

MFSA

MALTA FINANCIAL SERVICES AUTHORITY

**Securities and Markets
Supervision Unit**

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22th December 2015

To: Investment Services Licence Holders

Attn. The Compliance Officer

Dear Sir/Madam,

Re: Thematic Review on compliance with the requirements on Governance, Compliance and Risk Management

We refer to the Thematic Review on compliance with the requirements on Governance, Compliance and Risk Management issued on the 29 September 2014. This thematic exercise was extended for 2015 and also included clients' monies and clients' assets reconciliation process. By way of a summary, the Authority is disappointed to note that shortcomings which were noted in 2014 are still prevalent within the investment firms' industry.

The objective of this letter is to inform the industry on the shortcomings identified during these focused reviews and to encourage licence holders to avoid these common pitfalls, and where necessary take corrective action in order to observe regulatory and compliance standards. The key findings are as follows:

1. Procedures

When assessing the written procedures manual the Authority noted two common issues. Firstly, that the procedures manual did not include adequate policies and processes designed to detect the risk of failure to comply with all relevant regulations. Furthermore, in certain instances the level of compliance risk as experienced by the investment firm was not always specified in the procedures manual.

Secondly, the procedures manual failed to tailor for the specific circumstances of the licence holder to the extent that in some instances the procedures manual purely replicated the Investment Services Rules. In this regard, the Authority expects that Licence holders are to establish a procedures manual which is reflective of the current standing of the organisation taking into account the specific nature and actual procedures of the Licence holder.



2. Client Monies and Client Assets accounts

I. Reconciliations process

The Authority noted the following main deficiencies when testing the reconciliations process of Client Monies and Client Asset accounts:

- Reconciliations were not being conducted in a timely manner; and
- There was no evidence of the dual control as reconciliations were not duly signed by the preparer and reviewer.

The Authority considers that client monies and client assets reconciliations as critical processes and therefore these processes should be accurate and performed on a regular basis. Moreover the dual control principle should be resorted to at all times.

It is highly recommended that the compliance function conducts re-performance checks of a sample of the reconciliations in order to ensure that these are being conducted in an orderly manner.

II. Designation of client monies and assets accounts

The firm has to ensure that all of its clients' monies and assets accounts are designated as '*Clients*'. Furthermore, it is recommended that the firm obtains from the Bank/Custodian a declaration in writing that the latter renounces and will not attempt to enforce or execute, any charge, right of set-off or other claim against the account, or combine the account with any other account in respect of any debt owed to the Bank/Custodian by the firm, and that interest payable on the account will be credited to the account. It is advisable for the firm to obtain such confirmation from the Bank/Custodian upon the opening of such accounts.

May we remind investment firms that the COREP return should include all clients' monies bank account details and balances, except when client monies accounts with zero balances are held.

III. "Parked" client monies

Firms should ensure that client monies which are "parked" for an extended period of time are safeguarded from misappropriation risks. Hence firms should discourage retaining large amounts of client monies parked in the client monies accounts and should make every effort to deploy these monies at the earliest. Client procedures should also be drawn up with a view to ensure that "parked" client monies are duly protected.



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3. Governance

The Authority noted the following main deficiencies in the Governance structures:

- Internal reporting lines were not clearly defined and were not formalised in the procedures manual. We expect that the respective responsibilities of the persons in charge of making decisions are properly defined and explained in the investment firm's procedures manual.
- The Business Continuity Plan ('BCP') was not in line with the Guidance Notes to the Investment Services Rules for Investment Services Providers. Moreover logs of business continuity testing were not always maintained. We expect investments firms to be familiar with the referred Guidance Notes as well as to maintain appropriate business continuity logs.
- In cases where the firm's organisational structure incorporates internal committees, it was noted that the related Terms of Reference (ToR) were not drawn up or else the referred ToR were not signed by the relevant parties. It is highly recommended that these issues are taken care of when such internal committees are initially set-up.
- The minutes of the Board of Directors meeting did not reflect material issues, where applicable, and often lacked the necessary detail in relation to salient and important business issues which would typically have a high impact on the financial performance and other key aspects (including regulatory compliance) of the business. We strongly recommend that minutes provide a better reflection of the issues discussed during board meetings as well as action points arising therefrom, responsible parties for implementing such action points with agreed timescales for implementation.

4. Compliance

We are concerned to note that the MFSA officials encountered the same issues as observed during the previous thematic review. MFSA views the compliance function as a very important control element within a firm's organisational structure. Therefore, it is not acceptable that the Compliance Officer is not fully involved in material business affairs of the investment firm. Furthermore, the Compliance officer is expected to be aware of the Conduct of Business requirements in relation to the assessment of the Client Profile requirements.

Another important aspect is that the compliance officer should refrain from conducting front office duties notably in relation to the provision of financial planning and advice. In such situations we have requested that the compliance officer refrains from conducting front-office duties due to apparent conflicts of interests.



4. Compliance (cont.)

Other valid points are as follows:

- I. During our review, we came across situations wherein compliance reports were not being prepared and presented to the Directors. Proper compliance reports should be periodically presented to senior management, at least annually. It is recommended that compliance reports are prepared in accordance with the *ESMA Guidelines on certain aspects of the MiFID compliance function requirement*.
- II. It is very important that the compliance officer prepares and continually reviews the Compliance Monitoring Programme, in line with the compliance risk assessment. The latter should consider the level and nature of compliance risk that the Company faces, taking into account the investment services provided, as well as the types of financial instruments traded and distributed.

5. Risk Management [including Remuneration Policy]

MFSA officials assessed the ‘*risk management*’ aspect of the investment firms’ business by conducting a review of the risk management procedures, RMICAAP and Remuneration Policy. MFSA officials also conducted interviews with the risk manager or person(s) responsible for risk management. The main deficiencies noted were as follows:

- The risk management policies and procedures were of a general nature and did not reflect the actual and specific circumstances of the investment firm.
- In certain instances, the RMICAAP report was not endorsed by two directors, as required by SLC 7.72 of the Investment Services Rules. It is important to note that the RMICAAP report should be structured in accordance with Appendix 10 of the Investment Services Rules.
- We noted that certain Category 2 and 3 investment firms did not have a Remuneration policy in place. Such firms are obliged to have a remuneration policy in place, in accordance with SLC 1.41 of the Investment Services Rules. Appendix 10 to the Investment Services Rules, (*‘Additional technical criteria on the treatment of remuneration risk’*) provides further detail on the structure of the Remuneration Policy. Firms should consider the variable remuneration structure of ‘Identified Staff’, in order to ensure that the referred staff is discouraged from taking unnecessary risks in the company’s name.



6. Ancillary issues

The MFSA came across a number of issues which, albeit fall outside the remit of the thematic review, we feel should be brought to your attention:

I. Website disclosures

In a number of cases we noted that the website featured a number of activities which the firm was not licensed to perform.

It is therefore important that the websites disclosures are reviewed in order to ensure that these are in line with the investment services licence. Furthermore any risks associated with the investment firm's activities and/or financial products should be clearly highlighted.

II. Best Execution policy and Order Execution policy

The Authority was concerned to note that a number that firms had not established and implemented an Order Execution policy and/or Best Execution policy. Furthermore, not all firms understood the purpose of these polices where these had been implemented.

In this respect, in accordance with SLC 2.63 to 2.69 of the Investment Services Rules, Licence holders are expected to implement an order execution policy, if an investment firm is only receiving client orders and simply transmitting these orders to a third party broker(s) for execution. This policy should identify in respect of each class of instruments, the entities with which the orders are placed or to which the firm transmits orders for execution.

On the other hand, SLC 2.54 of the Investment Services Rules requires Licence holders to establish a Best Execution policy, in order to fulfil its obligation to take all reasonable steps to obtain, when executing orders, the best possible result for its clients taking into account price, cost, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the order. Moreover, within the best execution policy, firms have to identify, amongst other details, a list of execution venues which enable the Licence Holder to obtain on consistent basis the best possible result for the execution of client orders.

Licence holders are expected to monitor annually the effectiveness of their Best Execution/Order Execution policy.



7. MiFID II guidelines

The objective of this sub-section is to make licence holders aware of MiFID II guidelines which have been issued or are in the process of being issued.

I. Final Report on Guidelines on complex debt instruments and structured deposits in MiFID II

Licence holders should note that ESMA has published the Final report on Guidelines on complex debt instruments and structured deposits in MiFID II. These guidelines were subject to a consultation period earlier on during this year. These guidelines are intended to enhance investor protection by identifying complex financial instruments and structured deposits for which the provision of so-called execution-only services is not possible (i.e. the firm has to ask information on client's knowledge and competence in order to carry out an appropriateness test). The guidelines also cover debt instruments embedding a derivative.

The guidelines will be translated into the official EU languages and published on the ESMA website. The publication of the translations will trigger a two-month period during which competent authorities must notify ESMA whether they comply or intend to comply with the guidelines. These guidelines will apply as from **3 January 2017**.

II. Final Report on Guidelines for the assessment of knowledge and competence

Licence holders should note that ESMA has published the Final Report on Guidelines for the assessment of knowledge and competence. The objective of these guidelines is to specify criteria for the assessment of knowledge and competence of the investment firm's personnel giving investment advice or information about financial instruments, investment services or ancillary services to clients on behalf of the investment firm to fulfil their obligations under Article 24 and Article 25.

The referred guidelines can be accessed from the following link. The referred guidelines will come into effect on **3 January 2017**.



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8. Conclusion

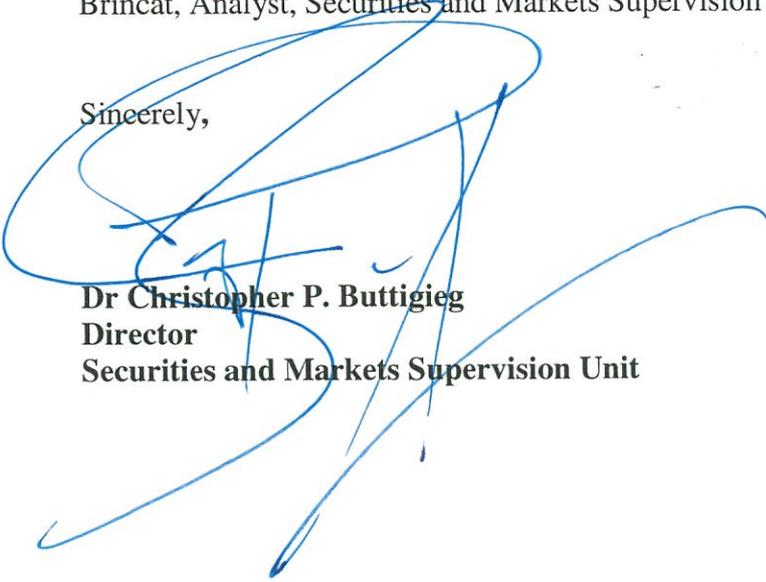
We trust that the guiding principles outlined in this letter will help licence holders to identify common pitfalls that we have seen in recent compliance visits and to take the appropriate actions.

We remain committed to continue helping you in accomplishing your plans for adherence to compliance and regulatory standards.

During the forthcoming year, the Securities and Markets Supervision Unit plans on carrying out a number of focused thematic visits which may, but not exclusively, focus on governance, compliance, best execution, risk management functions and also review the reconciliation process of client's monies and client's assets. Licence holders will be notified a few weeks before the scheduled visit to prepare relevant documents for reviews, prior to the regulatory visits.

Should you have any queries regarding the above, please do not hesitate to contact: undersigned or Mr John Sammut, Deputy Director, Securities and Markets Supervision Unit at jrsammut@mfsa.com.mt or Ms Sara Antonia Borg, Analyst, Securities and Markets Supervision Unit at saborg@mfsa.com.mt or Mr Luciano Brincat, Analyst, Securities and Markets Supervision Unit at lbrincat@mfsa.com.mt.

Sincerely,



Dr Christopher P. Buttigieg
Director
Securities and Markets Supervision Unit