b] adopt effective arrangements, processes and mechanisms to manage the risks relating to the Authorised Person's activities, processes and systems, in light of that level of risk tolerance.

The Authorised Person shall have in place sound, effective and complete strategies and processes to assess and maintain on an ongoing basis the amounts, types and distribution of internal capital that they consider adequate to cover the nature and level of the risks to which they are or might be exposed. This is hereinafter referred to as the Authorised Person's Internal Capital Adequacy Assessment Process.

The Authorised Person shall, on yearly basis, review its risk management and internal capital adequacy assessment process ('RMICAAP') with the aim of ensuring that this process remains comprehensive and proportionate to the nature, scale and complexity of the activities of the Authorised Person concerned.

In preparing, reviewing and updating its RMICAAP, an Authorised Person shall refer to the Guidance Notes on Risk Management and Internal Capital Adequacy Assessment for Investment Services Licence Holders, Regulated Markets and Central Securities Depositories.

- 1.28 As at the 31st January of every calendar year, the Authorised Person shall confirm to the MFSA that it has an RMICAAP in place and that this is comprehensive and proportionate to the nature, scale and complexity of the activities of the Authorised Person. Such confirmation shall be signed by two directors of the Authorised Person.
- 1.29 The Authorised Person may from time to time be requested by the MFSA to submit a RMICAAP Report outlining the arrangements, strategies, processes and mechanisms implemented by the Authorised Person to comply with Rule 1.27. The report shall *inter alia* indicate: [i] the risks to which the Authorised Person is/could be exposed; and [ii] the manner in which the Authorised Person is managing/intends to manage these risks. Such report shall be signed by two directors of the Authorised Person.
- 1.30 Taking into account the technical criteria set out in the Guidance Notes on Risk Management and Internal Capital Adequacy Assessment for Investment Services Licence Holders, Regulated Markets and Central Securities Depositories, the MFSA shall review the RMICAAP Report submitted by an Authorised Person in terms of Rule 1.29 and evaluate the extent to which the Authorised Person has arrangements, strategies, processes and mechanisms in place which ensure a sound management and coverage of all material risks.

PART II – FINANCIAL RESOURCES REQUIREMENTS AND GUIDANCE ON THE COMPILATION OF THE FINANCIAL RETURN

2.0 Financial Resources Requirement

- 2.01 The Authorised Person shall at all times maintain own funds equal to or in excess of its capital resources requirement. This shall constitute the Authorised Person's Financial Resources Requirement.
- 2.02 Authorised Persons shall comply with any further financial resources requirements set by the MFSA. If the MFSA so determines, the Authorised Person will be given due notice in writing of the additional financial resources requirements which shall be applied.
- 2.03 The Authorised Person shall immediately advise the MFSA if at any time it is in breach of its Financial Resources Requirement. In this case, the MFSA may, if the circumstances justify it, allow the Authorised Person a limited period within which to restore its financial resources to the required level.

3.0 The Capital Resources Requirement

- 3.01 The Capital Resources Requirement of an Authorised Person shall be the higher of (i) and (ii) below:
- i. Initial Capital;
 - ii. the sum of the non-trading book business risk components, the trading book risk components, the commodities instruments - risk component, the large exposures risk component, the foreign exchange risk component, and the operational risk component.

4.0 General Outline of the Initial Capital and the Risk Components

- 4.1 This section is aimed at explaining the elements which make up the capital resources requirement. Firstly a definition of initial capital is given and this is followed by the minimum capital requirements for the various categories of Authorised Persons. A description of each of the risk components is given in Rules 4.1.2 to 4.1.7. This is followed by an illustration of all the applicable risk components for Authorised Persons.

4.1.1 Types of Authorised Persons and Initial Capital

For the purpose of these Rules, '*initial capital*' shall be comprised of:

- i. **equity capital** meaning: share capital subscribed by shareholders or other proprietors, in so far as it has been paid up, plus share premium accounts but excluding cumulative preferential shares; and
- ii. **reserves** meaning: revenue reserves, interim net profits/retained profits for the year, unrealised fair value movements in held for trading financial instruments and other reserves.

<u>Type of Authorised Person</u>	<u>Initial Capital</u> <u>EURO</u>
Regulated Market	730,000
Central Securities Depository	730,000
Regulated Market <u>and</u> Central Securities Depository	1,460,000

4.1.2 Risks associated with non-trading book business

This category is made up of the credit/ counterparty risk component, being the possibility of a loss occurring due to:

- i. the failure of a debtor of an Authorised Person to meet its contractual debt obligations; or
- ii. the loss in value of any other asset which forms part of the Authorised Person's balance sheet.

4.1.3 Risks associated with trading book business

This category is made up of four risk components:

- i. The position risk component:
The risk of losses, arising from movements in market prices, in on and off balance sheet investments in financial instruments which qualify as trading book business.

ii. The settlement risk component:
Settlement risk is the risk that the Authorised Person's cash against documents transactions in financial instruments which qualify as trading book business are unsettled after their due delivery dates.

iii. The counterparty risk component:
Counterparty risk is the amount of capital which the Authorised Person must hold against exposures in financial derivative instruments and credit derivatives.

iv. Free deliveries:
Free Deliveries caters for the risk that the Authorised Person has either: (a) paid for free deliveries transactions in financial instruments which qualify as trading book business before receiving them; or (b) has delivered financial instruments which qualify as trading book business, sold in a free deliveries transaction, before receiving payment for them.

4.1.4 Commodities Instruments - Risk Component

Commodities Risk is the risk component required to cover the Authorised Person's risk of holding or taking positions in commodities such as physical products which are and can be traded in the secondary market, including commodity derivatives.

4.1.5 Large Exposures Risk Component

The purpose of the large exposure requirement is to ensure that an Authorised Person manages its exposure to counterparties within appropriate limits set in relation to its capital resources requirements.

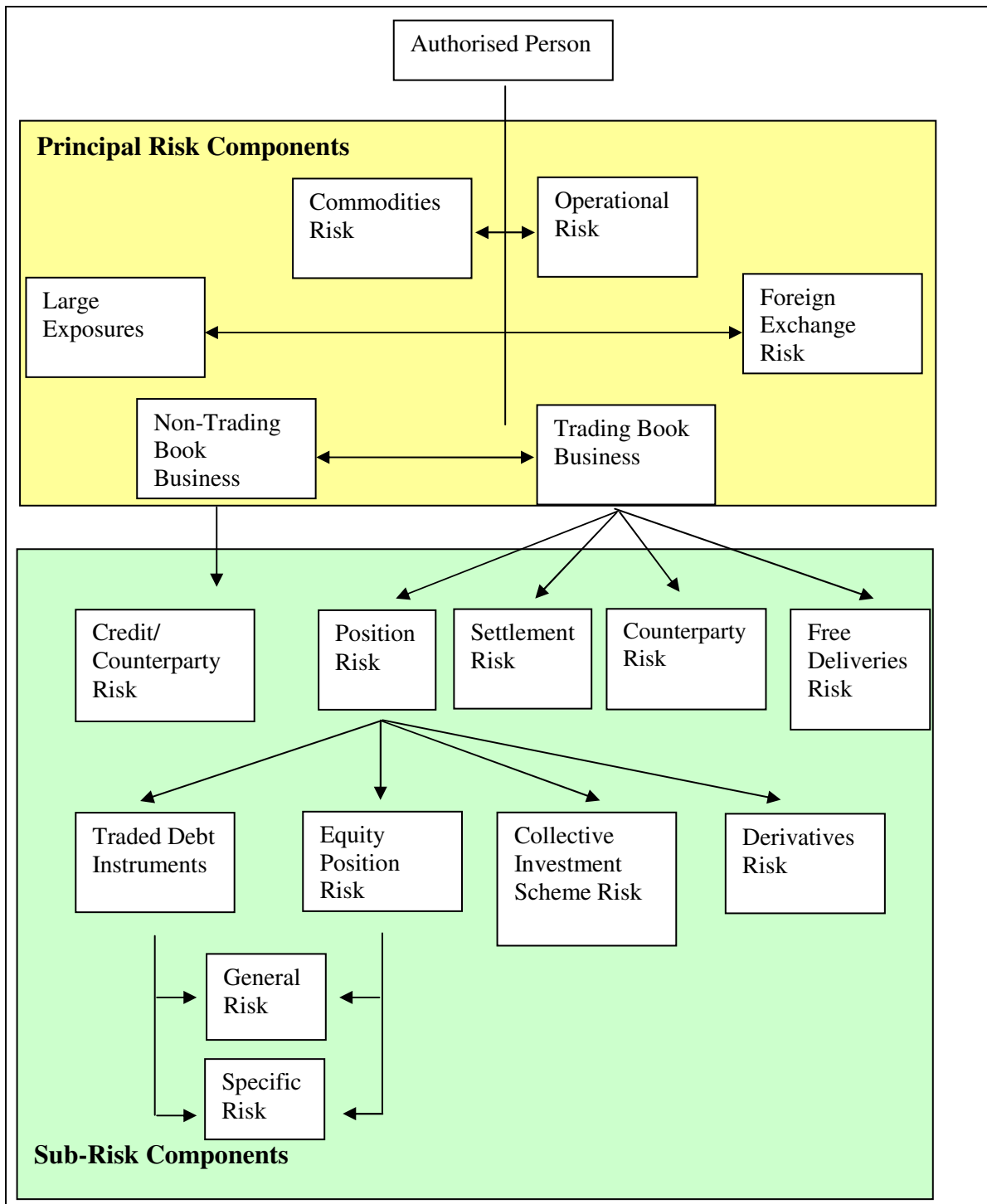
4.1.6 Foreign Exchange Risk Component

Foreign Exchange Risk is the risk that an asset or liability denominated in a currency other than the reporting currency may be adversely affected by a change in the value of the foreign currency.

4.1.7 Operational Risk Component

Operational Risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, and includes legal risk.

Table outlining the various risk components



5.0 Trading Book

5.1 The trading book of an Authorised Person shall consist of all positions in financial instruments held either with trading intent or in order to hedge other elements of the trading book and, which are either free of any restrictive covenants on their tradability or are able to be hedged.

Provided that where the following requirements are met, trading book positions may be accounted for as non-trading book positions:

- a. the trading book business of the Authorised Person does not normally exceed 5 %; and
- b. their trading-book positions do not normally exceed EURO 15 Million; and
- c. the trading book business of the Authorised Person never exceeds 6% of total business (being the combined off and on balance sheet business) and total trading book positions never exceed EUR 20 million.

In order to calculate the proportion that trading book business bears to total business for the purposes of points (a) and (c) above, Authorised Persons may refer to either: (i) to the size of the combined on and off-balance-sheet business, to the income statement or (ii) to the own funds of the institutions in question, or to a combination of those measures.

When the size of on and off balance-sheet business is assessed, **debt instruments** shall be valued at their market prices or their principal values, **equities** at their market prices and **derivatives** according to the nominal or market values of the instruments underlying them. Long positions and short positions shall be summed regardless of their signs.

If an Authorised Person subject to the exemption from the trading book requirement, exceeds:

- i. either or both of the limits imposed in paragraphs (a) and (b); or
- ii. either or both of the limits imposed in paragraph (c).

the Authorised Person shall be required to: (a) notify the MFSA immediately and (b) meet the requirements outlined in Rule 7.2.2.

5.2 The trading book shall also include all positions in derivative financial instruments whether or not these are held for trading.

5.3 In complying with Rule 5.1 above, an Authorised Person shall abide by the following conditions:

5.3.1 *Positions held with trading intent*

Positions held with trading intent are those held intentionally for short-term resale and/or with the intention of benefiting from actual or expected short-term price differences between buying and selling prices or from other price or interest rate variations and positions arising from client servicing and market making.

5.3.2 *Trading intent*

Trading intent shall be evidenced on the basis of the strategies, policies and procedures set up by the Authorised Person to manage the position or portfolio. These shall include the following:

- a. The Authorised Person shall have a clear documented trading strategy for the position/instrument or portfolios. Such strategy shall be approved by senior management, and shall include the expected holding horizon;
- b. The Authorised Person shall have clearly defined policies and procedures for the active management of the position, which shall include the following:
 - i. positions entered into on a trading desk;
 - ii. position limits are set and monitored for appropriateness;
 - iii. dealers have the autonomy to enter into/manage the position within agreed limits and according to the approved strategy;
 - iv. positions are reported to senior management as an integral part of the Authorised Person's risk management process; and
 - v. positions are actively monitored with reference to market information sources and an assessment made of the marketability or hedge-ability of the positions or its competent risks, including the assessment of, quality and availability of market inputs to the valuation process, level of market turnover, sizes of positions traded in the market; and
- c. The Authorised Person shall have clearly defined policies and procedures to monitor the positions against the Authorised Person's trading strategy including the monitoring of turnover and stale positions in the Authorised

Person's trading book.

5.3.3 Systems and controls

Authorised Persons shall establish and maintain systems and controls to manage their trading book. Such systems and controls shall be sufficient to provide prudent and reliable valuation estimates and shall include:

a. Documented policies and procedures for the process of valuation.

These should include clearly defined responsibilities of the various areas involved in the determination of the valuations, sources of market information and review of their appropriateness, frequency of independent valuation, timing of closing prices, procedures for adjusting valuations, month end and ad-hoc verification procedures; and reporting lines for the department accountable for the valuation process that are clear and independent of the front office. The reporting line shall ultimately be to a main board executive director.

b. Prudent valuation methods as follows:

- i. Marking to market, comprising as a minimum, the daily valuation of positions at readily available close out prices that are sourced independently. Examples include exchange prices, screen prices, or quotes from several independent reputable brokers;
- ii. When marking to market, the more prudent side of bid/offer shall be used unless the Authorised Person is a significant market maker in the particular type of financial instrument or commodity in question and it can close out at mid market;
- iii. Where marking to market is not possible, Authorised Persons must mark to model their positions/portfolios before applying trading book capital treatment. Marking to model is defined as any valuation which has to be benchmarked, extrapolated or otherwise calculated from a market input;
- iv. The following requirements must be complied with when marking to model:
 - senior management shall be aware of the elements of the trading book which are subject to mark to model and shall understand the materiality of the uncertainty this creates in the reporting of the risk/performance of the business;
 - market inputs shall be sourced, where possible, in line with market prices, and the appropriateness of the market inputs of the

particular position being valued and the parameters of the model shall be assessed on a frequent basis;

- where available, valuation methodologies which are accepted market practice for particular financial instruments shall be used;
- where the model is developed by the Authorised Person itself, it shall be based on appropriate assumptions, which have been assessed and challenged by suitably qualified parties independent of the development process;
- there shall be formal change control procedures in place and a secure copy of the model shall be held and periodically used to check valuations;
- the person/s responsible for risk management shall be aware of the weaknesses of the models used and how best to reflect those in the valuation output; and
- the model shall be subject to periodic review to determine the accuracy of its performance (e.g. assessing the continued appropriateness of assumptions, analysis of profit and loss versus risk factors, and comparison of actual close out values to model outputs).

For the purposes of the fourth bullet point above, the model shall be developed or approved independently of the front office and shall be independently tested, including validation of the mathematics, assumptions and software implementation.

Independent price verification should be performed in addition to daily marking to market or marking to model. This is the process by which market prices or model inputs are regularly verified for accuracy and independence. While daily marking to market may be performed by dealers, verification of market prices and model inputs should be performed by a unit independent of the dealing room, at least monthly (or, depending on the nature of the market/ trading activity, more frequently). Where independent pricing sources are not available or pricing sources are more subjective, prudent measures such as valuation adjustments may be appropriate.

c. Procedures for considering valuation adjustments/reserves which make provision for (i) unearned credit spreads; (ii) close-out costs; (iii) operational risks; (iv) early termination; (v) investing and funding costs; (vi) future administrative costs and (vii) where relevant, model risk.

- d. Standards for less liquid positions as follows:*
- i. Less liquid positions could arise from both market events and Authorised Person-related situations e.g. concentrated positions and/or stale positions.
 - ii. Authorised Persons shall consider several factors when determining whether a valuation reserve is necessary for less liquid positions. These factors include the amount of time it would take to hedge out the position/risks within the position, the volatility and average of bid/offer spreads, the availability of market quotes (number and identity of market makers) and the volatility and average of trading volumes, market concentrations, the aging of positions, the extent to which valuation relies on marking-to-model, and the impact of other model risks.
 - iii. When using third party valuations or marking to model, Authorised Persons shall consider whether to apply a valuation adjustment. In addition, Authorised Persons shall consider the need for establishing reserves for less liquid positions and on an ongoing basis review their continued suitability.
 - iv. When valuation adjustments/reserves give rise to material losses in the current financial year, these shall be deducted from the Authorised Person's income statement.
 - v. Other profits/losses originating from valuation adjustments/reserves shall be included in the calculation of 'net trading book profits' and are to be added to/deducted from the Total Own Funds eligible to cover the risk components according to such provisions.
 - vi. Valuation adjustments/reserves which exceed those made under the accounting framework to which the Authorised Person is subject shall be treated in accordance with either point (iv) if they give rise to material losses, or otherwise in accordance with point (v) above.
- e. Policies and procedures covering inclusion in the trading book as follows:*
- i. Authorised Persons shall have clearly defined policies and procedures for determining which position to include in the trading book for the purposes of calculating their capital requirement, consistent with the criteria set out in rules 5.3.1 and 5.3.2 above and taking into account the Authorised Person's risk management capabilities and practices. Compliance with these policies and procedures shall be fully documented and for those Authorised Person having an internal audit function.
 - ii. Authorised Persons shall have clearly defined policies and procedures for

overall management of the trading book. As a minimum these policies and procedures shall address:

- the activities the Authorised Person considers to be trading and as constituting part of the trading book for capital requirement purposes;
- the extent to which a position can be marked-to-market daily by reference to an active, liquid two-way market;
- for positions that are marked-to-model, the extent to which the Authorised Person can: (i) identify all material risks of the position; (ii) hedge all material risks of the position with instruments for which an active, liquid two-way market exists; and (iii) derive reliable estimates for the key assumptions and parameters used in the model;
- the extent to which the Authorised Person can, and is required to, generate valuations for the position that can be validated externally in a consistent manner;
- the extent to which legal restrictions or other operational requirements would impede the Authorised Person's ability to effect a liquidation or hedge of the position in the short term;
- the extent to which the Authorised Person can, and is required to, actively risk manage the position within its trading operation; and
- the extent to which the Authorised Person may transfer risk or positions between the non-trading and trading books and the criteria for such transfers.

5.3.4 Internal Hedging

When including internal hedging in their trading book, Authorised Persons shall comply with the following:

- a. An internal hedge is a position that materially or completely offsets the component risk element of a non-trading book position or a set of positions. Positions arising from internal hedges are eligible for trading book capital treatment, provided that they are held with trading intent and that the general criteria on trading intent and prudent valuation specified in Rules. 5.3.1 and 5.3.2 are met. In particular:
 - internal hedges shall not be primarily intended to avoid or reduce

capital requirements;

- internal hedges shall be properly documented and subject to particular internal approval and audit procedures
 - the internal transaction shall be dealt with at market conditions;
 - the bulk of the market risk that is generated by the internal hedge shall be dynamically managed in the trading book within the authorised limits; and
 - internal transactions shall be carefully monitored;
 - monitoring must be ensured by adequate procedures.
- b. The treatment referred to in point (a) applies without prejudice to the capital requirements applicable to the ‘non-trading book leg’ of the internal hedge.

6.0 The Automated Financial Return

This section of the Rules provides detailed instructions on how Authorised Persons are to use the Automated Financial Return. It then provides an explanation of how Authorised Persons are to complete a number of worksheets in the Return, namely:

- i. Cover Sheet;
- ii. the Input Sheet (Sheet 1);
- iii. the Income Statement (Sheet 2);
- iv. the Balance Sheet (Sheet 3);
- v. Representations (Sheet 15); and
- vi. Validation Sheet.

Detailed explanations of the:

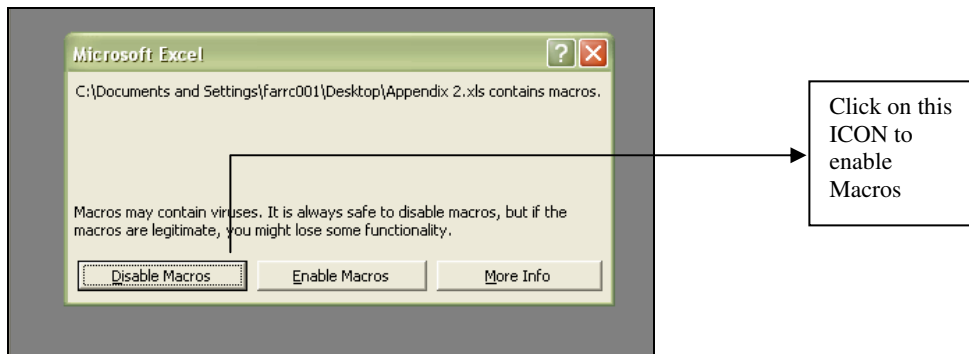
- i. Own Funds (Sheet 4);
- ii. the Risk Components (Sheets 5 – 13); and
- iii. the Capital Resources Requirement (Sheet 14)

are provided in section 7.0 of these Rules

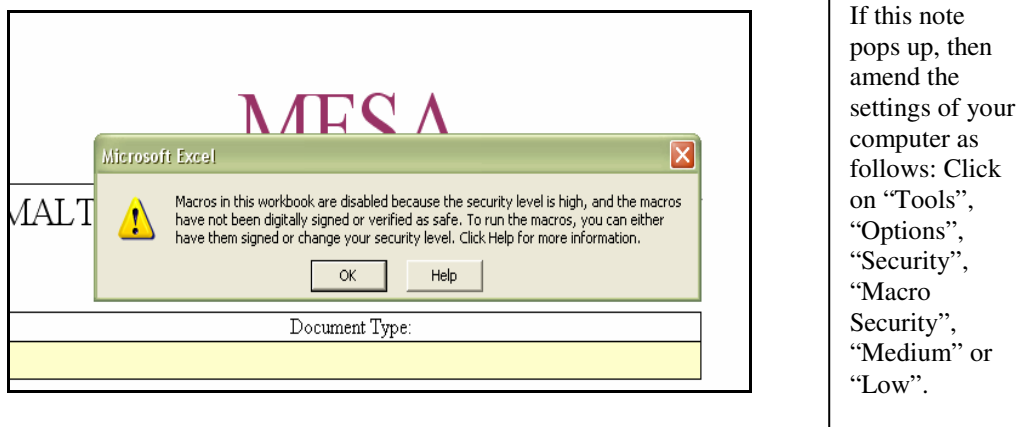
6.1 *Instructions for using the Automated Financial Return*

- a. This section of the Rules provides guidance for Authorised Persons when compiling the automated Interim Financial Return (“IFR”), the automated Annual Financial Return (“AFR”) and the automated Annual Audited Financial Return (“AAFR”). Unless otherwise specified, the term “Return” and in these Rules refers to the IFR, AFR and AAFR.
- b. The Return is compiled via an Ms Excel file titled, “FMR APPENDIX 1.XLS”. This file has been optimised for use on Microsoft Excel 2002. Some functions may not work if converted for use with other software or previous versions of Excel. These Excel files are to be retained as Master Copies.

When opening the Excel Spreadsheet named “FMR APPENDIX 1.XLS” a window will open up which will give the option to enable the macros. Click on the button “Enable Macros” prior to proceeding with the compilation of the Return.



If a further pop-up window appears on screen, as shown in the figure below, kindly amend the program's settings as described on the next page.



- c. Each Return consists of sixteen worksheets. To select a worksheet, go to the “CONTENTS” sheet and click on the button next to the required sheet.
- d. The worksheets are password protected. With the exception of cells highlighted in yellow, all cells in this program are locked and only these cells allow the inputting, deleting and amending of values.
- e. In instances where the cells are linked, only the values need to be inputted once.
- f. Subtotals are calculated automatically.
- g. A number of worksheets require manual intervention by being prompted to execute a function or to input a value. Any computer prompted instructions are to be followed carefully.
- h. Authorised Persons are to provide additional details where required. This is

required at the bottom of “SHEETS 2 and 3”. It is preferable that entries should not exceed the space provided for this purpose.

- i. A number of worksheets require the Authorised Person to provide supporting documentary evidence of how a particular figure was calculated. Authorised Persons are to attach such documents as annexes to the Return and clear reference to the relevant worksheet should be included.
- j. The compilation of the automated Return should start from the first worksheet (that is, the “COVER SHEET”). Details should be inserted (as and where appropriate) starting from the top and moving to the end of each worksheet.
- k. The following is an outline of all the applicable sheets together with an indication of which sheets require manual input and those which are fully automated:

<u>Sheet</u>	<u>Sheet title</u>	<u>Action to be taken</u>
Cover Sheet		Manual Input (mandatory)
Contents Sheet	Contents	N/A
Sheet 1	Input Sheet	Manual Input (mandatory)
Sheet 2	Income Statement	Manual Input (where applicable)
Sheet 3	Balance Sheet	Manual Input (where applicable)
Sheet 4	Own Funds	Manual Input (where applicable)

<u>Sheet</u>	<u>Sheet title</u>	<u>Action to be taken</u>
Sheet 5	Credit/Counterparty Risk	Fully Automated
Sheet 6	Position Risk Component Traded Debt Instruments (Specific Risk Component)	Manual Input (where applicable)
Sheet 7	Position Risk Component Traded Debt Instruments (General Risk Component)	Fully Automated
Sheet 8	Position Risk Component Equity	Manual Input (where applicable)
Sheet 9	Position Risk Component Collective Investment Schemes	Manual Input (where applicable)
Sheet 10	Settlement Risk Component	Fully Automated
Sheet 11	Free Deliveries	Fully Automated
Sheet 12	Large Exposures Risk Component	Manual Input (where applicable)
Sheet 13	Foreign Exchange Risk Component	Manual Input (where applicable)
Sheet 14	Capital Resources Requirement	Manual Input (where applicable)

<u>Sheet</u>	<u>Sheet title</u>	<u>Action to be taken</u>
Sheet 15	Representations	Manual Input (mandatory)
Validation Sheet		Fully Automated

- l. For ease of reference, the sheets which require manual input have been marked in blue in the “CONTENTS” Sheet.
- m. Users should not key in “0” or “-” whenever a value is nil but should leave the cell empty.
- n. **Only the worksheets which are marked in red in the “CONTENTS” sheet must be printed.**
- o. **Returns should be submitted by their due date in both hardcopy (signed) and electronic format (by diskette, compact disc or e-mail). Please note that the submission of Returns by e-mail is at the Authorised Person’s own discretion and risk (since communications by e-mail may not be secure).**

6.2 *Cover Sheet*

- a. All cells in items 1 to 8 which are highlighted in yellow are to be completed.
- b. Item 1: Select document type – either Annual or Interim Financial Return – from the drop down list depending on the period for which the Return is being compiled.

MFSA
MALTA FINANCIAL SERVICES AUTHORITY

1. Document Type:

2. Name of Licence Holder:

Select Document type – either Interim Financial Return or Annual Financial Return

- c. Returns are to be prepared in the currency in which the Audited Annual Financial Statements are compiled. The Reporting Currency of the accounts should be inserted in ISO Code.
- d. Irrespective of the Reporting Currency, the relevant Middle Exchange Rate converting EUR to the Reporting Currency is to be inserted in Item 8.
- e. Upon satisfactory completion of items 1 – 8, click on the button “Contents Page” at the bottom of this sheet to go to the “Contents Sheet”.

5.0 For the period from: to:
Enter dates in the form dd/mm/yy

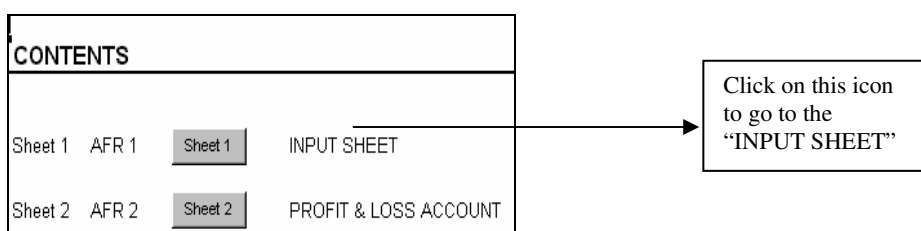
6.0 Number of months covered by reporting period:
Interim: Insert 3, 6 or 9
Annual: Insert 12

7.0 Currency in which accounts are reported:
Choose the currency from the drop down list

8.0 Exchange rate as at end of reporting period converting the reporting currency to EURO:
If Reporting Currency is USD and for example 1 USD = 0.80 EURO, then enter 0.80

When this sheet is completed click here to go to the contents page

6.3 Input Sheet – Sheet 1



- a. Click on the button “SHEET 1” in the ‘Contents Sheet’ to go to the “INPUT SHEET”.
- b. The Input Sheet has a similar structure to a Trial Balance. All amounts on the credit (mainly items of income and liabilities) are to have a negative figure, by inserting a ‘-’ sign before the figure. On the other hand, all the amounts on the debit (mainly assets and expenses) should be indicated as positive by inserting the ‘+’ sign before the figure. If a negative amount is filled in a cell representing an asset, the program will prompt the Authorised Person to insert a positive amount. In general, the Authorised Person will not be allowed to insert a negative amount in a cell representing an asset or an expense. Similarly such Authorised Person will not be allowed to insert a positive amount in a cell representing an item of income or a liability. For convenience, some cells have an automated pop-up window explaining what must be inserted.
- c. The “INPUT SHEET” is mainly divided into six sections as follows:
 - i. Income
 - ii. Expenditure
 - iii. Assets
 - iv. Liabilities
 - v. Capital & Reserves
 - vi. Other
- d. Under the “Income and Expenditure” sections, the revenue/ expenses earned/ incurred by the Authorised Person during the reporting period are to be included.

(N.B.) Besides providing for taxation in the Annual Income statement included in the AFR, Authorised Persons are also required to provide for taxation in the Interim (monthly, quarterly or half-yearly – as applicable) Income statement in the IFR.

- e. Allowable Commissions and Fees, Item 2 (a) in the “Revenue” section relates to commissions and fees payable, provided they are directly attributable to commissions and fees receivable which are included in total

revenue.

- f. For the purpose of the IFRS prudential reporting framework report: (i) Unrealised fair value movements on financial instruments which are designated at inception as instruments to be maintained at fair value through the profit and loss account, Item 2(o)(ii) Unrealised fair value movements on “held for trading” financial instruments, Item 2 (p)(iii) fair value movements on ‘available for sale’ financial instruments as per IAS 39, Item 2 (t), and (iv) revaluations on property as per IAS 40, Item 2 (u).
- g. Exceptional Expenditure, Item 2(c)(i) in the “Expenditure” section are items of expenditure for which the MFSA’s no-objection should be sought prior to their inclusion in the Return.
- h. Under the “Assets” section, financial instruments, both long and short positions, held on the Authorised Person’s (item 3 (d)) balance sheet are to be categorised under one of the available headings. The long or short position in a particular investment is the net of any long or short positions held in that same investment. Short positions in any financial instrument are to be included as positions held with trading intent only. The Authorised Person must include both the balance sheet value and the market value of these financial instruments. Where financial instruments are held at fair values, the Authorised Person must input the market value under both cells. It is important that financial instruments are inserted under their appropriate heading.
- i. Collective investment schemes, Item 3 (e)(iii), are any amounts receivable by the Authorised Person from transactions in collective investment schemes.
- j. Group creditors - due within 1 year, Item 4 (c) and Group creditors - due after more than 1 year, Item 4.0 (g). These represent amounts receivable from group companies and/ or connected persons. The definition of “Group” to be considered is that defined in the Companies Act, 1995 and “connected counterparty” as defined in Rule 7.2.4 (A)(iii).
- k. The Authorised Person must also indicate under Item 6 (a) whether it has any assets or liabilities denominated in a Foreign Currency. If the answer is “YES” the Authorised Person must compile Sheet 13 which deals with Foreign Exchange Risk adjustments.
- l. Secured Liabilities, Item 6(b). Under item (i), the Authorised Person must include the total secured liabilities which are due within 1 year. On the other hand, under item (ii) the Authorised Person must insert that part of the amount inserted in (i) which is secured by a charge on land and buildings.

Under item (iii), the Authorised Person must include the total secured liabilities which are due after more than 1 year. Similarly, under item (iv) the Authorised Person must insert that part of the amount inserted in (iii) which is secured by a charge on land and buildings.

- m. The Authorised Person is to input the relevant figures for items 6(c), 6(d), 6(e), 6(f), 6(g), and 6(i) if these are applicable.
- n. The Authorised Person should indicate the credit/ counterparty risk calculation which has been used in the Return in Item 6 (h).
- o. The Authorised Person should indicate under Item 6 (j) whether it holds positions in derivative financial instruments. If the answer is “YES” the Authorised Person should refer to Rule 7.2.2.1 of these Rules and include the total Derivative Risk component in Sheet 14 item 3(a).
- p. If the Authorised Person held positions in commodities during the reporting period, then Item 6 (k) should be marked as “YES”. The Authorised Person should refer to Rule 7.2.3 and include the total Commodities Instruments - Risk Component in Sheet 14 Item 4.
- q. Once the relevant parts of Sections 1 – 6 have been completed click on the button “Print Set-up”. Automatically, all those cells which have been left empty will be hidden. After printing this sheet, the user may click on the button “Show all” and all the hidden cells will re-appear. Click on the button “Return to Contents” to return to the contents page.

6.4 *Income Statement – Sheet 2*

- a. This sheet is fully automated except for Items 8.0 and 20.0.
- b. The space provided in Item 8.0 (“Details of ‘Other FMA related revenue’ and/or Any other details or comments”) is to be used to explain Item 5.0 (“Other FMA related revenue”).
- c. The space provided in Item 20.0 (“Details of Exceptional items of expenditure allowed by MFSA, other variable expenditure and other fixed expenditure”) should provide explanations to Item 10.0 (a) (“Exceptional Items of expenditure allowed by MFSA”), item 11.0 (j) (‘Other Variable Expenditure’) and item 11.0 (k) (‘Other Fixed Expenditure’).

6.5 Balance Sheet – Sheet 3

- a. This sheet is fully automated except for Item 12.0.
- b. The space provided in Item 12.0 (“Details of ‘Amounts due to/ from other connected persons’ and/or ‘Amounts due to/ from Group Companies’ and/or Any other details or comments”) should include explanations to the following Items:
 - i. Item 3.0 (c) (“Amounts due from Group Companies”)
 - ii. Item 3.0(d) (“Amounts due from other connected persons”)
 - iii. Item 4.0 (c) (“Amounts due to Group Companies – within 1 year”)
 - iv. Item 4.0(d) (“Amounts due to other connected persons – within 1 year”)
 - v. Item 7.0(b) (“Amounts due to Group Companies – after more than 1 year”)
 - vi. Item 7.0 (c) (“Amounts due to other connected persons – after more than 1 year”)

6.6 Sheet 15 – Representations

- a. Where applicable, all the cells marked in yellow are to be inputted.
- b. Some cells enable the user to select a reply from a drop down menu.
- c. Items 1 – 3 of this sheet must be filled by the Authorised Person.
- d. The date when the Authorised Person approved the Return is to be inputted in item 4.
- e. The Authorised Person may add further details/comments in item 5 of this Sheet.
- f. The Return is to be signed by two Directors or other authorised signatories. When the Return is signed by the latter, the Authorised Person should provide a certified true copy of the Board of Directors’ Resolution authorising the individual to sign the Return on behalf of the Directors.
- g. Where the Return is being compiled as an Audited Annual Financial Return, items 6 and 7 of the Return are to be completed. Furthermore, it must also be signed by the auditor of the Authorised Person

6.8 *Validation Sheet*

Prior to submitting the Return to the MFSA, the Authorised Person must ensure that all Validations are marked “OK”. Where the Validation is marked “ERROR”, the Authorised Person should check and correct the relevant sheet accordingly.

7.0 The various elements which make up the calculation of the Own Funds, the Risk Components and the Fixed Overheads Requirement

7.1 *Own Funds*

Own Funds means the sum of tier one capital, tier two capital and tier three capital.

7.1.1 *Tier One Capital*

Tier one Capital is made up of items of a capital nature which: (a) are permanent; (b) are able to absorb losses; (c) rank for repayment upon winding up after all other debts and liabilities; and (d) do not yield a fixed return to their investors but provide dividends/ interest at the discretion of the board of directors of the Authorised Person.

Tier one capital, being the summation of points (A) + (B) – (C) - (D) below:

(A) *Core Tier One Capital:*

i. Ordinary share capital:

The nominal paid-up value of the share capital. The unpaid element of partly paid-up shares or authorized share capital is to be excluded.

ii. Share premium account:

Any amount received in excess of the nominal value of any issued ordinary shares.

iii. Revenue reserves:

Revenue Reserves as at the beginning of the reporting period.

iv. Interim net profits/retained profits for the year:

Profits for the reporting period.

v. Other reserves

(B) *Non - Core Tier One Capital:*

i. Perpetual non-cumulative preference shares:

Perpetual (non-redeemable) non-cumulative preference shares, which have been issued and paid up.

ii. Minority Interests (applicable for the scope of consolidation)

That portion of the profit or loss and net assets of a subsidiary attributable to equity interests that are not owned, directly or indirectly through subsidiaries, by the parent.

(C) Deductions from Tier One Capital:

i. Investments in own shares:

Own Shares held at book value.

ii. Goodwill:

Future economic benefits arising from assets that are not capable of being individually identified and separately recognised.

iii. Other Intangible assets:

Any other indefinable non-monetary assets without physical substance.

iv. Material current year losses/retained losses for the year:

Losses for the reporting period.

(D) Additional deductions from Tier One Capital (IFRS Prudential Filters):

For the purpose of prudential filters for regulatory capital, any unrealised losses on Items (i) to (iii) below are to be fully deducted.

i. Deduct 100% of unrealised losses on financial assets which are designated at inception as assets to be maintained at fair value through the profit and loss account - (in accordance with IAS 39).

ii. Deductions in relation to fair value movements on 'available for sale' financial instruments as per IAS 39.

iii. Unrealised losses on revaluation of property as per IAS 40.

7.1.2 Tier Two Capital

Tier two Capital consists of instruments that combine the features of debt and equity wherein they are structured like debt but exhibit some of the loss absorption and funding flexibility forms of equity.

Tier two capital, being the summation of points (A) + (B) + (C) – (D) below:

(A) Upper Tier Two Capital:

Perpetual securities are securities including cumulative preference shares which fulfil the following conditions: (a) they may not be reimbursed on the bearer's initiative or without the prior agreement of the MFSA; (b) the debt agreement must provide for the Authorised Person to have the option of deferring the payment of

interest on the debt; (c) the lender's claims on the reporting Authorised Person must be wholly subordinated to those of all non-subordinated creditors; (d) the documents governing the issue of the securities must provide for debt and unpaid interest to be such as to absorb losses, whilst leaving the reporting Authorised Person in a position to continue trading; (e) only full paid-up amounts are to be considered.

(B) Lower Tier Two Capital:

i. Fixed Term Preference Share Capital

Fixed term cumulative and non-cumulative preference shares (if not redeemable within 5 years), which have been issued and paid up.

ii. Bank and/or other third party guarantees

Bank or third party guarantees approved by the MFSA. The guarantee must be in the form set out in Appendix IV or V.

N.B. As explained in Rule 7.1.4 total tier two capital shall not be greater than 100% of total tier one capital after deductions. Lower tier two capital must at all times be less than 50% of total tier one capital after deductions.

iii. Subordinated Loan Capital

Subordinated loans which have been approved by the MFSA. The subordinated loans must be approved by the MFSA and must be in the form set out in Appendix III.

N.B. As explained in Rule 7.1.4 total tier two capital shall not be greater than 100% of total tier one capital after deductions. Lower tier two capital must at all times be less than 50% of total tier one capital after deductions.

iv. Internal ratings based approach (IRB) to risk weight exposure:

Applicable only for Authorised Persons availing of the internal ratings based approaches, in the calculation of credit risk. These approaches are explained in Rule 7.2.1.1 (A).

(C) Prudential Filters additions to Own Funds

i. Unrealised profits on financial assets which are designated at inception as assets to be maintained at fair value through the profit and loss account - (in accordance with IAS 39)

This calculation adds back 65% of additions to fair value movements on assets to be maintained at fair value through the profit and loss account.

ii. Additions in relation to fair value movements on 'available for sale'

financial instruments as per IAS 39

This calculation adds back 65% of additions to fair value movements on available for sale financial assets.

iii. Unrealised gains on revaluation of property

This calculation adds back 65% of the Unrealised losses on revaluation of property done in terms of IAS 40.

(D) *Deductions from Tier Two Capital*

i. Material Holdings in credit and financial institutions

These being holdings by the Authorised Person of more than 10% of the capital of other credit or financial institutions as defined in the European Directive 2006/48 EC relating to the taking up and pursuit of the business of credit institutions. .

ii. Expected losses from risk weighted exposure amount using the Internal Ratings Based approach to credit risk

Applicable only for Authorised Persons availing of the internal ratings based approaches, in the calculation of credit risk. These approaches are explained in Rule 7.2.1.1 (A).

iii. IRB value adjustments

Applicable only for Authorised Persons availing of the internal ratings based approaches, in the calculation of credit risk. These approaches are explained in Rule 7.2.1.1 (A).

iv. Additional deductions

Where the Authorised Person forms part of a financial conglomerate, participations and/ or other instruments held in insurance schemes, reinsurance schemes and insurance holding companies are to be deducted.

v. Additional capital requirement

Additional capital requirement - in the case where half of the total of items (i) to (iv) above exceed total tier two capital (Upper Tier Two Capital + Lower Tier Two Capital), the amount by which tier two capital is exceeded should be taken as a deduction from own funds.

7.1.3 Tier Three Capital

Tier three capital is composed of Interim Trading Book Profits and Losses. Any profits or losses which the Authorised Person makes with respect to trading book business which includes any foreseeable charges and dividends and which has not been included in the Income Statement.

7.1.4 Restrictions on Own Funds

- a. Non-core tier one capital is to be **less than 50%** of total tier one capital after deductions;
- b. Total tier two capital **must at all times be less** than total tier one capital after deductions;
- c. Lower tier two capital **must at all times be less than 50%** of total tier one capital after deductions; and
- d. Total tier two capital after deductions and tier three capital **must at all times be less than 200%** of total tier one capital after deductions

Authorised Persons must ensure that the above conditions are met at all times. Should the Authorised Person be in breach of any of the above conditions, the MFSA is to be immediately notified.

7.1.4 The Return

Sheet 4 – (Own Funds) of the Return, which calculates the Authorised Person's own funds is fully automated and does not require any form of manual intervention in the case where the Standardised Approach to credit/counterparty risk is used by the Authorised Person.

The Authorised Person is to ensure that items 1.0 – 3.0 in the section “OWN FUNDS WARNINGS”, section of Sheet 4 are in order. This ensures that any of the restrictions listed in Rule 7.1.4 have not been exceeded. Where the restrictions on Own Funds have been exceeded, the Authorised Person should inform the MFSA of the action to be taken to reduce this exposure.

7.2 *Risk Components*

7.2.1 Non Trading Book Business Risk Component:

This category is made up of the credit/counterparty risk component.

7.2.1.1 *Credit/Counterparty Risk Component*

Being the possibility of a loss occurring due to:

- i. the failure of a debtor of a Authorised Person to meet its contractual debt obligations; or
- ii. the loss in value of any other asset (excluding derivatives which are exclusively dealt with in the sections on trading book business and commodities instruments – risk component) which forms part of the Authorised Person’s balance sheet except for: (a) intangible assets including goodwill; (b) cash in hand and at bank; (c) those financial instruments which fall within the category of trading book business; and (d) commodity positions.

(A) Measuring the Credit/Counterparty Risk

The credit/ counterparty risk can be measured through any one of the following three methods: (i) the Standardised Approach, (ii) the Foundation Internal Ratings Based Approach (FIRB) or the (iii) the Advanced Internal Ratings Based Approach (AIRB).

The Standardised Approach calculates the credit risk component by applying a broad category of risk weights to non-trading book business asset exposures.

N.B. These Rules and the Return cater for the Standardised Approach. The FIRB and the AIRB approaches are based on the Authorised Person’s assessments of the risks to which it is exposed. It is strongly recommended that MFSA’s guidance is sought prior to adopting these alternative methods, which methods are to be approved by the MFSA.

(B) Credit/ Counterparty Risk applying the Standardised Approach

The computation of the credit/counterparty risk component using the standardised approach is calculated as follows:

- i. identify the exposure value of the asset item – i.e. the balance sheet value of that particular asset;
- ii. assign each exposure to one of the exposure classes defined in (C) below;
- iii. calculate the risk weighted exposure amounts by multiplying the exposure value by an applicable risk weight;

- iv. add the total risk weighted exposure amounts; and
- v. the credit/counterparty risk capital component is 8% of the total risk weighted exposure amounts.

(C) Exposure classes

The non-trading book business asset exposures of Authorised Persons are to be categorised within one of the 8 exposure classes which are explained further on in this Rule.

A number of these Exposure Classes apply the Credit Quality Steps Approach ('CQSA'). In terms of CQSA, the individual risk weighting of non-trading book asset exposures is to be assigned a risk weighting depending on their credit quality assessment rating.

Steps to use the CQSA:

- i. Check whether the relevant non-trading book business asset exposure is rated by one of the following rating agencies: Fitch Rating, Moody's, and Standard and Poor's;
- ii. Obtain from the rating agency the rating of the relevant non-trading book business asset exposure;
- iii. Apply the following mapping table to categorise the non-trading book business asset exposure in one of the credit quality steps:

Credit Quality Step	Fitch's assessment	Moody's assessment	S&P assessment
1	AAA to AA-	Aaa to Aa3	AAA to AA-
2	A+ to A-	A1 to A3	A+ to A-
3	BBB+ to BBB-	Baa1 to Baa3	BBB+ to BBB-
4	BB+ to BB-	Ba1 to Ba3	BB+ to BB-

Credit Quality Step	Fitch's assessment	Moody's assessment	S&P assessment
5	B+ to B-	B1 to B3	B+ to B-
6	CCC+ and below	Caal and below	CCC+ and below

- iv. the risk weighting assigned to the non-trading book business asset exposure will vary depending on the type of exposure class and the credit quality step assigned.

Exposure – Class 1

Tangible Assets such as land, building, office furniture.

Risk Weighting: The risk weight to be applied is 100%.

Exposure – Class 2

Claims or contingent claims on central governments or central banks such as Government Bonds or T-bills.

Risk Weighting:

- a. Exposures to EEA States
Exposures to EEA states' central governments and central banks denominated in the national currency of the borrower should be assigned a 0% risk weight.
- b. Applying the CQSA
Use the CQSA where the non-trading book business asset exposure is rated by one of the rating agencies mentioned in C (iii) above. The following risk weightings will apply depending on the credit quality step category within which the relevant non-trading book business asset exposure falls.

Credit Quality step	1	2	3	4	5	6
Risk weight - %	0	20	50	100	100	150

- c. Other Class 2 exposures

Other exposures are to be allocated a risk weight of 100%.

Exposure – Class 3

Amounts receivable from EEA Financial Services Licensed Entities such as accruals and debt securities

Risk Weighting:

- a. Exposures to debt securities redeemable after three months
Applying the CQSA: Use the CQSA where the exposure to debt securities issued by EEA Financial Services Licensed Entities is rated by one of the rating agencies mentioned above. The following risk weightings will apply depending on the credit quality step category within which the relevant debt exposure falls.

Credit Quality step	1	2	3	4	5	6
Risk weight - %	20	50	50	100	100	150

Unrated exposures which fall within this category are to be allocated a risk weight of 50%.

- b. Exposures to debt securities redeemable before three months
Applying the CQSA: Use the CQSA where the exposure to debt securities issued by EEA Financial Services Licensed Entities is rated by one of the rating agencies mentioned above. The following risk weightings will apply depending on the credit quality step category within which the relevant debt exposure falls.

Credit Quality step	1	2	3	4	5	6
Risk weight - %	20	20	20	50	50	150

Unrated exposures which fall within this category are to be allocated a risk weight of 20%.

- c. Other Class 3 exposures
Amounts which fall within this category and are due within three months are to be assigned a risk weight of 20%.

Other amounts due should be assigned a risk weight of 50%.

Exposure – Class 4

Amounts receivable from Corporates/ other Entities other than EEA Financial Services Licensed Entities

Risk Weighting:

a. Applying the CQSA:

Use the CQSA where the exposure to debt securities issued by corporates other than EEA Financial Services Licensed Entities is rated by one of the rating agencies mentioned above. The following risk weightings will apply depending on the credit quality step category within which the relevant debt exposure falls.

Credit Quality step	1	2	3	4	5	6
Risk weight - %	20	50	100	100	150	150

b. Other Class 4 exposures

Other exposures including which fall within this category are to be allocated a risk weight of 100%.

Exposure – Class 5

Investments in collective investment schemes

Risk Weighting:

a. High Risk Collective Investment Schemes:

Investments in units of Collective Investment Schemes which have the majority of their portfolio invested in high risk instruments such as derivatives should be allocated a risk weight of 150%.

b. Other Collective Investment Schemes:

Investments in other collective investment schemes should be allocated a risk weight of 100%.

Exposure – Class 6

Shares

Risk Weighting:

a. Shares traded on a EU Regulated Market or the Regulated Market of a developed financial centre

The risk weight to be applied is 100%.

b. Other Shares (including investments in Venture Capital Firms private equity investments)

The risk weight to be applied is 150%.

c. Investments in connected companies.

The risk weight to be applied is 100%.

Exposure – Class 7

Amounts receivable from Government Bodies and Local Authorities

Risk Weighting:

Amounts due within three months are to be assigned a risk weight of 20%. Other amounts due should be assigned a risk weight of 50%.

Exposure – Class 8

Other Balance Sheet Items such as Prepayments and accrued income; amounts due from group or connected companies; amounts due from collective investment schemes; and other debtors

Risk Weighting:

The risk weight to be applied is 100%.

Credit/Counterparty Risk - Steps to be followed in the Return

In the Input Sheet of the Return:

- i. identify those assets which qualify as non-trading book business asset exposure;
- ii. categorise the non-trading book business asset exposure under one of the Exposure Classes referred to above;
- iii. input a description of the relevant non-trading book business asset exposure;
- iv. input the ‘balance sheet value’ and the ‘market value’ of the non-trading book business asset exposure in the adjacent columns
- v. qualify the asset as a non-trading book business asset exposure by choosing letter ‘N’ from the drop down list which is available in the column titled ‘Held with trading intent?’;
- vi. where the risk weighting of the non-trading book business asset exposure is determined through the CQSA, depending on the category of asset, choose the applicable option from the drop down list which is available in the column titled ‘Credit Quality Assessment’;

- vii. the return will automatically compute the credit risk component in sheet 5.

7.2.2 Trading Book Business Risk Component:

This category is made up of four risk components: (i) the position risk component; (ii) the settlement risk component; (iii) the counterparty risk component; and (iv) free deliveries.

7.2.2.1 *Position Risk*

The position risk component is defined as the risk of losses in on and off balance sheet investments in financial instruments, which qualify as trading book business, arising from the movement in market prices. For the purpose of the calculation of position risk, financial instruments are categorised under one of the following titles: (i) Traded Debt Instruments; (ii) Traded Equities; (iii) Collective Investment Schemes; and (iv) Derivatives.

N.B. These Rules and the Return provide for the calculation of the position risk component of all types of financial instruments except for derivatives. As it is generally the exception that Authorised Persons invest in derivatives, MFSA has taken the approach that the calculation of the risk related to investments in such assets may be catered for on a case by case basis. Authorised Persons who invest in derivatives should contact the MFSA for guidance as to how the derivatives related position risk component should be catered for in their Return.

(A) *Measuring the Position Risk Component*

The methodology for measuring the position risk component varies depending on the type of financial instrument. The following explains the manner in which the position risk component is calculated.

(B) *Traded Debt Instruments / Traded Equities*

The calculation of the position risk component for Traded Debt Instruments, and Traded Equity is based on two factors being:

- i. the specific risk factor which is the risk of a price change in the instruments due to risks inherent to its Issuer; and
- ii. the general risk factor being the risk of a price change in the instruments due to a change in the level of interest rates in the case of a traded debt instrument or a broad equity market movement unrelated to specific attributes of individual securities in the case of equity.

Traded Debt Instruments: Specific Risk

The specific risk factor of the position risk component of a traded debt instrument is equivalent to the market value of the debt instrument multiplied by the

applicable position risk weighting. In order to establish the risk weighting, the following is taken into consideration:

- a. the classification of the debt instrument;
- b. the rating of the debt instrument (if any) – for an explanation of how to establish the rating of a Debt Instrument, please refer to the explanation of the CQSA in point ((C)) of Rule 7.2.1.1; and
- c. the number of months to maturity.

In order to calculate the specific risk for the position risk component of traded debt instruments, the following classifications/position risk weightings apply:

<u>Traded Debt Instrument Classifications</u>	<u>Rating Credit Quality Steps</u>	<u>Number of months to maturity</u>	<u>Risk Weights</u>
CATEGORY 1 Debt instruments issued by the central governments or <i>centralbanks</i> - same as credit risk - class 2 exposure however, falling within the definition of trading book business	CQS 1 or 0% Risk Weight	Any	0%
	CQS 2 or 3	0 - 6 Months	0.25%
		6 – 24 Months	1%
		Over 24 Months	1.6%
	CQS 4 or 5	Any	8%
	CQS 6	Any	12%
CATEGORY 2 Debt instruments issued by EEA Financial Services Licensed Entities - same as credit risk – class 3 exposure however, falling within the definition of trading book business	CQS 1 or 2 or 3	0 - 6 Months	0.25%
		6 – 24 Months	1%
		Over 24 Months	1.6%
	CQS 4	Any	8%
	CQS 5 or 6	Any	12%

<u>Traded Debt Instrument Classifications</u>	<u>Rating Credit Quality Steps</u>	<u>Number of months to maturity</u>	<u>Risk Weights</u>
<p>CATEGORY 3</p> <p>Other debt instruments being – Debt instruments issued by Corporates /other entities other than EEA Financial Services Licensed Entities– class 4 exposure however, falling within the definition of trading book business</p> <p>Debt instruments which show a particular risk due to insufficient solvency of the issuer which fall within any of the above categories are to be included the maximum weighting.</p>	CQS 1 or 2	0 - 6 Months	0.25%
		6 – 24 Months	1%
		Over 24 Months	1.6%
	CQS 3 or 4	Any	8%
	CQS 5 or 6	Any	12%

Traded Debt Instruments: General Risk

The general risk factor of the position risk component of a traded debt instrument is equivalent to the market value of the debt instrument multiplied by the applicable position risk weighting, which weighting depends on: (a) the coupon rate; (b) the number of months to maturity; and (c) the zone within which the said debt instrument falls. Traded debt instruments are categorised into three zones depending on the time to maturity of each particular instrument. The scope of this categorisation is to net any opposite positions (long and short) within the same zone.

The table in the following page outlines the applicable general position risk weighting of debt instruments which qualify as trading book business:

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Zone	Maturity Band		Weighting
	Coupon which is less than 3%	Coupon which is 3% or more	
One	0 to 1 month	0 to 1 month	0.00%
	Over 1 month and less than or equal to 3 months	Over 1 month and less than or equal to 3 months	0.20%
	Over 3 months and less than or equal to 6 months	Over 3 months and less than or equal to 6 months	0.40%
	Over 6 months but less than or equal to 12 months	Over 6 months but less than or equal to 12 months	0.70%
Two	Over 12 months but less than or equal to 23 months	Over 12 months but less than or equal to 24 months	1.25%
	Over 23 months but less than or equal 34 months	Over 24 months but less than or equal 36 months	1.75%
	Over 34 months but less than or equal to 43 months	Over 36 months but less than or equal to 48 months	2.25%
Three	Over 43 months but less than or equal to 52 months	Over 48 months but less than or equal to 60 months	2.75%
	Over 52 months but less than or equal to 68 months	Over 60 months but less than or equal to 84 months	3.25%
	Over 68 months but less than or equal 88 months	Over 84 months but less than or equal 120 months	3.75%

Zone	Maturity Band		Weighting
	Coupon which is less than 3%	Coupon which is 3% or more	
	Over 88 months but less than or equal 112 months	Over 120 months but less than or equal 180 months	4.50%
	Over 127 months but less than or equal to 144 months	Over 180 months but less than or equal to 240 months	5.25%
	Over 144 months but less than or equal to 240 months	Over 240 months	6.00%
	Over 240 months		8.00%

Traded Debt Instruments: Specific Risk and General Risk of the Position Risk Component – Steps to be followed in the Return

In the Input Sheet of the Return:

- a. identify those financial instruments which fall within the traded debt instruments category and which qualify as trading book business asset exposures;
- b. input a description in section 3 (d) of the relevant trading book business asset exposure;
- c. input the ‘balance sheet value’ and the ‘market value’ of the trading book business asset exposure in the adjacent columns;
- d. qualify the asset as a trading book business asset exposure by choosing ‘YES’ from the drop down list which is available in the column titled ‘Held with trading intent?’;
- e. input the number of months to maturity in the adjacent column;
- f. where the risk weighting of the trading book business asset exposure is determined through the CQSA, depending on the category of asset, choose

the applicable option from the drop down list which is available in the column titled 'Credit Quality Assessment';

- g. input the coupon rate in the final column;
- h. the return will automatically compute both the specific and general risk for traded debt instruments in Sheet 6 and Sheet 7 respectively.

Equity: Specific Risk

The specific risk factor of the position risk component of an equity instrument is equivalent to the overall gross position in equity instruments multiplied by the applicable risk weighting. The overall gross position is defined as the summation of the market values of all long and short positions in equity instruments. In order to establish the risk weighting, the following should be taken into consideration:

- the classification of the equity instrument into either: (a) shares traded on an EU Regulated Market or the Regulated Market of a developed financial centre; and (b) Other Shares (including investments in venture capital firms and private equity investments);
- the applicable risk weighting of the equity instrument, is 2% for equity instruments which fall within classification (a) of the above first bullet point and 4% for equity instruments falling within classification (b) of the above first bullet point.

Equity: General Risk

The general risk factor of the position risk component of an equity instrument is equivalent to the overall net position of the equity instrument multiplied by 8%. The overall net position is defined as long positions less short positions in equity instruments. Equity instruments which are classified as: (a) shares traded on an EU Regulated Market or the Regulated Market of a developed financial centre and (b) Other Shares (including investments in venture capital firms and private equity investments) are both assigned a risk weight of 8%.

Equity: Position Risk Component – Steps to be followed in the Return

In the Input Sheet of the Return:

- a. identify those financial instruments which fall with the equity instruments category and which qualify as trading book business asset exposures;
- b. input a description in Section 3(d) of the relevant trading book business asset exposure;

- c. input the 'balance sheet value' and the 'market value' of the trading book business asset exposure in the adjacent columns;
- d. qualify the asset as a trading book business asset exposure by choosing letter 'Y' from the drop down list which is available in the column titled 'Held with trading intent?';
- e. the Return will automatically compute both the specific and general risk for traded debt instruments in Sheet 8.

Collective Investment Schemes: Specific and General Risk

The specific and general risk factor of the position risk component in the case of collective investment schemes is combined. In this case, the position risk component is the equivalent of the market value of the units in the collective investment scheme multiplied by the applicable position risk weighting. In order to establish the risk weighting, the following is taken into consideration:

- the classification of the financial instrument into: (a) investments in high risk collective investment schemes; and (b) other collective investment schemes;
- the applicable risk weighting of the financial instrument, is 16% for collective investment schemes which fall within classification (b) of the above bullet point and 32% for collective investment schemes falling within classification (a) of the above bullet point.

Collective Investment Schemes: Risk Component - Steps to be followed in the Return

In the Input Sheet of the Return:

- a. identify those investments in collective investment schemes which qualify as trading book business asset exposures;
- b. input a description of the relevant trading book business asset exposure;
- c. input the 'balance sheet value' and the 'market value' of the trading book business asset exposure in the adjacent columns;
- d. qualify the asset as a trading book business asset exposure by choosing letter 'Y' from the drop down list which is available in the column titled 'Held with trading intent?';
- e. the Return will automatically compute the position risk component for

collective investment schemes in Sheet 9.

7.2.2.2 *Settlement Risk – Cash Against Documents*

For the purpose these rules, cash against documents transactions shall mean transactions where the purchaser takes ownership of the financial instrument the moment cash is handed over to the seller (delivery versus payment).

Settlement risk is the risk that the Authorised Person's cash against documents transactions in financial instruments which qualify as trading book business are unsettled after their due delivery dates.

(A) *Measuring the Settlement Risk Component*

The Settlement Risk Component is the equivalent of the difference between the agreed settlement price and the current market value of a financial instrument which qualifies as trading book business and whose payment is unsettled after its due delivery date, multiplied by the relevant risk weight. The applicable risk weights are outlined in the following table:

Number of working days after the due settlement date	Risk Weight
5-15	8%
16 - 30	50%
31 – 45	75%
46 or more	100%

(B) *Settlement Risk Component – Steps to be followed in the Return*

In the Input Sheet of the Return:

Debtors – Unsettled Securities transactions - cash against documents

- i. identify those financial instruments which have been delivered by the Authorised Person and which qualified as trading book business but for which payment is still due after delivery date;
- ii. identify the cash amounts which have been settled by the Authorised Person in respect of undelivered financial instruments and which qualified as trading book business/cash against documents;

- iii. categorise in the section 3 (e) (i) of the input sheet the unsettled securities transactions, identified in (i) and (ii) above, under one of the available headings, which headings reflect the headings in the above table;
- iv. enter the balance sheet value of the amount due to the Authorised Person and in the adjacent column include the current market value.
- v. the Return will automatically compute the relevant settlement risk component in Sheet 10.

7.2.2.3 *Counterparty Risk Component*

For the purpose of these Rules, counterparty risk is the amount of capital which the Authorised Person must hold against exposures in financial derivative instruments and credit derivatives (which can be defined as a contract between two parties that allows for the use of a derivative instrument to transfer credit risk from one party to another).

N.B. These Rules and the Return do not cater for the calculation of the trading book business Counterparty Risk Component. As it is generally the exception that Authorised Persons invest in derivatives, the MFSA has taken the approach that the calculation of the counter party risk related to investments in such assets may be catered for on a case by case basis. Authorised Persons who invest in derivatives should contact the MFSA for guidance as to how the counterparty risk component should be calculated and catered for in the Return.

7.2.2.4 *Free Deliveries*

For the purpose these Rules, free deliveries transactions shall mean non delivery versus payment transactions in financial instruments.

Free Deliveries caters for the risk that the Authorised Person has either: (a) paid for free deliveries transactions in financial instruments which qualify as trading book business before receiving them; or (b) has delivered financial instruments which qualify as trading book business, sold in a free deliveries transaction, before receiving payment for them.

(A) *Measuring Free Deliveries*

Both where: (i) financial instruments which fall within the definition of trading book business were delivered by the Authorised Person prior to receiving payment, or (ii) where the Authorised Person has paid for the financial instruments which fall within the definition of trading book business; the applicable free deliveries risk factor is calculated as follows:

Multiply the market value of the financial instrument by the applicable discount

factor as detailed in the following table:

Period	Risk Discount Factor
Up to first payment/ delivery leg	0%
From first payment/ delivery leg to four days after second payment/ delivery leg	8%
From five business day post payment/ delivery leg until extinction of transaction	100%

(B) Free Deliveries - Steps to be followed in the Return

In the Input Sheet of the Return:

Debtors – Unsettled securities transactions – free deliveries

- i. identify those financial instruments which have been delivered by the Authorised Person and which qualified as trading book business/free deliveries but for which payment is still due after delivery date;
- ii. identify the cash amounts which have been settled by the Authorised Person in respect of undelivered financial instruments which qualified as trading book business/free deliveries;
- iii. categorise in the section 3 (e) (ii) of the input sheet the unsettled securities transactions, identified in (i) and (ii) above, under one of the available headings, which headings reflect the heading in the above table;
- iv. enter the balance sheet value of the amount due to the Authorised Person and for debtors classified under (ii) above, in the adjacent column, include the current market value;
- v. the Return will automatically compute the relevant free deliveries risk component in Sheet 11.

7.2.3 *Commodities Instruments - Risk Component*

Commodities Risk is the risk component required to cover the Authorised Person's risk of holding or taking positions in commodities such as physical products which are and can be traded in the secondary market including commodity derivatives.

Some traditional examples of commodities include grains, gold, beef, oil and natural gas. More recently, the definition has been expanded to include: (a) financial products such as foreign currencies and indices, and (b) cell phone minutes and bandwidth.

(A) Measuring the Commodities Instruments - Risk Component:

Steps to measure the Commodities Risk Component:

- i. identify the commodity positions;
- ii. express each position in terms of the standard unit of measurement of the commodity concerned (for example barrels of oil) ;
- iii. calculate the individual commodity risk for each commodity position by summing 15% of the net position (long – short) of standard unit of measurement;
- iv. multiply the result as per (iii) by the spot price of the commodity;
- v. calculate the individual commodity risk for each commodity position by summing 3% of the gross position (long + short) of standard unit of measurement;
- vi. multiply the result in as per (v) by the spot price of the commodity;
- vii. add the resulting figure as per (iv) and (vi) above to obtain the risk component for each individual position;
- viii. the Commodities instruments - risk component is equivalent to the result of the sum of each individual position.

(B) An Authorised Person's commodities instruments - risk component calculation shall include the following items:

- i. forwards, futures, contracts for differences, synthetic futures and options on a single commodity;
- ii. a commitment to buy or sell a single commodity at an average of spot prices prevailing over some future period;

- iii. forwards, futures contracts for differences, synthetic futures and options on a commodity index; and
- iv. commodity swaps.

(C) *Commodities Instruments – Risk Component - the Return*

N.B. The Return does not cater for the Commodities Instruments - Risk Component. As Authorised Persons rarely invest in commodities or commodity derivatives, risk related to investments in such assets may be catered for on a case by case basis. Authorised Persons who invest in commodities or commodity derivatives should contact the MFSA for guidance as to how the commodities instruments - risk component should be catered for in the Return.

7.2.4 *Large Exposures Risk Component*

The purpose of the large exposure requirement is to ensure that a firm manages its exposure to counterparties within appropriate limits set in relation to its capital resources requirements. A large exposure may be in the form of a loan to a single borrower, or it may arise across many transactions involving different types of financial instruments with several counterparties.

A large exposure means the exposure to: (a) an individual counterparty; (b) connected counterparties; or (c) a group of connected clients (all three terms are defined in point (A) below).

Condition regarding Individual Large Exposures

Authorised Persons are to adopt policies within which exposures to any class of the above-mentioned categories of counterparties do not exceed 25% of their Own Funds and/ or 20% in the case of an Associate Company.

The Large Exposures Risk Component shall be the equivalent of the summation of the amount which is in excess of the above-mentioned limits.

Condition regarding Total Individual Large Exposure

Authorised Persons are to adopt policies wherein the total of individual exposures exceeding 10% of Own Funds are not to exceed 800% of their Own Funds. Authorised Persons shall monitor and control their large exposures to ensure that the total large exposures does not exceed this limit.

(A) *Types of Counterparties*

Individual Counterparties

An individual counterparty may be either a natural or a legal person. Examples of counterparties include:

- i. the client which includes governments, local authorities, public sector entities, individual trusts, corporations, unincorporated businesses and non-profit making bodies and individual clients;
- ii. where the Authorised Person is providing a guarantee, the person guaranteed;
- iii. for a derivatives contract, the person with whom the contract was made; and
- iv. the company in which a Authorised Person acquires shares which are traded on a regulated market either as principal or on behalf of clients.

Groups of Connected clients

A group of connected clients is defined as one of the following either:

- i. two or more persons who unless proved otherwise constitute a single risk because one of them is the parent undertaking of the other/s; or
- ii. two or more persons who do not have the relationship as defined in (a) but who are regarded as constituting a single risk because they are so interconnected that if a member were to encounter financial difficulties the other members are likely to face repayment difficulties. Relationships between individual counterparties which might be considered to constitute a single risk for the purposes of the definition of group of connected clients include: schemes in the same group; companies whose ultimate owner (whether wholly or significantly) is the same individual or individuals, and which do not have a formal group structure; companies having common directors or management; and counterparties linked by cross guarantees.

Connected counterparties

For the purpose of the calculation of large exposure risk component, connected counterparty means another person ('P') to whom the Authorised Person has an exposure and who fulfils at least one of the following conditions:

- i. P is closely related to the Authorised Person; or
- ii. P is an associate of the firm; or
- iii. the same persons significantly influence the governing body of P and the Authorised Person; or
- iv. the Authorised Person has an exposure to P that was not incurred for the

clear commercial advantage of the Authorised Person and which is not on an arm's length basis.

(B) Measuring the Large Exposures Risk Component / The Return

- i. classify the Authorised Person's exposures under one of the categories of counterparties mentioned in (A) above. By way of example, classify a company in which the Authorised Person has an investment as either an individual counterparty; or a connected counterparty; or a group of connected clients;
- ii. report in sheet 12 all the Authorised Person's individual counterparty exposures which exceed 10% of own funds;
- iii. the Return will automatically calculate the large exposures risk component in Sheet 12.

(C) Large Exposures - Exempt Exposures

The following exposures are fully or partially exempt from the calculation of the individual and total large exposure calculation:

Exempt Exposures	Proportion Exempt
i. asset items constituting claims on central governments or central banks which, unsecured, would be assigned a 0% risk weight under the Credit/Counterparty Risk Calculation;	100%
ii. asset items constituting claims on international organisations or multilateral development banks which, unsecured, would be assigned a 0% risk weight under Credit/Counterparty Risk Calculation;	100%
iii. asset items constituting claims carrying the explicit guarantees of central governments, central banks, international organisations, multilateral development banks or public sector entities, where unsecured claims on the entity providing the guarantee would be assigned a 0% risk weight under the Credit/Counterparty Risk Calculation;	100%
iv. other exposures attributable to, or guaranteed by, central governments, central banks, international organisations, multilateral development banks or public sector entities, where unsecured claims on the entity to which the	

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Exempt Exposures	Proportion Exempt
exposure is attributable or by which it is guaranteed would be assigned a 0% risk weight under the Credit/Counterparty Risk Calculation;	100%
v. asset items constituting claims on and other exposures to central governments or central banks not mentioned in point (a) which are denominated and, where applicable, funded in the national currencies of the borrowers;	100%
vi. asset items and other exposures secured to the satisfaction of the MFSA, by collateral in the form of debt securities issued by central governments or central banks, international organisations, multilateral development banks, member states' regional governments, local authorities or public sector entities, which securities constitute claims on their issuer which would receive 0% risk weighting under the Standardised Approach to credit/counterparty risk;	100%
vii. asset items and other exposures secured, to the satisfaction of the MFSA, by collateral in the form of cash deposits placed with the lending credit institution or with a credit institution which is the parent undertaking or a subsidiary of the lending institution;	100%
viii. asset claims and other exposures secured to the satisfaction of the MFSA, by collateral in the form of certificates of deposits issued by the lending credit institution or by a credit institution which is the parent undertaking or subsidiary of the lending credit institution and lodged with either of them;	100%
ix. asset items constituting claims on and other exposures to credit institutions or investment firms, with a maturity of one year or less, but not forming part of their Own Funds;	100%
x. trade bills avalised by a prime credit institution with a maturity of twelve months or less;	100%
xi. covered bonds as defined under the Standardised Approach to Credit/Counterparty Risk;	100%

Exempt Exposures	Proportion Exempt
xii. holdings in the insurance and reinsurance companies up to 40% of the own funds of the Authorised Person acquiring such a holding;	100%
xiii. exposures to prime credit institutions with a maturity of over one year but not more than three years;	80%
xiv. exposures to prime institutions of over three years' maturity in the form of debt instruments issued by a prime institution provided such instruments are effectively negotiable in a professional market and are subject to a daily quotation on that market;	50%
xv. asset items constituting claims on EEA states regional government and local authorities where such claims receive a zero risk weight under the standardised approach to credit/counterparty risk.	100%
xvi. asset items constituting claims on EEA States, Regional Governments and Local Authorities where such claims receive a 20% risk weight under the standardised approach to credit risk.	80%

(D) General

Authorised Persons shall not deliberately avoid the additional capital requirements that would otherwise exceed 25% of their Own Funds or 20% of their Own Funds in the case of an associate company, by temporarily transferring the exposures in question to another company, whether within the same group or not, and/or by undertaking artificial transactions to close out the exposure and create a new exposure. Authorised Persons shall maintain systems which ensure that any transfer which has this effect is immediately reported to the MFSA

7.2.4 Foreign Exchange Risk Component

Foreign Exchange Risk is the risk that an asset or liability denominated in a currency other than the reporting currency may be adversely affected by a change in the value of the foreign currency.

N.B. These Rules and the Return provide for the calculation of the Foreign Exchange Risk component of all types of asset exposures except for derivatives. As Authorised Persons rarely invest in derivatives, MFSA has taken the approach that for the purpose of the Return, the calculation of the risk related to investments in such assets

may be catered for on a case by case basis. Authorised Persons which undertake transactions in derivatives should contact the MFSA for guidance as to how the derivatives related foreign exchange risk component should be calculated and catered for in the Return.

(A) *To calculate its foreign exchange risk component which will form part of the applicable capital resources requirement, an Authorised Person shall identify the foreign currencies to which it is exposed and then calculate the open currency position by:*

- i. calculating the net (long/short) open currency position in each foreign currency to which the Authorised Person is exposed;
- ii. converting each net open position into its base currency equivalent at current spot rates;
- iii. summing all short net positions and summing all long net positions and selecting the larger sum; and
- iv. multiplying the sum of the net open currency position in base currency equivalent by 8%.

(B) *An Authorised Person's foreign exchange risk component calculation shall include the following items regardless whether they are trading book business positions or non-trading book business positions or commodity positions:*

- i. all financial instruments which are denominated in a foreign currency;
- ii. all spot positions in foreign currency (including accrued interest); and
- iii. other assets/liabilities including gold positions.

(C) *Foreign Exchange Risk Component - Steps to be followed in the Return*

- i. identify those asset exposures denominated in a currency other than the currency in which the financial statements are prepared;
- ii. categorise these exposures in sheet 13 of the Return under one of the available sub-headings. Input the forex exposure in each currency under one of the available columns;
- iii. in section 3 of sheet 13 input the exchange rate converting the foreign currency to reporting currency;
- iv. the Return will automatically compute the relevant foreign exchange risk

component in Sheet 13.

7.2.6 Operational Risk Capital Requirement

Operational Risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, and includes legal risk.

The operational risk capital requirement (“ORCR”) for a Authorised Person is an amount calculated in accordance with one of the following methods:

- i. The Basic Indicator Approach (‘BIA’);
- ii. The Standardised Measurement Approach (‘SMA’); and
- iii. The Advanced Measurement Approach (‘AMA’).

N.B. These Rules cater for the Basic Indicator Approach. An explanation on how to apply the SMA and the AMA approaches and the applicable qualifying criteria to use both methods will be provided by the MFSA upon request.

(A) *The ORCR as calculated by the BIA is equivalent to 15% of the relevant indicator which is defined hereunder:*

- i. The relevant indicator is defined as the three year average of the sum of the Authorised Person’s (a) net interest income; and (b) net non-interest income.
- ii. The three year average must be calculated on the basis of the last three yearly observations at the end of the financial year. Where audited figures are not available, business estimates may be used.
- iii. If the sum of (a) and (b) above is negative or equal to zero, this figure must be excluded from both the numerator and denominator when calculating the three year average. The relevant indicator shall be calculated as the sum of positive figures divided by the number of positive figures.
- iv. The relevant indicator shall be expressed as the sum of elements listed hereunder. Each element must be included in the sum with a positive or negative sign.
 - a. Interest receivable and similar income
 - b. Interest payable and similar charges
 - c. Income from shares and other variable/fixed-yield securities

- d. Commissions/fees receivable
 - e. Commissions/fees payable
 - f. Net profit or net loss on financial operations
 - g. Other operating income
- v. Considerations prior to calculating the Relevant Indicator
- a. For the purpose of the above calculation, any income from a participation held in an undertaking of the Authorised Person, is not to be included in the relevant indicator calculations, thereby ensuring that intra-group dividends and other intra-group income flows are not double counted;
 - b. Furthermore, any income received under an operating lease, should be included as gross income less depreciation and not as gross rental income;
 - c. The relevant indicator must be calculated before the deduction of any provisions and operating expenses;
 - d. Operating expenses shall include fees paid for outsourcing services rendered by third parties. These third parties should not be **(i)** a parent or subsidiary of the Authorised Person or **(ii)** a subsidiary of a parent company which is also the parent of the Authorised Person. Expenditure on the outsourcing of services rendered by third parties will reduce the relevant indicator if such expenditure is incurred by: **[i]** a company licensed in terms of the Investment Services Act, 1994 or **[ii]** an Authorised Person under these Rules. **Outsourcing** may be defined as a Authorised Person's use of a third party to perform activities on a continuing basis that would normally be undertaken by the Authorised Person now or in future;
 - e. The following elements shall **not** be used in the calculation of the relevant indicator:
 - Realised profits/losses from the sale of non-trading book items;
 - Income from extraordinary or irregular items; and
 - Income derived from insurance.
 - f. When revaluations of trading items forms part of the income statement,

such revaluations could be included in the calculation of the relevant income indicator.

(B) Operational Risk - the Return

N.B. The Return does not cater for the Operational Risk Component. MFSA decided that for the purpose of the Return, the calculation of the operational risk component may be catered for on a case by case basis. Authorised Persons should contact the MFSA for guidance as to how the operational risk component should be catered for in the Return.

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**Guidance Notes on Risk Management and
Internal Capital Adequacy Assessment for
Investment Services Licence Holders,
Regulated Markets and Central Securities
Depositories**

Guidance Notes on Risk Management and Internal Capital Adequacy Assessment for Investment Services Licence Holders, Regulated Markets and Central Securities Depositories

Introduction

Risk

Risk can be defined as the combination of the probability of an event and its consequences. In all types of undertaking, there is the potential for events and consequences that constitute opportunities for benefit (upside) or threats to success (downside).

Risk Management

Risk management is about sound management of an organisation and the establishment of systems to avoid adverse effects and to take advantage of opportunities.

Risk management is a central part of any organisation's strategic management. It is the process whereby organisations methodically address the risks attaching to their activities with the goal of achieving sustained benefit within each activity and across the portfolio of all activities.

The focus of good risk management is the identification and treatment of these risks. Its objective is to add sustainable value to all the activities of the organisation. It marshals the understanding of the potential upside and downside of all those factors which can affect the organisation. It increases the probability of success and reduces both the probability of failure and the uncertainty of achieving the organisation's overall objectives.

Risk management should be a continuous and developing process which runs throughout the organisation's strategy and implementation of the strategy. It must be integrated into the culture of the organisation with an effective policy and a programme led by the most senior management. It must translate the strategy into tactical and operational objectives, assigning responsibility throughout the organisation with each manager and employee responsible for the management of risk as part of their job description. It supports accountability, performance measurement and reward, thus promoting operational efficiency at all levels.

Purpose & Contents

Certain Investment Services Licence Holders, Regulated Markets and Central Securities Depositories [henceforth referred to as 'Authorised Persons'] are, in terms of the Rules which apply to these types of institutions, required to identify the risks relating to their activities, processes and systems, and to manage these risks effectively.

The purpose of these Guidance Notes is to afford Authorised Persons with best practice guidance on the manner in which they may comply with the applicable risk management requirements.

These Guidance Notes also have the purpose of implementing part of the Pillar II requirements of the EU Capital Requirements Directive.

These Guidance Notes are divided into two parts: **Part A** explains the Risk Management and Internal Capital Adequacy Assessment Process and outlines the manner in which an Authorised Person may compile a RMICAAP Report. **Part B** explains the technical criteria on the review and evaluation by the MFSA of an Authorised Person's RMICAAP.

Source

In preparing these Guidance Notes reference was made *inter alia* to: **[i]** Guidelines on the Application of the Supervisory Review Process issued by the Committee of Banking Supervisors on the 25th January, 2006; **[ii]** Paper on the Internal Capital Adequacy Assessment Process (ICAAP) for small institutions issued by the Committee of European Banking Supervisors on the 27th March, 2006; **[iii]** Guidance Note on Basel II: Pillar 2 – The ICAAP & the SREP, issued by the Gibraltar Financial Services Commission on the 18th December, 2007; and **[iv]** the Risk Management Standard issued by the Institute of Risk Management, the Association of Insurance and Risk Managers and the National Forum for Risk Management in the Public Sector during 2002.

Part A

The Risk Management and Internal Capital Adequacy Assessment Process

Risk management covers all processes involved in identifying, assessing and judging risks, assigning ownership, taking actions to mitigate or anticipate them and monitoring and reviewing progress.

The internal capital adequacy assessment process has the purpose of: **[a]** ensuring that the Authorised Person adequately identifies, measures, aggregates and monitors its risks; **[b]** holds adequate internal capital in relation to its risk profile; and **[c]** uses sound risk management systems.

The risk management and internal capital adequacy assessment process (RMICAAP) can be subdivided into six stages: **[i]** risk identification; **[ii]** description of risk; **[iii]** risk estimation; **[iv]** risk tolerance and evaluation; **[v]** risk treatment; and **[vi]** risk recording/ reporting.

[I] Risk Identification

Risk identification is the process whereby the Authorised Person identifies its exposure to uncertainty. This requires an intimate knowledge of the organisation, the market in which it operates, the legal, social, political and cultural environment in which it exists, as well as the development of a sound understanding of its strategic and operational objectives, including factors critical to its success and the threats and opportunities related to the achievement of these objectives.

The purpose of this initial stage in the risk management process is to record (in a structured form) as many risks as possible which might hinder the Authorised Person in attaining its goals. Risk identification should be approached in a methodical way to ensure that all significant activities within the organisation have been identified and all the risks flowing from these activities defined.

This is especially important given that it sets the stage for the remainder of the risk management process.

The following is a list of risks to which an Authorised Person may be exposed:

[a] Pillar I Financial Return - Non-Trading Book Business Risks

[a 1] Credit/Counterparty risk: This being the probability of a loss occurring due to: **[i]** the failure of a debtor of an Authorised Person to meet its contractual

debt obligations; or [ii] the loss in value of any other asset which forms part of the Authorised Person's balance sheet.

In relation to Credit/Counterparty risk, it is recommended that the Authorised Person assesses whether its credit/counterparty risk is fully captured by the Pillar I requirements as reflected in the financial return which the Authorised Person is required to submit in terms of the applicable MFSA rules i.e. For Investment Services Licence Holders - Part B of the Investment Services Rules for Investment Services Providers - For Regulated Markets and Central Securities Depositories - the Financial Markets Rules stipulating financial recourses and financial reporting requirements applicable to Regulated Markets and Central Securities Depositories.

[b] Pillar I Financial Return - Trading Book Business Risks

[b 1] Position Risk: The risk of losses, arising from movements in market prices, in on and off balance sheet investments in financial instruments which qualify as trading book business.

[b 2] Settlement Risk: Settlement risk is the risk that the Authorised Person's cash against documents transactions in financial instruments which qualify as trading book business are unsettled after their due delivery dates.

[b 3] The counterparty risk component: Counterparty risk is the amount of capital which the Authorised Person must hold against exposures in financial derivative instruments and credit derivatives.

[b 4] Free deliveries: Free Deliveries caters for the risk that the Authorised Person has either: (a) paid for free deliveries transactions in financial instruments which qualify as trading book business before receiving them; or (b) has delivered financial instruments which qualify as trading book business, sold in a free deliveries transaction, before receiving payment for them.

In relation to Trading Book Business risks, it is recommended that the Authorised Person assesses whether the above-mentioned risks are fully captured by the Pillar I requirements as reflected in the financial return which the Authorised Person is required to submit in terms of the applicable MFSA rules.

[c] Other Risks covered in the Authorised Person's Pillar I Financial Return

[c 1] Commodities Risk: The risk of holding or taking positions in commodities such as physical products which are and can be traded in the secondary market including commodity derivatives.

[c 2] Large Exposures: Is defined as any single (direct and/or indirect) exposure or group of exposures to a limited number of counterparties, a large transaction, or

to a single product type which have the potential to produce material losses which could threaten an Authorised Person's solvency or ability to maintain its core business.

[c 3] Foreign Exchange Risk: The risk that an asset or liability denominated in a currency other than the reporting currency may be adversely affected by a change in the value of the foreign currency.

[c 4] Operational Risk: Is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, and includes legal risk – [applicable to Category 3 investment services licence holders, regulated markets and central securities depositories].

In relation to the other risks covered in the Authorised Person's Pillar I Financial Return, it is recommended that the Authorised Person assesses whether the above-mentioned risks are fully captured by the Pillar I requirements as reflected in the financial return which the Authorised Person is required to submit in terms of the applicable MFSA rules.

[d] Other Possible Risks

[d 1] Liquidity risk: An assessment of the extent to which the Authorised Person might face a mismatch between assets and liabilities which could occur as a result of the Authorised Person's assets being pledged, the inability to sell assets quickly or costs and timing constraints of reducing asset positions at difference levels of market liquidation.

[d 2] Compliance Risk: The risk of legal or regulatory sanctions, financial loss, or reputational impact due to a failure to comply with laws, regulations, standard or codes of conduct.

[d 3] Technology Risk: The Risk of loss associated with failed, compromised or inadequate information technology on which the business depends and which can further expose an organisation to additional risk – legal, regulatory, reputation, revenue, and so forth.

[d 4] Strategic Risk: The risk of loss arising from adverse business decisions that poorly aligns to strategic goals, failed execution of policies and processes designed to meet those goals, and inability to respond to macro-economic and industry dynamics.

[II] Description of Risk

The objective of risk description is to display the risks in a structured format. The use of a well designed structure is necessary to ensure a comprehensive risk

identification and description process. This will in turn assist the Authorised Person in assessing the risk.

At this stage, it is recommended that the Authorised Person prepares a table which indicates the risk to which the Authorised Person is exposed and the nature of such risk.

[III] Risk Estimation

Risk estimation is a combination of **IMPACT** [being the potential harm that could be caused] and **PROBABILITY** [the likelihood of the particular event occurring]. It is recommended that Authorised Persons assess their risks in terms of possible impact and probability.

Depending on the type of risk, the **impact assessment** may take the form of a quantitative and/or qualitative assessment. A **quantitative assessment** is carried out by calculating the possible financial impact on the Authorised Person of the occurrence of a specific risk. A **qualitative assessment** is the assessment of a risk in terms of a possible impact: **[a] which cannot be quantified** e.g. impact of possible reputational risk due to the inadequate provision of an investment service; **or [b] the quantification of which cannot be calculated in its entirety** e.g. impact of the imposition by the MFSA of an administrative penalty and the publication of such penalty on the MFSA's web-page.

Probability is defined as the likelihood of the occurrence of a risk. This is usually based on the history of occurrences of the same risk or similar risks. It is recommended that Authorised Persons classify the probability of a risk as either: **High** – There is more than 75% chance of occurrence; **or Medium** - There is from 25% to 75% chance of occurrence; **or Low** - There is less than 25% chance of occurrence.

Where the impact of a risk is quantifiable in its entirety, it is recommended that the Authorised Person quantifies its **Gross Risk**, this being the multiplication of the impact assessment by the percentage probability of occurrence.

[IV] Risk Tolerance and Evaluation

Risk tolerance is equivalent to the amount of risk which the Authorised Person is willing to take in order to achieve its strategic and business objectives. The higher the Authorised Person's risk tolerance, the more risk such Authorised Person is willing to take.

Risk evaluation is the process used to determine risk management priorities by comparing the level of risk against the Authorised Person's level of tolerance, this with the purpose of determining which risks are acceptable.

Further to quantifying its risks, it is recommended that the Authorised Person establishes its level of risk tolerance and evaluates its risks by comparing the estimated risks against the risk tolerance criteria which it has established. Through this risk evaluation process, the Authorised Person makes decisions regarding the significance of risks and whether each specific risk ought to be accepted or treated.

[V] Risk Treatment

Risk treatment is the process of selecting and implementing measures to mitigate the risk to which the Authorised Person is exposed with the aim of bringing such risk within the parameters of the Authorised Person's risk tolerance levels. Risk treatment can take the form of either: **[i]** risk control; or **[ii]** risk transfer; or **[iii]** risk financing. An Authorised Person may choose to take a combination of measures in order to mitigate its risks.

[A] Risk Control are measures which aim at either reducing the likelihood or consequences or both of a risk occurring – e.g. stress testing the business of the Authorised Person by contemplating a scenario where the business of the Authorised Person is reduced by 30% and in turn: **[i]** analysing the impact of such a reduction in business on the Authorised Person's financial resources – i.e. in such a scenario will the Authorised Person continue satisfying the financial resources requirement; and **[ii]** considering the action which the Authorised Person's person could take in order to mitigate a possible deficit of financial resources – e.g. possibly entering into a subordinated loan agreement.

[B] Transfer of Risk this is a process whereby the Authorised Person transfers risk in whole or in part to another organisation – e.g. taking a professional indemnity insurance to *inter alia* cover the potential risk of liability resulting from any breach of a provision of the relevant requirements which apply to the Authorised Person and any administrative penalty resulting from such breach.

[C] Risk Financing refers to the mechanisms for funding the financial consequences of risk - e.g. increasing the Own Funds to provide for liquidity risk, which risk is not catered for in the Financial Return which Authorised Persons are required to submit to the Authority on a periodic basis.

In order for an Authorised Person to assess the adequacy of its capital, it is recommended that the Authorised Person applies Risk Financing to treat those risks the impact of which can be calculated in its entirety. In this regard, it is recommended for Authorised Persons to assess:

[a] whether the risks captured by the Pillar I capital requirement calculation, adequately reflect the actual size of the risks faced by the Authorised Person.

In this regard, it is recommended that the Authorised Person to estimate the additional capital needed (if any) to protect its business operations from such risks; and

[b] the remaining risks which are not captured under by the Pillar I regime – classified in section [I d] above as ‘*Other Possible Risks*’ and where relevant, to estimate any additional capital requirements to mitigate such risks.

Further to the above assessment it is recommended that the Authorised Person carries out a **RMICAAP Risk Financing Calculation** by calculating the total risk capital component required to mitigate the Total Gross Risk (i.e. the summation of all the Gross Risks to which the Authorised Person is exposed). In this regard, in making this calculation it is recommended that the Authorised Person uses the table titled *RMICAAP – Risk Financing Calculation Report* which is outlined in the Annex to these Guidance Notes.

[VI] Risk Recording / Reporting

An Authorised Person is required to assess on a yearly basis whether its RMICAAP is comprehensive and proportionate to the nature, scale and complexity its activities, and to take any necessary measures to ensure this is the case.

Furthermore, on the 31st January of each calendar year, an Authorised Person is required to provide the Authority with a confirmation that it has a RMICAAP in place and that this is comprehensive and proportionate to the nature scale and complexity of the activities of the Authorised Person.

Lastly, an Authorised Person may be required by the Authority to submit a RMICAAP Report.

Given the above-quoted requirements, it is recommended for the Authorised Person to keep a record of: **[i]** all the risks which it has identified, **[ii]** the estimation of such risks, **[iii]** its risk tolerance level and evaluation; and **[iv]** the manner in which these risks are being addressed. In the case of Risk Financing, a record of the RMICAAP Risk Financing Calculation should also be retained. These records should be updated on a yearly basis.

Should the Authorised Person be requested by the Authority to submit a RMICAAP Report, the Authorised Person would be expected to submit a report in the suggested format set out in the Annex to these Guidance Notes i.e. a report on: **[a]** the Authorised Person’s risk identification and monitoring process – i.e. a general overview of the arrangements and processes implemented by the Authorised Person with the aim of identifying and monitoring its risks; **[b]** the individual risks to which the Authorised Person is exposed; and **[c]** a RMICAAP

Risk Financing Calculation Report. It is therefore recommended for an Authorised Person to use the Specimen RMICAAP Report in order to keep a record of: **[a]** its risk identification and monitoring process; **[b]** all the risks which it has identified; and **[c]** the RMICAAP Risk Financial Calculation.

Part B**Technical criteria on the review and evaluation by the MFSA of an Authorised Person's RMICAAP**

The task of the MFSA is to review and evaluate an Authorised Person's RMICAAP. The purpose of this process is to ensure that an Authorised Person has sufficient capital to support all material risks to which the Authorised Person's business is exposed. The MFSA's review and evaluation of an Authorised Person's RMICAAP will effectively be to:

- [i]** review and evaluate:
 - ◆ the Authorised Person's risk profile;
 - ◆ the adequacy and reliability of the Authorised Person's RMICAAP; and
 - ◆ the adequacy of the Authorised Person's own funds and internal capital in relation to the assessment of its overall risk profile;
- [ii]** monitor ongoing compliance with standards laid down in the Capital Requirements Directive as implemented in Malta; and
- [iii]** identify any weaknesses or inadequacies, and the necessary prudential measures taken to address such weaknesses or inadequacies.

The following is a list of the technical criteria which the MFSA may apply when reviewing and evaluating an Authorised Person's RMICAAP:

- [i]** the robustness, suitability and manner of application of the policies and procedures implemented by the Authorised Person for the management of risks;
- [ii]** the exposure to and management of non-trading book business risks, trading business risks, commodities risk, large exposures, foreign exchange risk, and (in the case of Category 3 investment services licence holder, regulated markets and central securities depositories) operational risk by the Authorised Person;
- [iii]** the exposure to and management of other possible risks to which the Authorised Person may be exposed;
- [iv]** the impact of diversification effects and how such effects are factored into the risk measurement system; and
- [v]** the results of stress tests carried out by institutions using an internal model to

calculate market risk capital.

Annex**SPECIMEN RMICAAP – Report**

Name of Authorised Person	ABC Investment Services Limited
Date of Compilation	31 January 2009
Contents	Section I – Risk Identification and Monitoring Process Section II - RMICAAP Report on the individual risks Section III – RMICAAP Risk Financing Calculation Report

Section II - RMICAAP Report on the individual risks

Name of Risk	E.G. Compliance Risk – Late submission of documents
Nature of the Risk	The risk of legal or regulatory sanctions, financial loss, or reputational impact due to a failure to comply with the financial reporting requirements set-out in the applicable MFSA Rules: i.e. late submission of financial returns.
Risk Estimation	<p>Quantitative Impact: ABC Investment Services Limited could be subject to [i] an initial fine amounting to between € 58.23 and € 114.69; and [ii] possibly a daily fine amounting to between € 11.65 and € 69.88.</p> <p>Qualitative Impact: MFSA name and shame policy (impact cannot be quantified).</p> <p>Probability: The accounting department of ABC Investment Services Limited is currently understaffed and therefore the probability of late submission of a financial return is High.</p>
Risk Tolerance	ABC Investment Services Limited considers its reputation as fundamental for its business and therefore classifies its reputational risk tolerance as low.
Risk Treatment	<p>E.G. Risk control</p> <p>Short Term: The General Manager of ABC Investment Services Limited has agreed with the accounts official to work over-time in order to be in a position to submit the financial return on the due date.</p> <p>Long Term: The Board of Directors of ABC Investment Services Limited have decided that within the next year the staff complement of the accounts department should be increased.</p>

Section III - RMICAAP – Risk Financing Calculation Report

RMICAAP – Risk Financing Calculation Report E.g. For a Category 2 Investment Services Licence Holder	<i>As reported in the Annual Financial Return</i>	<i>Gross Risks as calculated by the Authorised Person further to the risk estimation process</i>
	<i>Euro</i>	<i>Euro</i>
<i>Pillar I Risks</i>		
Non-Trading Book Business Risks	50,000	50,000
Trading Book Business Risks	230	230
Commodities Risk	-	
Large Exposures	10,000	15,000
Foreign Exchange Risk	2,000	2,000
Operational Risk (Applicable to Cat 3)	-	
<i>Total Risk</i>	62,230	67,230
<i>Other Possible Risks</i>		
Liquidity Risk		2,000
Compliance Risk		-
Technology Risk		-
Strategic Risk		-
Total RMICAAP Capital Requirement		69,230
Current total Own Funds (minimum Euro 125,000)		126,000
Surplus		56,770