



Technical Assistance Consultant's Report

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People's Republic of Bangladesh: Enhancing Efficiency of the Capital Market (Financed by the Japan Fund for Poverty Reduction)

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For: Bank and Financial Institutions Division of Ministry of Finance
Bangladesh Securities and Exchange Commission

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Asian Development Bank



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Bangladesh Securities and Exchange Commission

ADB TA-8228 BAN: Enhancing Efficiency of the Capital Market

FINAL REPORT

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Summary

1. This Final Report summarises the action taken to complete the work of the three components of this TA. The work has focussed on action and capacity building rather than the drafting of documents.
2. The contract period was for two years but the work has been completed in 19 months (from June 2013 to December 2014). ISC's three expert international consultants and three domestic consultants worked under the overall direction of the ISC Group Managing Director.
3. As a result of Components 1 and 3 were in effect logical progressions of our previous work in the areas of BSEC capacity building and demutualisation of exchanges.
4. As a result of Component 1 Strengthened enforcement capacity of SEC, the BSEC is now better equipped to face its regulatory challenges and if the right number and calibre of new staff are recruited should be able to manage their capacity enhancement as a body themselves although consideration should be given to supporting training and educational study tours as the need arises.
5. We have drafted an outline of a paper for market consultation (*Appendix 1.8: Outline of a Draft Consultation on New Risk Based Capital Adequacy (RBCA) Regime for Licensed Persons (November 2014)*) which we recommend that the BSEC distributes.
6. We believe that a small system (*Appendix 1.1: Regulatory System Design for Bangladesh Securities and Exchange Commission (24 July 2014)*) should be obtained and we have provided TOR to the BSEC. The ADB may care to consider this.
7. We also expanded on our work to include elements of a road map for BSEC. Most are outside the direct scope of this TA.
8. Component 2, **Expedited adjudication of enforcement actions**, which included the establishment and operationalisation of a Tribunal to deal with securities market related cases, presented legal problems which had apparently not been foreseen. Our work related to finding solutions to meet the policy objectives and consulting widely over the way forward. Our background work included a paper on the International Requirements and Best Practices for Capital Market Tribunals. BSEC has already addressed some of the issues that were of concern.
9. Section 25 B had been added to the Securities Ordinance to create a Securities Tribunal which needs to be operated under the Criminal Code and will not be able to fast track cases. The BSEC now has the following options:
 - Leave the amended legislation in place and follow our recommendation to create an Administrative Tribunal by way of licensing condition (the so called contractual route) which has been successfully used by other developing markets in the absence of primary legislation. We have has drafted Administrative Tribunal Rules which include fast track procedures for this option;
 - Lobby for changes to the Code of Criminal Procedure of 1898 to enable the Special Criminal Tribunal to operate under "fast track" case management procedures. We have drafted case management rules to enable this; or
 - Draft amendments to the Ordinance which specifically create an "Administrative Tribunal" and consequential amendments to the Code of Civil Procedure of 1908 (and all other related enactments); enable this Tribunal to be operated either under the auspices of the

Ministry of Justice (and as such part of the Court system) or enable this Tribunal to be operated under the Arbitration Act and administered by the Bangladesh International Arbitration Centre and additionally repeal the amendment which created the Special Criminal Tribunal. This is outside our terms of reference and is for future consideration by the relevant authorities. It would be time consuming.

10. Detailed workshops were held with the BSEC, industry participants and with Judges of the Supreme Court. These workshops were accredited for the purposes of continuing professional development by the General Council of the bar for England and Wales.
11. The BSEC is still considering the exact way forward for the Tribunal.
12. We also noted that there is an urgent need for a dedicated “Commercial Bench Division” to be established in the Supreme Court and for “Fast Track” Procedural Case Management Rules to be introduced in Supreme Court (Civil and Criminal Jurisdictions).
13. Component 3: **Improved regulation, governance and operation of stock exchanges** required actions pursuant to the Exchanges Demutualisation Act 2013 e.g. submission of Demutualisation Scheme and related documents by exchanges, approval of the scheme and documents by the BSEC, publication of the approved scheme by the exchanges, adopting a special resolution to change the memoranda and articles by the exchanges, submission of the approved documents to the BSEC and the Registrar and the first meeting completing the elections of the board of the exchanges. These deadlines for these actions were met.
14. We have drafted the necessary Rule changes and produced the following reports:
 - Report on Fit and Proper Criteria
 - Report on Exchange Registration Rules, 2014
 - Report on Self-listing of the Dhaka and Chittagong Stock Exchanges
 - Report on Margin Rules
 - Presentation to Board of the BSEC
 - Report on stock broker and stock dealer rules, 2014
15. The exchanges are now demutualised – a considerable achievement by the BSEC and the Government, which was made in a shorter period than in many more developed countries-but the benefits of demutualisation will not be realised unless the BSEC and the exchanges take action.
16. Key to the success of demutualization, in particular, is the need to ensure that the environment in which the exchanges operate is conducive to a for-profit exchange in which the new shareholders expect a return on their investment instead of exclusive membership of a club within a mutual exchange. This can only be achieved by further extensive work to enhance and expand the capital markets of Bangladesh including expanding the products, continuing to strengthen the capacity and resources of BSEC, training and education of all participants, training of independent directors for the exchanges and empowerment and training of executive management of exchanges.

Introduction

17. ISC is honoured to have undertaken this important work. We should like to thank in particular Members and officers of the Securities and Exchange Commission of Bangladesh (BSEC), especially Mr Md. Saifur Rahman, Executive Director and Project Director and ADB officer Mr Syed Ali-Mumtaz H. Shah, Senior Financial Sector Specialist, Financial Sector, Public Management and Trade Division at the South Asia Department for the considerable help which has enabled ISC to complete the work.
18. The Technical Assistance (TA) was designed to support the Second Capital Market Development Program (CMDP II) approved by ADB on November 2012 and to meet the capacity building needs of the BSEC, to help the BSEC discharge its capital market oversight functions more effectively. The TA was to support BSEC's own efforts to enhance its capacity and capabilities in the area of enforcement, as well as its efforts to establish a specialized adjudicatory body to hear and rule in capital markets cases. It was also to support the government's efforts to make changes in the ownership and governance structure of the two stock exchanges in support of enhanced governance and management of the exchanges.
19. The contract period was June 2013 to June 2015 but the work was finished in November 2014 following a meeting between ISC Group Managing Director and the Chairman of the BSEC in Dhaka.
20. This is an **action oriented** TA and the deliverables have been structured accordingly. The Terms of Reference (TOR) extracted from the RFP dated April 2013 are set out on the following page.
21. This Final Report sets out a summary of the work done. Additional discussion and comment may be available in the preceding Reports:
 - Inception Report;
 - First Quarterly Report;
 - Second Quarterly Report;
 - Third Quarterly Report;
 - Fourth Quarterly Report; and
 - Draft Final Report and Seventh Quarterly Report.

Terms of Reference

1. Strengthened enforcement capacity of SEC

This component will focus on upgrading SEC's inspection, investigation and enforcement capacity to more fully meet its current and future regulatory obligations and promote market stability. This component will initially focus on ensuring an effective and efficient structure for detecting possible violations of securities laws and regulations, investigating irregularities and prosecuting cases. Subsequently, the focus will be on developing processes for discovering and analyzing evidence, taking testimony under oath, and formulating and prosecuting cases.

The **principal aim** of this assignment will be to strengthen inspection, investigation and enforcement capacity of SEC staff. The initial focus will be on ensuring an effective and efficient structure for detecting possible violations of securities laws and regulations (such as market or price manipulation, insider trading, failure to comply with conduct of business, capital adequacy, segregation of client assets, or AML rules), investigating irregularities and prosecuting cases. Subsequently, the focus will be on developing processes for discovering and analyzing evidence, taking testimony under oath, and formulating and prosecuting cases.

Specific tasks will include: (i) developing an effective structure for the SEC's enforcement activities (that includes organizing a sustainable program to follow up on customer complaints and termination for cause of members of the stock exchanges); (ii) developing internal guidelines and procedures for investigation and enforcement (that includes establishing a cause investigation program and training SEC officials in performing this function); (iii) assisting SEC in conducting audit and inspection of the stock exchanges and member-brokers of the stock exchanges; (iv) providing on-the-job training to SEC officials in the conduct of audit and inspection of the operations of stock exchange members and other market participants; and (v) training investigation and enforcement staff (which includes training SEC staff in conducting investigation and preparing securities cases for prosecution).

2. Expedited adjudication of enforcement actions

The second component will focus on developing and promoting mechanisms to ensure disposition of capital markets enforcement actions in an effective and timely manner. This may include the establishment of a separate expert tribunal/court to hear capital market cases.

The **principal aim** of this assignment will be to develop and promote mechanisms to ensure disposition of capital markets enforcement actions in an effective and timely manner.

Specific tasks will include: (i) developing a model organizational framework for expedited adjudication; (ii) drafting the required legislative and procedural framework; (iii) consulting with industry stakeholders; (iv) assist and advise on the process of enacting the legislation and/or issuing the relevant regulations; (v) operationalizing the special tribunal; and (vi) training judges to handle securities cases in a competent and expedient manner.

3. Improved regulation, governance and operation of stock exchanges

The third component will facilitate the demutualization process of the Dhaka Stock Exchange (DSE) and Chittagong Stock Exchange (CSE) by introducing international best practices in their governance structures.

The **principal aim** of this assignment will be to develop and promote mechanisms to facilitate the demutualization process of the Dhaka Stock Exchange (DSE) and Chittagong Stock Exchange (CSE) by introducing international best practices in their governance structures.

The **focus** will be on improving regulation, governance and operation of the two stock exchanges. Specific tasks will include: (i) developing appropriate governance structures in the CSE and DSE; (ii) drafting the required legislative and procedural framework; (iii) consulting with industry stakeholders; as well as (iv) assist and advise on the process of enacting the legislation and/or issuing the relevant regulations.

Key Issues

22. BSEC has recently had some considerable achievements e.g. gaining IOSCO category A recognition, renewing efforts looking at risk based capital, appointing a Chief Accountant and installing the surveillance system. However many issues on which we and others have made recommendations (some as long as over 20 years ago) still remain and were discussed by the consultants with BSEC even though they may not have been covered in the current TOR.
23. The small numbers of staff who are knowledgeable and qualified are the key reason for the general lack of progress. We have commented to the BSEC on the new organisational chart which is being considered at government level and the projected staff numbers. The key matter is to recruit the right number and calibre of staff and in due course to deploy them flexibly to meet the changing needs of the market.
24. Having sufficient staff will means that backlogs can be dealt with. For example, under ADB TA Loan No. 2232-BAN Improvement of Capital Market and Insurance Governance Project Sub-project 3: Improvement of Capital Markets Governance Project, ISC drafted a complete set of courses with examinations for intermediaries. Qualifications are essential for improving the standard of the industry. However the draft regulation has not been passed and the system has not been implemented. This is recognized as important by BSEC who will deal with the matter shortly.
25. At the start of the TA the **most urgent matters** were those related to demutualisation under **Component 3 Improved regulation, governance and operation of stock exchanges**, some deadlines for this component being defined by requirements in the Exchanges Demutualisation Act 2013. This followed on from work under a separate TA. Time sensitive issues were completed by the due dates and included:
 - Submission of Demutualisation Scheme and related documents by exchanges
 - Approval of the scheme and documents by the BSEC
 - Publication of the approved scheme by the exchanges
 - Adopting a special resolution to change the memoranda and articles etc by the exchanges
 - Submission of the approved documents to the BSEC and the Registrar
 - The first meeting completing the elections of the board of the exchanges
26. The **most challenging** was **Component 2: Expedited adjudication of enforcement actions**. The policy objective was not met by the addition of clause 25B to the Securities Ordinance. Clause 25B of the Securities Ordinance has at best added a dedicated criminal court which tangentially assists by providing another venue for the trial of securities markets offences and worst created another venue that is beset by the general delays currently being experienced in the criminal courts.
27. However we have provided avenues by which the objectives could be met and for the first time ever we understand the BSEC was able to host a meeting of Supreme Court Judges which discussed the issue.
28. **Component 1: Strengthened enforcement capacity of BSEC** built on previous work by ISC and others. We also provided advice additional to that required in the TOR (such as commenting on the new surveillance system) and we consider that the BSEC has gained greater understanding in these areas.
29. In general we consider that the BSEC given an increase in qualified staff is well able to sustain activities in components 1, 2 and 3.
30. We noted that study tours (under previous funding) had been conducted formally and efficiently and these remain valuable areas of assistance.

31. A question that always needs to be asked is - how successful has ISC's work been? We may have completed the deliverables, made recommendations, assisted staff and drafted rules but there need to be continuous follow up. The BSEC Project Director has ensured wide distribution of our work and we noted additional requests for soft copies so that work could be followed up.

Component 1: Strengthened Enforcement Capacity of BSEC

Component 1: Strengthened enforcement capacity of SEC. “This component will focus on upgrading SEC’s inspection, investigation and enforcement capacity to more fully meet its current and future regulatory obligations and promote market stability. This component will initially focus on ensuring an effective and efficient structure for detecting possible violations of securities laws and regulations, investigating irregularities and prosecuting cases. Subsequently, the focus will be on developing processes for discovering and analyzing evidence, taking testimony under oath, and formulating and prosecuting cases.”

Key Deliverables

32. The following key deliverables were made and where appropriate are attached at the appendices indicated:

| Appendix Reference | Deliverables |
|--------------------|--|
| 1.1 | Regulatory System Design for Bangladesh Securities and Exchange Commission (24 July 2014) |
| 1.2 | BSEC Training Workshops Handout (19 June 2014) |
| 1.3 | BSEC Risk Based Regulatory Model: Elements of a Risk Based Supervision Framework and RBS – a Supervision Index (November 2014) |
| 1.4 | Risk Assessment Questionnaire (November 2014) |
| 1.5 | Supervision and Regulation of Intermediaries (SRI): Inspection Procedures Manual and Guidelines (November 2014) |
| 1.6 | Oversight Review Manual: Dhaka and Chittagong Stock Exchanges; and Central Depository of Bangladesh Limited (November 2014) |
| 1.7 | Review of Market Surveillance (November 2014) |
| 1.8 | Outline of a Draft Consultation Paper on New Risk Based Capital Adequacy (RBCA) Regime for Licensed Persons (November 2014) |
| 1.9 | Draft Submission for BSEC to pass to ADB: Risk Based Regulatory System and Enterprise Resource Planning System for Bangladesh Securities and Exchange Commission (November 2014) |

33. The TA has been addressed in two ways, addressing issues in the TOR and also assisting in developing fundamental regulatory processes particularly with regard to the introduction of Risk Based Supervision (RBS).
34. For the first approach the following has been completed:

| TOR Item | Approach |
|--|--|
| The initial focus will be on ensuring an effective and efficient structure for detecting possible violations of securities laws and regulations (such as market or price manipulation, insider trading, failure to comply with conduct of business, capital adequacy, segregation of client assets, or AML rules), investigating irregularities and prosecuting cases. | Development and training on Risk Based Supervision (RBS). Assistance with development of appropriate Risk Based Capital Adequacy (RBCA) System. Assistance with review of surveillance alerts. |

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| Subsequently, the focus will be on developing processes for discovering and analyzing evidence, taking testimony under oath, and formulating and prosecuting cases. | Discussion with enforcement and complaints staff were held and review of case files undertaken. Generally the process was working but the lack of Tribunal hampered progress. The Tribunal issue is addressed in Component 2 of the TA. |
| (i) developing an effective structure for the SEC's enforcement activities (that includes organizing a sustainable program to follow up on customer complaints and termination for cause of members of the stock exchanges); | This is part of the ongoing training that has been given and development of RBS techniques. These have been developed and also templates for risk based scoring of brokers and capital adequacy monitoring developed. |
| (ii) developing internal guidelines and procedures for investigation and enforcement (that includes establishing a cause investigation program and training SEC officials in performing this function); | New RBS inspection guidelines have been written in line with training provided. |
| (iii) assisting SEC in conducting audit and inspection of the stock exchanges and member-brokers of the stock exchanges; | Training of SMRIC staff in inspection techniques. DSE/CSE inspection planning. |
| (iv) providing on-the-job training to SEC officials in the conduct of audit and inspection of the operations of stock exchange members and other market participants; | This has been undertaken. |
| (v) training investigation and enforcement staff (which includes training SEC staff in conducting investigation and preparing securities cases for prosecution) | Review completed. Overall training given. |

35. While the above remained the key thrust, the consultant's work was also reoriented to address some of the fundamental issues which need resolving to ensure BSEC has the capacity and institutional arrangements in place in order to address its oversight and enforcement processes.
36. Having the capacity to introduce agreed changes has always been an issue with BSEC. This point was made strenuously to BSEC in reports leading up to demutualization. It is essential that the BSEC address the myriad of issues identified and that it has a realistic road map of regulatory improvement.
37. Following the discussions with BSEC and DSE management the consultant has identified 25 items for attention which may make up the components of a road map. It should be noted that much of this is not new and has been provided/recommended by ISC (and others) under this as well as past TAs.
38. The action items for Road Map are:
- Implement the new BSEC Organisation Structure and hire adequate staffing ensuring alignment of divisions with workflow required. (We have commented on the detailed structure presented to the Government).
 - Hire professional managers at all levels across BSEC, implement a fast track Human Resources plan for a significant increase in staff.

- Carry out capacity building, training and accreditation across the whole securities industry:
 - a) BSEC;
 - b) Exchanges;
 - c) CDBL; and
 - d) Intermediaries.
- Move to modern adequate premises (if possible rent now prior to new building occupation).
- Develop IT systems at BSEC (ERP system for BSEC Operations including electronic gateways and document handling system, RBCA System, RBS Monitoring system, Licensing system, BSEC general ledger).
- Carry out a post demutualisation review of regulations impacting on exchanges (this has been covered to some extent in Component 3 of this TA).
- Set out SRO functions of exchanges and Central Depository Bangladesh Limited (CDBL) by executing an MOU between BSEC, the exchanges and the CDBL.
- Execute an MOU with Bangladesh Bank (BB) particularly regarding oversight and regulation of margining finance of brokers and the leverage provided by banks and resolution of the “zombie” accounts left from 2010 crisis.
- Review and implement of new minimum paid in capital and ongoing risk based capital as per the BSEC’s committees work, particular attention to the level of leverage in bank associated margin financing.
- Rewrite the margin rules in light of risk based capital adequacy requirements.
- Set initial capital requirements to a level that will force merger of smaller brokers and reduce substantively the number of intermediaries.
- Implement straight through processing of clearing and settlement through to CDBL and modernisation of CDBL systems.
- Implement a plan to move to a Central Counter Party (CCP) and the ownership and regulation of the CCP.
- Rationalise which institutions can be clearing participants and move to a true DVP process via BB gateway. CDBL to become quasi bank.
- Develop settlement guarantee funds and investor protection funds.
- Implement the new enforcement tribunal. This is covered in Component 2 of this TA.
- Review of surveillance arrangements with exchanges and develop and implement an MOU as to responsibilities attaching thereto.
- Implement the Inter Market surveillance unit as recommended by ISC under previous TAs.
- Update the listing and disclosure rules of the exchanges (including as recommended by ISC under previous TAs).

- Facilitate direct market access and internet trading.
- Modernise of the Securities law and draft of a Derivatives Act and Commodities Act.
- With exchanges, examine business case for derivatives and commodity trading.
- Implement FRA, FRC and oversight of auditing profession (we understand the FR Act is due to be passed this parliamentary session).
- Implement Risk Based Supervision (RBS) oversight of intermediaries and DSE/CSE/CDBL, utilise outsourcing through exchanges and the accounting profession.
- Upgrade the BSEC's research and market information capacity and publication, modernise the web site and disseminate market statics and quality indicators.

Recommendations

39. The main recommendations are set out in the Road Map above most of which are outside the direct scope of this TA.
40. We have drafted an outline of a paper on November 2014 for Market consultation (*Appendix 1.8: Outline of a Draft Consultation on New Risk Based Capital Adequacy (RBCA) Regime for Licensed Persons (November 2014)*) which we recommend that the BSEC distributes.
41. We believe that a small system for (*Appendix 1.1: Regulatory System Design for Bangladesh Securities and Exchange Commission (24 July 2014)*) be obtained and we have provided TOR to the BSEC. The ADB may care to consider this.
42. If the right number and calibre of staff are recruited soon with the amount of assistance already received from the ADB we believe that the BSEC can pursue its own capacity building developments without too much external assistance. ISC is always prepared to answer brief queries on the work done, notwithstanding the fact that the TA has finished.
43. The provision of study tours to cover development topics is always valuable provided that they focussed and are managed efficiently.

Component 2: Expedited Adjudication of Enforcement Actions

Component 2: Expedited adjudication of enforcement actions. “The second component will focus on developing and promoting mechanisms to ensure disposition of capital markets enforcement actions in an effective and timely manner. This may include the establishment of a separate expert tribunal/court to hear capital market cases.”

Key Deliverables

44. These are attached as Appendices as in the table below.

| Appendix Reference | Deliverables |
|--------------------|---|
| 2.1 | Draft Securities Markets Administrative Tribunal Rules (14 May 2014) |
| 2.2 | Draft Case Management Rules for the Special Tribunal (25 February 2014) |
| 2.3 | Judicial Workshop Handout (31 May 2014) |
| 2.4 | BSEC Training Workshop Handout (2 June 2014) |
| 2.5 | Industry Consultation Workshop Handout (5 June 2014) |
| 2.6 | Informal Presentation to BSEC Chairman and Commissioners (11 June 2014) |
| 2.7 | The International Requirements and Best Practices for Capital Market Tribunals (October 2013) |

45. This Final Report highlights (as has been the case in our previously quarterly reports) the difficulties presented by the amendment to the Securities Ordinance which created “the Special Criminal Tribunal” and recommends measures to obviate these difficulties.
46. ISC has met the TOR in so far as the major limitations imposed on us by the amendment to the Ordinance allow. We have proposed ways of accelerating the consideration of cases which require no further amendment to the Ordinance and, further, drafted proposed case management rules.
47. Contrary to what we assume the regulatory policy intention, this Tribunal:
- only has jurisdiction to deal with criminal matters and is thus in effect no more than an additional criminal court subject to outdated procedural rules which can only be changed by primary legislation;
 - does not address expedited enforcement in regulatory disciplinary cases in line with international best practices and leaves BSEC in the unenviable position of appearing to flout the principles of natural justice (and the IOSCO principles) by acting as investigator, decision maker and reviewer of its decisions;
 - has resulted in BSEC providing premises and administrative support for the Special Criminal Tribunal. In order for a Criminal Court to operate as such it must be properly constituted as a Criminal Court as proceedings are open to the public. Thus there is a doubt about the legality of such any such Criminal Court operating from BSEC which is compounded by the fact that the perception of the independence of the Special Criminal Court is called into question by the support BSEC is required to provide; and
 - does not follow the international model for independent Tribunals which act as a forum for the challenge to disciplinary and regulatory matters (usually called Administrative Tribunals) leaving all criminal matters to the existing criminal justice system.

48. We have the following recommendations to obviate this obstacle:

- Leave the amended legislation in place and follow our recommendation to create an Administrative Tribunal by way of licensing condition (the so called contractual route) which has been successfully used by other developing markets in the absence of primary legislation. **ISC has drafted Administrative Tribunal Rules which include fast track procedures for this option;**
- Lobby for changes to the Code of Criminal Procedure of 1898 to enable the Special Criminal Tribunal to operate under “fast track” case management procedures. **ISC has drafted rules to enable this; or**
- Draft amendments to the Ordinance which specifically create an “Administrative Tribunal” and consequential amendments to the Code of Civil Procedure of 1908 (and all other related enactments); enable this Tribunal to be operated either under the auspices of the Ministry of Justice (and as such part of the Court system) or enable this Tribunal to be operated under the Arbitration Act and administered by the Bangladesh International Arbitration Centre and additionally repeal the amendment which created the Special Criminal Tribunal. **This is outside ISC’s terms of reference and is for future consideration by the relevant authorities.**

The Implications of section 25B

49. The amendment to the Securities Ordinance 1969, new clause 25B, states:

“(1) for the purpose of this Ordinance, the Government may, by notification in the official gazette, establish one or more Special Tribunal.

“(2) a Special Tribunal shall consist of a sessions Judge or additional Session judge, who shall be appointed by the Government and shall have all the powers conferred by the Code of Criminal Procedure, 1898 (act no V of 1898), on a court of Session exercising original jurisdiction.

“(3) The Court of Sessions may, of its own, or upon an application made by the Commission, transfer at any stage, any case from this court to another Special Tribunal.

“(4) The Special Tribunal shall try the case from such stage wherefrom the case was so transferred.”

50. The amendment to the ordinance to create a “Special Criminal Tribunal” failed to contemplate the consequential amendment of the Criminal Procedure Code to enable fast track case management. It also failed to recognise the increasing regulatory preference to impose disciplinary sanctions (financial penalties and disqualification from working in the industry) as a more effective means of punishment as opposed to referral of cases to the prosecuting authority with the consequent procedural and evidential requirements in addition to meeting the more onerous burden of proof.

51. Ideally the ordinance should have been amended to create an “Administrative Tribunal” and the Civil Procedure Code should have been disapplied with regard to the conduct of proceedings before the Tribunal and BSEC given the explicit power to require that all licence holders exhaust their remedies before the Tribunal prior to issuing proceedings in the High Court; BSEC should also have been given the explicit power to issue rules as to the practice and procedure before the Tribunal, that the Tribunal Panel should be appointed by the Chief Justice and that all the costs of running the Tribunal should be met by the Ministry of Justice.

52. Our proposals have:

- a) addressed the obstacle of a lack of track procedural rules (otherwise known as case management rules) for the Special Criminal Tribunal, however the rules we have drafted will have to be taken before Parliament as the Criminal Procedural Code needs to be amended to accommodate the operation of these rules in the Special Criminal Court;
- b) provided a legally workable way forward to enable expedited enforcement, in line with IOSCO and international best practices and which would obviate the need for the fundamentally flawed process of BSEC reviewing its own enforcement decisions thus driving the industry to the Courts; and
- c) at the request of BSEC we extended the proposed remit of the Administrative Tribunal to cover challenges to listing decisions.

Consultation Feedback

- 53. We have engaged the industry and the Judiciary in a full consultation process for the proposed way forward to expedited enforcement.
- 54. Workshops were held as set out above. Informal feedback from the Industry welcomes the introduction of an Administrative Tribunal and the Senior Judiciary fully support the introduction of such a Tribunal in line with international best practice. They further support our recommendation that the preferred way forward to achieve this is by repeal of the provisions creating the Special Criminal Tribunal and the introduction of carefully crafted legislative amendment (and consequential amendments of the Civil Procedure Rules) which would achieve greater legal certainty than the proposed scheme which seeks to circumvent the ineffective legislative amendment enabling the establishment of the Special Criminal Court and introduce an Administrative Tribunal by way of licensing condition to avoid further legislative change.
- 55. By way of example, the most recent figures produced by the Ministry of Justice in the UK show that some 800,000 cases (this figure covers the entire specialist Tribunals in the UK but includes The Financial Services and Markets Tribunal), some that would otherwise have been before the Civil Courts were disposed of by specialist Tribunals. This alleviates the burden on the Civil Courts leaving the Judiciary time to adjudicate on complex legal issues rather than challenges to the level of financial penalties imposed by the securities markets regulators.
- 56. The Bangladesh International Arbitration Centre (BIAC)¹ welcomed the introduction of the Administrative Tribunal proposal and made a few detailed comments on the draft rules which have been incorporated in the final draft. Furthermore BIAC offered to provide administrative and secretariat support and a venue for hearings. Given BIAC's expertise in arbitration arrangements such an offer is welcomed and it is recommended that this is followed up.

¹ BIAC was established in 2011 with the full support of the Judiciary and the Ministry of Justice. It operates under the internationally recognised UNCITRAL Rules. It is registered as a not-for-profit organisation and is sponsored by the International Chamber of Commerce-Bangladesh, Dhaka Chamber of Commerce & Industry and Metropolitan Chamber of Commerce & Industry. Additionally the International Finance Corporation with funds from UK Aid and European Union is supporting BIAC in the initial stages under a co-operation agreement. BIAC provides a neutral, efficient and reliable dispute resolution service while operating under the Bangladesh Arbitration Act 2001. It has a qualified and experienced Secretariat and its panel Arbitrators are members of the Judiciary and trained by Centre for Effective Dispute Resolution (CEDR) the leading international training experts in dispute resolution.

Accreditation by General Council of the Bar of England and Wales

57. All three workshops were accredited for the purposes of continuing professional development and training by the General Council of the Bar for England and Wales which is internationally recognised for its excellence in the regulation and training of the legal profession in the UK².

Commissioners' Comments

58. Following the presentation at the conclusion of the last Mission the Commissioners and Chairman were divided in their view as to the merits of the introduction of a fast track administrative Tribunal for the market in Bangladesh. We have received no written comments from BSEC or legal arguments as to why our proposals to create an Administrative Tribunal would not work for the Bangladesh market save that BSEC seek legal certainty for any proposals.
59. We agree that legal certainty is desirable and it is preferable that that this achieved by legislative amendment however such an option was not within the scope of our current TORs and we have thus made a recommendation that takes account of this limitation and that offers a practical way forward without legislative change. However our concluding recommendations accept that the desired way forward is carefully crafted and compressive legislative amendment following the Indian model. The recommendation in India for a dedicated securities markets Administrative Tribunal followed an extensive consultation process and took account of all the consequential amendments needed to make such a Tribunal operational.

The Current Situation

60. ISC has noted the series of events which has led up to the imminent operationalisation of the Special Tribunal. A press cutting (Financial Express) dated 9 July 2014 summarises the situation as below.

- On January 2, 2014, the government set up the Special Tribunal in a gazette notification under the Securities and Exchange Ordinance (SEO)-1969 aiming to quickly dispose of the cases relating to the stock market.
- The government, on February 24, appointed District Judge Humayun Kabir at the tribunal. Mr Kabir joined the tribunal submitting his joining letter to the Bangladesh Securities and Exchange Commission (BSEC) on March 16.
- However, (BSEC official) said, functions of the special tribunal will be run under the power of the Code of Criminal Procedure (CrPC)-1898 rather than its own separate rules.
- The authorities had primarily thought to frame a separate set of rules for the tribunal, but later they refrained from doing so, according to the official.
- In absence of any separate "mode of operandi", some legal experts apprehended, multiple complexities may arise during the adjudication process at the tribunal.

61. We understand that there are only one or two criminal cases currently pending resolution and which could in theory be handed over to this new criminal court.
62. As at December 2014, the BSEC are preparing separate premises away from the main building. The Judge recruited has completed a study tour in India.

Options for the BSEC

63. The key options are to:

² The Consultant made these special arrangements.

- follow our preferred recommendation to carefully craft legislative changes and **consequential amendments with the repeal of the amendment to Ordinance to create an Administrative Tribunal in accordance with international best practices;**
- continue with the consultation exercise creating an Administrative Tribunal by way of licensing condition which (theoretically) meets the TOR, circumvents the obstacles created by the Special Criminal Tribunal but is reliant on Industry co-operation and “buy in” and which cannot completely assuage BSEC concerns about legislative certainty; or
- leave the Special Criminal Tribunal in place (notwithstanding our concerns about its fundamental flaws).

Other General Recommendations and Observations

The Role of the Judiciary in the Securities Markets

64. There is an urgent need for a dedicated “Commercial Bench Division” to be established in the Supreme Court. The Supreme Court is not arranged into “Divisions” by way of judicial expertise and experience in area of law unlike other jurisdictions (India, UK, Australia, and Hong Kong). This does not assist with consistency or standards of adjudication. Commercial litigation may involve complex areas of law and fact and calls for a cadre of Judges with that expertise and who have had the benefit from judicial training directed at law and markets, focusing on a practical understanding of the context of commercial litigation.
65. Increasingly agencies such as the World Bank and the European Bank for Reconstruction and Development have recognised the need to establish specialised commercial courts with case management procedures and to provide the Judges of those Courts with dedicated training and an understanding of how the law applies in practice to markets and commerce. This training enhances the quality of judicial decisions and judges’ ability to ask probing questions of witnesses. A model curriculum would ideally include:
- introduction to markets and economic analysis;
 - corporate structures, capital and financing;
 - public and privatised enterprises, including motives for and methods of privatisation;
 - financial intermediaries and securities market instruments; and
 - financial crimes such as fraudulent misrepresentation; market manipulation and abuse and insider trading.
66. It is recommended that such a project would benefit both the securities markets industry and the Judiciary.
67. Whilst making allowances for the variable quality of reporting by financial journalists in the press in Bangladesh there is a fundamental concern that the Judges in the High Court who are seized of cases concerning BSEC matters may lack a basic understanding of the relevant regulatory legislative framework and the policy rationale behind the structure.
68. This is exemplified by the recent case of:
- a challenge to vires of BSEC listing rules by way of what appears to be judicial review proceedings (the case was started in December 2012 and challenged rules promulgated in November 2011 about minimum shareholding in listed companies).

69. No regulatory agency is immune from suit however a clear understanding of the law by the Judiciary should offer a shield. BSEC have to appeal both the above cases following what appear to unfortunate first instance judgements ruling against them.

Judicial Knowledge and Understanding interacts with the urgent need for “Fast Track” Procedural Case Management Rules to be introduced in Supreme Court (Civil and Criminal Jurisdictions)

70. The considerable delay in disposal of cases by the Supreme Court is being exploited as a means of “fettering” BSEC’s regulatory authority for example rules promulgated in 2011 following consultations should not only now be subject to a judicial review hearing some two years after the case was started: the matter should have been disposed of within three months of the application.
71. Unfortunately the delay in disposal of cases can only be remedied by the Ministry of Justice expediting case management reform arrangements for the whole of the High Court across both its civil and criminal jurisdiction. The Judiciary would welcome such reforms.

The Need for a Comprehensive, Durable and up to date Legislative Framework for the Securities Markets

72. The fragmented, poorly drafted and out of date securities markets legislative framework is an ideal vehicle for obfuscation and mounting challenges before the Courts. The Courts are not equipped to robustly and consistently interpret these challenges nor are BSEC which results in delay and uncertainty.
73. The legislative framework is in need of a complete redraft to ensure high standards in the draft itself, greater clarity as to the powers of BSEC, to bring it in line with international developments and to sever where possible the links in the securities legislation to other out dated enactments such enforcement of non-payment of regulatory fines by means of Land Debt law.
74. BSEC does not appear to receive expert and independent legal advice from external professional practitioners specialising in securities markets law and which should be accepted and acted on by the Commission. On the contrary there appears to be much speculation about what the Ordinance does or does not mean (unsupported by any legal argument or case law) and whilst legislative interpretation is ultimately a matter for the Courts BSEC should be reliant on clear legal advice from professional practitioners and act accordingly. No regulator is ever afforded the luxury of legal certainty but it would appear that the interpretational issues raised (with or without merit) are being used as a further impediment to enforcement decision making.

Component 3: Improved Regulation, Governance and Operation of Stock Exchanges

Component 3: Improved regulation, governance and operation of stock exchanges.
“The third component will facilitate the demutualization process of the Dhaka Stock Exchange (DSE) and Chittagong Stock Exchange (CSE) by introducing international best practices in their governance structures.”

Key Deliverables

75. These are attached as Appendices as in the table below. The Scheme Document the consultant's comments on Exchange Regulations are not included.

| Appendix Reference | Deliverables |
|--------------------|---|
| 3.1 | Report on Fit and Proper Criteria (24 February 2014) |
| 3.2 | Report on Exchange Registration Rules, 2014 (24 February 2014) |
| 3.3 | Report on Self-listing of the Dhaka and Chittagong Stock Exchanges (24 February 2014) |
| 3.4 | Report on Margin Rules (26 February 2014) |
| 3.5 | Presentation to Board of the BSEC (24 February 2014) |
| 3.6 | Report on stock broker and stock dealer rules, 2014 (31 July 2014) |

76. The consultant has completed all the actions specified in the TOR. As set out below, a number of Rules await the attention of the BSEC.

Comments on Some Deliverables

77. The key deliverables, their raison d'être, and final remarks areas are follows:

| Deliverable | Raison d'être | Remarks |
|--|--|---|
| Exchange Demutualisation Scheme Document (not attached as Appendix) | The Exchange Demutualisation Scheme Document was a requirement of the Exchanges Demutualisation Act 2013. The document was prepared by BSEC and the exchanges with input and support of the consultant. The document provides detail on how the exchanges are to be demutualised, owned, governed and operated. | The document was issued by the exchanges and approved by their respective memberships in EGM. |
| Fit and Proper Assessment Rules, 2013 | The Exchanges Demutualisation Act 2013 and the Demutualisation Scheme Document issued by the exchanges laid down the criteria by which a person may be a director of an exchange. The Fit and Proper Assessment Rules follow the international practice of applying fit and proper assessment criteria to all persons regulated by BSEC. | The consultant gave a presentation to the Commission on the proposed Fit and Proper Assessment Rules. The Rules have not as yet been implemented by the Commission. |

| Deliverable | Raison d'être | Remarks |
|---|--|--|
| Review and comment on revised draft Regulations governing: <ul style="list-style-type: none"> • Board and Administration Regulations; • Investor Protection Fund Regulations; • Settlement Guarantee Fund Regulations; • Automated Trading Regulations; • Listing Regulations; • Direct Listing Regulations; • TREC Holder Regulations; • TREC Holder Margin Regulations; and • Settlement Regulations. <p>(not attached as Appendix)</p> | <p>The Demutualisation of the exchanges necessitated a complete review of the Regulations issued by the exchanges. Draft Regulations were prepared by the exchanges and approved by BSEC. The consultant reviewed and commented on the draft Regulations and provided support and advice to BSEC to ensure that the Regulations complied with the legislation and modern securities market practice and procedure.</p> | <p>The Regulations were issued by the exchanges and are currently in operation.</p> |
| Exchange Registration Rules, 2014 | <p>The Demutualisation of the exchanges necessitated a review of the Securities and Exchange Rules, 1987 ('the 87 Rules'). The 87 Rules deal with three separate matters namely: stock exchanges; members of a stock exchange; and listing on a stock exchange. This Report deals with the first of these three matters – namely the application and maintenance of registration of a stock exchange. However, in consultation with the Commission, it was agreed to include Commodity Exchanges into new Rules to be called the Exchange Registration Rules, 2014. The draft Rules fully comply with IOSCO requirements and international practice.</p> | <p>The consultant gave a presentation to the Commission on the proposed Exchange Registration Rules. The Rules have not as yet been implemented by the Commission.</p> |
| Stock Exchange Self Listing Rules | <p>An exchange company seeking a listing on its own market would create a conflict of interest if the exchange, which is responsible for ensuring compliance with the initial and continuing obligations of listing, were</p> | <p>The consultant gave a presentation to the Commission on the draft Rules and their application. The Rules will only be required and become</p> |

| Deliverable | Raison d'être | Remarks |
|--|---|--|
| | to regulate itself. The Report, using the Australian exchange as a model, provides BSEC with a policy, rules, regulations and procedures for BSEC to regulate an exchange company seeking a listing on its own market. | effective in the event of an exchange seeking a self-listing. |
| Report on Margin Rules | The purpose of the Report is to identify changes required to the Margin Rules, 1999 ("the Margin Rules") in light of the passage of the Exchanges Demutualisation Act, 2013. | The Margin Rules are presently under review by BSEC. A draft was prepared in 2012, and was reviewed and commented on by the consultant, but has so far not been implemented. |
| Draft Stock Broker and Stock Dealer Rules, 2014 | In reviewing the Securities and Exchange Rules, 1987 ('the 87 Rules') for compliance with the Exchanges Demutualisation Act, 2013, it was agreed with BSEC to merge those matters contained in the 87 Rules pertaining to Broker/Dealers with the Securities and Exchange Commission (stock-broker, stock-dealer and authorized representative) Rules, 2000 and to bring those Rules up to international standards and practice; in particular IOSCO Principles 21 to 24 inclusive which deal with market intermediaries. | The draft Rules have been completed. |

Recommendations

78. Completion of the work as set out above does not necessarily mean that the demutualisation of the stock exchanges in Bangladesh will successfully achieve its objectives. At this point, it is worthwhile reminding ourselves of what these objectives are³:
- a) enhancement of the stock market in terms of value, liquidity, and market perception;
 - b) enhancement of the stock market in terms of efficiency and independence; and
 - c) consideration of the interests of all stakeholders.
79. Key to the success of demutualization, in particular, is the need to ensure that the environment in which the exchanges operate is conducive to a for-profit exchange in which the new shareholders expect a return on their investment instead of exclusive membership of a club within a mutual exchange.
80. This can only be achieved by further extensive work to enhance and expand the capital markets of Bangladesh including:
- **Expanding the product range** – Expansion of the product ranges of the exchanges to include, for example, bonds, derivatives, commodities and other non-equity related instruments. Currently, the exchanges trade only equities. They need to diversify into other types of products if they are to successfully achieve their profit potential.

³ ADB Report "BAN: Demutualization Act – Policy Paper" dated 12 September 2012 (ISC consultant Andy Wilson)

- **Strengthening the capacity and resources of BSEC** – The demand for new products by the exchanges, market participants and investors, needs to be met by BSEC developing its resources to be able to respond in a timely manner to those demands by ensuring that it has in place the legislation and the regulatory environment whereby these new products can be successful. Failure by BSEC to ensure that it has the necessary structure, systems and sufficiently qualified and experienced staff and is acting in a timely and responsive manner, could lead to accusations that it is impeding the proper development of the capital markets.
- **Training and education** – New products will only truly be successful if market participants and investors are trained and educated in their use and BSEC is trained in their regulation. Derivative securities can be highly effective as hedging instruments but if properly applied they can also be used to increase risk exposure thereby achieving a better and quicker return on one's investment. It is therefore important that all market users, including BSEC, are properly educated and trained in their use.
- **Training of independent directors** – The Exchanges Demutualization Act, 2013 ensures that control of exchange boards no longer resides with the trading members of the exchanges by stipulating that the boards must comprise a majority of independent directors and that the chairman of the board and the key committees must be selected from the independent directors. It is therefore imperative that independent directors of exchanges are properly trained and educated in their roles and responsibilities.
- **Empowerment and training of executive management of exchanges** – The Exchanges Demutualization Act, 2013 and subsequent subsidiary legislation requires that day-to-day control of the operation of the stock exchanges be vested in the CEO and executive management of the exchanges. Extensive training is therefore required to ensure that management is able to accommodate a change from effectively a service industry culture to one in which profitability is a key critical success factor. In addition, in a mutual exchange environment, management responded to the needs of a single stakeholder whereas demutualization requires that the interests of all stakeholders are considered equally. The exchanges are likely to need training and assistance in effecting this change of culture.

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| COMPONENT 1: STRENGTHENED ENFORCEMENT CAPACITY OF BSEC | |
| 1.1 | Regulatory System Design for Bangladesh Securities and Exchange Commission (24 July 2014) |
| 1.2 | BSEC Training Workshops Handout (19 June 2014) |
| 1.3 | BSEC Risk Based Regulatory Model: Elements of a Risk Based Supervision Framework and RBS – a Supervision Index (November 2014) |
| 1.4 | Risk Assessment Questionnaire (November 2014) |
| 1.5 | Supervision and Regulation of Intermediaries (SRI): Inspection Procedures Manual and Guidelines (November 2014) |
| 1.6 | Oversight Review Manual: Dhaka and Chittagong Stock Exchanges; and Central Depository of Bangladesh Limited (November 2014) |
| 1.7 | Review of Market Surveillance (November 2014) |
| 1.8 | Outline of a Draft Consultation Paper on New Risk Based Capital Adequacy (RBCA) Regime for Licensed Persons (November 2014) |
| 1.9 | Draft Submission for BSEC to pass to ADB: Risk Based Regulatory System and Enterprise Resource Planning System for Bangladesh Securities and Exchange Commission (November 2014) |
| COMPONENT 2: EXPEDITED ADJUDICATION OF ENFORCEMENT ACTIONS | |
| 2.1 | Draft Securities Markets Administrative Tribunal Rules (14 May 2014) |
| 2.2 | Draft Case Management Rules for the Special Tribunal (25 February 2014) |
| 2.3 | Judicial Workshop Handout (31 May 2014) |
| 2.4 | BSEC Training Workshop Handout (2 June 2014) |
| 2.5 | Industry Consultation Workshop Handout (5 June 2014) |
| 2.6 | Informal Presentation to BSEC Chairman and Commissioners (11 June 2014) |
| 2.7 | The International Requirements and Best Practices for Capital Market Tribunals (October 2013) |
| COMPONENT 3: IMPROVED REGULATION, GOVERNANCE AND OPERATION OF STOCK EXCHANGES | |
| 3.1 | Report on Fit and Proper Criteria (24 February 2014) |
| 3.2 | Report on Exchange Registration Rules, 2014 (24 February 2014) |
| 3.3 | Report on Self-listing of the Dhaka and Chittagong Stock Exchanges (24 February 2014) |
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APPENDICES

COMPONENT 1:

**STRENGTHENED ENFORCEMENT CAPACITY OF
BSEC**

Appendix 1.1: Regulatory System Design for Bangladesh Securities and Exchange Commission (24 July 2014)



বাংলাদেশ সিকিউরিটিজ অ্যান্ড এক্সচেঞ্জ কমিশন
Bangladesh Securities and Exchange Commission

ADB TA-8228 BAN: Enhancing Efficiency of the Capital Market

REGULATORY SYSTEM DESIGN FOR BANGLADESH SECURITIES AND EXCHANGE COMMISSION (BSEC)

July 2014



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Regulatory system design for Bangladesh Securities and Exchange Commission (BSEC)

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Regulatory system design for Bangladesh Securities and Exchange Commission (BSEC)

BACKGROUND

Regulatory Agencies in Emerging Markets require a system development strategy that is straight forward and simple and can be implemented at least cost utilizing open source solutions where possible as well as deploying existing risk based regulatory systems that have been implemented in emerging market jurisdictions in recent years.

PHILOSOPHY: KEEP IT SIMPLE SOFTWARE

Given the staffing and financial resource limitations of both the Regulator and the Regulated Entities there is a need to keep the system and process as simple and user friendly as possible. **Keep It Simple Software** is an overarching principle for the design and architecture of the required system(s). The more complex the system the less likely it is to be used and updated. Systems expensive to maintain with ongoing software licensing that are out of scale with the Regulator's budget resources are not likely to be used beyond the startup period.

The Regulated entities do not have technical resources to utilize sophisticated processes like XBRL that require significant effort and cost just to implement them. The processes and tools need to be simple enough and within the capacity of a middle level employee in both the Regulator and the Regulated Entity to use without extensive specialized training.

The design team needs to look to construct a product that works reliably and can be easily grasped by the users and is consistent with their current environment.

Utilization of more dynamic tools like XBRL can be adapted later in the systems development cycle.

Some specialist risk based supervisory systems developed by other regulators are also available to be utilized. Current examples are the Attain regulatory system designed and implemented in Kenya and the VIZOR regulatory system currently being implemented in Botswana¹.

APPROPRIATE TECHNOLOGY

Emerging markets all now have reasonable internet access which is available to the business community and to working professionals. They have a well developed and fairly extensive mobile telephone network. Most regulated entities (with the exception of small operators) have some computerization with experience in word processing and spreadsheets as well as industry specific software applications. Internet access and therefore experience with web browsers is growing and prevalent with business professionals.

Internet users are familiar with unstructured data such as annual reports, regulations and similar data in PDF or Document formats are common and familiar. Businesses both large and small often use spreadsheets for record keeping and analysis. Almost anyone who uses the internet has used login screens and setup and managed their own accounts. These experiences appear to be to be common to most of the people involved in regulated entities in these markets.

¹ See annexure for more detail on the Attain and Vizor Systems

Regulatory system design for Bangladesh Securities and Exchange Commission (BSEC)

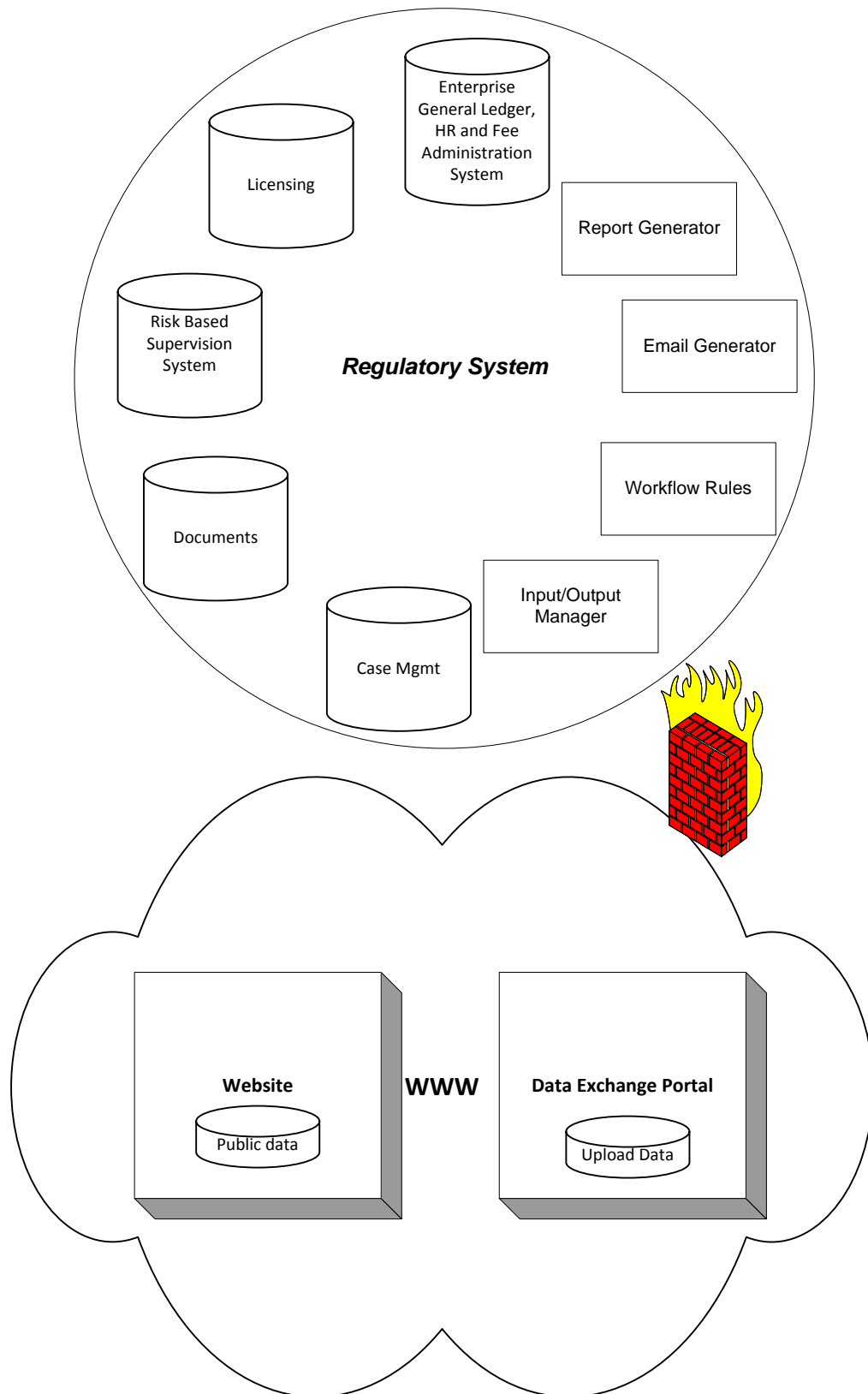
While there are some local firms providing some sophisticated database systems and programs this is an area of limited expertise and cannot be assumed to be available to many of the regulated entities.

Data will be both structured (financial reports and filings with specific data fields) and unstructured (annual reports, board minutes, industry analysis, etc in text and prose form)

BASIC SYSTEMS REQUIREMENTS

- A core database of entities, people and instruments all of which can be related to each other;
- A Licensing system to manage and cross connect the entities, people and instruments;
- A Document collection and management system to link each document to the relevant entity, person or instrument;
- A risk based regulatory assessment and monitoring system related to licensing, inspections and capital adequacy monitoring;
- A case management system to record and track complaints, inspections and inquiries involving entities, people and instruments;
- An automated process of sending notices and reminders to the relevant regulator staff and/or regulated entities and people;
- A data collection, storage, analysis and reporting system for financial data for licensed entities including data on collective investment schemes; and
- Regulatory reporting and MIS system incorporating market data from securities and derivative exchange activities.

Regulatory system design for Bangladesh Securities and Exchange Commission (BSEC)



Regulatory system design for Bangladesh Securities and Exchange Commission (BSEC)

DOCUMENT MANAGEMENT SYSTEMS

Document Management Systems (DocMan) are designed to collect unstructured documents and make them easy to find and link together.

A sample overview representative of DocMan systems from OpenKM is shown:

Product overview

OpenKM is an Open Source electronic document management system, which, due to its characteristics, can be used by large companies as well as by the small ones, as a useful tool in knowledge management processing, providing a more flexible and lower-cost alternative to other proprietary applications.

The use of knowledge management systems by a company helps it to manage intelligence on the resources available to the company, more efficiently. This leads to a medium-term increase in productivity. Using these systems, the information, as well as the knowledge generated within the organization, can be universally accessed.

Using OpenKM to manage documents at your company, will be easy. One of our major goals is the usability case study. OpenKM is a document management application with a web user interface that allows the following operations to be carried out: **sharing, setting security roles, auditing and finding enterprise documents and registers**. With OpenKM users can easily collaborate and communicate.

Documents are not created or consumed in a vacuum – information is created for a purpose. The flow of documents through the business cycle can be managed and tracked.

From initial capture and creation, sharing and collaboration, across approval, review and revisions

OpenKM ensures information workers can find, use, share and secure valuable corporate content. Information assets contribute to on-going business. Collaborating on new or existing documents is central to how users engage with corporate information. Secure interactive repository connect teams to their critical, even across the most distributed, decentralized organizations.

OpenKM is offered on a wide range of different supports adapted to the needs of major organizations.

The source code is available to the community, which can freely use, modify and redistribute it under the GNU General Public License version 2 licenses.

From OpenKM version 4.0 is distributed only in one version with all enhancements.

SHARE AND COLLABORATE

Help users save time by finding the right information when it is needed. Empower teams to share, access, enrich and store high quality content in a single place. OpenKM can manage all of your organization's documents and valuable intellectual assets in a secure document repository built to scale across the enterprise.

Regulatory system design for Bangladesh Securities and Exchange Commission (BSEC)

Create, share and enrich documents within team collaborative workspaces, ensure appropriate approval and reviews with intuitive workflow.

PROCESS AND REVIEW

Documents requiring structured approvals, reviews or sign-off benefit from the JBPM workflow capability. Document lifecycles can be tailored for your unique business environment, quickly configured or with template to reflect internal procedures and to meet your legal compliance requirements.

SEARCH AND FIND

With the OpenKM search, documents are easily found and retrieved by querying content or metadata. Frequently run queries can be saved and re-used.

OpenKM special configuration and extra services

- OpenKM - cluster (For great infrastructures make your document management system scalable).
- OpenKM - mirror (Ensures your system is always up, preventing hardware system fails).

FINANCIAL SUPERVISION SOFTWARE (FDCS)

Financial Supervision Software (FDCS) for regulators of Banks and non Bank Financial Institutions collects structured financial data which can be analyzed and consolidated.

A sample functionality list representative of FDCS systems from FinA is shown:

What is the FinA?

FINA is the state-of-the-art, Free (Open Source) information management system for Financial and Fiscal Supervision Authorities to collect data, store them in the database and generate different reports using very flexible report designer tools.

Who can use FinA?

- National / Central Banks;
- Deposit Insurance Agencies;
- Ministry of Finance and Economy;
- Treasury & Tax Department;
- Bank Supervision Agencies;
- Non-Bank Financial Institution Supervision Agencies;
- Economic Research Department;
- Independent Monetary Authorities;
- Fiscal Monitoring offices;

Regulatory system design for Bangladesh Securities and Exchange Commission (BSEC)

Key features

- **FREE** - Open Source under the Gnu/GPL license;
- **Customizable** and **localizable** system;
- **Independent** of legal, regulatory and accounting framework;
- **Platform independent** -Windows / Linux / Solaris / AIX;
- **Database independent**- MS SQL, Oracle, DB2,MySQL;
- **Scalable** and **extendable** 3 tire **Java** (J2EE) application.

SIMPLE APPROACHES

The essence of the approach is to use technology readily available and in use by the Regulator and Regulated entities.

A system base on a modified CRM approach can have simple browser based forms for staff use and extend data input for simple forms to clients using appropriate SSL security and encryption techniques

Spreadsheets (eg: MS Excel, Open Office, Libre office, Star Office, Numbers, etc) can be provided to reporting entities and uploaded to the Regulator where the needed data is extracted and stored in a database

A document management system with approval workflow can be used to upload, store and index the relevant documents and link them to the appropriate entities and cases.

DEVELOPMENT OF A BASIC SOFTWARE APPROACH

Regulators can use existing tools the users are familiar with and create a useful while not exhaustive system based on common sense and user friendly approaches without reinventing or designing a whole new system from scratch.

BANGLADESH SEC NEEDS

The BSEC is largely at present a paper based system with some Microsoft PC utilization. Plans are to expand the BSEC rapidly over the next 10 years, with new premises and a four to fivefold increase in staff. There is huge potential for productivity gains from the use of appropriate technology and the development of simple incremental regulatory support systems might enable a sizable reduction in planned human resources if proper system solutions are implemented from an early date.

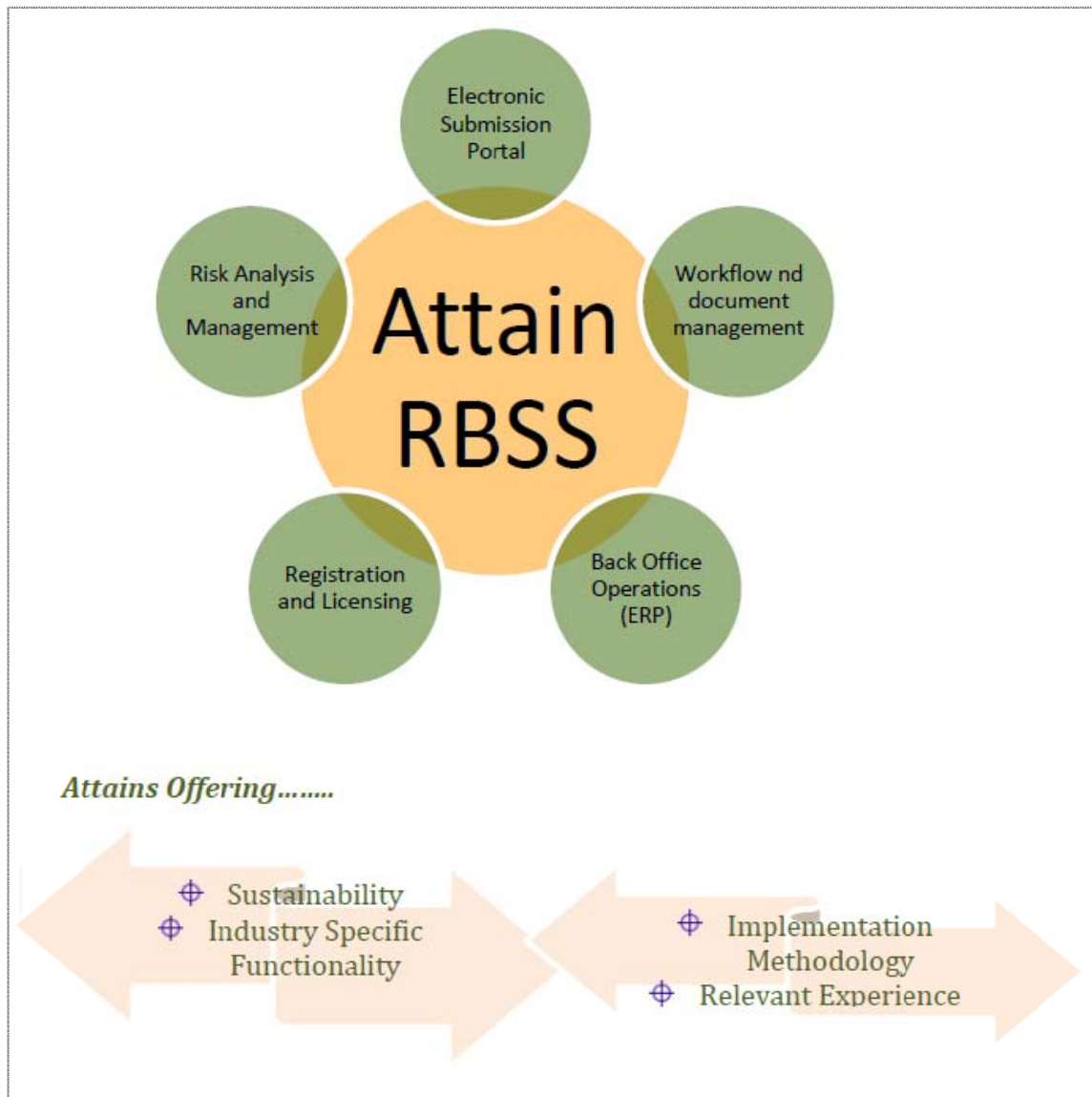
Both the Kenyan and Botswana regulators were assisted by the World Bank FLSAP program and the African development Bank with systems implementation budgets of approximately \$US 2million and \$US 1.2 million respectively for the core regulatory systems with the regulators budgets providing supporting PC networks for regulatory staff.

It is recommended that BSEC seek support from Asian Development Bank (ADB) to assist it develop a systems solution to many of its current issues.

Regulatory system design for Bangladesh Securities and Exchange Commission (BSEC)

Annexure – Attain and Vizor Systems

ATTAIN RBSS RISK BASED SUPERVISORY SYSTEM FOR REGULATORY AUTHORITIES



The complete Risk Based Supervisory Solution

Our solution collects all your regulatory functions into one integrated system. Experience a comprehensive solution that identifies measures and controls risks through the risk management framework put in by regulators. Attain RBSS also offers breakthrough user experience that simplifies access to information, improves regulatory agility, streamlines integration, and enhances reporting and efficient help desk automation.

Regulatory system design for Bangladesh Securities and Exchange Commission (BSEC)

Key Benefits

Effective compliance to regulatory rules and regulations

Fast secure online and mobile payments, effective collection of levies, notifications, automated calculation of risks, notifications for renewals, supervision, and submission of reports ensures the industry players are constantly informed.

Improved customer satisfaction and service

Personalized quality service, easy accessibility both online and mobile access, Complaints handling ensuring all your issues are handled by the correct persons while receiving progress. Registration, licensing and collection of certificates are done online.

Helps people work faster and better

Faster approval processes, improved workflows and document management, enhanced collaboration and centralized feedback within the authority. Employees can also access the system on smart phones, tablets and IPads.

Bird's view of industry operations

Intelligent dashboards enable the Authority to gain greater control of its performance therefore assisting in decision making.

NBFIRA, Botswana Chooses Vizor Software

Vizor Canada Inc. is delighted to announce that Botswana's Non-Bank Financial Institutions Regulatory Authority (NBFIRA) has chosen Vizor Software. Mandated to regulate and enforce compliance within the NBF sector in order to safeguard the stability, fairness and efficiency of the non-bank financial sector, the Authority's regulatory portfolio encompasses a wide variety of industries including Insurance, Pension, Capital Markets, Non-Bank Lenders, Collective Investment Undertakings (CIUs), Asset Managers, Investment Advisors, and Custodians (among others).

Built using Vizor Software the Non-Bank Financial Institutions Regulatory Authority Risk Based Supervision System (NBFIRA RBSS) is set to go live in November, 2014 and will deliver the following objectives:

- Reduce time taken to prepare data outputs and analysis
- Enable registration for individuals and corporate entities, and license renewal
- Facilitate corporate notifications
- Improve off-site and on-site supervision
- Introduce risk profile management
- Implement market data production
- Ease enquiry and complaint handling
- Accelerate enforcement and penalty handling
- Provide levy analysis capabilities

Appendix 1.2: BSEC Training Workshops Handout (19 June 2014)



বাংলাদেশ সিকিউরিটিজ অ্যান্ড এক্সচেঞ্জ কমিশন
Bangladesh Securities and Exchange Commission

ADB TA-8228 BAN: Enhancing Efficiency of the Capital Market

COMPONENT 1:
STRENGTHENED ENFORCEMENT CAPACITY OF BSEC

BSEC TRAINING WORKSHOPS HANDOUT

19 June 2014



The International Securities Consultancy Limited

9A, Carfield Commercial Building, 75-77 Wyndham Street, Central, Hong Kong
Tel +852 2877 3417 ♦ Fax +852 3017 8360 ♦ info@isc-global.com ♦ www.isc-global.com

BSEC TRAINING WORKSHOP ON RISK BASED SUPERVISION

**'Inspection process for Intermediaries and the
Exchanges/Depository'**

Hotel Purbani International Limited
Dhaka, Bangladesh
19 June 2014, Thursday

ADB TA-8228 BAN: Enhancing Efficiency of the Capital Market
Component 1: Strengthened enforcement capacity of BSEC

ISC
The International Securities Consultancy Limited

| Time | Activities |
|----------------------|--|
| 10:45 to 11:00 am | Registration/signing attendance list Please sign to receive your Accreditation Certificate. Thank you. |
| 11:00 to 11:10 am | Brief Introduction by Saifur Rahman Executive Director BSEC |
| 11:10 to 11:45 am | What is Risk Based Supervision? (Risk Scoring of Intermediaries and RBCA) |
| 11:45 am to 12:00 am | Tea break |
| 12:00 am to 12:45 pm | Intermediary Inspections |
| 12:45 pm to 2:00 pm | Lunch |
| 2:00 pm to 2:45 pm | Exchange Inspections and Risk Based Supervision |
| 2:45 pm to 3:00 pm | Tea break |
| 3:00 pm to 3:30 pm | Depository Inspections and Risk Based Supervision |

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Bangladesh Securities and Exchange Commission **ADE**

Agenda Session I

Background to Risk Based Supervision
 RBS Framework
 Risk Profiling
 On site / Off site Supervision
 Capital Adequacy

ISC বাংলাদেশ সিকিউরিটিজ অ্যান্ড এক্সচেঞ্জ কমিশন
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Key Elements of Risk Based Supervision

- An overall approach
- Tailored to the jurisdiction
- Involvement of Commission, staff and market
- Reviewed, evaluated and amended annually

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Components

- Intermediaries
 - Brokers and Investment Banks
 - Asset and Investment Fund Managers
- Credit Rating Agencies
- Custodians
- CDBL - Registrars
- DSE/CSE
- BSEC itself

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The Risks to be addressed

The Market Environment

The Exchanges, Clearing & Settlement

The Regulatory Authority

Intermediaries' Financial Risks

Intermediaries' Non Financial Risks

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Key Risks related to intermediaries

- Capital adequacy of the licensed entities
- Abuse of client relationships
 - Front running
 - Churning
 - Poor trade allocations
- Abuse and misuse of client assets
- Internal control failures
- Risk management failures



Lessons learned from other regulators

- Inadequate capital adequacy due to poor liquidity of assets held
- Deficiencies in Exchange trading rules which enabled abuse of client funds
- Fraud on clients and the abuse of client relationships



Lessons learned from other regulators

- Staff embezzlement
- Conduct of business through associated nominee entities, other brokers and use of un-reconciled inter-broker accounts
- Internal control failures relating to accounting and system audit failures, including expunged computer records
- Risk Management Failures

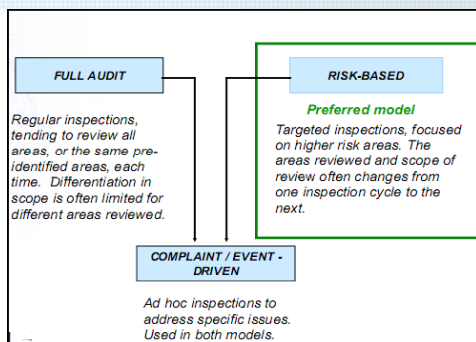


Lessons learned from other regulators

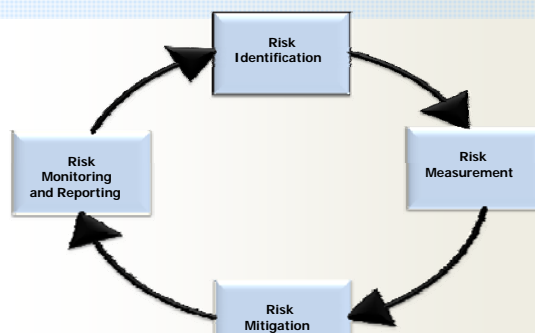
- Extension of credit to clients, directors, management and staff
- Banking practice failures
- Margin finance collateral issues
- The use of agents
- Regulatory reporting failures, the lack of early warning procedures and tardiness in taking appropriate action
- Need for tougher earlier enforcement action

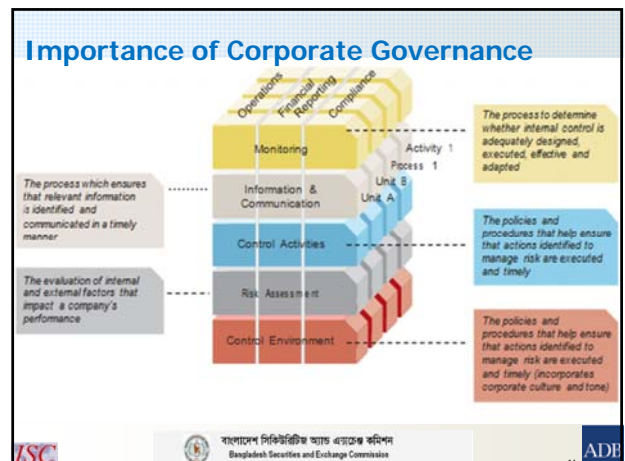
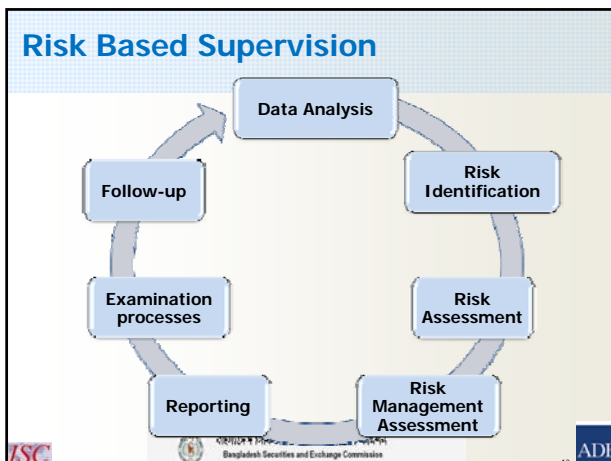


Risk Based vs Compliance Based



Framework





Regulatory Approach - Best practice

- Supervisory mission and focus:
 - A balanced approach
- Supervisory Activities:
 - Business conduct supervision
 - Prudential supervision

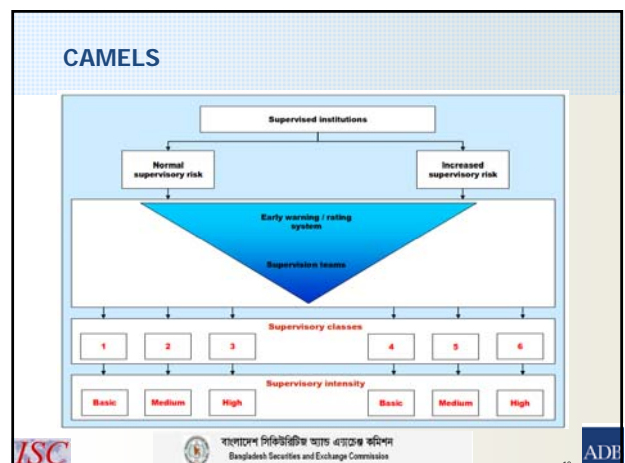
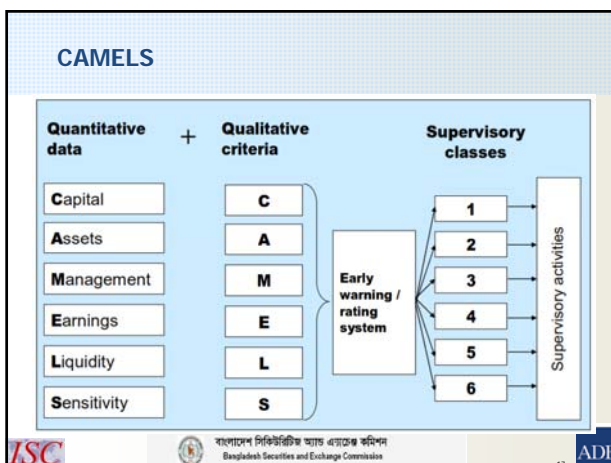
ISC Bangladesh Securities and Exchange Commission ADE

Regulatory approach

- Banking
- Insurance
- Pensions
- Capital markets

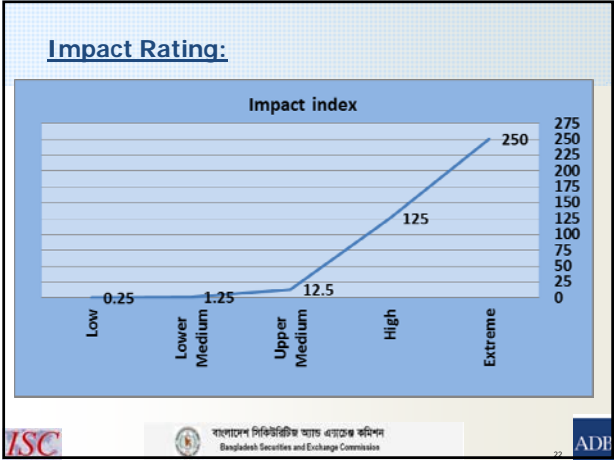
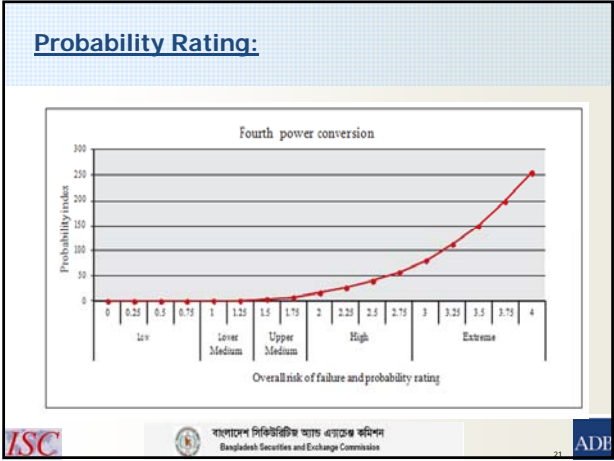
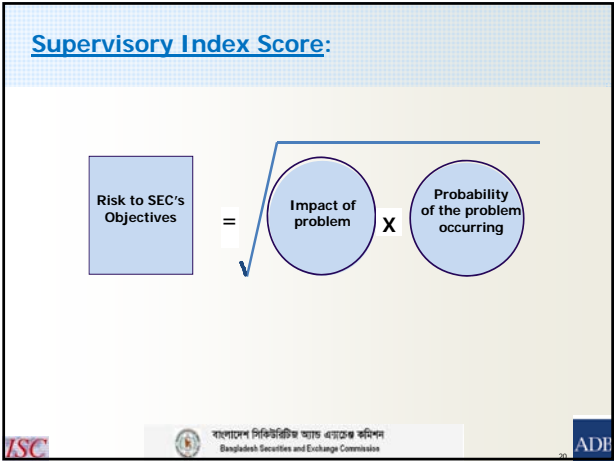
Same framework – different emphasis

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Supervision Matrix:

| | | | | |
|---------------------------|---------------------|----------------------|----------------------|----------------------|
| High Probability | Medium Low Priority | Medium High Priority | High Priority | High Priority |
| Medium High Probability | Medium Low Priority | Medium High Priority | High Priority | High Priority |
| Medium Low Probability | Low Priority | Medium Low Priority | Medium High Priority | Medium High Priority |
| Low Probability | Low Priority | Low Priority | Medium Low Priority | Medium High Priority |
| Probability ↑ Impact → | Low Impact | Medium Low Impact | Medium High Impact | High Impact |



Supervisory Attention Index:

| Impact rating | Impact index | Supervisory Attention Index | | | | |
|--------------------|--------------|-----------------------------|--------------|--------------|------|---------|
| Extreme | 250 | 16 | 35 | 63 | 142 | 253 |
| High | 125 | 11 | 25 | 45 | 101 | 179 |
| Upper Medium | 12.5 | 4 | 8 | 14 | 32 | 57 |
| Lower Medium | 1.25 | 1 | 3 | 4 | 10 | 18 |
| Low | 0.25 | 1 | 1 | 2 | 5 | 8 |
| Probability rating | | Low | Lower Medium | Upper Medium | High | Extreme |
| Probability index | | 1 | 5 | 16 | 81 | 256 |


Comparison to credit ratings:

| Probability index | Indicative external rating |
|-------------------|----------------------------|
| 1 | AAA |
| 1 | AA+ |
| 1 | AA |
| 1 | AA- |
| 2 | A+ |
| 3 | A |
| 5 | A- |
| 8 | BBB+ |
| 11 | BBB |
| 16 | BBB- |
| 26 | BB+ |
| 39 | BB |
| 57 | BB- |
| 81 | B+ |
| 123 | B |
| 181 | B- |
| 256 | CCC |


| Supervisory Attention Index | |
|-----------------------------|--------------|
| Status | Matrix level |
| Normal | 1-4 |
| Watch List | 5-20 |
| Remedial Action | 21-50 |
| On-site Supervision | 51-100 |
| Restructure | >101 |

| Risk to Objectives | Description |
|---|---|
| Financial Failure (FF) | The risk to the market confidence and consumer protection statutory objectives - arising from the insolvency or illiquidity of a firm. For high-impact firm/groups this may also include financial losses that, while short of causing failure, can still adversely affect market confidence because of the scale of these firm/groups in relation to particular markets. |
| Misconduct and/or mismanagement (MM) | The risk to the consumer protection and market confidence statutory objectives of mis-selling or mis-handling of regulated products by firms, of inappropriate behaviour by firms in their wholesale market activities, or other mismanagement of their operations. |
| Customer understanding (CU) | The risk to the consumer protection and public awareness statutory objectives arising from possible lack of understanding by customers of regulated products bought from firms. |
| Market quality (MQ) | The risk to the market confidence and consumer protection statutory objectives arising from possible deterioration in a market's function. This may relate to IPOs, new market products being introduced like NIFTY, etc. etc., where a large firm may through its actions undermine confidence in the market. |
| Fraud or dishonesty (FD) | The risk to the financial crime and market confidence statutory objectives of the incidence of fraud or dishonesty - either within firms, or by external parties defrauding firms. |
| Market abuse (MA) | The risk to the financial crime, consumer protection and market confidence statutory objectives of market abuse conducted by firms. |
| Money laundering (ML) | The risk to the financial crime and market confidence statutory objectives of money laundering conducted through firms. |

| Business Complex | | | | | | |
|--------------------|-------------------------------|-------------------------------------|------------------------|----------------------------------|----------------------------|-------------------------------------|
| Environmental | Business Model | Controls | Oversight & Governance | | Other Mitigants | Net Probability |
| Environmental Risk | Customers, Products & Markets | Customer, Product & Market Controls | Control Functions | Management, Governance & Culture | | Customer Treatment & Market Conduct |
| | Business Processes | Financial & Operating Controls | | | | Operating |
| | Prudential | Prudential Risk Controls | | | Excess Capital & Liquidity | Financial Soundness |
| Business Risks | | Controls | Oversight & Governance | | | |



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| Business Risks: | |
|---|--|
| <ul style="list-style-type: none"> ➤ Environmental Risks <ul style="list-style-type: none"> ➢ Economic Environment ➢ Competitive Environment ➤ Customers, Products & Markets <ul style="list-style-type: none"> ➢ Institutional Client/Counterparty Characteristics ➢ Retail Customer Characteristics ➢ Institutional Product/Market Characteristics ➢ Retail Product Characteristics ➢ Distribution Channels ➢ Conflicts of Interest | |

| Business Risks: | |
|--|--|
| <ul style="list-style-type: none"> ➤ Business Process Risks <ul style="list-style-type: none"> ➢ Litigation/Legal Risk ➢ People Risk ➢ IT Systems ➢ Structure & Ownership ➤ Prudential Risks <ul style="list-style-type: none"> ➢ Credit Risk ➢ Market Risk ➢ Operational Risk ➢ Liquidity Risk ➢ IPO Underwriting Risk | |

| Control Risks: | |
|--|--|
| <ul style="list-style-type: none"> ➤ Customers, Products & Markets Control <ul style="list-style-type: none"> ➢ KYC Requirements ➢ Sales Process & Product Development ➢ Post Sale Handling of Customers/Counterparties ➢ Market Conduct Controls ➢ Conflict of Interest Management ➤ Financial and Operating Controls <ul style="list-style-type: none"> ➢ Clearing and Settlement Arrangements ➢ Financial Controls ➢ IT Security and Controls ➢ Policies, Procedures and Controls ➢ Human Resources Controls ➢ Security of Client Assets or Client Money ➢ Business Continuity Planning | |

Control Risks:

- Prudential Risk Controls
 - Credit Risk Controls
 - Market Risk Controls
 - Operational Risk Controls
 - Liquidity Risk Controls
- Control Functions
 - Compliance
 - Internal Audit
 - Enterprise-wide Risk Management

Control Risks:

- Management, Governance and Culture
 - Culture & Management
 - Corporate Governance
 - Relationship with Regulators
 - Strategic Planning
 - Relationship with Rest of Group
- Capital & Liquidity
 - Adequacy of Capital
 - Adequacy of Liquidity
 - Adequacy of Surplus capital

| | Risk Groups | Risk Elements | Level of Risk | Risk Weight | |
|---|-------------------------------|---------------|---------------|-------------|--|
| 1 | Environmental Risks | 1 | M | 4 | Economic Environment |
| | | 2 | M | 4 | Competitive Environment |
| 2 | Customers, Products & Markets | 3 | H | 16 | Institutional Client/Counterparty Characteristics (strength, relationship, and business generated) |
| | | 4 | M | 4 | Retail Customer Characteristics (High net worth, small or agency clients) |
| | | 5 | M | 4 | Institutional Product/Market Characteristics (Equity Bonds, IPOs) |
| | | 6 | M | 4 | Retail Product Characteristics (Speculative, Blue chip, Derivatives) |
| | | 7 | H | 16 | Distribution Channels (Agents, Banks, Internet, Shop Fronts) |
| | | 8 | H | 16 | Conflicts of Interest |
| 3 | Business Process Risks | 9 | L | 2 | Litigation/Legal Risk (disclosed or unreported) |
| | | 10 | H | 16 | People Risk Including Turnover Rate |
| | | 11 | H | 16 | IT Systems |
| | | 12 | M | 4 | Structure & Ownership |
| 4 | Prudential Risks | 13 | H | 16 | Reputational Risk |
| | | 14 | H | 16 | Credit Risk (level of uncollected client amounts, controls over client dealing, exposure to advisors overtrading client funds) |
| | | 15 | H | 16 | Market Risk |
| | | 16 | H | 16 | Operational Risk |
| | | 17 | M | 4 | Liquidity Risk |
| | | 18 | M | 4 | ISD Underwriting Risk |

| Business Risk | Element Weight | Score | Weighted Score Visit 1 | Converted Scale 0-4 |
|---|----------------|---|------------------------|---------------------|
| 1 Environmental Risks | 5% | 70% | 3.500% | 1.20 |
| 2 Customers, Products & Markets | 25% | 59% | 14.833% | 1.63 |
| 3 Business Process Risks | 30% | 67% | 20.052% | 1.33 |
| 4 Prudential Risks | 40% | 58% | 23.143% | 1.69 |
| Control Risk | 100% | | 61.529% | 1.54 |
| 5 Customers, Products & Markets Control | 30% | 57% | 16.966% | 1.74 |
| 6 Financial and Operating Controls | 15% | 49% | 7.359% | 2.04 |
| 7 Prudential Risk Controls | 20% | 58% | 11.500% | 1.70 |
| 8 Control Functions | 10% | 57% | 5.667% | 1.73 |
| 9 Management, Governance and Culture | 10% | 50% | 5.045% | 1.98 |
| 10 Capital & Liquidity | 15% | 27% | 4.000% | 2.93 |
| | 100% | | 50.537% | 1.98 |
| Sector Weight | | | | |
| Business Risk | 35% | 61.53% | 22% | 1.54 |
| Control Risk | 45% | 50.54% | 33% | 1.98 |
| | 100% | | 54% | 1.82 |
| Probability Index | | (Weighted Score 1.82 ^{4th power}) | | 11 |
| Indicative Rating | | | | BBB |
| Risk Impact | | | | High |
| Supervisory Rating | | | | 12 |
| Supervisory Attention | | | | Watch List |

Impact Assessment:

NB \$US 1 = 77 Tk and 87 KES

| | Low | Lower Medium | Upper Medium | High | Extreme |
|----------------------------|--------------|--------------------------|------------------------|---------------------------|--------------|
| Total Liabilities | < 20 mil shs | 20-75 mil shs | 75-125 mil shs | 125-200 mil shs | >200 mil shs |
| Number Active Customers | <5000 | 5000-25000 | 25000-75000 | 75000-150000 | >150000 |
| Settlement Max last 6 mths | < 25 mil shs | 25 mil shs to 50 mil shs | 50 mil shs -75 mil shs | 75 mil shs to 100 mil shs | >100 mil shs |
| Client Debtors > 30 days | < 5 mill | 5-10 mil shs | 10-20 mil shs | 20 -50 mil shs | >50mil shs |
| Complaints Per Annum | <10 | 10-50 | 50-100 | 100-200 | >200 |
| Impact Score | 0.25 | 1.25 | 12.5 | 125 | 250 |

Risk Questionnaire

- Assist SEC undertake the profiling
- Provides an opportunity for firm to state its practices and situation
- Enables SEC to understand better firm's metrics and status

Supervisory Framework

- Risk identification
- Risk assessment
- Risk based supervisory approach

Supervisory outcomes/results

RBS Requires

- Appropriate regulations and early warnings mechanism
- Proactive monitoring
- Proportionate Monitoring
 - Off-site monitoring
 - On-site review

Demonstration of Risk profile applications

- Brokers/Investment banks
- Exchanges/CSDs
- Pensions
- Insurance
- CRAs

Off- site monitoring at regulator

- Risk Profiling
- Market Surveillance
- Sales practices monitoring (secret shopper)
- Capital adequacy returns and data monitoring
- Complaints Monitoring

Supervisory outcomes/results

On-site monitoring

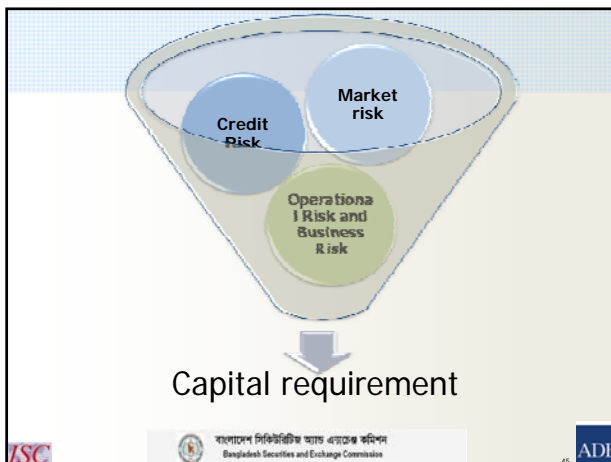
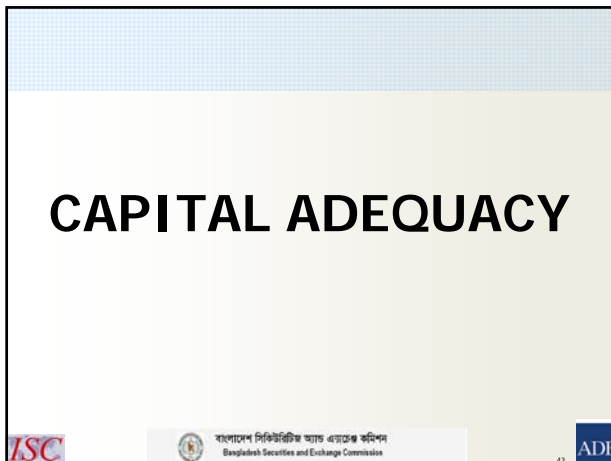
Inspections with outcomes and results

- Routine inspection
- Special inspection
- Thematic inspection
- Prudential visits

Supervisory outcomes/results

Surveillance Systems

Important essential aid to RBS



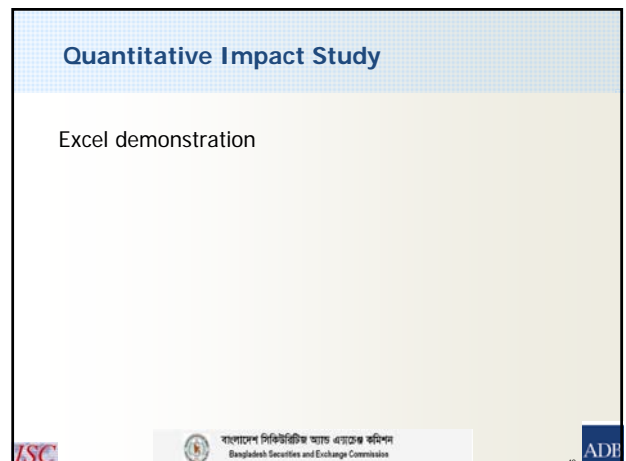
Haircuts

| DESCRIPTION | HAIRCUT PERCENTAGE % |
|--|----------------------|
| HAIRCUT PERCENTAGES FOR SHARES LISTED IN KENYA FOR THE PURPOSES OF THESE REGULATIONS | |
| Shares which are listed on a licensed securities exchange being a constituent of the NSE20 Index | 15 |
| to the extent not already covered in paragraph (a), being a constituent of the NSE All Share Index and not suspended from trading | 25 |
| being any share not referred to in paragraph (a) or (b) | 50 |
| Shares which are listed on a licensed stock market but are not stratified according to stock indices | 50 |
| HAIRCUT PERCENTAGES FOR QUALIFYING DEBT SECURITIES, BY ISSUER OR GUARANTOR, ETC | |
| Where the issuer or guarantor of the qualifying debt securities- | |
| (a) is the Government | 0 |
| (a) has an issue or issues currently rated by- | 5 |
| (i) Moody's Investors Service at Aaa or Prime-1; or | |
| (ii) Standard & Poor's Corporation at AAA or A-1 or | |
| (iii) Equivalent of the (i) and (ii) above | 5 |
| Where the qualifying debt securities are any certificate of deposit, the issuer of which is an authorized financial institution or an approved bank incorporated outside Kenya | |
| To the extent not already covered in Tier 1 or Tier 2 | |
| (a) where the qualifying debt securities are listed on a licensed securities | 15 |

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| Item | Balance Sheet Input | Code | Date (Item 2) | Minimum Capital Item |
|------|--|-----------------------|---------------|----------------------|
| 1 | Bank Name | AAA-00 | 30-Jun-11 | 30,000,000 |
| 5 | Assets | Regulations Reference | | |
| 5 | Bank balances | | | |
| | Cash in hand | 17(a) | | |
| | Cash at bank in company's account | 17(b) | | |
| | Cash at bank accounts for clients (aggregated) | 17(c) | | |
| | Cash deposits with licensed Stock Exchange | Not Used | | 0 |
| | Trading Cash Monies held at CCSC | 21(1)(b) | | |
| | Cash deposits with CMA | Not Used | | 0 |
| | Cash at bank other accounts and short term deposits | 17(d) | | |
| 6 | Amounts receivable from exchange and clearing houses | | | |
| | NSC | Not Used | | 0 |
| | CCSC reserve fund contributions | 21(1)(d) | | |
| | Other Clearinghouses not CCSC | 21(f) | | |
| 7 | Amounts Receivable Securities Trading | | | |
| | Amount receivable from clients 1-15 days | 19(1)(a) | | |
| | Amount receivable from clients >15 <30 days | 19(1)(b) | | |
| | Amount receivable from clients >30 <60 days | 19(1)(c) | | |
| | Amount receivable from clients >60 days | 19(1)(d) | | |
| | Amounts receivable from clients | 19(a) | | |
| | Amounts receivable from clients for subs of securities - | 18 | | |
| | FOs | | | |
| 8 | Amounts receivable from securities dealers arising from dealing in securities | 19 | | |
| 9 | Amounts receivable arising from stock borrowing and Lending Agreements | Not Used | | 0 |
| 10 | Amounts receivable from margin clients (Note 5) | Not Used | | 0 |
| 11 | Amounts provided or receivable to support Repos and Short Selling | Not Used | | 0 |
| 12 | Proprietary positions in securities and specified | 20 (1) | | 0 |
| 13 | Proprietary positions in Derivatives | 20 (2) | | 0 |
| 14 | Current Portfolio Lending Products (after ED reserves) | | | |
| | Repo purchase | Not Used | | 0 |
| | Lending | Not Used | | 0 |
| | Property and Other finance provided | Not Used | | 0 |
| | Long Term Finance | Not Used | | 0 |
| 15 | Other assets arising from | | | |
| | Advisory Fees outstanding less than three months | 23(a) | | |
| | Repeat deposits, security deposits and Advisory fees which are older than three months | 23(c) | | |

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Capital Adequacy Issues from:

- Brokers/Investment Banks
- Asset Managers/ Custodians/Registrars
- DSE/CSE
- CSD
- CRAs
- Impact of products:
 - Margin Financing
 - SBL
 - SS
 - Derivatives
 - Commodities



Key Elements of Risk Based Supervision

- SEC Licensing and Fit & Proper Rules
- SEC Conduct of Business Rules
- SEC Corporate Governance Rules
- Codes of Conduct
- Appropriate Exchange and CSD Rules
- Risk Profiling
- Risk Management Questionnaire
- Management, Internal Control and Risk Management Guidelines
- RBCA – Financial Resources Rules
- Surveillance Systems
- Comprehensive IT and Data Management Systems



BSEC TRAINING WORKSHOP ON RISK BASED SUPERVISION

**'Inspection process for Intermediaries and the
Exchanges/Depository'**

Hotel Purbani International Limited
Dhaka, Bangladesh
19 June 2014, Thursday

ADB TA-8228 BAN: Enhancing Efficiency of the Capital Market
Component 1: Strengthened enforcement capacity of BSEC

ISC
The International Securities Consultancy Limited

Agenda Session II

Inspection Manuals/Guidelines
 BSEC Responsibilities and
 Objectives –what to look for
 Working Papers - Audit
 worksheets and checklists
 On site / Off site Supervision
 Inspection reports follow-up

ISC বাংলাদেশ সিকিউরিটিজ অ্যান্ড এক্সচেঞ্জ কমিশন
Bangladesh Securities and Exchange Commission

ADE


**What an Inspection Manual Should
Cover**

- Recording and safeguarding information;
- The risks to the Commission's objectives;
- The Commission's risk assessment methodology;
- The Commission's licensing policy and criteria for assessing applications;
- Desk- based supervision;
- On site visits;
- Enforcement hand-off;
- Checklists for the key risk areas; and
- Audit/Inspection worksheets

ISC বাংলাদেশ সিকিউরিটিজ অ্যান্ড এক্সচেঞ্জ কমিশন
Bangladesh Securities and Exchange Commission

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BSEC Inspection Guidelines



Guideline (BSEC Inspections).pdf

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Bangladesh Securities and Exchange Commission

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BSEC Responsibilities

- Regulating the business of the Stock Exchanges or any other securities market
- Registering and regulating the business of stock-brokers, sub-brokers, share transfer agents, merchant bankers and managers of issues, trustee of trust deeds, registrar of an issue, underwriters, portfolio managers, investment advisers and other intermediaries in the securities market

ISC বাংলাদেশ সিকিউরিটিজ অ্যান্ড এক্সচেঞ্জ কমিশন
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BSEC Responsibilities

- Registering, monitoring and regulating of collective investment scheme including all forms of mutual funds.
- Monitoring and regulating all authorized self-regulatory organizations in the securities market.
- Prohibiting fraudulent and unfair trade practices relating to securities trading in any securities market

ISC বাংলাদেশ সিকিউরিটিজ অ্যান্ড এক্সচেঞ্জ কমিশন
Bangladesh Securities and Exchange Commission

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BSEC Responsibilities

- Promoting investors' education and providing training for intermediaries of the securities market
- Prohibiting insider trading in securities
- Regulating the substantial acquisition of shares and take-over of companies
- Undertaking investigation and inspection, inquiries and audit of any issuer or dealer of securities, the Stock Exchanges and intermediaries and any self-regulatory organization in the securities market.
- Conducting research and publishing information



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BSEC Key Objectives

- Ensure proper markets infrastructure
- Ensure Fair, Efficient, and Transparent Markets
- Ensure proper Governance of Exchanges and the Depository
- Protection of Investors
- Prosecute Market Abuse and Insider Trading



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BSEC Key Objectives

- Monitor the Governance and Conduct of Business of Market Intermediaries
- Monitor Capital Adequacy and Risk in the market place
- Monitor and institute mechanisms to prevent Systemic Risk



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Key issues to look at

- The integrity and competence of the intermediary and its key personnel;
- Corporate governance and risk management
- The financial resource requirements;
- The handling of client assets;



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Key issues to look at

- The relationship and conduct of business with the client and the handling of complaints;
- Rules and practices concerning conflicts of interest;
- The relationship with the Commission; and
- Record keeping.



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The Inspection Process

- Working Papers
- Worksheets
- Checklists



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Oversight work papers generally serve to:

- Provide the principal support for the supervision department report;
- Aid in the planning and performance of the oversight work;
- Document whether the oversight objectives were achieved;
- Facilitate third party reviews;



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Oversight work papers generally serve to:

- Provide a basis for evaluating the inspection quality assurance program;
- Provide support, in circumstances such as market abuse and insider trading cases, and lawsuits; and
- Aid in the professional development of the oversight staff.



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Completion of Work papers and Cross references

- Working papers need to be well organised
- Clear working papers cross referenced to such documents as trial balances and reconciliations
- Separate files should be compiled for the major aspects of the inspections
- All papers should be noted as to compiler and reviewer as well as dated



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Working Papers evidence that:

- The work has been adequately planned and supervised.
- A sufficient understanding of the brokerage firm's business has been obtained to plan the inspection and to determine the nature, timing, and extent of tests to be performed.
- The inspection evidence obtained, the examining procedures applied, and the testing performed have provided sufficient, competent, evidential matter to afford a reasonable basis for the conclusions stated in the inspection report.



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What should be on file

- Notes and memorandums resulting from interviews;
- Organizational data, such as organizational charts and job descriptions;
- Copies of important contracts and agreements particularly related to IT;
- Information about operating policies;
- Planning documents and oversight work programs;



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What should be on file

- Risk control questionnaires (RCQs), flowcharts, checklists, and narratives;
- Results of operational control evaluations and assessments;
- Letters of confirmations and representation;
 - Results of analytical overview procedures; and
 - The oversight report and management's responses.
- Oversight correspondence if it documents the oversight review conclusions reached.



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Office Preparation

- Office preparation allows a macro approach
- Need to establish an annual inspection program covering:
 - Risk Based Selection of Firms
 - Establishment of themes to be covered
 - Planning of inspection teams and work program capacity
- Past inspection file review
- History of financial filings



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Office Preparation

- Discussion with DSE CSE and CDBL to receive their input
- Review of Surveillance Department findings re suspicions or notations
- Review of BSEC complaints
- Development of working papers file
- Establishment of an inspection program
- Development of support papers for each part of the program



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Market Surveillance System

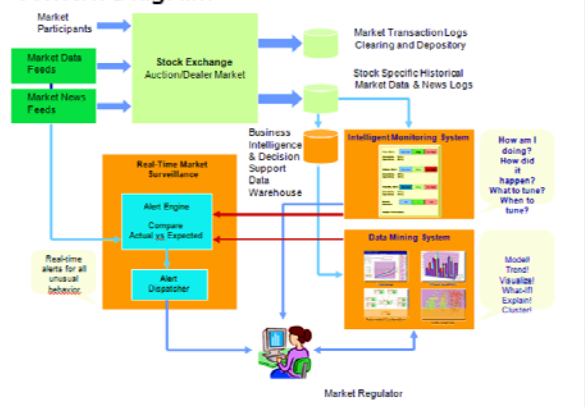
- Enables detection market abuse
- Builds profiles of market trading
- Enables Compliance to build a picture of each firm's activities
- Provides a rich source of intelligence about the firm



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Context Diagram



Use of questionnaires, flow charts, and worksheets

- Example Risk Questionnaire as a pre inspection tool
- Example of Audit flow charts
- Example of Audit worksheets



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Entry Interview with MD or GM of Firm

- Reason for inspection.
- What will be reviewed?
- Sample period (trade and related documents and records for that period).
- Ask for a place to work.
- Other requests:
 - (a) Specific paperwork, documents, forms.
 - (b) Copies may be taken to bring back to BSEC office (originals left at member's office).



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Other Information which may be requested by Inspectors:

- Names of key personnel and supervisors, and names of personnel who might assist during inspection.
- Organization chart, with names, channels of communication, staff responsibilities.
- Names of authorized traders, and what they trade (Plus the name of any other authorized person for access on and use of the Trading System).
- Customer Complaint and Advertising Files.



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Other Information which may be requested by Inspectors:

- Customer information form.
- Customer agreement/contract.
- Auditor's report (and Quarterly report).
- Supervisory, Compliance, or operating procedures and Manuals.
- Trading and trade processing procedures, particularly regarding Block, Principal, and Cross trades.
- Order/trade ticket or trade information form.
- Re-registration procedures along with Registration Files.



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Trading information:

- List of Member's principal trading accounts and customer accounts, particularly discretionary and active accounts:
 - Account names.
 - Account numbers.



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Financial data:

- Financial data:
- Latest trial Balance
- BSEC financial returns and liquid capital computation
- Ageing of customer accounts
- Disposition of Securities Held
- Bank Account details/ Reconciliations
- Balance Sheet proofs and reconcilements
- See sample worksheets



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Audit Worksheets

- Assist Organisation of Work
- Documents what has been done
- Gives management evidence of inspection work
- Demonstration of Audit Workbook



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Exit interview:

The purpose of an exit interview at on-site examinations is to give the firm's management the opportunity to address any factual discrepancies that may exist affecting examination findings and to clarify facts which may impact the examiner's analysis and the ultimate conclusion of whether violations occurred.



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Exit interview:

- In this regard the process greatly assists the examiner in preparing accurate examination reports, deficiency letters and/or Enforcement referrals. Some of the "findings" of deficiencies may be explained away and therefore clarified, providing additional documentation or deeper, better explanations.
- The procedures and timing of exit interviews should be determined based upon the circumstances of each examination, taking into consideration the firm's location, level of cooperation, severity of findings, and potential for referral to the Inspections/Enforcement Department.

Exit interview:

- Exit interviews may not be appropriate in the cause examination setting, e.g., in possible manipulation or fraud cases; consult with Compliance Department management in these situations.
- The inspector should require management and/or the Compliance Officer of the firm to sign and date the List of Inspection Findings at the close of the exit interview.

Exit interview:

- All later conversations will stem from the items in this list. These signatures ensure adequate supervisory attention to the results and finding of the inspection process.
- The signed list also provides documentation that supervisors must now use as benchmark for changes of internal procedures and provides a formal list from which the firm's management can direct remedial and corrective actions. Provide the firm's managers with a signed copy of this document.

The Inspection report:

- To describe the businesses and activities performed by the registered member or person, description of the process and methodology of the inspection, the description of the findings of deficiencies, and recommendations for action to be taken.
- To serve as a notification of the findings of the inspection in a letter to the registered firm. Findings should be isolated, edited, and then incorporated into a letter sent to the registered firm.

The Inspection report:

- To describe the businesses and activities performed by the registered member or person, description of the process and methodology of the inspection, the description of the findings of deficiencies, and recommendations for action to be taken.
- To serve as a notification of the findings of the inspection in a letter to the registered firm. Findings should be isolated, edited, and then incorporated into a letter sent to the registered firm.

| INSPECTION CHECK LIST | | |
|--|-----------------------------------|----------------------------|
| Exchange Firm Name: _____ | | |
| Membership No: _____ | | |
| Type of Organization: <input type="checkbox"/> Bank/Co-op <input type="checkbox"/> Corporate <input type="checkbox"/> Partnership | | |
| Membership: <input type="checkbox"/> IND <input type="checkbox"/> FNO | | |
| Number of employees: _____ | Number of Branch Offices: _____ | |
| Number of total Authorized Representatives: _____ | Inspection Start Date: _____ | Inspection End Date: _____ |
| Date of previous inspection: _____ | | |
| General major violations in the previous inspection require additional investigation: <input type="checkbox"/> Yes <input type="checkbox"/> No | | |
| Investigation conducted: <input type="checkbox"/> Yes <input type="checkbox"/> No | | |
| Date of report: _____ | | |
| SECTION 1.00 PERFORMED | Particular of affected Membership | Compliance |
| A. CUSTOMER RELATED INFORMATION AND TRADING PRACTICES | | Yes No |
| Customer Account Information Form (C-AIF) filed in as per Rule 10.01 of SEC, 1987, if any deficiencies found please attach supporting | | |
| Customer Identification (KYC) | | |
| Identification information | | |
| Authenticity of Client's Signature & Photo (To be examined by a SA/MD or any authorized person) | | |
| Clear Agreement | | |
| Written Buy/Sale Orders from clients as per clause 4.11 of SEC, 1987 | | |
| Trade Confirmation to the Customers as per Rule 9 of SEC, 1987 | | |
| Customer's Account Statements as per Rule 8 of SEC, 1987 | | |
| Customer Complaint Record | | |
| Unauthorized Transactions | | |
| Telephone Orders properly recorded & signed as per Rule 4.11 of SEC, 1987 | | |

| B. SUPERVISORY MANAGEMENT | Yes | No |
|--|-----|----|
| Appointment of Supervisory Compliance Authority | | |
| Internal Written Policies and Procedures of internal control system | | |
| Operational Review | | |
| Supervision of New Customer Accounts | | |
| Supervision of Daily Transaction | | |
| Review & Handling of Customer Complaints | | |
| C. BOOKS AND RECORDS | Yes | No |
| Maintenance of Cash Book, Bank Book, General Ledger and Clients Financial Ledger as per Rule 8 of SEBI, 1987 | | |
| Maintenance of Stock Register/book as per Rule 13 of the SEBI Act, 1956 (as amended) (a) Separate a separate sheet for each client; (b) Separate sheet for each client; (c) Separate sheet for each client | | |
| Maintenance of Client Register as per Rule 13 of the SEBI Act, 1956 (as amended) (a) Separate sheet for each client; (b) Separate sheet for each client; (c) Separate sheet for each client | | |
| Other Items, if any (mentioned): | | |
| D. BUSINESS AND RECORDS | Yes | No |
| Statement of Transaction in Dealer Account with required verification given for 1 (one) year | | |
| Statement of margin loan provided by the stock broker to their clients on a specific date | | |
| Statement of daily trade volume, commission and other charges (if any) for 1 (one) year | | |
| Statement of commission and other charges (if any) transferred from customer consolidated account to company account for 1 (one) year | | |

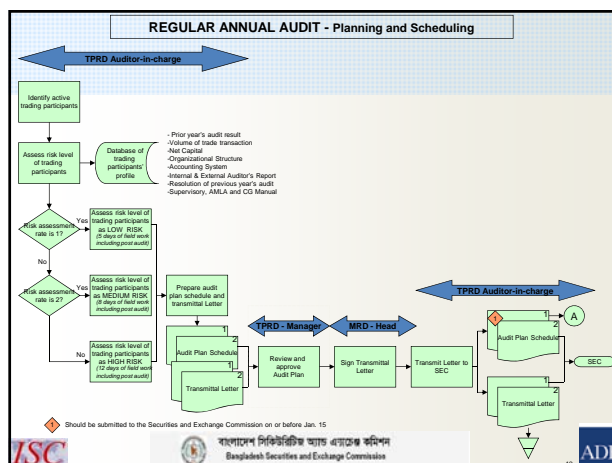
| | Yes | No |
|---|-----|----|
| E. FINANCIAL RISK AND COMPLIANCE | | |
| Last years audited Financial Statements in per Rule 130(a) of the Securities Act reveal when (last, first, no) a negative ability exists, since: | | |
| Net Capital listed in per Rule 302 of Securities and Exchange Commission Rules, 1987 | | |
| Aggregate liabilities on or specific date | | |
| Compliance of rule 1 of the Margin Rules, 1996 | | |
| Employment in single class in rule 3 of the Margin Rules, 1996 | | |
| Maintenance of unconsolidated customer accounts in per Rule 6A of SEC, 1947 | | |
| Compliance of Rule 15 of SEC, 1987 (Risk Based Capital Adequacy i.e. net Capital balance and Aggregate liabilities maximum 1:20) | | |
| Statements of Cash Receipts & Payments required as required by Inspecting officials | | |
| Maintenance of Money Receipts Note and Payment Voucher | | |
| Reconciliation of availability of fund in unconsolidated customers bank account with all Receipts/Payments and all other related transaction on a particular date | | |
| Reconciliation of stock balance of all client with BOMEN's holding report of CYMR, on a particular date | | |
| Reconciliation of Company Account and Disbursements if any. | | |
| Any irregularities in Clients Payments/settlements | | |
| Any other agreement with any other Financial Institution | | |
| F. CYMR, law matters (including account settlement) | Yes | No |
| RO Account Opening Form | | |
| Pay in Transfer form | | |
| Pay out Transfer form | | |
| Statement of Opening Account | | |
| Availability of Different Form of CYMR. | | |
| G. Company Status | Yes | No |
| Minutes of last Board of Directors Meeting | | |
| Latest Form 323 of RJCRC | | |

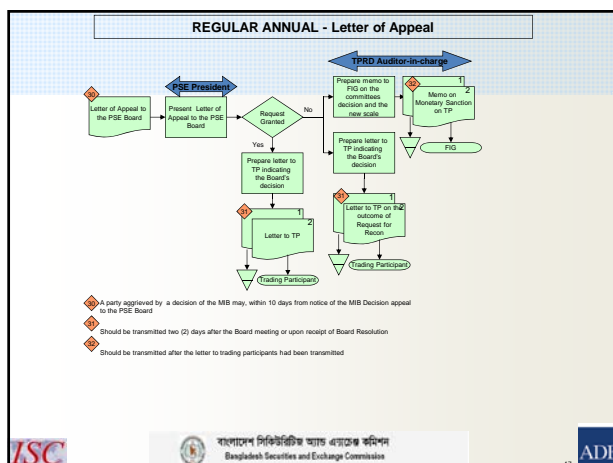
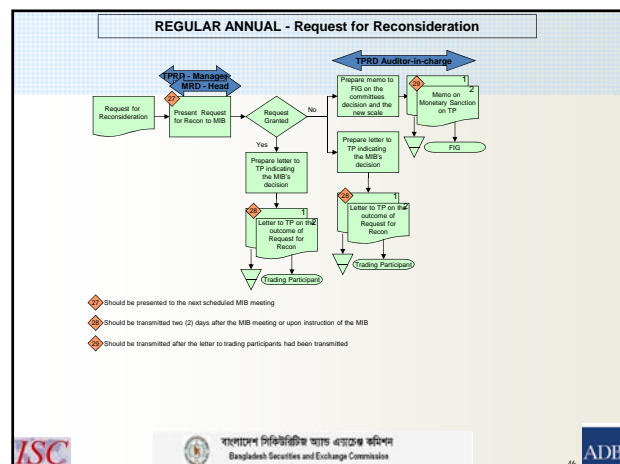
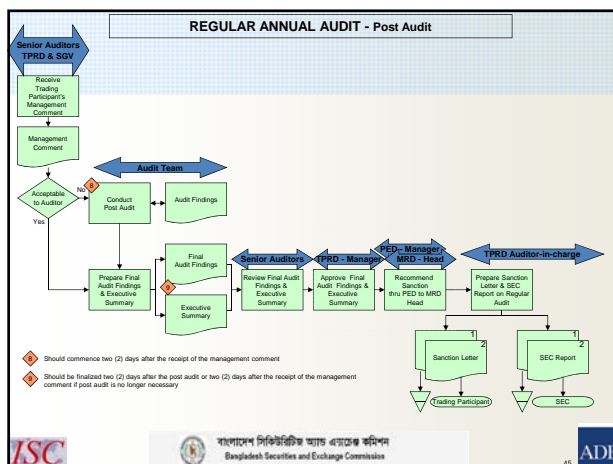
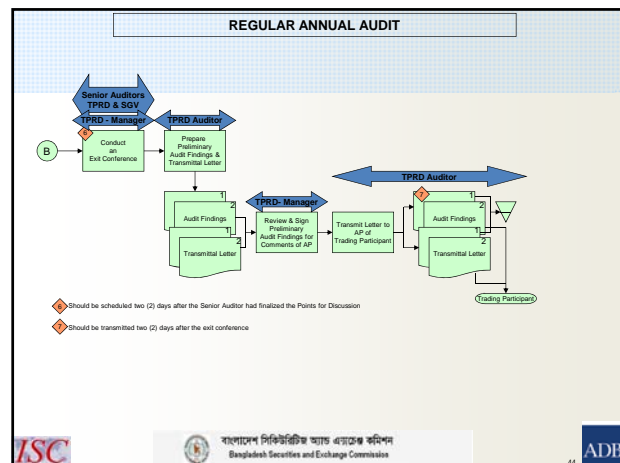
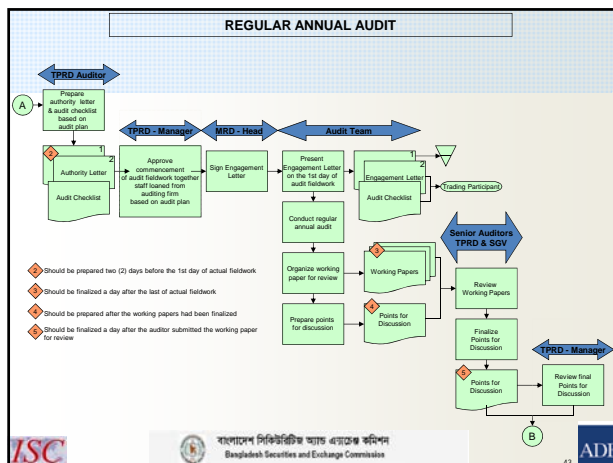
Organization of the Report

Minimum Elements of Inspection Reports

- Risk Assessment

- Inspection Findings
- Liquid Capital
- Internal Controls
- Supervisory Review and Approval
- Follow up Action required





BSEC TRAINING WORKSHOP ON RISK BASED SUPERVISION

'Inspection process for Intermediaries and the Exchanges/Depository'

Hotel Purbani International Limited
 Dhaka, Bangladesh
 19 June 2014, Thursday

ADB TA-8228 BAN: Enhancing Efficiency of the Capital Market
 Component 1: Strengthened enforcement capacity of BSEC

ISC
 The International Securities Consultancy Limited

Agenda Session III

- SRO Oversight
- Key areas for inspection
- Exchange Inspections
- CDS Inspections
- Risks in CDS

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SRO Oversight

| REGULATOR | MOU oversight process | SRO |
|--|-----------------------|---|
| Approves rules | ↔ | Adopts rules |
| Sets principles for corporate governance | ↔ | Adopts corporate governance policies and procedures |
| Review reports | ↔ | Files financial and other reports |
| Ongoing monitoring and communication | ↔ | Administers & enforces rules and supervision programs |
| Inspection of operations | ↔ | Prepares self-assessment of operations |

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Some Key Areas

- Corporate Governance
- Financial Stability
- Demutualisation Implementation
- SRO Relationship – MOU
- Review of Operations

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Some Key Areas

- Technology Planning
- Trading System Development
- Data warehousing
- Index calculation and information dissemination
- Disaster Recovery Plans

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Key Areas

- Surveillance Systems
- Disclosure Systems
- Record Retention Policies
- Links to CSD - efficiencies
- ATS, Bond market Issues

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Key Areas

- Compliant process and status
- CSD Independence
- CSD Risk Management
- Guarantee Fund Planning

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Oversight Examinations

```

graph TD
    FA[FULL AUDIT] --- CE[COMPLAINT / EVENT - DRIVEN]
    RB[RISK-BASED] --- CE
    
```

FULL AUDIT
 Regular inspections, tending to review all areas, or the same pre-identified areas, each time. Differentiation in scope is often limited for different areas reviewed.

RISK-BASED
Preferred model
 Targeted inspections, focused on higher risk areas. The areas reviewed and scope of review often changes from one inspection cycle to the next.

COMPLAINT / EVENT - DRIVEN
 Ad hoc inspections to address specific issues. Used in both models.

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Preparation

- Implementing an inspection program on a "Risk Based Supervision" (RBS) Approach
- Management, Organization of Inspection teams and maintenance of oversight working papers
- The Oversight Inspection (Audit) Program
- Selection of the Areas to reviewed on each inspection cycle

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Exchange & CSD Inspections

- Pre-Inspection preparation and desk- based supervision
- Allocation of resources and time to different functional areas

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Exchange & CSD Inspections

- Technology systems (Trading, Disclosure and Surveillance), security and planning including disaster recovery (Specialist Skills, outside help?)
- Trading systems and market information dissemination review

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Entry Interview (Exchange & CSD)

- Pre Desk Work
- Understand the issues and key metrics
- Have a clear work program, requirements and objectives
- Tell the senior people what you expect to do, how long it will take and the resources being applied
- Make it clear you will undertake an exit interview and make recommendations based on findings and give an opportunity to comment

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Exchange

- Entry Interview
- Corporate Governance, and Financial Stability
 - Financial Stability – Plans & Budget
 - Governance & Conflict of Interest (CG Rules -3 Directors)
 - Demutualisation Implementation
- Exchange Operational Review
- Compliance Review



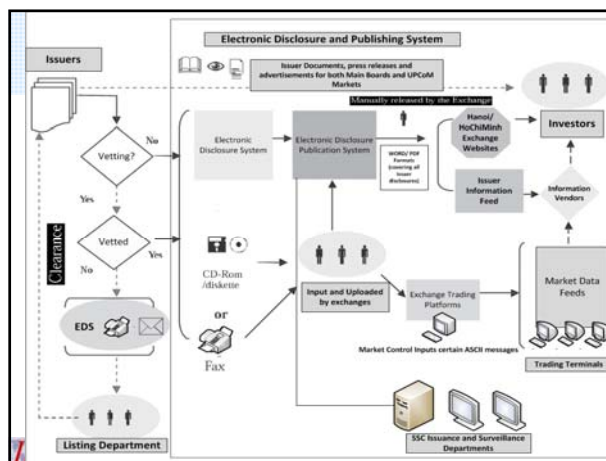
Exchange Operational and Compliance Review

- Interview management and Key Staff
- Document Policy and procedures
- Review Board Minutes and Decisions
 - Governance
 - Conflicts
 - Adequacy of Decisions (breaches of rules)
- Test against Case Files
- Findings
- Review
- Document Findings



Exchange

- Review of Primary Market (IPOs Continuous Disclosure)
- Issuance and Disclosure Management
- Market Surveillance Activities
- Membership, Member Surveillance, and Capital Adequacy
- Miscellaneous areas of review: (CSD Links, Record Retention, Complaints Handling)



Market Surveillance

- Review Market Dynamics and Volatility
- Review of Surveillance System and Processes
- Review open and closed investigations
- Review of Actions taken
- Review of Adequacy Staff
- Review Conflicts with Market Operations Role



Surveillance Investigations

- Access to Beneficial Holders
- Access to Issuer disclosure
- Access to Intermediary Records
- Arrangements for sharing of information
- Domestic and Foreign regulators



Member Compliance

- Trading Participants' Compliance
- Audit of members Activities
- Audit Results Overview
- Review files for completeness



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Capital Adequacy

- Review capital adequacy returns
- Review sample returns for accuracy, completeness and sufficiency



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Exchange Oversight report

- Exit Interview
- Documentation of Findings
- Follow up



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CSD functionality

| Division / Department | Responsibilities |
|------------------------------------|--|
| OPERATIONS DIVISION | Manage day to day operations of the CSD |
| Clearing & Settlement Department | Post-trade processing, through to settlement Added-value services such as securities lending and repo |
| Corporate Events Department | Processing of corporate events |
| Securities Registration Department | New and additional registration of securities |
| Depository Services Department | Custody services (account administration, statements etc) Vault operations, receipt and withdrawal of physical certificates |
| Issuer Services Department | Processing of issuer requests (for information on securities holders etc) |
| Membership Department | Admission and termination of CSD members Monitoring of member compliance with capital requirements and other regulations |



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CSD functionality

| | |
|-------------------------------------|---|
| TECHNOLOGY DIVISION | Drive new IT infrastructure developments, applications and solutions Deliver and support IT services for the CSD |
| Infrastructure Department | Network & participant access Hardware / data centre / disaster recovery centre Capacity management Daily IT operations (running the jobs) |
| Applications Department | Software maintenance & development: Clearing settlement and depository systems Added value systems (e.g. stock lending)* Non business-critical systems (e.g. accounting) |
| IT Planning & Governance Department | IT strategy, planning & budgets Quality assurance and testing System security Business continuity planning Programme management office* |
| IT Customer Relations Department | IT support and training desk Office desktop support Relations with vendors* |



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CSD functionality

| | |
|---|--|
| BUSINESS DEVELOPMENT DIVISION | Plan business expansion Develop new products Market CSD services to issuers, securities companies, custodians, investors and others Manage customer relationships |
| Strategy, Research & Product Development Department | Strategic planning Research and development of new markets and products |
| Marketing Department | Marketing of all services External customer relationships |



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| CSD functionality | |
|--------------------------------------|---|
| CORPORATE SERVICES DIVISION | Oversee the HR, finance & administration, and corporate communications functions |
| Finance Department | Accounting, budgets, treasury |
| Human Resources Department | HR policy, administration and payroll |
| Administration Department | Management of premises and miscellaneous services |
| Corporate Communications Department* | PR, event management, corporate website, relationships with other exchanges, investor relations (if demutualised), international co-operation |
| Other units (reporting to the CEO): | |
| Internal Audit and Compliance | Provide independent assurance to the Board, Audit Committee and management that the CSD's risk management, controls and governance processes are adequate and effective |
| Risk Management | Management of risks arising from clearing and settlement and other operations |
| Legal & Company Secretary* | |

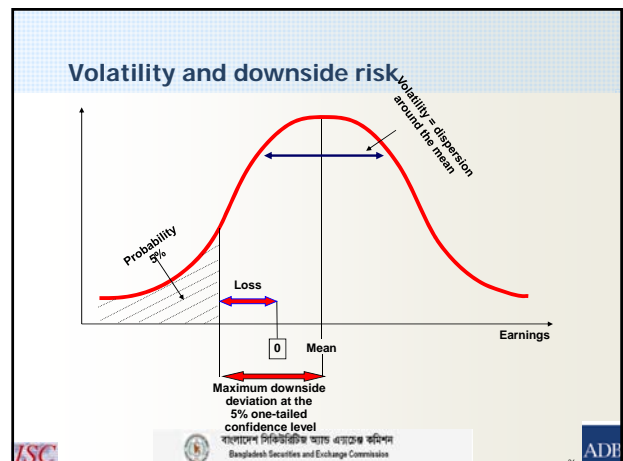
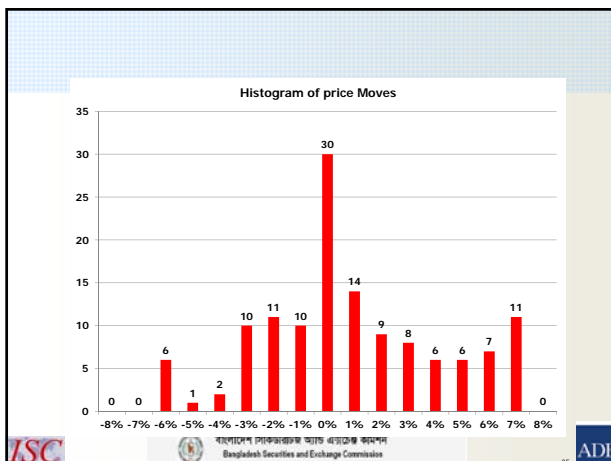
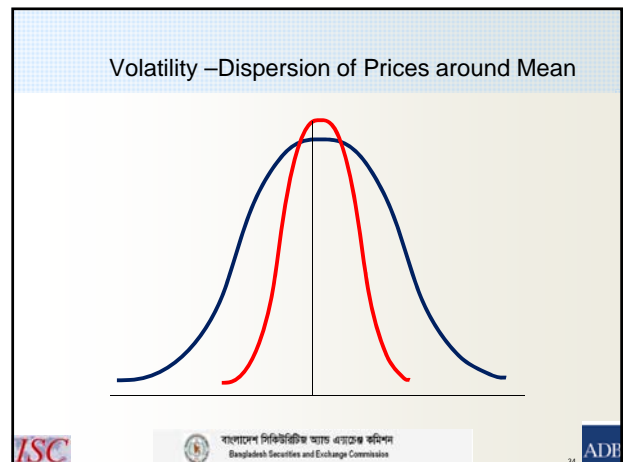
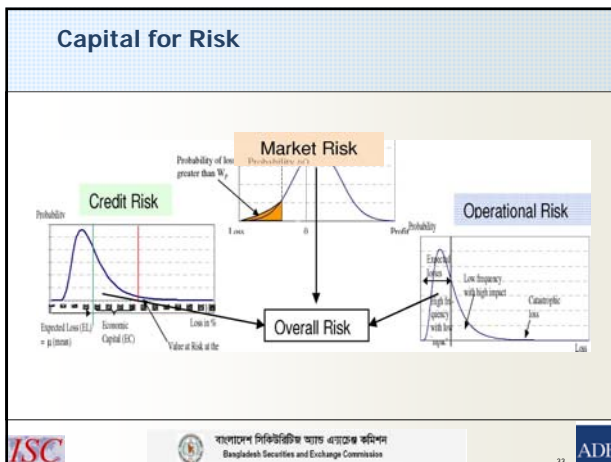
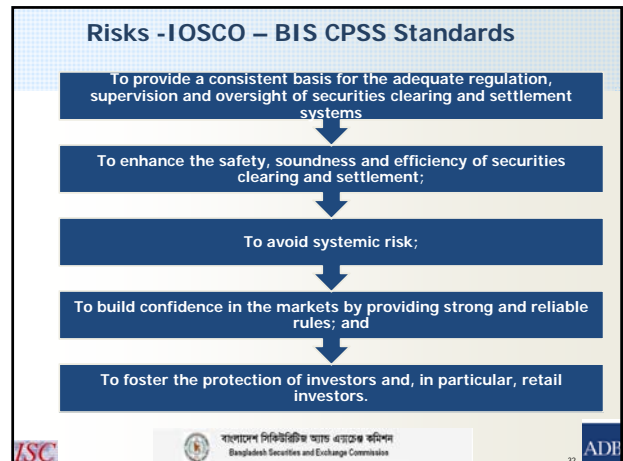
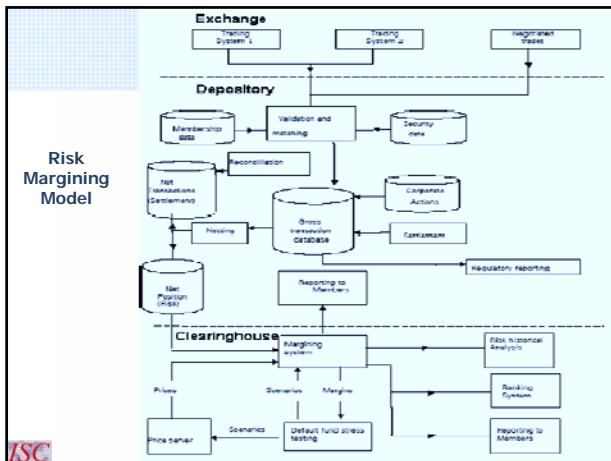
| CSD Inspections |
|---|
| <ul style="list-style-type: none"> • Entry Interview • Review of Operations • Financial Standing – Budgets • Internal Audit • Independence of Management Decisions • System Capacity – Reliability – Security • Technology Planning • Disaster Recovery Plans |

| CSD Systems and Risk Review |
|---|
| <ul style="list-style-type: none"> • CSD – IT Systems, Settlement Process and Settlement Bank methodology • CSD - Risk Management • CSD – Physical and System Security Aspects of Depository |

| CSD Review |
|---|
| <ul style="list-style-type: none"> • Settlement Processes • CCP planning • Settlement Banking issues • Depository Processes • Corporate Actions • Registration function • Physical Security review |

| CSD Review |
|--|
| <ul style="list-style-type: none"> • Risk management • Link to member capital adequacy, • Trading Limits (Caps) • Risk deposit requirement |

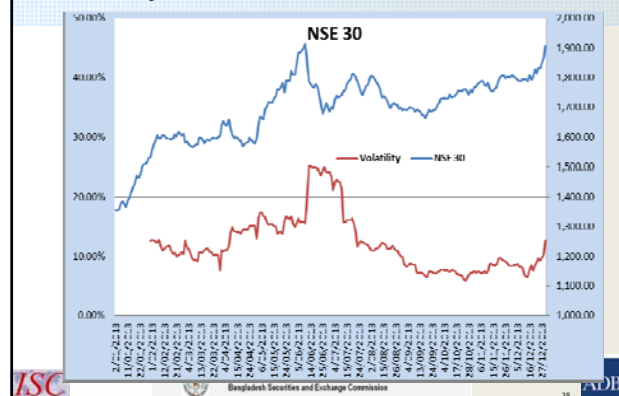
| CSD Review |
|---|
| <ul style="list-style-type: none"> • Collateral management – Investment management policy • Planning for Guarantee Fund - Size, Investment Policy, Management • Complaints • Exit interview • Issuance of inspection findings and follow-up for completion and rectification |



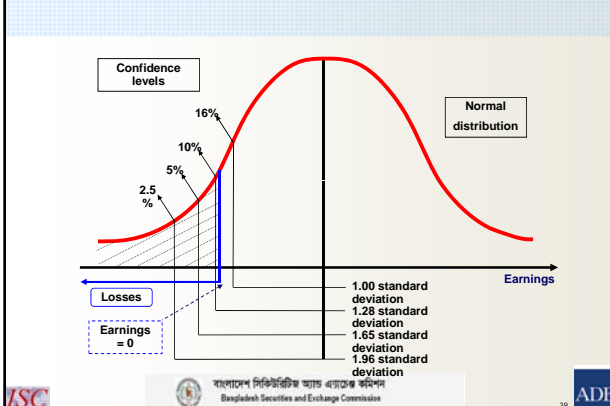
Use of Volatility

- Once you know volatility you can measure the likely change in price over a time period either up or down
- Inputs are
 - Current Price
 - Volatility
 - Time
 - Number of Standard Deviations of Movement
- A clearinghouse sets the margin required according to time frame for volatility calculation and number of standard deviations
 - Example 3 days and 4 standard deviation move

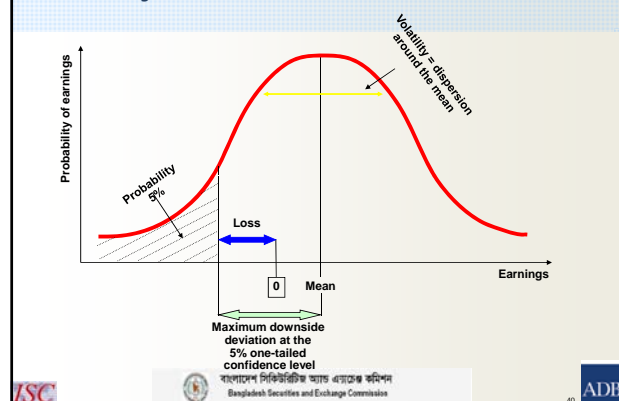
Volatility 2013 for NSE 30



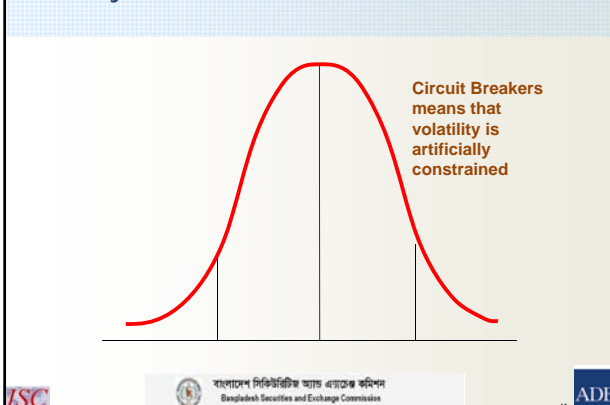
Confidence levels for a normal distribution



Volatility and downside risk



Doubly Truncated Distribution

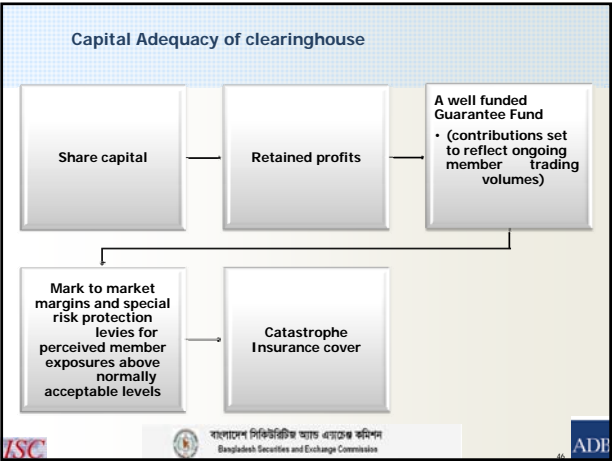
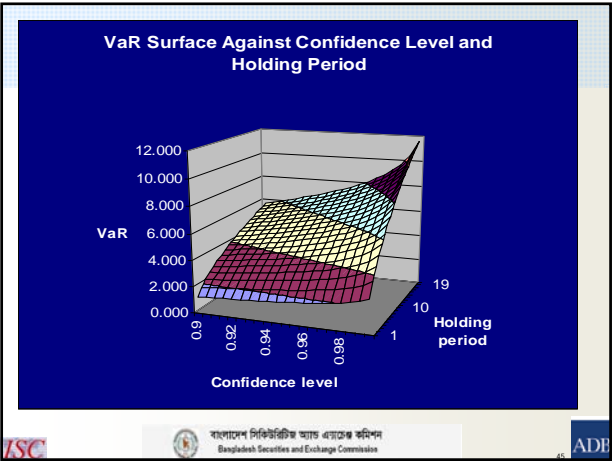


Equity Share N 100,000,000

| Position | N 100,000,000 | | | |
|----------------------|---------------|-----------------------|------------|------------|
| Daily Volatility | 2.58% | | | |
| Annual Volatility | 40.0% | | | |
| Confidence Level (%) | | Holding Period (Days) | | |
| | Multiplier | 1 | 3 | 10 |
| 84.0% | 1.0 | 2,580,000 | 4,468,691 | 8,158,676 |
| 95.0% | 1.64 | 4,231,200 | 7,328,653 | 13,380,229 |
| 99.0% | 2.33 | 6,011,400 | 10,412,050 | 19,009,716 |
| 99.9% | 3.0 | 7,740,000 | 13,406,073 | 24,476,029 |
| | | VAR | | |
| | | 24% | | |

| VaR – Foreign Exchange | | | |
|---|-------------------|-------------------------|-----------|
| Position | GBP 10,000,000 | | |
| Current USD/GBP | 1.5747 | | |
| Position Value | USD 15,747,000 | | |
| Risk Factor | USD / GBP FX Rate | | |
| Sensitivity to 1% Change in Risk Factor | USD 157,470 | | |
| Estimated Daily Volatility of Risk Factor | 0.30% | | |
| Confidence Level | Multiplier | Multiplier x Volatility | VAR (USD) |
| 84% | 1.00 | 0.30% | 47,516 |
| 95% | 1.64 | 0.50% | 78,157 |
| 99% | 2.33 | 0.70% | 110,539 |

| VaR and Holding Period | | | | |
|---|------------|-----------------------|---------|---------|
| VARIATION OF VAR WITH HOLDING PERIOD AND CONFIDENCE LEVEL | | | | |
| Confidence Level (%) | Multiplier | Holding Period (Days) | | |
| | | 1 | 3 | 10 |
| 84% | 1.00 | 47,516 | 82,300 | 150,259 |
| 95% | 1.64 | 78,157 | 135,372 | 247,154 |
| 99% | 2.33 | 110,539 | 191,459 | 349,554 |



- Exchange & CSD Inspections**
- Transparency of reports and action programs
 - Enforcement relating to key recommendations

Appendix 1.3: BSEC Risk Based Regulatory Model: Elements of a Risk Based Supervision Framework and RBS – a Supervision Index (November 2014)



বাংলাদেশ সিকিউরিটিজ অ্যান্ড এক্সচেঞ্জ কমিশন
Bangladesh Securities and Exchange Commission

ADB TA-8228 BAN: Enhancing Efficiency of the Capital Market

BSEC - RISK BASED REGULATORY MODEL

ELEMENTS OF A RISK-BASED SUPERVISION FRAMEWORK AND RBS – A SUPERVISORY INDEX

November 2014



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BSEC - Risk Based Regulatory Model

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BSEC - RISK BASED REGULATORY MODEL

1. BSEC should adopt a balanced approach in supervising intermediaries with particular focus on their business conduct and financial soundness, for the protection of investors and for the benefit of the financial industry as a whole.

A balanced approach

2. By adopting a balanced approach, BSEC should seek to:
 - (a) Secure an appropriate degree of protection for the investing public, without stifling market development; and
 - (b) Achieve proportionate risk-based supervision whereby greater supervisory effort can be directed to licensed entities that are classified as having higher scores in the Supervisory Attention Index derived from the probability of regulatory issues and the level of impact the problem may lead to.
3. The Supervisory Attention Index has been devised to assess where a licensed entity fits into a matrix bounded by “High risk firms” which generally refers to licensed entities that warrant closer supervisory attention on account of their management style and the state of their systems and controls and “high impact firms”, which generally refers to licensed entities whose roles and volume of activities in the market, number of clients served, and amount of client or fund assets held are so significant that any instability in their operations may have a significant impact on the investors’ confidence and market stability.
4. By measuring where in the matrix an entity falls, a suitable inspection process can be devised for that entity.
5. No regulatory regime can ensure zero-failure, and the suggested overall supervisory framework should be designed with a view to minimising any adverse impact on the investors and the market when a licensed corporation goes out of business.
6. BSEC should refrain from over-regulation and micro-management. The senior management of each firm is responsible for the licensed corporation’s activities and for properly managing the risks associated with such activities. Appropriate measures should be implemented and maintained for ensuring that the licensed corporation complies with the relevant legislative and regulatory requirements. To this end, senior management of licensed entities should be required to, among other things:
 - (a) Develop and implement appropriate systems and controls commensurate with the scale and depth of the licensed corporation’s business activities;
 - (b) Continually and timely appraise the status of the licensed corporation’s operations and financial position, including qualitative and quantitative risks posed thereto or weaknesses detected therein;
 - (c) Ensure that management and supervisory functions are performed by qualified and experienced individuals; and
 - (d) Ensure that its staff acts honestly, fairly and in the best interests of clients and the integrity of the market.

BSEC - Risk Based Regulatory Model

7. The supervisory activities should primarily focus on the following two areas:

Prudential supervision

8. All capital Market entities will be required to properly manage their financial risks and maintain at all times financial resources commensurate with the level of risk undertaken for the proper performance of their business, including ensuring compliance with certain minimum requirements set out in Financial Resources Rules ("FRR").
9. The FRR will reflect the implementation of the RBCA Committees report November 2014 and these will require each licensed corporation to maintain at all times adequate liquid capital, after making provision for market and counterparty risks, so as to enable it to meet all of its liabilities. Various tools will be employed to assess and monitor licensed entities' financial risks and subject high supervisory attention firms to closer scrutiny, given that their financial distress may bring about significant issues for the industry and BSEC.

Business conduct supervision

10. All licensed entities will be required to properly supervise their business conduct and in particular, they should comply with the requirements of the proposed new Business Conduct Regulations and supported by appropriate Management, Supervision and Internal Control Guidelines as well as abide by general principles such as acting with due skill, care and diligence and dealing with their customers in a fair and honest manner.
11. BSEC should implement programs so that it identifies, assesses and monitors licensed entities' business conduct through on-site inspections and following up on complaints and self-reported breaches. Those firms with a high supervisory index score will be generally subject to more frequent on-site inspections and closer scrutiny.

Supervisory Framework

12. To achieve the above BSEC should deploy a frame work based upon:
- (a) Risk identification
 - (b) Risk assessment and supervisory approach
 - (c) Supervisory outcomes/results
13. This will involve identification of firm-specific risks, utilisation of off-site monitoring and on-site reviews with appropriate corrective actions taken by management of licensed entities. Where necessary, BSEC units will subject the licensed entity to further enquiry / investigation as required. On referral BSEC may impose licensing conditions or restriction notices.
14. This report has already dealt with methodologies for risk identification. As noted above risks fall into two categories:
- (a) financial risks; and
 - (b) business conduct risks.
15. Other risks may be more wide spread arising from non-firm specific issues. These may be:
- (a) Economic and market performance;

BSEC - Risk Based Regulatory Model

-
- (b) Market evolution; and
 - (c) Regulatory Developments.
16. The risk assessment and supervisory approach for all licensed entities should be premised upon the following:
- (a) The senior management bears primary responsibility for ensuring proper management of risks associated with the licensed entity's business, maintenance of appropriate standards of conduct and adherence to proper procedures by the licensed entity on a day-to-day basis; and
 - (b) The level and nature of risks and impact that a licensed entity poses to the regulatory objectives of BSEC essentially determine the intensity of supervision to be applied in respect of that corporation.
17. This paper discusses various supervisory methodologies and tools which when implemented will assist BSEC identify, assess and monitor the relevant risks of a licensed entity. These can be broadly categorised as:
- (a) Appropriate regulations and early warnings mechanism; and
 - (b) By providing detailed risk management guidance for senior management of licensed entities, imposing various regulatory limits (e.g., in the development of margin financing the re-pledging limits that cap the amount of client collateral that can be re-pledged by licensed entities with banks) and the FRR (with its early warning systems), licensed firms are able to properly monitor and manage their financial position and business themselves.

Proactive monitoring

18. This can be broadly categorised into off-site monitoring and on-site review. Off-site monitoring primarily entails maintaining ongoing dialogues with senior management of licensed entities, performing regular sensitivity / stress testing and other detailed analyses of financial and non-financial intelligence, while key business conduct and compliance risks are typically subject to further assessment during an on-site review.

Proportionate Monitoring

19. A proportionate supervisory approach should be undertaken on individual licensed entities commensurate to their risks and the extent of their impact on the capital markets. Effectively, each licensed entity will be subject to review of their regular RBCA financial returns and other submissions to BSEC as well as BSEC's on-site review from time to time.
20. More intensive supervision will, however, be adopted towards licensed entities that pose higher regulatory risks or have significant impact to the market. For example, they may be subject to more frequent inspections and the breadth and depth of the inspection scope may be adjusted, depending on BSEC's risk assessment of the firm. Off-site monitoring may also be stepped up.

Off-site monitoring

21. For the purpose of off-site monitoring, BSEC should maintain regular interactions with licensed entities in order to understand their business models, latest plans and aspirations,

BSEC - Risk Based Regulatory Model

and the risks inherent in such activities, with a view to identifying and assessing the risks arising from their business activities.

22. BSEC should also tap into intelligence from different sources, follow up complaints and any self-reported breaches as well as consider applications for subordinated loans and rule modifications/ waivers upon application by licensed entities. Through consolidating information gathered from various sources, BSEC would be in a better position to form a holistic view of the business profile of the licensed corporation.
23. A major part of the off-site monitoring will be to assess the financial soundness of licensed entities, mainly through analysis of regular financial returns submitted by licensed entities, and identify any licensed entities that may potentially be in financial difficulties. This should be achieved by:
 - (a) the use of system-aided risk indicators (including trend analyses and peer comparisons) to identify firms showing apparent out of sync performance for follow-up actions;
 - (b) performance of sensitivity and stress testing in a timely fashion to identify particular financially vulnerable firms. Increased vigilance will be placed on such identified firms, and where warranted, they may be required to develop and implement appropriate contingency or remedial plans; and
 - (c) the development of the RBCA database system is essential for this purpose.
24. In addition, other information about licensed entities' risks should be collected from time to time through licensed entities' filings with BSEC, including but not limited to annual audited accounts, compliance reports, business and risk management questionnaires, etc.
25. Any issue raised or qualified opinion expressed by the external auditor of a licensed entity should be followed up and where applicable swift actions taken to contain the situation and protect clients which may involve working with the auditor.
26. To enhance BSEC's data analysis, intelligence from other sources should also be collected including:
 - (a) market news or media reports;
 - (b) actions taken by other divisions of BSEC;
 - (c) sharing with or referrals from fellow regulators (such as the CBK, RBA and Financial Intelligence Unit);
 - (d) frequent dialogue with market practitioners / industry and trade associations; and
 - (e) industry surveys conducted by BSEC from time to time.
27. Following up on complaints against licensed entities and self-reported breaches is another important aspect of BSEC's supervisory functions, because they may potentially uncover deep seeded issue inherent thereto. Typically, the process should encompass initial fact- finding, detailed analysis and follow-up actions. Where a regulatory breach is suspected to have been committed by the firm or its staff, such may be subject to further enquiry and/or investigation depending on the seriousness of the breach. Assessment should also be made if the firm has since taken appropriate remedial actions to prevent the self- reported breaches from recurring in the future.
28. Another important task, in the future, will be the handling applications for subordinated loans as well as modification / waivers of rules to facilitate the specific business needs of licensed entities under any new FRRs. These applications should be carefully considered and approval only granted when the interests of the investing public are not prejudiced.

BSEC - Risk Based Regulatory Model

On-site review

29. An on-site review is a key supervisory tool that helps BSEC understand a firm's business operation, risk management and internal controls, and gauge the level of compliance with relevant laws and regulatory requirements. This should enable BSEC to assess whether, and to what extent, licensed entities act with due skill, care and diligence and adopt proper business conduct, procedures and practices in accordance with the relevant laws and regulations. However, it should be noted that on-site reviews cannot identify and correct all breaches and deficiencies, bearing in mind the following factors:
- (a) The scope of review must be limited to selected areas of relatively high importance based on professional judgement and therefore may not reveal all breaches, deficiencies and irregularities that may exist; and
 - (b) The findings of an on-site review only represent a snap-shot of the firm's business activities at a particular point of time.
30. There are four types of on-site review, namely:
- (a) Routine inspection;
 - (b) Special inspection;
 - (c) Thematic inspection; and
 - (d) Prudential visit.
31. Different inspection checklists and programs have to be developed to cover the different business activities conducted by licensed entities, and these should be used as guidance only as the scope and depth of each review is tailor-made to suit the specific circumstances of each case, thereby maximising the effectiveness of BSEC's supervision.

Routine inspection

32. All licensed entities should have a positive probability of being inspected over a reasonable time period (e.g. a 3 to 5 year cycle) and being inspected does not "immunize" the institution from future repeat inspections. Where the number of institutions is small this translates into regular inspections at least once every 3 years, for example. For others, for example over 100 stand-alone pension schemes or 42 insurance brokers this might translate into a random selection on a stratified sampling basis. These inspections are general checks on the firms' systems and controls, as well as their compliance with the relevant rules and regulations, in the area(s) of relatively high importance. Typically, before the inspection is due to commence, the inspection team will identify the key potential risk areas and formulate an inspection plan.
33. BSEC should aim to ensure a balanced top-down and bottom-up approach is adopted which is set to assess the overall effectiveness of a licensed entity's systems and controls for ensuring compliance with key legal and regulatory requirements applicable thereto. This should be achieved by:
- (a) First gaining a high-level understanding of the licensed corporation's business activities, operations, systems and controls, as well as future aspirations, based on information collected and analysis prepared as part of off-site monitoring work and through discussions with senior management; and
 - (b) Taking appropriate examination steps to ascertain how the firm's systems and controls have been implemented in practice, such as -
 - i. Performing walk-through tests on key control procedures and processes;

BSEC - Risk Based Regulatory Model

- ii. Reviewing selected underlying documentation (such as bank and custodian statements to confirm the existence and valuation of assets held) and performing sample compliance tests; and
- iii. Interviewing relevant staff to assess the control environment of the firm.

Special inspection

- 34. Special inspections will be performed on licensed entities suspected to pose imminent risks to the market or to their customers, for example, where there is reason to suspect misappropriation of client assets. In this case, inspection steps are tailor-made to cater for the specific circumstances of each case. Normally, a special inspection will involve carrying out detailed substantive testing and forensic reviews to assist in gauging any potential losses to investors.
- 35. Special inspections should also be performed on a licensed entity if its financial position is considered vulnerable. In this case, an on-site inspection should be arranged as soon as practicable to assess its latest financial and liquidity positions, as well as determine if client interests may be at risk, so that BSEC can move to ring fence the licensed entity if necessary.

Thematic inspection

- 36. Thematic inspection will be the primary tool used to assess the scale and nature of a particular market sector risk mitigation initiative, which may be triggered upon BSEC identifying trends, emerging risks and compliance lapses that require prompt regulatory response. A sample of licensed entities will be selected for review in each round of thematic inspection. The review steps are normally tailor-made, which typically revolve around analysing certain sector-specific business aspects, activities or practices - an example may be determining the extent of client liabilities not covered by client cash balance.

Prudential visits

- 37. Prudential visits will be part of BSEC's continuous supervisory process. Through visiting the office of the licensed entity and meeting with their management team BSEC can obtain a high level understanding of the licensed entity's latest business developments, business outlook and how it manages the challenges it faces. In particular, information on both firm-specific events and significant market / industry events would be discussed during the meeting to assist BSEC ascertain their impact on the licensed firm and the industry as a whole. Such visits will also serve as a platform that enables BSEC to build rapport with the senior management of the licensed entities. They provide an opportunity for sharing views on the market and regulatory environment and discussing any regulatory issues or concerns.

Supervisory outcomes/results

- 38. Strong emphasis should be placed in early detection and management of potential risks so as to contain the damage that may arise in case the potential risk crystallises. It will also strive to ring fence risky firms to minimise the spread of contagion risks. In the event that non-compliance with applicable laws and regulations or control deficiencies have been identified, or where a licensed firm is considered to be running its business aggressively without properly managing the corresponding financial risks, such findings and/or concerns will be communicated to the licensed corporation. The licensed corporation will also be required to

BSEC - Risk Based Regulatory Model

take prompt and effective remedial actions, or where appropriate, implement contingency plans (such as injection of capital or subordinated loans), to deal with the problems.

39. At times there may be a need to alert the BSE or CSD for their consideration of the need for additional risk management measures, such as imposing appropriate trading caps, etc. on the licensed corporation.
40. Where major breaches or non-compliance have been identified, BSEC's enforcement department may conduct further enquiry / investigation into the case and, where appropriate, take disciplinary actions (which include reprimands, revocations or suspension of licenses and monetary fines).
41. In cases where internal controls are poor and client assets may be exposed to misappropriation risks, apart from requiring the firm's senior management to tighten related controls, the firm may be required to appoint external consultants to conduct internal control review or circularisation of client balances and positions. BSEC may also impose appropriate licensing conditions on the licensed entity. If investors' interests are proven to be at imminent risk, expeditious restrictive actions should be taken to preserve the client assets and to contain the damage that could be caused by the firm as far as possible. This can include arranging for the issuance of a notice (after securing approval from BSEC Board) to restrict the way the firm conducts its business or deals with its property.
42. When there are particular issues which should usefully be shared with the industry (for example, some unsatisfactory practices noted from its thematic inspection, survey work and/or other regulatory exercises), BSEC should depending on the nature of the matter, issue a report, circular or compile a list of frequently asked questions and answers to remind the industry of particular legal or regulatory requirement and/or to better communicate the expected standards. Upon identifying more fundamental concerns (including new or emerging risks) which require a regulatory response, BSEC could initiate a detailed review of the regulatory framework for the relevant areas.

Risk profiling Techniques

43. To assist in the process of identifying which firms should have heightened attention a risk based supervision framework will involve risk profiling firms.

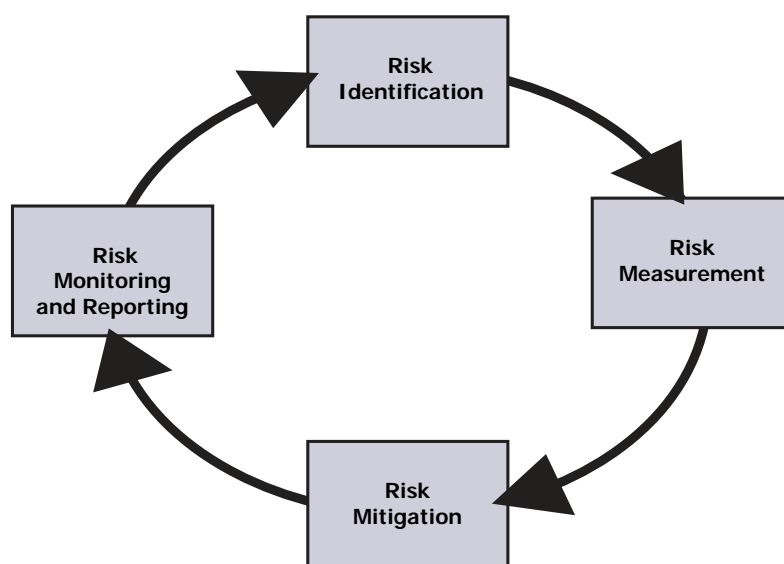
RBS – A supervisory Index

Introduction

1. The previous section covered: “ELEMENTS OF A RISK-BASED SUPERVISION (RBS) FRAMEWORK” this RBS framework envisaged a regulatory model in place that enabled BSEC to identify which intermediaries posed the highest risks to BSEC.
2. Thus it is essential that BSEC has a methodology as part of its introduction of risk based supervision of determining which intermediaries pose greatest risk in order for BSEC to devote more attention and resources to these firms.
3. Such a model of RBS envisages BSEC implementing a risk matrix methodology to risk score intermediaries as to the probability of causing regulatory issues and the likely impact that the firm may have. This section develops two alternative risk scoring methodologies for BSEC drawing on the experience in other jurisdictions particularly the United Kingdom’s FSA’s Arrow system, the Australian prudential regulator, APRA’s ‘SOARS/PAIRS’ systems and the development of the risk profiling for the Kenya Capital Markets Authority.
4. The risk profiling methodologies proposed in this paper have considered the Botswana market characteristics. Initially the two alternative methods are presented and experience elsewhere has seen utilisation of both models and then the selection of the most appropriate one based on practical field application. The first model is more appropriate to Capital market entities and the second more suitable for Insurance and pension fund oversight.

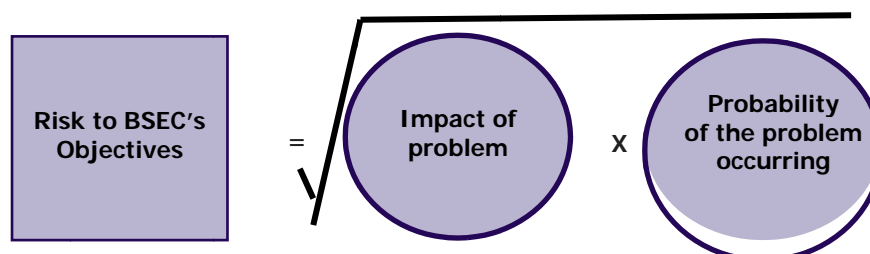
Framework Overview

5. The methodologies framework can be described as follows:

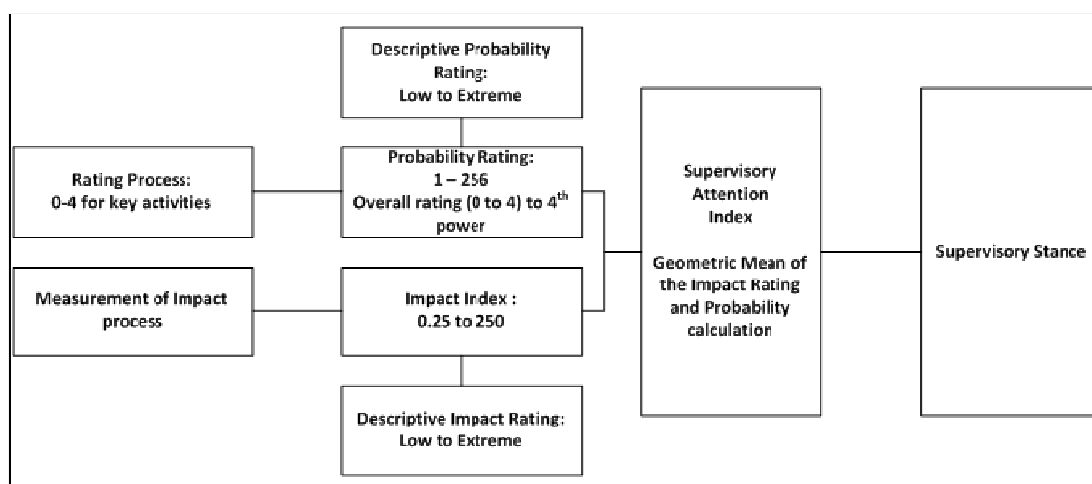


BSEC - Risk Based Regulatory Model

6. BSEC will consider risk to be the combination of impact (the potential harm that could be caused) and probability (the likelihood of the particular event occurring). This may be shown as follows:



7. Another way at look at this proposition is to consider the interaction of impact and probability of default as follows:



8. In BSEC context, it combines calculations of impact and probability factors to give a measure of the overall risk posed to its statutory objectives. BSEC will then use this measure to prioritise risks and make decisions on what, if anything, its regulatory response should be.
9. It also uses it to set out strategic aims and outcomes and to allocate resources based on its regulatory priorities.

Impact and probability Framework

10. Thus the Supervisory Attention Index has been devised to assess where a licensed entity fits into a matrix bounded by "High risk firms" which generally refers to licensed entities that warrant closer supervisory attention on account of their management style and the state of their systems and controls and "high impact firms", which generally refers to licensed entities whose roles and volume of activities in the market, number of clients served, and amount of client or fund assets held are so significant that any instability in their operations may have a significant impact on the investors' confidence and market stability. By measuring where in the matrix an entity falls, a suitable inspection process can be devised for that entity.
11. Scoring within the framework is on a simple five-point scale: impact and probability (and risk – the combination of the two) are each rated as either:
- (a) Low;
 - (b) Lower Medium;

BSEC - Risk Based Regulatory Model

- (c) Upper Medium;
- (d) High; and
- (e) Extreme.

12. BSEC calculates the impact and probability associated with the firm as a whole, as well as assessing the risk associated with issues relating to the firm. The rating will determine the overall approach and provides BSEC with a supervisory attention index.
13. The supervisory index is the geometric mean of the impact rating (X) and the firm's probability rating (Y) of causing a regulatory concern (Geometric Mean = Square root (X * Y)). BSEC thus utilises a risk scoring matrix to profile licensed entities as follows:

| Impact Rating | Impact rating | Impact index | Supervisory Attention Index | | | | |
|--------------------|--------------------|--------------|-----------------------------|--------------|--------------|------|---------|
| | Extreme | 250 | 16 | 35 | 63 | 142 | 253 |
| | High | 125 | 11 | 25 | 45 | 101 | 179 |
| | Upper Medium | 12.5 | 4 | 8 | 14 | 32 | 57 |
| | Lower Medium | 1.25 | 1 | 3 | 4 | 10 | 18 |
| | Low | 0.25 | 1 | 1 | 2 | 5 | 8 |
| | Probability rating | | Low | Lower Medium | Upper Medium | High | Extreme |
| Probability index | | | 1 | 5 | 16 | 81 | 256 |
| Probability Impact | | | | | | | |

14. The supervisory rankings may also be colour coded off the matrix as follows:

| Supervisory Attention Index | |
|-----------------------------|--------------|
| Status | Matrix level |
| Normal | 1-4 |
| Watch List | 5-20 |
| Remedial Action | 21-50 |
| On-site Supervision | 51-100 |
| Restructure | >101 |

15. The key categories are :
 - (a) Normal Supervisory Action;
 - (b) Watch List (Entities requiring much regular Supervisory Action);
 - (c) Remedial Action Mandatory;
 - (d) On-site Monitoring and Oversight; and
 - (e) Restructure or revocation of license.
16. Rankings are used to assess the supervision appropriate to the licensed entity as well as incentives for best practice compliance by intermediaries from a regulatory and administrative view point.
17. BSEC will determine a frequency of profiling assessment and it is likely that the risk profiling exercise will be carried out at the beginning of each year and half year reviews will be conducted to track material changes, this may be more frequent, if necessary, based on issues arising from regular monthly or quarterly reporting by entities.
18. Intermediaries which have been profiled as remedial action or on-site supervision required will be subjected to extremely close supervision, during which all of operations are covered.

BSEC - Risk Based Regulatory Model

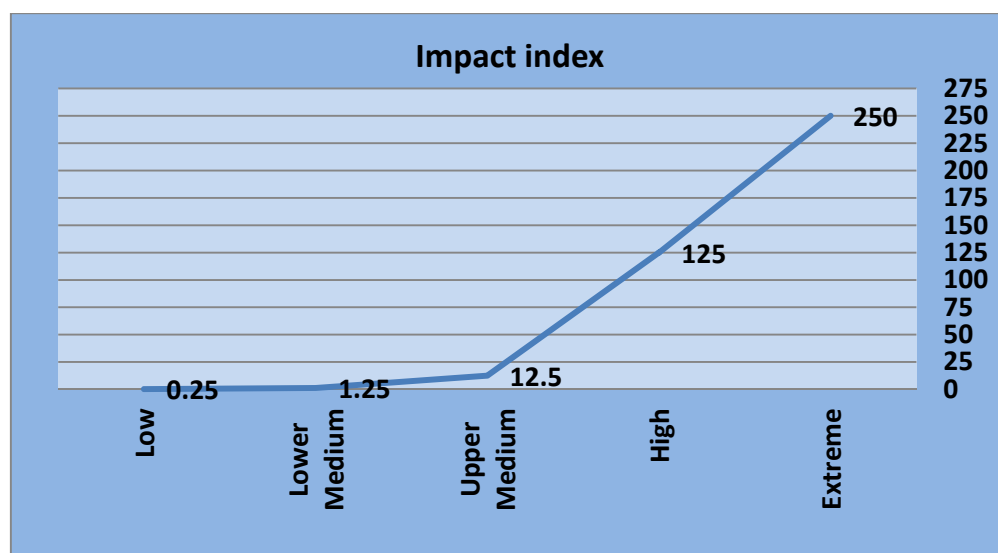
19. On-site inspections will be carried on a shortened timetable every year and regular off-site assessments will also be carried out on them.
20. Watch listed intermediaries will also undergo increased intensity in supervision during which all areas are covered. Both on-site and off-site inspections will be carried out as required but at least once a year.
21. Normal supervisory action intermediaries undergo modest supervision covering only the target core and the non-core but essential areas. Once a year onsite inspections are conducted and off-site assessments are done on routine basis. For some intermediaries cycles could be extended to once every two or three years.
22. Should a firm pose extreme risk an appropriate action plan will be drawn up as to necessary action which may include restructuring or statutory management action.

Impact Index

23. The impact index was set as follows:

| | | |
|-----|----------------------------------|------|
| (a) | Low impact | 0.25 |
| (b) | Lower medium (5 X low) | 1.25 |
| (c) | Upper medium (10 X lower medium) | 12.5 |
| (d) | High (10 times lower medium) | 125 |
| (e) | Extreme (2 X high) | 250 |

24. The index is an approximation to an exponential progression as see below:



25. An impact is a particular event or set of circumstances that presents risks to BSEC's statutory objectives and where the overall level of risk is considered sufficient to warrant action. The type of issues may be depicted as follows:

BSEC - Risk Based Regulatory Model

| Risk to Objectives | Description |
|--------------------------------------|---|
| Financial Failure (FF) | The level of threat to the market confidence and consumer protection statutory objectives - arising from the insolvency or illiquidity of a firm, and the potential for contagion among other market participants, including participants in different market sectors. For high-impact firms/groups this may also include financial losses that, while short of causing failure, can still adversely affect market confidence because of the scale of these firms/groups in relation to particular markets. |
| Misconduct and/or mismanagement (MM) | The level of threat to the consumer protection and market confidence statutory objectives of mis-selling or mis-handling of regulated products by entities, of inappropriate behaviour by firms in their wholesale market activities, or other mismanagement of their operations. |
| Customer understanding (CU) | The level of threat to the consumer protection and public awareness statutory objectives arising from possible lack of understanding by customers of regulated products bought from entities. |
| Market quality (MQ) | The level of threat to the market confidence and consumer protection statutory objectives arising from possible deterioration in a market's function. This may relate to IPOs, new market products being introduced like REIT, ETFs etc. where a large entity may through its actions undermine confidence in the market. |
| Fraud or dishonesty (FD) | The level of threat to the financial crime and market confidence statutory objectives of the incidence of fraud or dishonesty – either within entities, or by external parties defrauding entities. |
| Market abuse (MA) | The level of threat to the financial crime, consumer protection and market confidence statutory objectives of market abuse conducted by entities. |
| Money laundering (ML) | The level of threat to the financial crime and market confidence statutory objectives of prevention of money laundering conducted through entities. |

26. For each issue (whether related to an individual firm or thematic), BSEC will take into account not only quantitative information about the scope and severity of the potential problem (e.g. the number of customers affected, or the monetary amounts involved) but also

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qualitative factors (e.g. the vulnerability of the customers and the nature of the harm they are likely to suffer).

27. In assessing the whole firm, impact is designed to capture the size or 'regulatory footprint' of the firm and the potential harm it could do to BSEC's statutory objectives.
28. BSEC initially calculates this using numerical data, taken from the firm's regulatory returns.
29. Some examples of the types of data used to calculate impact for firms is as follows:

| | Low | Lower Medium | Upper Medium | High | Extreme |
|-----------------------------------|--------------|-----------------------|-----------------------|-----------------------|---------------|
| Total Liabilities | <100 mil Tk | 100-500 mil Tk | 500 mil -1 Bn Tk | 1 Bn to 3 Bn Tk | >3 Bn Tk |
| Number Active Customers | <1000 | 1000-5000 | 5000-10000 | 10000-20000 | >20000 |
| Settlement Max last 6 mths | < 100 mil Tk | 100 mil to 200 mil Tk | 200 mil to 500 mil Tk | 500 mil to 750 mil Tk | > 750 mill Tk |
| Margin Accounts | <100 mil Tk | 100-500 mil Tk | 500 mil -1 Bn Tk | 1 Bn to 3 Bn Tk | >3 Bn Tk |
| Impact Score | 0.25 | 1.25 | 12.5 | 125 | 250 |

30. Impact measures are, at best, proxy measures. Supervisory overrides can and do, therefore, take place where BSEC does not consider the numerical measure is a fair reflection of the firm's impact. From a review of each of the above matrix a firm will be classified as having the appropriate Impact index number.

Probability index

31. When considering the probability of harm to BSEC's objectives, BSEC consider both the gross risks inherent in a particular product, line of business, sector or firm, and the adequacy of the controls needed to reduce that risk.
32. The risk is mitigated either by controls or the Risk Based (Liquid) Capital held by the firm.
33. Two models have been devised as a cross check methodology.
34. Initially both models will be used and then at a later date probably rationalised into a final single model. In both risk models, BSEC classifies probability under ten high-level 'risk groups'. These 'risk groups' are further divided into 'risk elements'. These cover both business and control risks. The current set of risk groups and elements is as follows:

| | Risk Groups | Risk Elements | Level of Risk | Risk Weight | |
|---|-------------------------------|---------------|---------------|-------------|--|
| 1 | Environmental Risks | 1 | M | 4 | Economic Environment |
| | | 2 | M | 4 | Competitive Environment |
| 2 | Customers, Products & Markets | 3 | H | 16 | Institutional Client/Counterparty Characteristics (strength, relationship, and business generated) |

BSEC - Risk Based Regulatory Model

| | Risk Groups | Risk Elements | Level of Risk | Risk Weight | |
|---|---------------------------------------|---------------|---------------|-------------|--|
| | | 4 | M | 4 | Retail Customer Characteristics (High net worth, small or agency clients) |
| | | 5 | M | 4 | Institutional Product/Market Characteristics (Equity Bonds, IPOs) |
| | | 6 | M | 4 | Retail Product Characteristics (Speculative, Blue chip, Discretionary) |
| | | 7 | H | 16 | Distribution Channels (Agents, Banks, Internet, Shop Fronts) |
| | | 8 | H | 16 | Conflicts of Interest |
| 3 | Business Process Risks | 9 | L | 2 | Litigation/Legal Risk (disclosed or rumoured) |
| | | 10 | H | 16 | People Risk including Turnover Rate |
| | | 11 | H | 16 | IT Systems |
| | | 12 | M | 4 | Structure & Ownership Reputational Risk |
| 4 | Prudential Risks | 13 | H | 16 | Credit Risk (level of uncollected client amounts, controls over client dealing, exposure to advisors overtrading client funds) |
| | | 14 | H | 16 | Market Risk |
| | | 15 | H | 16 | Operational Risk |
| | | 16 | M | 4 | Liquidity Risk |
| | | 17 | M | 4 | IPO Underwriting Risk |
| | Control Risk Elements | | | | |
| 5 | Customers, Products & Markets Control | 18 | M | 4 | Accepting Customers |
| | | 19 | M | 4 | Sales Process & Product Development |
| | | 20 | H | 16 | Complaints and Post Sale Handling of Customers/Counterparties |
| | | 21 | H | 16 | Market Conduct Controls |
| | | 22 | L | 2 | Membership Arrangements for Exchange(s) |
| | | 23 | H | 16 | Conflict of Interest Management |
| 6 | Financial and Operating Controls | 24 | H | 16 | Clearing and Settlement Arrangements |
| | | 25 | H | 16 | Financial Controls |
| | | 26 | M | 4 | IT Security and Controls |
| | | 27 | M | 4 | Policies, Procedures and |

BSEC - Risk Based Regulatory Model

| | Risk Groups | Risk Elements | Level of Risk | Risk Weight | |
|----|------------------------------------|---------------|---------------|-------------|---|
| | | | | | Controls |
| | | 28 | M | 4 | Human Resources Controls |
| | | 29 | H | 16 | Security of Client Assets or Client Money |
| | | 30 | M | 4 | Business Continuity Planning |
| 7 | Prudential Risk Controls | 31 | H | 16 | Credit Risk Controls |
| | | 32 | H | 16 | Market Risk Controls |
| | | 33 | H | 16 | Operational Risk Controls |
| | | 34 | H | 16 | Liquidity Risk Controls |
| 8 | Control Functions | 35 | H | 16 | Compliance |
| | | 36 | M | 4 | Internal Audit |
| | | 37 | M | 4 | Enterprise-wide Risk Management –does it exist, is there higher oversight |
| 9 | Management, Governance and Culture | 38 | H | 16 | Culture & Management (Reviewer's assessment) |
| | | 39 | H | 16 | Corporate Governance |
| | | 40 | M | 4 | Relationship with Regulators |
| | | 41 | M | 4 | Strategic Planning |
| | | 42 | M | 4 | Relationship with Rest of Group |
| 10 | Capital Liquidity & | 43 | H | 16 | Adequacy of Capital |
| | | 44 | H | 16 | Adequacy of Liquidity |
| | | 45 | M | 4 | Adequacy of Surplus capital Capital impairment |

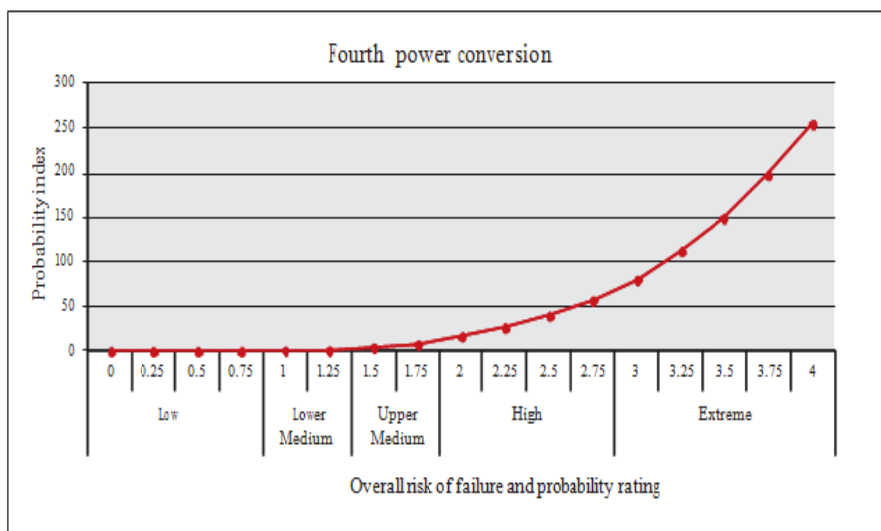
35. The highlighted risks are core risk issues that should be addressed by the firm. Each risk area is weighted between low, medium and high with low being rated at “2”, medium is the square of the low rate 2 being 4 and high is the square of the medium 4 being 16.
36. BSEC will rate all core risks and those other ones they believe apply to the firm. To assist this process a scale has been devised to rate each of the above risk elements as follows:

| Status | Score |
|---------------|-------|
| Excellent | 100% |
| V Good | 85% |
| Good | 75% |
| Upper Average | 60% |
| Lower Average | 40% |
| Poor | 15% |

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| | |
|--------|----|
| V Poor | 0% |
|--------|----|

37. Once the elements of risk have been scored it will provide the probability rating that a problem may arise. This is also measured as an exponential series. This is achieved by taking the total element score number from the weighted rating of factors used to assess risk. This weighted number is re-scaled to be calculated between 0 and 4 and the resultant assessment has been raised to the 4th power. This may be depicted as follows:



38. This index enables a mapping to indicative ratings similar to those used by S&P and Moody's ratings (S&P and Moody's both use similar processes to create indexes). This can be shown as follows:

| Probability index | Indicative external rating |
|-------------------|----------------------------|
| 1 | AAA |
| 1 | AA+ |
| 1 | AA |
| 1 | AA- |
| 2 | A+ |
| 3 | A |
| 5 | A- |
| 8 | BBB+ |
| 11 | BBB |
| 16 | BBB- |
| 26 | BB+ |
| 39 | BB |
| 57 | BB- |
| 81 | B+ |
| 123 | B |
| 181 | B- |
| 256 | CCC |

39. To rate the probability the model also takes an overall view of the firm, weighing both the positive and negative aspects and the importance of each risk element to the firm.
40. The approach to calculating the risk impact in firms will evolve as new regulatory returns come on-line as part of the Risk Based Regulatory Model and the roll out of risk based supervision.

BSEC - Risk Based Regulatory Model

Sample Risk Scoring Model I

41. Below is a sample rating and calculation of the probability of a firm causing a regulatory issue:

BSEC - Risk Based Regulatory Model

| | Risk Groups | Risk Elements | Level of Risk | Risk Weight | | Assessment | |
|-----|---------------------------------------|---------------|------------------------|-------------|---|---------------|-----------------------|
| 1 | Environmental Risks | 1 | M | 4 | Economic Environment | Poor | ▼ |
| | | 2 | H | 16 | Competitive Environment | Upper Average | ▼ |
| 2 | Customers, Products & Markets | 3 | H | 16 | Institutional Client/Counterparty Characteristics | Poor | ▼ |
| | | 4 | M | 4 | Retail Customer Characteristics | Upper Average | ▼ |
| | | 5 | M | 4 | Institutional Product/Market Characteristics | Upper Average | ▼ |
| | | 6 | M | 4 | Retail Product Characteristics | Good | ▼ |
| | | 7 | H | 16 | Distribution Channels | Excellent | ▼ |
| | | 8 | H | 16 | Conflicts of Interest | Good | ▼ |
| | | 3 | Business Process Risks | 9 | L | 2 | Litigation/Legal Risk |
| 10 | H | | | 16 | People Risk | V Good | ▼ |
| 11 | H | | | 16 | IT Systems | Upper Average | ▼ |
| 12 | M | | | 4 | Structure & Ownership | V Good | ▼ |
| 4 | Prudential Risks | 13 | H | 16 | Credit Risk | Good | ▼ |
| | | 14 | H | 16 | Market Risk | Upper Average | ▼ |
| | | 15 | H | 16 | Operational Risk | Upper Average | ▼ |
| | | 16 | M | 4 | Liquidity Risk | V Poor | ▼ |
| | | 17 | H | 16 | IPO Underwriting Risk | Good | ▼ |
| | Control Risk Elements | | | | | | |
| 5 | Customers, Products & Markets Control | 18 | M | 4 | KYC Requirements | Upper Average | ▼ |
| | | 19 | M | 4 | Sales Process & Product Development | Upper Average | ▼ |
| | | 20 | H | 16 | Post Sale Handling of Customers/Counterparties | Poor | ▼ |
| | | 21 | H | 16 | Market Conduct Controls | Lower Average | ▼ |
| | | 22 | L | 2 | Membership Arrangements for RIEs | V Good | ▼ |
| | | 23 | H | 16 | Conflict of Interest Management | V Good | ▼ |
| 6 | Financial and Operating Controls | 24 | H | 16 | Clearing and Settlement Arrangements | Lower Average | ▼ |
| | | 25 | H | 16 | Financial Controls | Upper Average | ▼ |
| | | 26 | M | 4 | IT Security and Controls | Good | ▼ |
| | | 27 | M | 4 | Policies, Procedures and Controls | V Good | ▼ |
| | | 28 | M | 4 | Human Resources Controls | Upper Average | ▼ |
| | | 29 | H | 16 | Security of Client Assets or Client Money | Upper Average | ▼ |
| | | 30 | M | 4 | Business Continuity Planning | Upper Average | ▼ |
| 7 | Prudential Risk Controls | 31 | H | 16 | Credit Risk Controls | V Good | ▼ |
| | | 32 | H | 16 | Market Risk Controls | Upper Average | ▼ |
| | | 33 | H | 16 | Operational Risk Controls | Good | ▼ |
| | | 34 | H | 16 | Liquidity Risk Controls | Lower Average | ▼ |
| 8 | Control Functions | 35 | H | 16 | Compliance | Upper Average | ▼ |
| | | 36 | M | 4 | Internal Audit | Good | ▼ |
| | | 37 | M | 4 | Enterprise-wide Risk Management | Good | ▼ |
| 9 | Management, Governance and culture | 38 | H | 16 | Culture & Management | Upper Average | ▼ |
| | | 39 | H | 16 | Corporate Governance | Upper Average | ▼ |
| | | 40 | M | 4 | Relationship with Regulators | V Good | ▼ |
| | | 41 | M | 4 | Strategic Planning | Good | ▼ |
| | | 42 | M | 4 | Relationship with Rest of Group | V Good | ▼ |
| 10 | Capital & Liquidity | 43 | H | 16 | Adequacy of Capital | Lower Average | ▼ |
| | | 44 | H | 16 | Adequacy of Liquidity | Poor | ▼ |
| | | 45 | M | 4 | Adequacy of Surplus capital | V Poor | ▼ |
| 476 | | | | | | | |
| | Purple Elements are Key Elements | | | | | | 59% |

BSEC - Risk Based Regulatory Model

42. Guidelines for undertaken the assessment questions are provided in **Annexure A**.
43. This sample assessment will result in a regulatory risk profile calculation, based on the firm being classified as a high impact firm, as follows:

| | Business Risk | Element Weight | Score | Weighted Score Visit 1 | Score | Rating Using 4 visit 1 |
|----|---------------------------------------|----------------------|--------|--------------------------------------|--------|------------------------|
| 1 | Environmental Risks | 5% | 51% | 2.571% | 94% | 1.94 |
| 2 | Customers, Products & Markets | 25% | 66% | 16.429% | 80% | 1.37 |
| 3 | Business Process Risks | 30% | 73% | 21.880% | 68% | 1.08 |
| 4 | Prudential Risks | 40% | 61% | 24.538% | 84% | 1.55 |
| | Control Risk | 100% | | 65.418% | | 1.38 |
| 5 | Customers, Products & Markets Control | 30% | 54% | 16.256% | 73% | 1.83 |
| 6 | Financial and Operating Controls | 15% | 56% | 8.438% | 75% | 1.75 |
| 7 | Prudential Risk Controls | 20% | 64% | 12.857% | 68% | 1.43 |
| 8 | Control Functions | 10% | 62% | 6.190% | 62% | 1.52 |
| 9 | Management, Governance and Culture | 10% | 64% | 6.364% | 74% | 1.45 |
| 10 | Capital & Liquidity | 15% | 33% | 5.000% | 35% | 2.67 |
| | | 100% | | 55.105% | | 1.80 |
| | | Sector Weight | | | | |
| | Business Risk | 35% | 65.42% | 23% | 78.63% | 1.38 |
| | Control Risk | 65% | 55.10% | 36% | 65.52% | 1.80 |
| | | 100% | | 59% | | 1.65 |
| | | | | Probability Index (score^4th) | | 7 |
| | | | | Indicative Rating | | A- |
| | | | | Risk Impact | High | |
| | | | | Supervisory Rating | | 30 |
| | | | | Supervisory Attention | | Remedial Action |

44. The risk matrix is reproduced below:

| Impact Rating | Impact rating | Impact index | Supervisory Attention Index | | | | |
|--------------------|--------------------|--------------|-----------------------------|--------------|--------------|------|---------|
| | Extreme | 250 | 16 | 35 | 63 | 142 | 253 |
| | High | 125 | 11 | 25 | 45 | 101 | 179 |
| | Upper Medium | 12.5 | 4 | 8 | 14 | 32 | 57 |
| | Lower Medium | 1.25 | 1 | 3 | 4 | 10 | 18 |
| | Low | 0.25 | 1 | 1 | 2 | 5 | 8 |
| | Probability rating | | Low | Lower Medium | Upper Medium | High | Extreme |
| | Probability index | | 1 | 5 | 16 | 81 | 256 |
| Probability Impact | | | | | | | |

45. Another way at address the risks within a firm are to see what mitigations are in place.
46. Issues are classified according to the underlying risk elements and consequently with each risk group. The probability rating for the issue will help to determine our overall rating of the firm.
47. When BSEC assesses the probability at the level of the firm as a whole, it considers separately each of the ten risk groups, but take into account any of the issues found during the course of risk assessment.
48. The risk model provides an overview of how inherent business risks, front-line controls and governance arrangements interact within a firm or group, leading to an overall assessment of net risk. This model of risk is shown in the matrix below:

BSEC - Risk Based Regulatory Model

| Environmental | Business Model | Controls | Oversight & Governance | | Other Mitigants | Net Probability |
|--------------------|-------------------------------|-------------------------------------|------------------------|----------------------------------|----------------------------|-------------------------------------|
| Environmental Risk | Customers, Products & Markets | Customer, Product & Market Controls | Control Functions | Management, Governance & Culture | | Customer Treatment & Market Conduct |
| | Business Processes | Financial & Operating Controls | | | | Operating |
| | Prudential | Prudential Risk Controls | | | Excess Capital & Liquidity | Financial Soundness |
| Business Risks | | Controls | Oversight & Governance | | | |

49. The risk model has both horizontal and vertical dimensions. Horizontally, risks are separated into three basic categories, represented by the three rows in the above matrix:
- risks associated with the firm's direct interactions with retail customers and market counterparties – this may be broadly characterised as the firm's 'front office';
 - risks associated with the firm's internal processes; and
 - prudential risks, relating to the financial soundness of the firm.
50. Each of the ten risk groups (represented by the coloured blocks in the diagram above) may affect one or more of the three rows. There are three risk groups that affect all the rows:
- Environmental Risk,
 - Control Functions; and
 - Management Governance and Culture.
51. As a consequence, strengths or weaknesses in these risk groups will affect all three rows. The remaining seven groups feature in one row only.
52. Vertically, the risk groups fall into four categories:
- Business Risks – defining the inherent or gross risks within the firm;
 - Controls – the primary risk controls of the firm, which should directly reduce the inherent business risk of the firm;
 - Oversight and Governance – defining the secondary and pervasive controls in the firm; and
 - Other Mitigates – the amount of excess capital and liquidity that can be used to absorb prudential risks.
53. These vertical categories are the driving factors that determine the nature of the relationship the firm will have with BSEC. The approach is not to take action or seek to mitigate issues with high levels of business risk if the controls are sufficient to manage those risks, for example:
- If the controls are assessed as high, then BSEC will require mitigating action.
 - If the oversight and governance of the firm is assessed as low risk, the mitigating action will largely fall on the firm to undertake.
 - If the oversight and governance is assessed as high risk, then the actions will typically be conducted by BSEC or third parties such as skilled persons.
54. The second method utilises the following score sheet:

BSEC - Risk Based Regulatory Model

| Risk Assessment PART II | Inherent risk | Management and control | Net risk | Significance weight |
|------------------------------|---------------|------------------------|----------|---------------------|
| Board | | | (0-4) | % |
| Management | | | (0-4) | % |
| Risk governance | | | (0-4) | % |
| Strategy and planning | (0-4) | (0-4) | (0-4) | % |
| Liquidity risk | (0-4) | (0-4) | (0-4) | % |
| Operational risk | (0-4) | (0-4) | (0-4) | % |
| Credit risk | (0-4) | (0-4) | (0-4) | % |
| Market and investment risk | (0-4) | (0-4) | (0-4) | % |
| Net risk total | | | (0-4) | 100% |
| Coverage/surplus | | | (0-4) | % |
| Earnings | | | (0-4) | % |
| Access to additional capital | | | (0-4) | % |
| Capital support total | | | (0-4) | 100% |
| Overall risk of failure | | | (0-4) | |

55. The Net Risk for Strategy and Planning, Liquidity, Operational, Credit and Market and Investment risk is the average of the scores for Inherent Risk and Management and Control Risks.
56. To complete this scoring the following key assessments need to be made:

Board

- (a) The Board of directors is responsible for providing stewardship and broad oversight of the regulated entity and determining its risk appetite. The majority of entities regulated by BSEC are required to meet various requirements with regard to Board structure and composition, as set out in the relevant legislation or prudential standards. These requirements may relate to the number of non-executive or independent directors. The skill set and experience of the Board should be commensurate with the complexity and diversity of the entity's operations.
- (b) When making an assessment of the Board, BSEC's objective is to review:
- the quality, skills and experience of all directors;
 - whether the Board meets composition and independence requirements;
 - whether the 'fit and proper' policy for the Board meets prudential requirements and how frequently the policy is reviewed;
 - whether directors individually and collectively meet the fit and proper requirements; and
 - conflicts of interest and key person risk at the Board level.

Management

- (a) Management is responsible for making, or participating in making, decisions that affect the whole or a substantial part of the business of the regulated entity. The management team has the capacity to affect significantly the entity's financial standing, enforces policies and implements strategies approved by the Board and develops and implements systems that identify, assess, manage and monitor risks to the business of the entity. Management also plays a vital role in monitoring the

BSEC - Risk Based Regulatory Model

-
- appropriateness, adequacy and effectiveness of an entity's risk management systems.
- (b) When making an assessment of management, BSEC's objective is to review the fitness, propriety and composition of the management team. The skill set and experience of the management team should be commensurate with the complexity and diversity of the entity's operations.
56. BSEC's assessment of management takes into consideration:
- (a) the composition and structure of management, including formal delegations;
 - (b) whether the entity's fit and proper policy meets prudential requirements and how frequently the policy is reviewed;
 - (c) whether members of the management team individually and collectively meet the fit and proper requirements;
 - (d) conflicts of interest and key person risk in the management team; and
 - (e) the level of management turnover and succession plans in place.

Risk governance

57. Risk governance focuses on the functioning and effectiveness of the internal and independent governance arrangements of the regulated entity.
58. It encapsulates not only the role and functioning of the Board but also other internal or independent functions in place to assess the adequacy of, and adherence to, operational controls and risk management policies and procedures, independent of management.
59. The key responsibilities of the Board in relation to risk governance include:
- (a) understanding the business environment and major risks;
 - (b) setting the risk management framework;
 - (c) determining the risk management strategy and major policies; and
 - (d) setting and reinforcing an appropriate culture and ensuring that the entity is managed and operated on a daily basis in accordance with the risk management strategy, policies and culture determined by the Board.
60. BSEC's evaluation of risk governance captures the Board as well as the functioning and effectiveness of other governance arrangements including:
- (a) Board committees, including the Audit Committee;
 - (b) compliance functions involved in setting policies and procedures for adherence to legal and regulatory requirements, the monitoring of compliance with those policies and procedures, and the reporting on legal and regulatory compliance matters to management and the Board; and
 - (c) internal and external audit functions charged with the responsibility for assessing the adequacy of and adherence to operational and organisational controls, risk management policies and procedures, and actual risk assessments, independent of management.
61. Risk governance arrangements need to be consistent with the complexity and diversity of the entity's operations. Small, less sophisticated entities may have relatively basic risk governance arrangements that meet prudential requirements and appropriately manage risk activities. However, larger and more complex entities will generally have far more comprehensive risk governance arrangements that provide, for example, more frequent reporting, tighter monitoring of complex activities and the aggregation of risks on a fully

BSEC - Risk Based Regulatory Model

consolidated basis across all business lines and activities. An independent internal compliance function is often established as a separate unit in larger entities.

62. BSEC's assessment of risk governance takes into consideration:
- (a) the role and functioning of the Board, including the existence of a formal charter and renewal policy;
 - (b) how the Board sets and reviews the risk management framework and ensures that risks are defined, understood and appropriately managed;
 - (c) the committee structure in place and its effectiveness, including the role, composition and functioning of the Audit Committee;
 - (d) the compliance framework in place including roles, responsibilities and independence; and
 - (e) the internal and external audit functions, including their skills, experience and independence.

Strategy and planning

Inherent risk

63. Strategic risk is the most fundamental of business risks. At its most basic, it is the risk associated with an entity's business model and how it wants to position itself strategically.
64. When making an assessment of strategic risk, BSEC's objective is to review:
- (a) the riskiness of the entity's strategy;
 - (b) the entity's current and intended future markets;
 - (c) diversification of the business;
 - (d) the entity's competitive advantage;
 - (e) expansion, acquisition and growth ambitions, or plans to exit certain business areas;
 - (f) susceptibility to external influences including environmental or economic change; and
 - (g) the entity's vulnerability to reputational and contagion risk.
65. Importantly, the short-term apparent success of a strategy does not impact on BSEC's assessment of the riskiness of that strategy.

Management and control

66. Management and controls should be commensurate with the level of strategic risk assumed by an entity. An entity with low strategic risk would not warrant the same level of controls as would be expected for an entity assessed to have a higher level of such risk.
67. Important considerations when reviewing the management and controls around strategy and planning include:
- (a) the overarching strategic planning practices;
 - (b) involvement in the development and monitoring of strategy by the Board and management;
 - (c) reasons for changes to the strategy and how those changes are controlled and monitored;
 - (d) underlying assumptions and scenarios/stress tests that support the strategy, including reliability of information sources;
 - (e) processes around the implementation of the strategy;
 - (f) resources required and the ability to execute the strategy; and

BSEC - Risk Based Regulatory Model

- (g) monitoring of performance against strategy.
68. The entity's strategy should be consistent with other plans such as its capital management plan, risk management strategy and, where applicable, the wider group business plan. Controls around potential reputational or contagion issues arising from the inter-connectivity of group plans are included in BSEC's review.

Liquidity risk

Inherent risk

69. Liquidity risk is the risk that an entity will be unable to meet its financial obligations as and when they fall due, without incurring significant unexpected costs.
70. It is reflected in the extent to which potential cash outflows may exceed potential cash inflows over given time period.
71. The following considerations are important in an assessment of an entity's inherent exposure to liquidity risk:
- (a) nature of liabilities;
 - (b) saleability of assets;
 - (c) the funding strategy to support the entity's current needs and future growth;
 - (d) funding mix and trends;
 - (e) concentration mix of assets and liabilities by market, counterparty and maturity;
 - (f) contingent/off balance sheet commitments; and
 - (g) intra-group funding arrangements.
72. The liquidity of assets is not constant but can change sharply in response to particular events or changing economic conditions. BSEC sees it as important to assess the number and diversity of active and prospective participants in a particular market segment, and the extent of supporting market infrastructure. As a general rule, liquidity is least when it is needed the most.

Management and control

73. Important considerations when reviewing the management and controls around liquidity risk include:
- (a) the awareness of liquidity risk by the Board;
 - (b) liquidity management functions and committees (such as Risk Committee and/or Asset/Liability Committee (ALCO)) in place;
 - (c) policies and procedures relating to liquidity risk management;
 - (d) limits in place and how they are reviewed and monitored;
 - (e) scenario analysis and models used, including dependability of information sources;
 - (f) reliability and extent of access to intra-group funding and standby facilities; and
 - (g) contingency arrangements in place, including any contribution to multilateral liquidity support arrangements.

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Operational risk

Inherent risk

74. Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. Exposure to this risk can result from deficiencies or breakdowns in internal controls or processes, technology failures, human errors, dishonesty/fraud and external events (e.g. physical infrastructure failure or natural disaster).
75. All entities regulated by BSEC are exposed to operational risk. Generally, smaller entities that have simple business flows and a low volume of transactions would be expected to have low levels of operational risk.
76. When making an assessment of operational risk, BSEC's objective is to review:
- (a) the size, sophistication, structure and complexity of operations;
 - (b) the complexity, level of change and vulnerability of the IT systems utilised. It is usual for entities that have a high degree of complexity within the IT systems environment and are undergoing or plan to undergo significant change within that environment to have higher levels of inherent operational risk;
 - (c) vulnerability to business interruptions/external events that may impact on the business. This is clearly influenced by the geographic location of the entity's physical facilities and any history of similar events in those particular locations or others with similar characteristics. BSEC sees it as important to understand the entity's operational and legal structure so as to assess the degree of vulnerability in these areas; and
 - (d) susceptibility to fraud (both internal and external).

Management and control

77. BSEC's assessment of the management and control framework for operational risk takes into account:
- (a) the awareness of operational risk by the Board;
 - (b) operational risk management functions and committee/s;
 - (c) policies and procedures;
 - (d) controls in place across the IT environment;
 - (e) management of operational issues including administration, outsourcing arrangements, new products, project management and fraud; and
 - (f) business continuity and disaster recovery plans, including testing processes in place and back-up arrangements such as data files, documentation, and regularity of file recovery and off-site location (and testing of such arrangements).
78. Some of the larger entities regulated by BSEC have dedicated operational risk management functions and committees with independent responsibility to the Board. However, these are not common features for smaller entities, where policies and procedures play a more important role in the control framework.

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Credit risk

Inherent risk

79. Credit risk relates to the risk of default by borrowers and transactional counterparties as well as the loss of value of assets due to deterioration in credit quality. Credit risk is a critical consideration for intermediaries that undertake direct credit activities.
80. The principal determinants in BSEC's assessment of the overall level of inherent exposure to credit risk include:
- (a) asset portfolio composition, including size and types of credit exposures;
 - (b) lending strategy;
 - (c) concentration of credit exposures, including the size of individual exposures relative to the size of the total portfolio and the extent to which separate exposures share common risk characteristics (increasing the likelihood of joint default). The more concentrated the portfolio, the greater the potential loss that could result from any single default causing event;
 - (d) the likelihood of default, including the financial strength of borrowers or counterparties and their ability to meet commitments; and
 - (e) the extent of loss should default actually occur.
81. This is largely dependent upon the types and amounts of security, if any, held against the exposures and the entity's bad debts/arrears experience.
82. Ratings are often also assigned by credit rating agencies, such ratings can be an indicator of credit risk.
83. Credit risk does not include the loss of value of assets due to changes in the market's pricing of credit risk; this is included in under market and investment risk.

Management and control

84. BSEC's assessment of the management and control framework for credit risk takes into account:
- (a) the awareness of credit risk by the Board;
 - (b) the credit risk management framework, systems and delegations in place;
 - (c) origination, security and collateral structures and valuation practices;
 - (d) credit-related policies and procedures;
 - (e) problem asset management including compliance with prudential requirements;
 - (f) information systems and portfolio management; and
 - (g) the role and functioning of independent credit review processes.
85. Large and/or sophisticated regulated entities offering credit generally use internal credit risk grading systems to assign the risk of default from individual counterparties and the overall portfolio. For these entities, the controls around the credit risk grading systems form an important part of BSEC's review.
86. Less sophisticated entities are unlikely to use credit risk grading systems. For these entities, assessing the level of credit risk may require the examination of loan provisioning/arrears reports or a sample of individual loans.

BSEC - Risk Based Regulatory Model

Market and investment risk

Inherent risk

87. Market risk is the risk of loss arising from adverse movements in the level or volatility of market rates or prices (interest rates, foreign exchange rates, equity, commodity, property and credit prices).
88. Risk refers to the probability of an adverse movement in the value of on-balance sheet assets and/or off-balance sheet obligations and is derived from a number of sources, including market risk and investment concentration risk.
89. When assessing an entity's inherent exposure to market and investment risk, BSEC's objective is to review:
- (a) the size, nature and complexity of market and investment activities;
 - (b) asset and liability mismatch;
 - (c) sensitivity to market risk;
 - (d) balance sheet instruments, including derivatives and foreign currency exposures;
 - (e) investment objectives and strategy (where applicable) e.g. aggressive or conservative;
 - (f) diversification across asset classes and asset allocations; and
 - (g) nature of asset valuations.
90. Generally, entities with relatively basic products and simple balance sheet instruments that are not sensitive to pricing movements would be assessed as having a low inherent exposure to market risk. Those entities using derivatives for speculative purposes and unhedged foreign currency exposures would usually have a high inherent exposure to market risk.
91. Credit risk arising from revaluation of investments due to changes in the market price for different types of credit is captured under Market and Investment Risk, as is exposure to the risks associated with unit pricing.

Management and control

92. BSEC's assessment of the management and controls around market and investment risk takes into account:
- (a) the awareness of market and investment risk by the Board;
 - (b) trading and investment functions, including segregation of responsibilities;
 - (c) Asset Liability Committee (ALCO) and/or investment committees in place;
 - (d) delegations and limits in place and how they are monitored and controlled;
 - (e) the process of reviewing and monitoring trading and/or investment strategies;
 - (f) investment management and asset valuation practices;
 - (g) market and investment policies and procedures including those relating to unit pricing;
 - (h) models used, including underlying assumptions and stress analysis;
 - (i) the strength of management information systems; and
 - (j) independent review functions.

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Prudential Capital - Coverage/surplus

93. Capital is the cornerstone to the strength of a regulated entity and provides a buffer against unexpected losses. The maintenance of adequate capital resources engenders confidence in the financial soundness and stability of a regulated entity.
94. It is the responsibility of an entity's Board and management to ensure that capital resources are appropriate to the size, business mix and complexity of its business. Accordingly, appropriate systems need to be in place to identify, manage and monitor the risks associated with an entity's business activities and to ensure that capital is held commensurate with its overall risk profile.
95. BSEC's assessment of coverage/surplus has three primary considerations:
- (a) the adequacy of capital;
 - (b) the quality and composition of capital; and
 - (c) capital management processes in place.
96. Capital adequacy will generally be reflected in the extent of surplus capital above the minimum regulatory capital requirements set out in prudential standards or determined by BSEC for individual entities. A minimum coverage has been set as 120% of the liquid capital requirement. However, this may be adjusted in individual circumstances if warranted. RBCA arrangements for capital market entities are yet to be addressed.
97. Where relevant, the quality of current capital is also considered i.e. its composition in terms of permanent and less permanent forms of capital. In some industries, this is referred to as Tier 1 and Tier 2 capital.
98. A regulated entity needs to have a robust system in place to manage its capital position, to ensure sufficiency of capital in relation to the current risks facing the business, sustainability over the long- term and compliance with minimum regulatory requirements. It is good practice for regulated entities to establish and maintain capital management plans. In some industries, a capital management plan consistent with the entity's overall strategy is a prudential requirement. Regulated entities also usually establish internal target capital ratios that are monitored and reviewed by the Board and management.
99. BSEC seeks to understand an entity's capital management practices on a stand-alone basis and, where relevant, across the group.

Earnings

100. Earnings are the most obvious source of additional capital to support growth or to replenish reserves in the event of unexpected losses. For regulated entities that are neither listed entities nor have parental support, earnings are usually the prime source of additional capital.
101. The credibility of earnings projections is fundamental to BSEC's assessment. The greater the variability in past performance and the less accurate past projections have proven, the less reliance that can be placed on the current set of projections. Current earnings and trends and actual performance against budget forecasts are critical considerations.
102. Entities with volatile earnings or ongoing losses would generally be considered higher risk.
103. In the case of a foreign branch licensed in Botswana, BSEC's assessment considers Head Office earnings results as well as those of the branch.

BSEC - Risk Based Regulatory Model

Access to additional capital

104. Reasons for requiring additional capital may include the need to fund strategic initiatives (e.g. acquisitions, new IT systems) or to replenish a diminishing capital base due to ongoing losses. It is important that an entity has the ability to raise additional capital when necessary.
105. For many entities, the options available to access further capital can be limited. For example, entities with mutual ownership or not listed on the stock exchange may have minimal access to public capital markets.
106. Important considerations in reviewing access to additional capital include:
- (a) the entity's ability to raise or access additional capital to meet requirements, particularly in an adverse environment, e.g. where an underwriting loss leads to the minimum capital adequacy requirement being breached;
 - (b) whether the entity (or its parent) is a listed entity;
 - (c) whether the entity has accessed additional capital from capital markets and the issues were supported;
 - (d) the group capital adequacy position where the entity is a member of a corporate group. In this case, BSEC would assess whether capital can be sourced from existing excess capital resources in the group (whether the local group or from an overseas parent); and
 - (e) whether there are competing demands from other entities within the group where the source of capital is from a parent entity.
107. While access to additional capital is not directly relevant for foreign branches, consideration is given to the support provided by the Head Office and Head Office's access to additional capital.
108. An important consideration is the relative weighting to each risk category and this has initially been set as follows:

| Risk Assessment PART II | Significance weight |
|------------------------------|---------------------|
| Board | 8% |
| Management | 8% |
| Risk governance | 10% |
| Strategy and planning | 5% |
| Liquidity risk | 5% |
| Operational risk | 25% |
| Credit risk | 25% |
| Market and investment risk | 15% |
| Net risk total | 100% |
| Coverage/surplus | 50% |
| Earnings | 25% |
| Access to additional capital | 25% |
| Capital support total | 100% |
| Overall risk of failure | |

BSEC - Risk Based Regulatory Model

109. A sample calculation under this model would be as follows:

| Broker Name: | | | Date: | | |
|------------------------------|---------------|------------------------|----------|---------------------|--------------|
| Risk Assessment PART II | Inherent risk | Management and control | Net risk | Significance weight | SCORE |
| Board | | | 2.30 | 8% | 0.17 |
| Management | | | 2.00 | 8% | 0.15 |
| Risk governance | | | 1.50 | 10% | 0.15 |
| Strategy and planning | 2.10 | 1.50 | 1.80 | 5% | 0.09 |
| Liquidity risk | 1.50 | 1.00 | 1.25 | 5% | 0.06 |
| Operational risk | 3.50 | 3.00 | 3.25 | 25% | 0.81 |
| Credit risk | 3.70 | 2.00 | 2.85 | 25% | 0.71 |
| Market and investment risk | 3.60 | 2.00 | 2.80 | 15% | 0.42 |
| Net risk total | | | 17.75 | 100% | 2.57 |
| Coverage/surplus | | | 2.00 | 50% | 1.00 |
| Earnings | | | 3.00 | 25% | 0.25 |
| Access to additional capital | | | 4.00 | 25% | 0.00 |
| Capital support total | | | 9.00 | 100% | 1.25 |
| Overall risk of failure | | | 8.75 | | 1.32 |
| 4th Power | | | | | 3 |
| Indicative rating | | | | | A |
| Risk Impact | | | | | Upper medium |
| Supervisory Rating | | | | | 6 |
| Supervisory Attention | | | | | Watch List |

Risk management questionnaire

110. To assist the initial assessments a Risk Questionnaire is should be completed by all firms and BSEC will undertake on-site visits to test the questionnaires findings and then map the responses from the questionnaire and its on-site findings to the scoring systems outlined above. The form of questionnaire is attached as **Annexure B**.
111. This process will help the Capital Markets Unit make an objective assessment, garnered from both the knowledge of the licensee's inspection history, as well as the questionnaire answers.

Further comments on intermediary supervision

112. By utilising the Supervisory Attention Index BSEC can assure it focuses on firms providing higher risk. BSEC's approach to supervision has to be first determined by the impact that a licensed firm may have on its statutory objectives.
113. For those firms that are assessed as having low impact, the supervisory attention will be lessened, placing reliance on thematic assessment, desk monitoring of the information submitted by the firm through RBCA returns and periodic on-site inspection.
114. For those firms that are designated as other than low impact, Capital Markets Unit will conduct regular assessments of risks within the firm. This may vary in length, depending on the risk profile of the firm and the length of time for which it is believed the risk assessment will remain valid.
115. Obviously the higher the supervisory index the more attention a firm will receive and mandatory improvements could be imposed on firm's presenting high or extreme probability of causing regulatory issues.

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116. Whilst Model I is recommended for BSEC at this time, however, as RBS improves a move to model II could be made. Certainly the principles included in model II can be considered when scoring firms under model I.

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Annexure A: Risk profiling Guidelines

The notes below beside the different risk elements are meant to give some indication of the typical reasoning to be considered when scoring each element of the risk profiling spread-sheet. They are not comprehensive, just indicative of questioning a scorer should consider when addressing the risks at each intermediary.

The mauve highlighted elements are usually the higher risks areas that need to be considered.

| Business risks | | Key issues to be considered |
|-------------------------------|--|--|
| Environmental Risks | Economic Environment | The economic environment risk is the risk posed to the business arising from the general economic climate, considerations are whether the economy is in an expansion or contraction phase and the likely risk posed to the style of business activity undertaken by the firm. Often the same rating will be assigned to all firms, although an individual firm may attract business due to its reputation of handling client assets and investments in poorer economic times. |
| | Competitive Environment | Does the competitive environment have a bearing on the ability of the firm to withstand competition and to build a business which is sustainable? Questions to be considered should address whether the firm has positioned itself correctly and whether it has the ability to meet the competition in the marketplace. What is the firm's market share with respect to its peers? Has the firm's market share is rising or declining? Does the firm have scalable resources (people and systems)? Are scalability tests conducted for forecasted growth of the firm? |
| Customers, Products & Markets | <i>Institutional Client/Counterparty Characteristics</i> | Does the entity deal with well capitalised institutional clients with solid credit ratings? Is the client base stable and does it provide an ongoing stream of good business? Are the firm's clients respected entities with good reputations? |
| | <i>Retail Customer Characteristics</i> | What are the characteristics of the retail customer with whom the firm is conducting business? Do the customers comprise high net worth individuals or small clients? How might this impact on the firm's risk profile? What is the rate of turnover of transactions, and clients? Are clients loyal to the firm or are they likely to switch firms or likely to have credit issues? |

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| | | |
|------------------------|---|---|
| | <i>Institutional Product/Market Characteristics</i> | Does the firm provide specialised structured product or generic services? Has the firm developed a defined set of product offerings? What distinguishes the organisation from others in the industry? Is the firm known for innovative and leading product offerings? |
| | <i>Retail Product Characteristics</i> | Undertake a review of the characteristics of retail customer products—is the firm undertaking any activity such as margin financing, overnight financing or other risky practice? Are clients staging IPOs or consistently trading secondary shares? Is the firm offering discretionary investment product? |
| | <i>Distribution Channels</i> | What are the risks from the style of distribution channels it uses? Does it use agents; provide internet services or direct market access trading? Does it use access to a bank's customers? Are there any characteristics of the distribution channels that might pose a risk to the business? |
| | <i>Conflicts of Interest</i> | What risk may arise to the business from the management of conflicts of interest? If the firm is offering both equity trading and asset management is there risk that needs to be managed. Is the risk a high one? Are there adequate Chinese Wall arrangements within the firm, such as the separation of dealers handling client funds or discretionary orders from those handling proprietary or staff accounts? Has the Management established policies and procedures regarding "Chinese Walls" to ensure that price-sensitive information privy to the research staff or staff handling corporate finance matters like a takeover and merger should not be available to staff outside those departments, except on a "need to know" basis? |
| Business Process Risks | <i>Litigation/Legal Risk</i> | Is there a history of prior disputes and is the entity subject to frequent litigation? Is the entity known for its adversarial positioning? Is the entity developing a product which may be subject to mis-selling claims by clients or disapproval by tax authorities? |
| | <i>People Risk</i> | How reliant is the organisation on key people? What is the quality of staff? Does the firm have high staff turnover, is it subject to frequent changes in management? Does the entity have good people policies (Code of Conduct, Conflict of Interest, etc.) in place? What is the morale within the firm like? Is the staff complement adequate for the size of operations? |

BSEC - Risk Based Regulatory Model

| | | |
|------------------|-----------------------|--|
| | IT Systems | <p>How reliant is the organisation on technology solutions and delivery of services to clients?</p> <p>Does the firm have good IT systems and do they have adequate staff to run the IT and maintain the equipment in proper order?</p> <p>Has the entity had problems in the past with IT systems?</p> <p>Does it rely on a bureau back office system or does it have its own system?</p> |
| | Structure & Ownership | <p>This is an important consideration as often a firm's structure may mask issues. The complexity of structure can impact on decision making and the ability of the firm to attract new capital. Also important is the capacity of the increase in capital when required. If the firm is part of a larger international group and the structure is clear then the firm will be in a better position to quickly inject capital as required.</p> |
| Prudential Risks | Credit Risk | <p>Does the entity have a clear policy and appetite for credit risk?</p> <p>Does the board and management have a good understanding of credit risk and have appropriate policies and procedures to measure and control credit risk?</p> <p>Does the firm extend credit in a prudent manner?</p> <p>Are there quantitative methodologies in place to effectively calculate and monitor the firm's credit exposure in relation to clients?</p> |
| | Market Risk | <p>Is the firm reliant on position taking and risk?</p> <p>Does it have clear policy for market risk positioning?</p> <p>Does the Management specify authorised products and instruments the firm may deal in and enforces effective procedures to ensure compliance?</p> |
| | Operational Risk | <p>What is the profile of past operational losses, small and frequent or large and irregular?</p> <p>Is the firm prone to operational risk or are the processes well defined and managed?</p> <p>Is there a physical and functional segregation of incompatible duties?</p> <p>Does the firm have adequate insurance cover for its exposures?</p> |
| | Liquidity Risk | <p>Is the entity careful with its liquidity positioning?</p> <p>Has it a history of poor liquid capital returns?</p> <p>Does it deal in illiquid instruments?</p> <p>What is the firms approach to liquidity management?</p> |
| | IPO Underwriting Risk | <p>Is the entity a regular underwriter or sub-underwriter of IPOs?</p> <p>What has been the history of getting IPOs away?</p> <p>Has it a good distribution network?</p> |

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| Control Risks | | |
|---------------------------------------|--|--|
| Customers, Products & Markets Control | KYC Requirements | How good are the “know your client” processes? Is client risk profiling used? Does management oversee the Salesperson’s assessment of client risk appetite? Is AML policy and procedure in place? Are credit checks undertaken? |
| | Sales Process & Product Development | Are any client abuses (fair and proper allocation of trades, churning or front running) monitored? Are any new products subject to review and approval by senior management? Is there an approval process for any new tax driven products? |
| | Post Sale Handling of Customers/Counterparties | Is the back office well run and managed? Are contract notes issued and statements and valuations regularly sent to clients? Does the client ledger reconcile with the GL? Are there many client complaints? Are all stock and Cash reconciliations up to date? |
| | Market Conduct Controls | Is front running, churning and insider trading monitored? Is there time stamping of orders? Is there a history of client abusive practice? |
| | Membership Arrangements for RIEs | What is entity relationship with Stock exchange; does it have a clear inspection history? Is the exchange concerned about the firm, its capital position or people? |
| | Conflict of Interest Management | How does the firm recognise and manage conflicts of interest? Is the staff handling client mandates rotated? Have there been instances of abuse of clients? |
| Financial and Operating Controls | Clearing and Settlement Arrangements | Does the entity meet its clearing and settlement responsibilities; does it have any settlement failures? Are client’s monies and securities properly segregated? Does the reconciliation of securities produce any errors? |
| | Financial Controls | Are the entity’s financial controls adequate and properly implemented? Are proper approvals for expenditure and disbursement in place? Is there a sense that management runs a tight ship? |
| | IT Security and Controls | Is IT security taken seriously? Is there regular testing of the physical and virtual IT security? Is there controlled access to IT areas? Is access to computer code strictly controlled? Are logs of after-hour access monitored? |

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| | | |
|--------------------------|---|---|
| | Policies, Procedures and Controls | Are written procedures in place, regularly updated and reviewed? Are the procedure manuals utilised by staff? Are there required policy documents for corporate governance, internal control, HR, credit, risk positioning, expenses and other critical management activities? |
| | Human Resources Controls | Is there a well-run HR function? Are there defined policies for remuneration, bonus and other benefits given to staff? Are there requisite training programs? Is there a monitoring of staff morale? Are performance reviews undertaken and is remuneration and assessment risk adjusted? |
| | Security of Client Assets or Client Money | Is client money properly segregated? Is there regular audit of segregation of money and securities? Have there been any complaints lodged with the exchange or regulator? |
| | Business Continuity Planning | Is there an acceptable BCP and DRP for both IT and business operations, has the plan been tested? Has a third party IT specialist been involved in the drawing up of the plans? How comprehensive are the plans, and has the regulator undertaken a walk-through of the plan? |
| Prudential Risk Controls | Credit Risk Controls | Are credit policies in place? Are they practised? What is the aging of accounts? Are there problem accounts – are they out of control? Does management regularly review the debtor listing? |
| | Market Risk Controls | Are limits in place? Are they breached regularly, is there proper control over market risk? Is the overall level appropriate for the capital held? Is there regular reporting of risks to the board? |
| | Operational Risk Controls | Is operational risk data (Loss Registers, Key Risk Indicators, Fraud Incidents, etc.) regularly collected and analysed? Is there a risk management dashboard? Does the board receive regular reports of operational loss? |
| | Liquidity Risk Controls | Is there a formal liquidity risk report, and who reviews it? Is the control adequate and appropriate to the size of operation? How quickly can assets held be converted to cash? |

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| | | |
|---|--|--|
| <i>Control Functions</i> | <i>Compliance</i> | Is there a defined and well run compliance function? Is it doing its job? Does it report to appropriate management? Is there compliance manual? Do staff actually complete required trading requests prior to undertaking trading activity? Does the compliance officer have a good relationship with the regulator – are they cooperative or aggressive in favour of management? |
| | <i>Internal Audit</i> | Does internal audit report to the board? Does it have a defined audit program and sufficient resources to undertake the work required? Are its recommendations for improvement actioned? |
| | <i>Enterprise-wide Management Risk</i> | Apart from the individual department risks is there an overall enterprise approach to risk management? Does the risk function report to a risk committee and is there aggregation of all risk types across the organisation? Does the board regularly discuss risk? |
| <i>Management, Governance and culture</i> | <i>Culture & Management</i> | What is the pervading culture of the organisation? Is it: Arrogant-aggressive-measured? Is there a sense that the culture is one that values control and compliance? |
| | <i>Corporate Governance</i> | Does the board comply with best management practice and have the required independence to fulfil its corporate governance duties? Does the board really understand the business and what is happening on a day to day basis? Is there a corporate governance committee? Is there a risk committee and audit committee? |
| | <i>Relationship with Regulators</i> | What is the organisation's relationship with regulators (exchange, capital market authority, other)? Does the entity cooperate as appropriate, respond to requested corrective actions? Is there a sense that the entity wishes to cooperate with the law, regulations, and rules? |
| | <i>Strategic Planning</i> | Is there an acceptable strategic plan approved by the board that makes sense? Is the operation following the plan? Is the plan regularly reviewed and the authority updated? |
| | <i>Relationship with Rest of Group</i> | Where applicable, does the entity have a good relationship with the other parts of the group? Does its culture clash with the other parts of the business? Would the parent readily supply additional capital if there were issues? |
| <i>Capital Liquidity &</i> | <i>Adequacy of Capital</i> | Does the firm have excess capital say > 120% of required capital? Does it file its CA returns on time and are they properly completed? |

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| | | |
|--|------------------------------------|--|
| | <i>Adequacy of Liquidity</i> | Are assets held in a form that is readily realisable? How much more than the minimum liquid capital is available? |
| | <i>Adequacy of Surplus capital</i> | How would the entity be positioned to meet a large loss, has it the capital available as a buffer or cushion to it? |

Annexure B: Risk management Questionnaire



বাংলাদেশ সিকিউরিটিজ অ্যান্ড এক্সচেঞ্জ কমিশন
Bangladesh Securities and Exchange Commission

ADB TA-8228 BAN: Enhancing Efficiency of the Capital Market

RISK ASSESSMENT QUESTIONNAIRE

November 2014



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Risk Assessment Questionnaire

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Risk Assessment Questionnaire

Risk Assessment Questionnaire

November 2014

Instructions

Please respond to all questions in this questionnaire. It is understood that the interpretation of the questionnaire and responding to the questionnaire requires a high level of professional judgement. However, the BSEC expects the responses to be honestly and truthfully completed.

Please also ensure completion of the full contact information at the end of the questionnaire and ensure it is signed by the appropriate officer.

| | |
|-------------------------|--|
| Name of Company: | |
| Address: | |

Name of person designated Representative of Company:

Last Name First Name email:

Name of person designated as Head of Compliance:

Last Name First Name email:

Name of person designated as Risk Management Officer:

Last Name First Name email:

Name of person designated as Money Laundering Officer:

Last Name First Name email:

TREC (Mark)

- ☐ Dhaka Stock Exchange
- ☐ Chittagong Stock Exchange

Risk Assessment Questionnaire

Business Activity

1. Does the firm act in any of the following capacities:

| | Activity | Yes | No |
|----|---|--------------------------|--------------------------|
| a) | Broker | <input type="checkbox"/> | <input type="checkbox"/> |
| b) | Dealer or trade securities on own account | <input type="checkbox"/> | <input type="checkbox"/> |
| c) | If Dealer – Liquidity provider | <input type="checkbox"/> | <input type="checkbox"/> |
| d) | Fund Manager including for CIU | <input type="checkbox"/> | <input type="checkbox"/> |
| e) | Investment Advisor | <input type="checkbox"/> | <input type="checkbox"/> |
| f) | Participates as an Underwriter | <input type="checkbox"/> | <input type="checkbox"/> |
| g) | Have Discretionary Accounts | <input type="checkbox"/> | <input type="checkbox"/> |
| h) | Conduct Investment Banking Activities | <input type="checkbox"/> | <input type="checkbox"/> |
| i) | Create and distribute Research reports | <input type="checkbox"/> | <input type="checkbox"/> |
| j) | Provides Client internet trading System | <input type="checkbox"/> | <input type="checkbox"/> |
| k) | Does the firm undertake OTC transactions | <input type="checkbox"/> | <input type="checkbox"/> |
| l) | Other Services – Please describe: | <input type="checkbox"/> | <input type="checkbox"/> |

2. What is the firms current **paid in Capital** Tk Millions _____

What is the net worth of the company Tk Millions _____

Date as at _____

3. Does the Company have **other branches** than the home office? Yes__ Number__

Locations: _____

4. Average **Number of Transactions, Volume and Value** per month over last six months:

- a. Number (Frequency) _____
- b. Volume (No Shares) Thousands _____
- c. Value Tk Million _____
- d. Number Bond Deals _____
- e. Value of Bond Deals _____

Risk Assessment Questionnaire

5. Number of Client Accounts

| | Values as at 31 st October 2014 | | |
|---------------------|--|--|--------------------------------------|
| TYPE | Number | Value due to Firm by Clients Tk Million | Due to Clients by Firm Tk Million |
| Cash Equity Trading | | | |
| Bond Trading | | | |
| Investment Advisory | | | |
| OTC | | | |
| Other (describe) | | | |
| | | Number last 6 months | Number unresolved at this date |
| Client Complaints | | | |

6. Make up of business revenue (approximate %age)

| <u>Activity</u> | <u>%age</u> |
|----------------------------|-------------|
| Institutional | |
| Retail | |
| Broker/dealers | |
| High Net Worth Individuals | |
| Foreign Clients | |
| Agency Business | |

Risk Assessment Questionnaire

Section A - Risk and Internal Control

Risk Management and Control

7. Briefly describe the risk management practices of your organization and your ability to identify, prioritize, monitor and manage the risks.
8. Briefly describe the roles and responsibilities of your compliance officer, and where applicable, the compliance, legal and internal audit departments.
9. Briefly describe the quality of controls within your organization and support your conclusion. Describe how the organization has addressed internal controls, management supervision and segregation of duties in the areas of dealing, settlement and client accounting, fund accounting, and finance/treasury functions, if applicable.

Risk Assessment Questionnaire

Internal Control Assessment

| A. Operational Controls | Yes | No | Comments |
|--|--------------------------|--------------------------|-----------------|
| Opening and handling of client accounts (In this section please provide copies of any forms, procedures etc that support answers) | | | |
| 1. Mandatory account opening procedures are clearly defined and followed. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 2. In the case of discretionary accounts, special procedures are implemented as follows: | | | |
| a. executing a discretionary account agreement which sets out the investment objectives and strategies of the client and the precise terms and conditions under which such discretion will be exercised; | <input type="checkbox"/> | <input type="checkbox"/> | |
| b. regular reviews of the performance of the account conducted by designated staff company(s) independent of the staff handling the account; | <input type="checkbox"/> | <input type="checkbox"/> | |
| c. providing the client with regular statements and timely ad hoc reports on account balance and transaction details, especially when the account balance falls below agreed levels or when large orders for the account are pending or executed; and | <input type="checkbox"/> | <input type="checkbox"/> | |
| d. clearly delineating the investment decision making process from the dealing process: order tickets similar to those used for non-discretionary agency business are completed and time-stamped to record the actual time orders are initiated. | <input type="checkbox"/> | <input type="checkbox"/> | |
| Providing investment advice | | | |
| 3. Where the firm is in the business of offering investment advice for remuneration, or has entered into a contractual advisory arrangement with a client, and in the course of such business, gives investment recommendations or advice, special procedures are implemented and followed as follows: | | | |
| a. establishing clear requirements and procedures regarding adequacy of research work and preparation and retention of documentation supporting the recommendations and advice; | <input type="checkbox"/> | <input type="checkbox"/> | |
| b. providing to the client in writing details of the fees, charges and penalties applicable to any recommended investment scheme; and | <input type="checkbox"/> | <input type="checkbox"/> | |
| c. documenting (and providing a copy to the client) the rationale underlying investment advice rendered or recommendations made. Such advice and recommendations must be suitable taking into account the client's particular investment experience and objectives and financial position. | <input type="checkbox"/> | <input type="checkbox"/> | |
| Dealing practices | | | |
| 4. The firm puts in place procedures to ensure that its staff's trading activities are not prejudicial to the | <input type="checkbox"/> | <input type="checkbox"/> | |

Risk Assessment Questionnaire

| | | | |
|---|--------------------------|--------------------------|--|
| interests of its clients. Staff members are required to disclose to the firm, on joining and regularly afterwards (at least semi-annually), details of holdings and trading activities in which they have an interest in relation to specific securities, futures and other investment products in which the firm deals in or in respect of which the firm acts as an investment adviser or commodity trading adviser. Staff members of a firm which is, or belongs to a group within which a group company is, a member of an exchange are required to trade through staff accounts in relation to products traded on that exchange. All transactions for staff accounts are separately recorded and diligently monitored by independent senior management. (Please provide a copy of the approval procedure) | | | |
| 5. The firm clearly defines parameters in relation to the acceptance by staff member(s) or the firm of gifts, rebates, benefits-in-kind or "soft-dollar" benefits received from clients or other business contacts. These include the circumstances under which acceptance is permitted and approval required. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 6. Effective procedures are established to ensure that whenever the firm or its staff member(s) have an interest in a transaction with a client (i.e. a direct/cross books transaction), this fact is disclosed to the client prior to the execution of the relevant transaction. For example, the firm may maintain a register of direct and cross books trades which also records the name of the client and the firm account involved, the person contacted and the time when the consent was received. The register is reviewed regularly (at least monthly) by designated staff member(s) performing the compliance function or a senior staff member in the dealing department. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 7. Order handling procedures are clearly documented and followed. | | | |
| a. Orders are recorded, using standard order forms, and time-stamped promptly upon initiation or receipt and are required to be transmitted to the dealer, floor trader or operators of terminals for automated trading systems within a reasonable time period, normally immediately. Where orders are system generated is there a time sequence audit trail available and filed daily. | <input type="checkbox"/> | <input type="checkbox"/> | |
| b. Prior to executing a client order, the following items are checked by designated staff: | | | |
| i. the status of the account (active, closed or being on an internal watch list, etc.); | <input type="checkbox"/> | <input type="checkbox"/> | |
| ii. applicable account limits, if any (e.g. trade, position, credit); | <input type="checkbox"/> | <input type="checkbox"/> | |
| iii. the sufficiency of available funds or available credit in the relevant account; | <input type="checkbox"/> | <input type="checkbox"/> | |

Risk Assessment Questionnaire

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|--|--------------------------|--------------------------|--|
| iv. in the case of a sell order, the sufficiency and availability of securities applicable; | <input type="checkbox"/> | <input type="checkbox"/> | |
| v. Effective procedures regarding the transmission of orders to the dealing room are established. Sufficient information should be given to enable client priority to be established. | <input type="checkbox"/> | <input type="checkbox"/> | |
| Chinese Walls | | | |
| 8. The firm avoids apparent and potential conflicts of interest by establishing and maintaining adequate "Chinese Walls", such as the separation of dealers handling client funds or discretionary orders from those handling proprietary or staff accounts. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 9. Management establishes and maintains policies and procedures regarding "Chinese Walls" to ensure that price-sensitive information privy to the research staff or staff handling corporate finance matters like a takeover and merger should not be available to staff outside those departments, except on a "need to know" basis. | <input type="checkbox"/> | <input type="checkbox"/> | |
| Back office and accounting | | | |
| 10. Deal tickets are transmitted to the designated back office staff member(s) who enter the details into the firm's own in-house system (whether automated or otherwise). At the end of each business day, the firm's own record of trades is matched by the back office staff to the trading/clearing lists received from the exchanges or clearing houses and where applicable, to confirmation documents issued by counterparties and executing brokers. Exception reports identifying mis-matched and unusual trades are produced, reviewed and follow-up actions taken, where necessary. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 11. All trades are confirmed promptly with the client on whose behalf the trade was executed and, for off-exchange trades, these are also confirmed promptly with the counterparty using reliable and pre-agreed methods (describe) Method: | | | |
| 12. All trade errors are reported to the person responsible for dealing and are allocated to an "error" or "suspense" account for prompt correction or closure of the position. The transactions in this account should be supported by clear documentation explaining the relevant circumstances and reviewed by the staff member(s) performing the compliance and internal audit functions. Any unusual circumstances or patterns should be investigated. | <input type="checkbox"/> | <input type="checkbox"/> | |

Risk Assessment Questionnaire

| Asset protection | | | |
|--|--------------------------|--------------------------|--|
| 13. Effective procedures are established and followed, when handling movements of firm and client assets. Procedures include: | | | |
| a. Clearly identifying staff member(s) and representatives of clients (for client assets) with authority to acquire, dispose of, lend, pledge or otherwise part with possession of, firm and client assets, and the parameters of such authority. The authority is checked with respect to each asset movement and client withdrawal request. | <input type="checkbox"/> | <input type="checkbox"/> | |
| b. Use of standardised and sequentially numbered receipts and despatch notes or other appropriate methods to acknowledge and account for asset movements. | <input type="checkbox"/> | <input type="checkbox"/> | |
| c. Securely storing firm and client assets, other important documents and controlled forms such as cheque books, contract notes etc., while at the firm's premises; and promptly depositing cheques, cashier orders and other negotiable instruments and securities into the appropriate account(s) at banks or securities depositories. During the period that physical scrip or cash is held at the firm's premises, routine counts are conducted to ensure proper safeguarding of :Firm assets. | <input type="checkbox"/> | <input type="checkbox"/> | |
| d. Maintaining reliable and adequate audit trails which enable the firm to thoroughly investigate suspected improprieties. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 14. Payment by cheque or other electronic methods (internet) to clients are made payable to the beneficial owner of the account or an authorised representative in conformity with applicable written standing client instructions. Similarly, the firm requires its clients to make payments to the firm by crossed cheques payable only to the firm. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 15. Authorisation requirements and authorised cheque signatories and applicable authority parameters, are clearly defined and communicated to the relevant bank; e.g. consider the need to require two or more authorised signatures. Under no circumstances are the firm's cheques to be signed unless the date, specified payee and amount portions of the cheques are properly filled in. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 16. Appropriate controls exist with respect to access to computer systems, facsimile transmission and telex devices, where such devices are used to transmit important information, e.g. funds transfer instructions, settlement instructions and trade confirmations. Clear policies regarding confidentiality of passwords are developed, e.g. passwords are regularly changed and relevant passwords disabled upon a staff member(s) leaving the firm. | <input type="checkbox"/> | <input type="checkbox"/> | |

Risk Assessment Questionnaire

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|---|--------------------------|--------------------------|--|
| 17. Regular compliance reviews and audits are conducted to detect activities or conditions which may violate, or contribute to non-compliance by the firm and its staff with, legal and regulatory requirements, as well as with the firm's own policies and procedures. | <input type="checkbox"/> | <input type="checkbox"/> | |
| B. Risk Management | | | |
| Risk management policy and measurements | | | |
| 18. The firm's risk policies and measurements and reporting methodologies are subject to regular review, particularly prior to the commencement of the firm's provision of new services or products, or when there are significant changes to the products, services, or relevant legislation, rules or regulations that might impact the firm's risk exposure. | <input type="checkbox"/> | <input type="checkbox"/> | |
| Credit risk | | | |
| 19. The firm establishes and maintains an effective credit granting approval process to evaluate client and counterparty creditworthiness. Clearly defined objective measures should be used to evaluate potential clients and determine/review the relevant credit approvals which are used to set appropriate credit limits for all clients, including existing clients. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 20. The staff performing risk management function utilises appropriate quantitative risk measurement methodologies to effectively calculate and monitor the firm's credit exposure in relation to clients, including: pre-settlement credit exposures (e.g. marking to market of outstanding trades) and settlement risk (e.g. exposure caused by timing differences between delivery versus payment). | <input type="checkbox"/> | <input type="checkbox"/> | |
| 21. The staff performing risk management function ensures that credit risks posed by all clients belonging to the same group of companies are aggregated for purposes of measuring the firm's credit exposure. Particular attention is paid to netting arrangements which may serve to reduce the firm's exposure to credit risk. Care must be taken to ensure that credit exposures are netted only if supported by appropriate executed netting agreements, or other appropriate protections. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 22. The staff performing risk management function specifies trading and position limits for each discretionary client based on their respective credit limits and trading needs. These limits are enforced. | <input type="checkbox"/> | <input type="checkbox"/> | |
| Market risk | | | |
| 23. Management specifies authorised products and instruments the firm may deal in and enforces effective procedures to ensure compliance. Relevant control techniques may include regular review of the balance sheet and profit and loss accounts, and records of individual traders and | <input type="checkbox"/> | <input type="checkbox"/> | |

Risk Assessment Questionnaire

| | | | |
|--|--------------------------|--------------------------|--|
| trading members for unauthorised investments or transactions; and confirmation of outstanding transactions with the firm's trading partners. | | | |
| 24. The staff performing risk management function reviews and otherwise enforces on an on-going basis compliance with trading and position limits in relation to proprietary trading and open positions with respect to each authorised product the firm trades or invests in. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 25. Management establishes and maintains effective risk management measures to quantify the impact on the firm -Risk measures used: | <input type="checkbox"/> | <input type="checkbox"/> | |
| a. unspecified adverse market movements - using an appropriate value-at-risk or other methodology to estimate potential losses (this is particularly important for firms which take significant proprietary positions in OTC derivative products); | <input type="checkbox"/> | <input type="checkbox"/> | |
| b. individual market factors - measures the sensitivity of the firm's risk exposure to specific market risk factors e.g. interest rate yield curve shifting and changes in market volatility; and | <input type="checkbox"/> | <input type="checkbox"/> | |
| c. stress testing - determining the effect of abnormal and significant changes in market conditions on the firm using various quantitative and qualitative variable assumptions. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 26. To discourage the firm's dealers from engaging in unauthorised trading, risk adjusted performance measures are used, which may impact a dealer's remuneration where his/her activities expose the firm to especially high risks. Dealers who have exceeded in pre-approved limits are subject to appropriate action. | <input type="checkbox"/> | <input type="checkbox"/> | |
| Liquidity risk | | | |
| 27. Management sets and enforces concentration limits with respect to particular products, markets and business counterparties, taking into account their respective liquidity profile and the firm's approved liquidity risk policies. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 28. Measures of maturity mis-matches between sources and funding requirements and concentrations of individual products, markets and business counterparties, are established and regularly monitored. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 29. Management establishes appropriate arrears and default procedures to alert staff member(s) responsible for liquidity management to potential problems and to provide them adequate time to take appropriate action to minimise the impact of client or counterparty liquidity problems. | <input type="checkbox"/> | <input type="checkbox"/> | |
| Operational risk | | | |
| 30. Management regularly reviews the firm's operations to ensure that the firm's risk of losses, whether financial or otherwise, resulting from fraud, errors, omissions and other operational and | <input type="checkbox"/> | <input type="checkbox"/> | |

Risk Assessment Questionnaire

| | | | |
|--|--------------------------|--------------------------|--|
| compliance matters, are adequately managed. Operational matters covered include: | | | |
| a. physical and functional segregation of incompatible duties such as trade, settlement, risk management and accounting; | <input type="checkbox"/> | <input type="checkbox"/> | |
| b. maintenance and timely production of proper and adequate accounting and other records, and the ability to detect fraud, errors, omissions and other non-compliance with external and internal requirements; | <input type="checkbox"/> | <input type="checkbox"/> | |
| c. security and the reliability of accounting and other information, such as exception reports which should accurately highlight unusual activities and facilitate the detection of fraud, errors and significant trends; and | <input type="checkbox"/> | <input type="checkbox"/> | |
| d. staffing adequacy including personnel with relevant and sufficient skills and experience to minimise the risk of loss due to the absence or departure of "key" staff member(s). | <input type="checkbox"/> | <input type="checkbox"/> | |
| 31. An effective business continuity plan appropriate to the size of the firm is implemented to ensure that the firm is protected from the risk of interruption to its business continuity. Key processes in this area include: a business impact study, identification of likely scenarios involving interruptions (e.g. break down in its data processing systems) and documentation and regular testing of the firm's disaster recovery plan. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 32. The firm has adequate insurance cover for different types of exposures, including but not limited to fidelity insurance, and replacement of equipment and other business and data processing devices. | <input type="checkbox"/> | <input type="checkbox"/> | |

Risk Assessment Questionnaire

Section B - Compliance

10. Part I – Identify which one of the following statements best describes the financial products offered by your organization.

- ☐ The company does not offer complex investment products.
- ☐ The company does not offer complex investment products but is planning to do so in the next 1-2 years.
- ☐ The company offers a few complex investment products e.g. Repos, margin finance.
- ☐ The company offers some complex investment products e.g. Repos, margin finance investment funds, derivatives and OTC transactions.
- ☐ The company offers a great number of complex financial products e.g Repos, margin finance investment funds, derivatives and OTC transactions, sponsored funds, exchange traded funds, commodity pools or hedge funds.

Part II - Briefly describe the nature of the financial products offered.

11. Part I - Identify which one of the following statements best describes the **size of your broking products and investment management operations**.

- ☐ Assets under administration over Tk 1billion.
- ☐ Assets under administration between Tk750 million to under Tk1 billion.
- ☐ Assets under administration between Tk 500 million to Tk 749 million.
- ☐ Assets under administration between Tk 250 million to Tk 499 million.
- ☐ Assets under administration under Tk 250 million.
- ☐ Part II - What are your approximate **assets under administration**? _Tk_____

12. Part I - Identify which one of the following statements best describes the **age of your organization**.

- ☐ Greater than 15 years.
- ☐ Greater than 10 years, but less than 15 years.
- ☐ Greater than 5 years, but less than 10 years.
- ☐ Greater than 2 years, but less than 5 years.
- ☐ Less than 2 years

Part II - If you wish to provide further detail, please describe below.

Risk Assessment Questionnaire

Strategic and Tactical Management

13. Part I - Taking the 12-month period which includes the past 6 months and the immediate future 6 months identify which one of the following statements best describes your business strategies and decision making process.

- ☐ No changes in strategic direction.
- ☐ Few changes in strategic direction, adequate resources and skills to implement the strategy.
- ☐ Moderate number of changes in strategic direction, adequate resources and skills to implement the strategy.
- ☐ Frequent changes to strategic direction, adequate resources and skills to implement the strategy.
- ☐ Frequent changes to strategic direction, inadequate resources and skills to implement the strategy.

Part II - For the statement chosen, substantiate your response by describing in further detail your business strategies and decision making process

14. Part I - Identify which one of the following statements best describes your **corporate structure/ownership**.

- ☐ This is the only legal entity within the corporate structure. No related parties.
- ☐ There are other entities within the corporate structure but do not engage in any business transactions with them.
- ☐ Simple corporate structure, low number of related party transactions.
- ☐ Complex corporate structure, low number of related party transactions.
- ☐ Complex corporate structure, high number of related party transactions.

Part II - If you wish to provide further information, please describe below.

Financial Condition

15. Part I - Identify which one of the following statements best describes the profitability and liquidity of your business operations.

- ☐ Able to continuously run the business in a profitable condition and experience significant growth in the revenue stream over the past 2 years. Adequate cash flow to meet debt obligations.
- ☐ Able to continuously run the business in a profitable condition with steady growth in the revenue stream over the past 2 years. Satisfactory cash flow to meet debt obligations.
- ☐ Able to run the business in a profitable condition but with no increase in revenue stream over the past 2 years.
- ☐ Adequate cash flow to meet debt obligations.

Risk Assessment Questionnaire

- ☐ The company experienced losses in 2 consecutive years, exhibits a trend of losing clients and decline in revenue stream. Low cash flow to meet debt obligations.
- ☐ The company experienced losses in consecutive 3 years or more and there was a going concern note on the most recent audited financial statements. Negative cash flow or overdrawing client accounts.

Part II - Briefly describe the corporate structure of your organization.

| |
|--|
| |
|--|

16. Part I - Identify which one of the following statements best describes any pending litigation and/or contingencies that may exist.

- ☐ No claims or litigation outstanding.
- ☐ No significant claims.
- ☐ Possible claim(s) however it is covered by adequate insurance.
- ☐ Possible claims beyond insurance coverage, excess claims to be covered by the company. May result in negative reputation of the company.
- ☐ Significant claims well beyond insurance coverage which may result in negative reputation of the company.

Part II - If any pending litigation and/or claim(s) are outstanding, briefly describe the nature of such pending litigation and/or claim(s) and the amount of the claim(s).

| |
|--|
| |
|--|

Regulatory Risk

17. Is the company or any of its staff subject to any regulatory investigations? If so full detail to be provided.
18. Have any disciplinary actions been taken in the last three years against any staff or the firm?
19. Briefly describe the ways in which you keep abreast of changes in the regulatory environment and how you respond to the changes.

Quality of Management and Staff

20. Does the firm have any formal training programs in place?

| | |
|----------------------|--|
| Sales training | |
| Compliance Training | |
| Industry conferences | |
| Back Office Training | |
| Product training | |
| Other | |

Risk Assessment Questionnaire

21. No. of staff by type:

| | |
|---------------------|--|
| Management | |
| Compliance & Legal | |
| Accounting Finance | |
| Sales Trading | |
| Back Office Support | |
| Other | |

22. Part I - Identify which one of the following statements best describes your organization with respect to the average level of experience of key management and staff.

- ☐ Greater than 15 years' industry experience.
- ☐ 10-15 years industry experience.
- ☐ 5-10 years industry experience.
- ☐ 3-5 years industry experience.
- ☐ Less than 3 years industry experience.

Part II - If you wish to provide further detail, please describe below

23. Part I - Identify which one of the following statements best describes the **turnover of key management and staff** in the last 5 years. [key management and staff is defined as officers, directors and portfolio managers].

- ☐ Less than 5% turnover in key management and staff.
- ☐ 5-10% turnover in key management and staff.
- ☐ 10-15% turnover in key management and staff.
- ☐ 15-20% turnover in key management and staff.
- ☐ Greater than 20% turnover in key management and staff

Part II - If you wish to provide further detail, please describe below.

24. Part I - Identify which one of the following statements best describes **the adequacy of staff resources** for the operation of your organization

- ☐ Adequate staffing levels to ensure that the day to day responsibilities are carried out efficiently and effectively. ("adequate" meaning no backlog in processing and no overtime).
- ☐ Adequate staffing levels to ensure that the day to day responsibilities are carried out efficiently and effectively. ("adequate" meaning no backlog in processing and little overtime).
- ☐ Inadequate staffing levels to ensure that the day to day responsibilities are carried out efficiently and effectively. ("inadequate" meaning backlog in processing and moderate level of overtime hours incurred).
- ☐ Lean staffing levels such that day to day responsibilities are not carried out efficiently and effectively.
- ☐ Low staffing levels such that day to day responsibilities are not carried out efficiently and effectively

Part II - If you wish to provide further detail, please describe below.

25. Part I - Identify which one of the following statements best describes your **back-up procedures for key person** reliance and the cross training in place:

Risk Assessment Questionnaire

- ☐ Back-up for key positions and adequate cross training provided to other individuals.
- ☐ Back-up for key positions and moderate cross training provided to other individuals.
- ☐ Back-up for key positions and limited cross training provided to other individuals.
- ☐ Inadequate back-up for key positions and limited cross training provided to other individuals.
- ☐ No back-up for key positions and no cross training provided to other individuals.

Part II - If you wish to provide further detail, please describe below.

Adequacy of and Changes in Systems

26. Part I - Identify which one of the following statements best describes the effectiveness and **availability of information technology** in your organization

- ☐ Systems and technology functionality are adequate to meet business needs, technology and communications hardware and software are adequate to meet user requirements. No systems outages, sufficient processing capacity for volume being handled, adequate system backup and disaster recovery procedures. ("adequate" meaning no downtime with respect to computer systems).
- ☐ Systems and technology functionality are adequate to meet business needs, technology and communications hardware and software are adequate to meet user requirements. Few systems outages, sufficient processing capacity for volume being handled, adequate system backup and disaster recovery procedures.
- ☐ Systems and technology functionality are inadequate to meet business needs, technology and communications hardware and software are adequate to meet user requirements. Few systems outages, sufficient processing capacity for volume being handled, adequate systems backup and disaster recovery procedures. Frequent systems outages, sufficient processing capacity for volume being handled, inadequate systems backup and disaster recovery procedures.
- ☐ Systems and technology functionality are inadequate to meet business needs, technology and communications hardware and software are inadequate to meet user requirements. Several systems outages, sufficient processing capacity for volume being handled, inadequate systems backup and disaster recovery procedures.
- ☐ Systems and technology functionality are inadequate to meet business needs, technology and communications hardware and software are inadequate to meet user requirements. Frequent systems outages, insufficient processing capacity for volume being handled, inadequate systems backup and disaster recovery procedures.

Part II - For the statement chosen, substantiate your response by describing in further detail the effectiveness of information technology in meeting your business needs.

27. Part I - Identify which one of the following statements best describes your current procedures with respect to **data integrity**. [Note: this is not an all-inclusive list.]

- ☐ Strong emphasis on data integrity and security including client and unitholder record keeping, passwords used, passwords changed frequently, virus software used, virus software updated at the time of new releases, firewalls in place if data accessed through the Internet.
- ☐ Strong emphasis on data integrity and security including client and unitholder record keeping, passwords used, passwords changed regularly, virus software used, virus software updated regularly, firewalls in place if data accessed through the Internet.

Risk Assessment Questionnaire

- ☐ Moderate emphasis on data integrity and security including client and unitholder record keeping, passwords used, passwords changed infrequently, virus software used, virus software updated infrequently, firewalls in place if data accessed through the Internet.
- ☐ Moderate emphasis on data integrity and security including client and unitholder record keeping, passwords used, passwords not changed, virus software used, virus software not updated regularly, some firewalls in place if data accessed through the Internet.
- ☐ Weak emphasis on data integrity and security including client and unitholder record keeping, no passwords used, no virus software used, no firewalls in place if data accessed through the Internet.

Part II - For the statement chosen, substantiate your response by describing in further detail your current procedures with respect to data integrity.

28. Part I - Identify which one of the following statements best describes your information systems operations

- ☐ Information systems are adequately developed, tested and implemented. No system changes recently. ("adequate" meaning system is reliable in functionality and no major problems encountered).
- ☐ Information systems are adequately developed, tested and implemented. Recent system changes are not complex and are fully integrated with existing systems.
- ☐ Information systems are adequately developed, tested and implemented. Recent system changes are complex and are fully integrated with existing systems.
- ☐ Information systems are inadequately developed, tested and implemented. Recent system changes are not complex and are not fully integrated with existing systems.
- ☐ Information systems are inadequately developed, tested and implemented. Recent system changes are complex and are not fully integrated with existing systems.

Part II - If you wish to provide further detail, please describe below.

Part III - If systems changes occurred within the past twelve months (i.e. implementation of a new system or major enhancements), briefly describe the reason for the change(s) and the nature of the change(s).

Part IV - If systems changes are being considered in the next 6-12 months (i.e. implementation of a new system or major enhancements), briefly describe the reason for the change(s) and the nature of the change(s).

Adequacy of Marketing and Selling Practices

29. Part I - Please identify if you use any of the following media in your marketing and selling practices:

- ☐ Printed media, i.e. newspapers, magazines
- ☐ Marketing brochures
- ☐ Electronic media, i.e. websites, email
- ☐ Audio/visual media, i.e. T.V., radio
- ☐ Presentations
- ☐ Seminars
- ☐ Other, please describe below.
- ☐ None of the above

Part II - For items chosen, substantiate your response by describing in further detail your current procedures with respect to the review and approval of marketing and selling material.

If you have a website, include the website address in your response.

Risk Assessment Questionnaire

Part III - Please describe how you ensure that your marketing and selling practices are in accordance with regulatory requirements

Adequacy of Operational Procedures

30. Part I - Identify which one of the following statements best describes your policies and procedures.

- ☐ Automated processes. Policies and procedures are well documented, effective and efficient, consistently applied and well understood.
- ☐ Complex automated processes. Policies and procedures are well documented, effective and efficient, consistently applied and well understood.
- ☐ Complex automated processes. Policies and procedures are inadequately documented, however they are effective and efficient, consistently applied and well understood.
- ☐ Mix of manual processes and automated processes with a high number of manual adjustments, cancels and corrections and unreconciled balances (i.e. client and unitholder record keeping, trust accounting and fund accounting). Policies and procedures are poorly documented, ineffective and inefficient, inconsistently applied and not well understood.
- ☐ Manual processes with a high number of manual adjustments, cancels and corrections and unreconciled balances (i.e. client and unitholder record keeping, trust accounting and fund accounting). Written policies and procedures do not exist.

Part II - If you wish to provide more information, please describe below.

Part III - Briefly describe the policies and procedures in place with respect to the following:

- i) Client record keeping including unitholder registration
- ii) Portfolio and fund accounting
- iii) Securities lending if applicable
- iv) Accounting functions, including segregation of monies.

31. Describe your valuation policies and strategies. In your answer, describe the assumptions used by management to calculate the net asset value ("NAV") (i.e. for the pricing of thinly traded securities or private placements). Describe the valuation methodology for securities adopted by management. Indicate if management performs price variance analyses, and if so, how often. Describe the process to monitor the valuation of investments.

32. Part I - Identify which one of the following statements best describes the oversight of the performance of service providers, including third parties and related parties.

- ☐ Continuous monitoring of activities.
- ☐ Monthly monitoring of activities carried out by the service provider to ensure in accordance with contract.
- ☐ Services provided are in accordance with contract. Company initiates semi-annual meetings with service provider.
- ☐ Quarterly monitoring of activities carried out by the service provider to ensure in accordance with contract.
- ☐ Services provided are in accordance with contract. Company initiates annual meetings with service provider.
- ☐ Semi-annual monitoring of activities carried out by the service provider to ensure in accordance with contract.

Risk Assessment Questionnaire

- ☐ No monitoring of activities carried out by the service provider to ensure in accordance with contract. Company does not initiate meetings with service provider.
- ☐ Not applicable.

Part II - For the statement chosen, substantiate your response by describing in further detail how you oversee the performance of service providers.

Susceptibility to Fraud or Unethical Behaviour

33. Describe the policies and procedures in place to ensure that inappropriate activities don't take place such as: misappropriation of assets, inflated NAV calculations, inappropriate movement of cash in client accounts and money laundering. If inappropriate activities have occurred, describe the process to escalate the issues to management and how the issues were rectified. Describe any recent instances (in the past 12 months) of any fraudulent or unethical behaviour, and how management resolved the issue(s).

34. Part I – Where applicable identify which one of the following statements best describes your **compensation structure** as a fund manager.

- ☐ Simple compensation structure and no incentive fees.
- ☐ Complex compensation structure and no incentive fees.
- ☐ Complex compensation structure and simple incentive fee calculation (i.e. incentive fees are referenced to a benchmark or index).
- ☐ Complex compensation structure and complex incentive fee calculation (i.e. incentive fees are partially referenced to a benchmark or index).
- ☐ Complex compensation structure and very complex incentive fee calculation is very complex (i.e. incentive fees are not referenced to a benchmark or index)

Part II - For the statement chosen, substantiate your response by describing in further detail your compensation structure.

Board Management and Staff

35. Briefly describe your organizational corporate and investment governance structures. Discuss the composition of the Board, frequency of meetings, reporting relationships, decision making process and information flow.

36. Briefly describe the management and staff culture of your organization, specifically as it relates to your appetite for risk, compliance and control, moral and ethical values and professional conduct.

Prepared By:

| | | |
|-----------|------------|----------|
| Last Name | First Name | Position |
|-----------|------------|----------|

Contact Information:

| | | |
|-----------|------------|----------|
| Last Name | First Name | Position |
|-----------|------------|----------|

Firm Name

Phone Number E-mail

Certified: I hereby certify that responses given by our organisation are both current in fact and truthfully compiled:

Risk Assessment Questionnaire

Last Name:

First Name

Senior Executive Officer

Date-----Signed -----

Appendix 1.4: Risk Assessment Questionnaire (November 2014)



বাংলাদেশ সিকিউরিটিজ অ্যান্ড এক্সচেঞ্জ কমিশন
Bangladesh Securities and Exchange Commission

ADB TA-8228 BAN: Enhancing Efficiency of the Capital Market

RISK ASSESSMENT QUESTIONNAIRE

November 2014



The International Securities Consultancy Limited

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Tel +852 2877 3417 ♦ Fax +852 3017 8360 ♦ info@isc-global.com ♦ www.isc-global.com

Risk Assessment Questionnaire

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Risk Assessment Questionnaire

Risk Assessment Questionnaire

November 2014

Instructions

Please respond to all questions in this questionnaire. It is understood that the interpretation of the questionnaire and responding to the questionnaire requires a high level of professional judgement. However, the BSEC expects the responses to be honestly and truthfully completed.

Please also ensure completion of the full contact information at the end of the questionnaire and ensure it is signed by the appropriate officer.

| | |
|-------------------------|--|
| Name of Company: | |
| Address: | |

Name of person designated Representative of Company:

Last Name First Name email:

Name of person designated as Head of Compliance:

Last Name First Name email:

Name of person designated as Risk Management Officer:

Last Name First Name email:

Name of person designated as Money Laundering Officer:

Last Name First Name email:

TREC (Mark)

- ☐ Dhaka Stock Exchange
- ☐ Chittagong Stock Exchange

Risk Assessment Questionnaire

Business Activity

1. Does the firm act in any of the following capacities:

| | Activity | Yes | No |
|----|---|--------------------------|--------------------------|
| a) | Broker | <input type="checkbox"/> | <input type="checkbox"/> |
| b) | Dealer or trade securities on own account | <input type="checkbox"/> | <input type="checkbox"/> |
| c) | If Dealer – Liquidity provider | <input type="checkbox"/> | <input type="checkbox"/> |
| d) | Fund Manager including for CIU | <input type="checkbox"/> | <input type="checkbox"/> |
| e) | Investment Advisor | <input type="checkbox"/> | <input type="checkbox"/> |
| f) | Participates as an Underwriter | <input type="checkbox"/> | <input type="checkbox"/> |
| g) | Have Discretionary Accounts | <input type="checkbox"/> | <input type="checkbox"/> |
| h) | Conduct Investment Banking Activities | <input type="checkbox"/> | <input type="checkbox"/> |
| i) | Create and distribute Research reports | <input type="checkbox"/> | <input type="checkbox"/> |
| j) | Provides Client internet trading System | <input type="checkbox"/> | <input type="checkbox"/> |
| k) | Does the firm undertake OTC transactions | <input type="checkbox"/> | <input type="checkbox"/> |
| l) | Other Services – Please describe: | <input type="checkbox"/> | <input type="checkbox"/> |

2. What is the firms current **paid in Capital** Tk Millions _____

What is the net worth of the company Tk Millions _____

Date as at _____

3. Does the Company have **other branches** than the home office? Yes__ Number__

Locations: _____

4. Average **Number of Transactions, Volume and Value** per month over last six months:

- | | |
|---------------------------------|-------|
| a. Number (Frequency) | _____ |
| b. Volume (No Shares) Thousands | _____ |
| c. Value Tk Million | _____ |
| d. Number Bond Deals | _____ |
| e. Value of Bond Deals | _____ |

Risk Assessment Questionnaire

5. Number of Client Accounts

| | Values as at 31 st October 2014 | | |
|---------------------|--|--|--------------------------------------|
| TYPE | Number | Value due to Firm by Clients Tk Million | Due to Clients by Firm Tk Million |
| Cash Equity Trading | | | |
| Bond Trading | | | |
| Investment Advisory | | | |
| OTC | | | |
| Other (describe) | | | |
| | | Number last 6 months | Number unresolved at this date |
| Client Complaints | | | |

6. Make up of business revenue (approximate %age)

| <u>Activity</u> | <u>%age</u> |
|----------------------------|-------------|
| Institutional | |
| Retail | |
| Broker/dealers | |
| High Net Worth Individuals | |
| Foreign Clients | |
| Agency Business | |

Risk Assessment Questionnaire

Section A - Risk and Internal Control

Risk Management and Control

7. Briefly describe the risk management practices of your organization and your ability to identify, prioritize, monitor and manage the risks.
8. Briefly describe the roles and responsibilities of your compliance officer, and where applicable, the compliance, legal and internal audit departments.
9. Briefly describe the quality of controls within your organization and support your conclusion. Describe how the organization has addressed internal controls, management supervision and segregation of duties in the areas of dealing, settlement and client accounting, fund accounting, and finance/treasury functions, if applicable.

Risk Assessment Questionnaire

Internal Control Assessment

| A. Operational Controls | Yes | No | Comments |
|--|--------------------------|--------------------------|-----------------|
| Opening and handling of client accounts (In this section please provide copies of any forms, procedures etc that support answers) | | | |
| 1. Mandatory account opening procedures are clearly defined and followed. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 2. In the case of discretionary accounts, special procedures are implemented as follows: | | | |
| a. executing a discretionary account agreement which sets out the investment objectives and strategies of the client and the precise terms and conditions under which such discretion will be exercised; | <input type="checkbox"/> | <input type="checkbox"/> | |
| b. regular reviews of the performance of the account conducted by designated staff company(s) independent of the staff handling the account; | <input type="checkbox"/> | <input type="checkbox"/> | |
| c. providing the client with regular statements and timely ad hoc reports on account balance and transaction details, especially when the account balance falls below agreed levels or when large orders for the account are pending or executed; and | <input type="checkbox"/> | <input type="checkbox"/> | |
| d. clearly delineating the investment decision making process from the dealing process: order tickets similar to those used for non-discretionary agency business are completed and time-stamped to record the actual time orders are initiated. | <input type="checkbox"/> | <input type="checkbox"/> | |
| Providing investment advice | | | |
| 3. Where the firm is in the business of offering investment advice for remuneration, or has entered into a contractual advisory arrangement with a client, and in the course of such business, gives investment recommendations or advice, special procedures are implemented and followed as follows: | | | |
| a. establishing clear requirements and procedures regarding adequacy of research work and preparation and retention of documentation supporting the recommendations and advice; | <input type="checkbox"/> | <input type="checkbox"/> | |
| b. providing to the client in writing details of the fees, charges and penalties applicable to any recommended investment scheme; and | <input type="checkbox"/> | <input type="checkbox"/> | |
| c. documenting (and providing a copy to the client) the rationale underlying investment advice rendered or recommendations made. Such advice and recommendations must be suitable taking into account the client's particular investment experience and objectives and financial position. | <input type="checkbox"/> | <input type="checkbox"/> | |
| Dealing practices | | | |
| 4. The firm puts in place procedures to ensure that its staff's trading activities are not prejudicial to the | <input type="checkbox"/> | <input type="checkbox"/> | |

Risk Assessment Questionnaire

| | | | |
|---|--------------------------|--------------------------|--|
| interests of its clients. Staff members are required to disclose to the firm, on joining and regularly afterwards (at least semi-annually), details of holdings and trading activities in which they have an interest in relation to specific securities, futures and other investment products in which the firm deals in or in respect of which the firm acts as an investment adviser or commodity trading adviser. Staff members of a firm which is, or belongs to a group within which a group company is, a member of an exchange are required to trade through staff accounts in relation to products traded on that exchange. All transactions for staff accounts are separately recorded and diligently monitored by independent senior management. (Please provide a copy of the approval procedure) | | | |
| 5. The firm clearly defines parameters in relation to the acceptance by staff member(s) or the firm of gifts, rebates, benefits-in-kind or "soft-dollar" benefits received from clients or other business contacts. These include the circumstances under which acceptance is permitted and approval required. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 6. Effective procedures are established to ensure that whenever the firm or its staff member(s) have an interest in a transaction with a client (i.e. a direct/cross books transaction), this fact is disclosed to the client prior to the execution of the relevant transaction. For example, the firm may maintain a register of direct and cross books trades which also records the name of the client and the firm account involved, the person contacted and the time when the consent was received. The register is reviewed regularly (at least monthly) by designated staff member(s) performing the compliance function or a senior staff member in the dealing department. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 7. Order handling procedures are clearly documented and followed. | | | |
| a. Orders are recorded, using standard order forms, and time-stamped promptly upon initiation or receipt and are required to be transmitted to the dealer, floor trader or operators of terminals for automated trading systems within a reasonable time period, normally immediately. Where orders are system generated is there a time sequence audit trail available and filed daily. | <input type="checkbox"/> | <input type="checkbox"/> | |
| b. Prior to executing a client order, the following items are checked by designated staff: | | | |
| i. the status of the account (active, closed or being on an internal watch list, etc.); | <input type="checkbox"/> | <input type="checkbox"/> | |
| ii. applicable account limits, if any (e.g. trade, position, credit); | <input type="checkbox"/> | <input type="checkbox"/> | |
| iii. the sufficiency of available funds or available credit in the relevant account; | <input type="checkbox"/> | <input type="checkbox"/> | |

Risk Assessment Questionnaire

| | | | |
|--|--------------------------|--------------------------|--|
| iv. in the case of a sell order, the sufficiency and availability of securities applicable; | <input type="checkbox"/> | <input type="checkbox"/> | |
| v. Effective procedures regarding the transmission of orders to the dealing room are established. Sufficient information should be given to enable client priority to be established. | <input type="checkbox"/> | <input type="checkbox"/> | |
| Chinese Walls | | | |
| 8. The firm avoids apparent and potential conflicts of interest by establishing and maintaining adequate "Chinese Walls", such as the separation of dealers handling client funds or discretionary orders from those handling proprietary or staff accounts. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 9. Management establishes and maintains policies and procedures regarding "Chinese Walls" to ensure that price-sensitive information privy to the research staff or staff handling corporate finance matters like a takeover and merger should not be available to staff outside those departments, except on a "need to know" basis. | <input type="checkbox"/> | <input type="checkbox"/> | |
| Back office and accounting | | | |
| 10. Deal tickets are transmitted to the designated back office staff member(s) who enter the details into the firm's own in-house system (whether automated or otherwise). At the end of each business day, the firm's own record of trades is matched by the back office staff to the trading/clearing lists received from the exchanges or clearing houses and where applicable, to confirmation documents issued by counterparties and executing brokers. Exception reports identifying mis-matched and unusual trades are produced, reviewed and follow-up actions taken, where necessary. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 11. All trades are confirmed promptly with the client on whose behalf the trade was executed and, for off-exchange trades, these are also confirmed promptly with the counterparty using reliable and pre-agreed methods (describe) Method: | | | |
| 12. All trade errors are reported to the person responsible for dealing and are allocated to an "error" or "suspense" account for prompt correction or closure of the position. The transactions in this account should be supported by clear documentation explaining the relevant circumstances and reviewed by the staff member(s) performing the compliance and internal audit functions. Any unusual circumstances or patterns should be investigated. | <input type="checkbox"/> | <input type="checkbox"/> | |

Risk Assessment Questionnaire

| Asset protection | | | |
|--|--------------------------|--------------------------|--|
| 13. Effective procedures are established and followed, when handling movements of firm and client assets. Procedures include: | | | |
| a. Clearly identifying staff member(s) and representatives of clients (for client assets) with authority to acquire, dispose of, lend, pledge or otherwise part with possession of, firm and client assets, and the parameters of such authority. The authority is checked with respect to each asset movement and client withdrawal request. | <input type="checkbox"/> | <input type="checkbox"/> | |
| b. Use of standardised and sequentially numbered receipts and despatch notes or other appropriate methods to acknowledge and account for asset movements. | <input type="checkbox"/> | <input type="checkbox"/> | |
| c. Securely storing firm and client assets, other important documents and controlled forms such as cheque books, contract notes etc., while at the firm's premises; and promptly depositing cheques, cashier orders and other negotiable instruments and securities into the appropriate account(s) at banks or securities depositories. During the period that physical scrip or cash is held at the firm's premises, routine counts are conducted to ensure proper safeguarding of :Firm assets. | <input type="checkbox"/> | <input type="checkbox"/> | |
| d. Maintaining reliable and adequate audit trails which enable the firm to thoroughly investigate suspected improprieties. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 14. Payment by cheque or other electronic methods (internet) to clients are made payable to the beneficial owner of the account or an authorised representative in conformity with applicable written standing client instructions. Similarly, the firm requires its clients to make payments to the firm by crossed cheques payable only to the firm. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 15. Authorisation requirements and authorised cheque signatories and applicable authority parameters, are clearly defined and communicated to the relevant bank; e.g. consider the need to require two or more authorised signatures. Under no circumstances are the firm's cheques to be signed unless the date, specified payee and amount portions of the cheques are properly filled in. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 16. Appropriate controls exist with respect to access to computer systems, facsimile transmission and telex devices, where such devices are used to transmit important information, e.g. funds transfer instructions, settlement instructions and trade confirmations. Clear policies regarding confidentiality of passwords are developed, e.g. passwords are regularly changed and relevant passwords disabled upon a staff member(s) leaving the firm. | <input type="checkbox"/> | <input type="checkbox"/> | |

Risk Assessment Questionnaire

| | | | |
|---|--------------------------|--------------------------|--|
| 17. Regular compliance reviews and audits are conducted to detect activities or conditions which may violate, or contribute to non-compliance by the firm and its staff with, legal and regulatory requirements, as well as with the firm's own policies and procedures. | <input type="checkbox"/> | <input type="checkbox"/> | |
| B. Risk Management | | | |
| Risk management policy and measurements | | | |
| 18. The firm's risk policies and measurements and reporting methodologies are subject to regular review, particularly prior to the commencement of the firm's provision of new services or products, or when there are significant changes to the products, services, or relevant legislation, rules or regulations that might impact the firm's risk exposure. | <input type="checkbox"/> | <input type="checkbox"/> | |
| Credit risk | | | |
| 19. The firm establishes and maintains an effective credit granting approval process to evaluate client and counterparty creditworthiness. Clearly defined objective measures should be used to evaluate potential clients and determine/review the relevant credit approvals which are used to set appropriate credit limits for all clients, including existing clients. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 20. The staff performing risk management function utilises appropriate quantitative risk measurement methodologies to effectively calculate and monitor the firm's credit exposure in relation to clients, including: pre-settlement credit exposures (e.g. marking to market of outstanding trades) and settlement risk (e.g. exposure caused by timing differences between delivery versus payment). | <input type="checkbox"/> | <input type="checkbox"/> | |
| 21. The staff performing risk management function ensures that credit risks posed by all clients belonging to the same group of companies are aggregated for purposes of measuring the firm's credit exposure. Particular attention is paid to netting arrangements which may serve to reduce the firm's exposure to credit risk. Care must be taken to ensure that credit exposures are netted only if supported by appropriate executed netting agreements, or other appropriate protections. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 22. The staff performing risk management function specifies trading and position limits for each discretionary client based on their respective credit limits and trading needs. These limits are enforced. | <input type="checkbox"/> | <input type="checkbox"/> | |
| Market risk | | | |
| 23. Management specifies authorised products and instruments the firm may deal in and enforces effective procedures to ensure compliance. Relevant control techniques may include regular review of the balance sheet and profit and loss accounts, and records of individual traders and | <input type="checkbox"/> | <input type="checkbox"/> | |

Risk Assessment Questionnaire

| | | | |
|--|--------------------------|--------------------------|--|
| trading members for unauthorised investments or transactions; and confirmation of outstanding transactions with the firm's trading partners. | | | |
| 24. The staff performing risk management function reviews and otherwise enforces on an on-going basis compliance with trading and position limits in relation to proprietary trading and open positions with respect to each authorised product the firm trades or invests in. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 25. Management establishes and maintains effective risk management measures to quantify the impact on the firm -Risk measures used: | <input type="checkbox"/> | <input type="checkbox"/> | |
| a. unspecified adverse market movements - using an appropriate value-at-risk or other methodology to estimate potential losses (this is particularly important for firms which take significant proprietary positions in OTC derivative products); | <input type="checkbox"/> | <input type="checkbox"/> | |
| b. individual market factors - measures the sensitivity of the firm's risk exposure to specific market risk factors e.g. interest rate yield curve shifting and changes in market volatility; and | <input type="checkbox"/> | <input type="checkbox"/> | |
| c. stress testing - determining the effect of abnormal and significant changes in market conditions on the firm using various quantitative and qualitative variable assumptions. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 26. To discourage the firm's dealers from engaging in unauthorised trading, risk adjusted performance measures are used, which may impact a dealer's remuneration where his/her activities expose the firm to especially high risks. Dealers who have exceeded in pre-approved limits are subject to appropriate action. | <input type="checkbox"/> | <input type="checkbox"/> | |
| Liquidity risk | | | |
| 27. Management sets and enforces concentration limits with respect to particular products, markets and business counterparties, taking into account their respective liquidity profile and the firm's approved liquidity risk policies. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 28. Measures of maturity mis-matches between sources and funding requirements and concentrations of individual products, markets and business counterparties, are established and regularly monitored. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 29. Management establishes appropriate arrears and default procedures to alert staff member(s) responsible for liquidity management to potential problems and to provide them adequate time to take appropriate action to minimise the impact of client or counterparty liquidity problems. | <input type="checkbox"/> | <input type="checkbox"/> | |
| Operational risk | | | |
| 30. Management regularly reviews the firm's operations to ensure that the firm's risk of losses, whether financial or otherwise, resulting from fraud, errors, omissions and other operational and | <input type="checkbox"/> | <input type="checkbox"/> | |

Risk Assessment Questionnaire

| | | | |
|--|--------------------------|--------------------------|--|
| compliance matters, are adequately managed. Operational matters covered include: | | | |
| a. physical and functional segregation of incompatible duties such as trade, settlement, risk management and accounting; | <input type="checkbox"/> | <input type="checkbox"/> | |
| b. maintenance and timely production of proper and adequate accounting and other records, and the ability to detect fraud, errors, omissions and other non-compliance with external and internal requirements; | <input type="checkbox"/> | <input type="checkbox"/> | |
| c. security and the reliability of accounting and other information, such as exception reports which should accurately highlight unusual activities and facilitate the detection of fraud, errors and significant trends; and | <input type="checkbox"/> | <input type="checkbox"/> | |
| d. staffing adequacy including personnel with relevant and sufficient skills and experience to minimise the risk of loss due to the absence or departure of "key" staff member(s). | <input type="checkbox"/> | <input type="checkbox"/> | |
| 31. An effective business continuity plan appropriate to the size of the firm is implemented to ensure that the firm is protected from the risk of interruption to its business continuity. Key processes in this area include: a business impact study, identification of likely scenarios involving interruptions (e.g. break down in its data processing systems) and documentation and regular testing of the firm's disaster recovery plan. | <input type="checkbox"/> | <input type="checkbox"/> | |
| 32. The firm has adequate insurance cover for different types of exposures, including but not limited to fidelity insurance, and replacement of equipment and other business and data processing devices. | <input type="checkbox"/> | <input type="checkbox"/> | |

Risk Assessment Questionnaire

Section B - Compliance

10. Part I – Identify which one of the following statements best describes the financial products offered by your organization.

- ☐ The company does not offer complex investment products.
- ☐ The company does not offer complex investment products but is planning to do so in the next 1-2 years.
- ☐ The company offers a few complex investment products e.g. Repos, margin finance.
- ☐ The company offers some complex investment products e.g. Repos, margin finance investment funds, derivatives and OTC transactions.
- ☐ The company offers a great number of complex financial products e.g Repos, margin finance investment funds, derivatives and OTC transactions, sponsored funds, exchange traded funds, commodity pools or hedge funds.

Part II - Briefly describe the nature of the financial products offered.

11. Part I - Identify which one of the following statements best describes the **size of your broking products and investment management operations**.

- ☐ Assets under administration over Tk 1billion.
- ☐ Assets under administration between Tk750 million to under Tk1 billion.
- ☐ Assets under administration between Tk 500 million to Tk 749 million.
- ☐ Assets under administration between Tk 250 million to Tk 499 million.
- ☐ Assets under administration under Tk 250 million.
- ☐ Part II - What are your approximate **assets under administration**? _Tk_____

12. Part I - Identify which one of the following statements best describes the **age of your organization**.

- ☐ Greater than 15 years.
- ☐ Greater than 10 years, but less than 15 years.
- ☐ Greater than 5 years, but less than 10 years.
- ☐ Greater than 2 years, but less than 5 years.
- ☐ Less than 2 years

Part II - If you wish to provide further detail, please describe below.

Risk Assessment Questionnaire

Strategic and Tactical Management

13. Part I - Taking the 12-month period which includes the past 6 months and the immediate future 6 months identify which one of the following statements best describes your business strategies and decision making process.

- ☐ No changes in strategic direction.
- ☐ Few changes in strategic direction, adequate resources and skills to implement the strategy.
- ☐ Moderate number of changes in strategic direction, adequate resources and skills to implement the strategy.
- ☐ Frequent changes to strategic direction, adequate resources and skills to implement the strategy.
- ☐ Frequent changes to strategic direction, inadequate resources and skills to implement the strategy.

Part II - For the statement chosen, substantiate your response by describing in further detail your business strategies and decision making process

14. Part I - Identify which one of the following statements best describes your **corporate structure/ownership**.

- ☐ This is the only legal entity within the corporate structure. No related parties.
- ☐ There are other entities within the corporate structure but do not engage in any business transactions with them.
- ☐ Simple corporate structure, low number of related party transactions.
- ☐ Complex corporate structure, low number of related party transactions.
- ☐ Complex corporate structure, high number of related party transactions.

Part II - If you wish to provide further information, please describe below.

Financial Condition

15. Part I - Identify which one of the following statements best describes the profitability and liquidity of your business operations.

- ☐ Able to continuously run the business in a profitable condition and experience significant growth in the revenue stream over the past 2 years. Adequate cash flow to meet debt obligations.
- ☐ Able to continuously run the business in a profitable condition with steady growth in the revenue stream over the past 2 years. Satisfactory cash flow to meet debt obligations.
- ☐ Able to run the business in a profitable condition but with no increase in revenue stream over the past 2 years.
- ☐ Adequate cash flow to meet debt obligations.

Risk Assessment Questionnaire

- ☐ The company experienced losses in 2 consecutive years, exhibits a trend of losing clients and decline in revenue stream. Low cash flow to meet debt obligations.
- ☐ The company experienced losses in consecutive 3 years or more and there was a going concern note on the most recent audited financial statements. Negative cash flow or overdrawing client accounts.

Part II - Briefly describe the corporate structure of your organization.

| |
|--|
| |
|--|

16. Part I - Identify which one of the following statements best describes any pending litigation and/or contingencies that may exist.

- ☐ No claims or litigation outstanding.
- ☐ No significant claims.
- ☐ Possible claim(s) however it is covered by adequate insurance.
- ☐ Possible claims beyond insurance coverage, excess claims to be covered by the company. May result in negative reputation of the company.
- ☐ Significant claims well beyond insurance coverage which may result in negative reputation of the company.

Part II - If any pending litigation and/or claim(s) are outstanding, briefly describe the nature of such pending litigation and/or claim(s) and the amount of the claim(s).

| |
|--|
| |
|--|

Regulatory Risk

17. Is the company or any of its staff subject to any regulatory investigations? If so full detail to be provided.
18. Have any disciplinary actions been taken in the last three years against any staff or the firm?
19. Briefly describe the ways in which you keep abreast of changes in the regulatory environment and how you respond to the changes.

Quality of Management and Staff

20. Does the firm have any formal training programs in place?

| | |
|----------------------|--|
| Sales training | |
| Compliance Training | |
| Industry conferences | |
| Back Office Training | |
| Product training | |
| Other | |

Risk Assessment Questionnaire

21. No. of staff by type:

| | |
|---------------------|--|
| Management | |
| Compliance & Legal | |
| Accounting Finance | |
| Sales Trading | |
| Back Office Support | |
| Other | |

22. Part I - Identify which one of the following statements best describes your organization with respect to the average level of experience of key management and staff.

- ☐ Greater than 15 years' industry experience.
- ☐ 10-15 years industry experience.
- ☐ 5-10 years industry experience.
- ☐ 3-5 years industry experience.
- ☐ Less than 3 years industry experience.

Part II - If you wish to provide further detail, please describe below

23. Part I - Identify which one of the following statements best describes the **turnover of key management and staff** in the last 5 years. [key management and staff is defined as officers, directors and portfolio managers].

- ☐ Less than 5% turnover in key management and staff.
- ☐ 5-10% turnover in key management and staff.
- ☐ 10-15% turnover in key management and staff.
- ☐ 15-20% turnover in key management and staff.
- ☐ Greater than 20% turnover in key management and staff

Part II - If you wish to provide further detail, please describe below.

24. Part I - Identify which one of the following statements best describes **the adequacy of staff resources** for the operation of your organization

- ☐ Adequate staffing levels to ensure that the day to day responsibilities are carried out efficiently and effectively. ("adequate" meaning no backlog in processing and no overtime).
- ☐ Adequate staffing levels to ensure that the day to day responsibilities are carried out efficiently and effectively. ("adequate" meaning no backlog in processing and little overtime).
- ☐ Inadequate staffing levels to ensure that the day to day responsibilities are carried out efficiently and effectively. ("inadequate" meaning backlog in processing and moderate level of overtime hours incurred).
- ☐ Lean staffing levels such that day to day responsibilities are not carried out efficiently and effectively.
- ☐ Low staffing levels such that day to day responsibilities are not carried out efficiently and effectively

Part II - If you wish to provide further detail, please describe below.

25. Part I - Identify which one of the following statements best describes your **back-up procedures for key person** reliance and the cross training in place:

Risk Assessment Questionnaire

- ☐ Back-up for key positions and adequate cross training provided to other individuals.
- ☐ Back-up for key positions and moderate cross training provided to other individuals.
- ☐ Back-up for key positions and limited cross training provided to other individuals.
- ☐ Inadequate back-up for key positions and limited cross training provided to other individuals.
- ☐ No back-up for key positions and no cross training provided to other individuals.

Part II - If you wish to provide further detail, please describe below.

Adequacy of and Changes in Systems

26. Part I - Identify which one of the following statements best describes the effectiveness and **availability of information technology** in your organization

- ☐ Systems and technology functionality are adequate to meet business needs, technology and communications hardware and software are adequate to meet user requirements. No systems outages, sufficient processing capacity for volume being handled, adequate system backup and disaster recovery procedures. ("adequate" meaning no downtime with respect to computer systems).
- ☐ Systems and technology functionality are adequate to meet business needs, technology and communications hardware and software are adequate to meet user requirements. Few systems outages, sufficient processing capacity for volume being handled, adequate system backup and disaster recovery procedures.
- ☐ Systems and technology functionality are inadequate to meet business needs, technology and communications hardware and software are adequate to meet user requirements. Few systems outages, sufficient processing capacity for volume being handled, adequate systems backup and disaster recovery procedures. Frequent systems outages, sufficient processing capacity for volume being handled, inadequate systems backup and disaster recovery procedures.
- ☐ Systems and technology functionality are inadequate to meet business needs, technology and communications hardware and software are inadequate to meet user requirements. Several systems outages, sufficient processing capacity for volume being handled, inadequate systems backup and disaster recovery procedures.
- ☐ Systems and technology functionality are inadequate to meet business needs, technology and communications hardware and software are inadequate to meet user requirements. Frequent systems outages, insufficient processing capacity for volume being handled, inadequate systems backup and disaster recovery procedures.

Part II - For the statement chosen, substantiate your response by describing in further detail the effectiveness of information technology in meeting your business needs.

27. Part I - Identify which one of the following statements best describes your current procedures with respect to **data integrity**. [Note: this is not an all-inclusive list.]

- ☐ Strong emphasis on data integrity and security including client and unitholder record keeping, passwords used, passwords changed frequently, virus software used, virus software updated at the time of new releases, firewalls in place if data accessed through the Internet.
- ☐ Strong emphasis on data integrity and security including client and unitholder record keeping, passwords used, passwords changed regularly, virus software used, virus software updated regularly, firewalls in place if data accessed through the Internet.

Risk Assessment Questionnaire

- ☐ Moderate emphasis on data integrity and security including client and unitholder record keeping, passwords used, passwords changed infrequently, virus software used, virus software updated infrequently, firewalls in place if data accessed through the Internet.
- ☐ Moderate emphasis on data integrity and security including client and unitholder record keeping, passwords used, passwords not changed, virus software used, virus software not updated regularly, some firewalls in place if data accessed through the Internet.
- ☐ Weak emphasis on data integrity and security including client and unitholder record keeping, no passwords used, no virus software used, no firewalls in place if data accessed through the Internet.

Part II - For the statement chosen, substantiate your response by describing in further detail your current procedures with respect to data integrity.

28. Part I - Identify which one of the following statements best describes your information systems operations

- ☐ Information systems are adequately developed, tested and implemented. No system changes recently. ("adequate" meaning system is reliable in functionality and no major problems encountered).
- ☐ Information systems are adequately developed, tested and implemented. Recent system changes are not complex and are fully integrated with existing systems.
- ☐ Information systems are adequately developed, tested and implemented. Recent system changes are complex and are fully integrated with existing systems.
- ☐ Information systems are inadequately developed, tested and implemented. Recent system changes are not complex and are not fully integrated with existing systems.
- ☐ Information systems are inadequately developed, tested and implemented. Recent system changes are complex and are not fully integrated with existing systems.

Part II - If you wish to provide further detail, please describe below.

Part III - If systems changes occurred within the past twelve months (i.e. implementation of a new system or major enhancements), briefly describe the reason for the change(s) and the nature of the change(s).

Part IV - If systems changes are being considered in the next 6-12 months (i.e. implementation of a new system or major enhancements), briefly describe the reason for the change(s) and the nature of the change(s).

Adequacy of Marketing and Selling Practices

29. Part I - Please identify if you use any of the following media in your marketing and selling practices:

- ☐ Printed media, i.e. newspapers, magazines
- ☐ Marketing brochures
- ☐ Electronic media, i.e. websites, email
- ☐ Audio/visual media, i.e. T.V., radio
- ☐ Presentations
- ☐ Seminars
- ☐ Other, please describe below.
- ☐ None of the above

Part II - For items chosen, substantiate your response by describing in further detail your current procedures with respect to the review and approval of marketing and selling material.

If you have a website, include the website address in your response.

Risk Assessment Questionnaire

Part III - Please describe how you ensure that your marketing and selling practices are in accordance with regulatory requirements

Adequacy of Operational Procedures

30. Part I - Identify which one of the following statements best describes your policies and procedures.

- ☐ Automated processes. Policies and procedures are well documented, effective and efficient, consistently applied and well understood.
- ☐ Complex automated processes. Policies and procedures are well documented, effective and efficient, consistently applied and well understood.
- ☐ Complex automated processes. Policies and procedures are inadequately documented, however they are effective and efficient, consistently applied and well understood.
- ☐ Mix of manual processes and automated processes with a high number of manual adjustments, cancels and corrections and unreconciled balances (i.e. client and unitholder record keeping, trust accounting and fund accounting). Policies and procedures are poorly documented, ineffective and inefficient, inconsistently applied and not well understood.
- ☐ Manual processes with a high number of manual adjustments, cancels and corrections and unreconciled balances (i.e. client and unitholder record keeping, trust accounting and fund accounting). Written policies and procedures do not exist.

Part II - If you wish to provide more information, please describe below.

Part III - Briefly describe the policies and procedures in place with respect to the following:

- i) Client record keeping including unitholder registration
- ii) Portfolio and fund accounting
- iii) Securities lending if applicable
- iv) Accounting functions, including segregation of monies.

31. Describe your valuation policies and strategies. In your answer, describe the assumptions used by management to calculate the net asset value ("NAV") (i.e. for the pricing of thinly traded securities or private placements). Describe the valuation methodology for securities adopted by management. Indicate if management performs price variance analyses, and if so, how often. Describe the process to monitor the valuation of investments.

32. Part I - Identify which one of the following statements best describes the oversight of the performance of service providers, including third parties and related parties.

- ☐ Continuous monitoring of activities.
- ☐ Monthly monitoring of activities carried out by the service provider to ensure in accordance with contract.
- ☐ Services provided are in accordance with contract. Company initiates semi-annual meetings with service provider.
- ☐ Quarterly monitoring of activities carried out by the service provider to ensure in accordance with contract.
- ☐ Services provided are in accordance with contract. Company initiates annual meetings with service provider.
- ☐ Semi-annual monitoring of activities carried out by the service provider to ensure in accordance with contract.

Risk Assessment Questionnaire

- ☐ No monitoring of activities carried out by the service provider to ensure in accordance with contract. Company does not initiate meetings with service provider.
- ☐ Not applicable.

Part II - For the statement chosen, substantiate your response by describing in further detail how you oversee the performance of service providers.

Susceptibility to Fraud or Unethical Behaviour

33. Describe the policies and procedures in place to ensure that inappropriate activities don't take place such as: misappropriation of assets, inflated NAV calculations, inappropriate movement of cash in client accounts and money laundering. If inappropriate activities have occurred, describe the process to escalate the issues to management and how the issues were rectified. Describe any recent instances (in the past 12 months) of any fraudulent or unethical behaviour, and how management resolved the issue(s).

34. Part I – Where applicable identify which one of the following statements best describes your **compensation structure** as a fund manager.

- ☐ Simple compensation structure and no incentive fees.
- ☐ Complex compensation structure and no incentive fees.
- ☐ Complex compensation structure and simple incentive fee calculation (i.e. incentive fees are referenced to a benchmark or index).
- ☐ Complex compensation structure and complex incentive fee calculation (i.e. incentive fees are partially referenced to a benchmark or index).
- ☐ Complex compensation structure and very complex incentive fee calculation is very complex (i.e. incentive fees are not referenced to a benchmark or index)

Part II - For the statement chosen, substantiate your response by describing in further detail your compensation structure.

Board Management and Staff

35. Briefly describe your organizational corporate and investment governance structures. Discuss the composition of the Board, frequency of meetings, reporting relationships, decision making process and information flow.

36. Briefly describe the management and staff culture of your organization, specifically as it relates to your appetite for risk, compliance and control, moral and ethical values and professional conduct.

Prepared By:

| | | |
|-----------|------------|----------|
| Last Name | First Name | Position |
|-----------|------------|----------|

Contact Information:

| | | |
|-----------|------------|----------|
| Last Name | First Name | Position |
|-----------|------------|----------|

Firm Name

Phone Number E-mail

Certified: I hereby certify that responses given by our organisation are both current in fact and truthfully compiled:

Risk Assessment Questionnaire

Last Name:

First Name

Senior Executive Officer

Date-----Signed -----

**Appendix 1.5: Supervision and Regulation of Intermediaries (SRI):
Inspection Procedures Manual and Guidelines
(November 2014)**



বাংলাদেশ সিকিউরিটিজ অ্যান্ড এক্সচেঞ্জ কমিশন
Bangladesh Securities and Exchange Commission

ADB TA-8228 BAN: Enhancing Efficiency of the Capital Market

SUPERVISION AND REGULATION OF INTERMEDIARIES (SRI) INSPECTION PROCEDURES MANUAL AND GUIDELINES

November 2014



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Capital Markets Inspection Procedures Manual and Guidelines

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CAPITAL MARKETS

INSPECTION PROCEDURES MANUAL AND GUIDELINES

1. Introduction

- 1.1. BSEC (the Commission) adopts a risk-based approach to Regulation. This manual sets out the Commission's assessment of the risks posed to its objectives by an intermediary and describes how it uses its regulatory tools to mitigate the risks.
- 1.2. The manual covers the following matters:
 - (a) This introduction;
 - (b) Recording and safeguarding information;
 - (c) The risks to the Commission's objectives;
 - (d) The Commission's risk assessment methodology;
 - (e) The Commission's licensing policy and criteria for assessing applications;
 - (f) Desk- based supervision;
 - (g) On site visits; and
 - (h) Enforcement.
- 1.3. In addition, there are schedules giving:
 - (a) The intermediaries' financial requirements;
 - (b) Checklists for the key risk areas; and
 - (c) A template for a licensing application form.
- 1.4. Throughout this manual there are references to the generic term "stockbroker" and this should be read to cover securities dealer. It is noted that the use of the term stockbroker is meant to convey the functionality of the activity rather than trying to strictly distinguish between what is a securities dealer and whether that can be described within the manual as a stockbroker, for the practical purposes of this document they are treated as one and the same.
- 1.5. There is a deliberate emphasis in this manual on the inspection of securities dealers (stockbrokers) as they are likely to pose the greatest risk to BSEC. However, where possible the same inspection techniques and requirements are just as applicable to other licensed entities, and where it has been felt appropriate the content in this document has been expanded to cover mutual fund managers, and portfolio/fund/asset managers.

2. Recording and Safeguarding Information

- 2.1. Each licensee should be allocated a file on which all information and correspondence should be placed. Electronic files on licensees should be coded and filed according to a standardised system.
- 2.2. The licensee file should be marked Confidential and kept in a secure cupboard. The cupboard should be locked and fireproof. Where information is secured electronically, it should be backed up on a daily basis and the back-up information should be stored off site. The off-site storage should be secure from theft or fire and flood damage. Where this storage is with an external service provider, the Commission should have service agreements covering the security of the site and the information which should be checked no less frequently than annually.
- 2.3. No information concerning the licensee should be disclosed except:
 - (a) to another officer of the Commission staff or to a member of the Commission Board, where that officer or member has a need to know the information in order to allow the Commission properly to carry out its functions; and
 - (b) where the Commission authorises further disclosure in accordance with any applicable law in Bangladesh.
- 2.4. Where information is passed to another officer of the Commission or a member of the Commission Board, that officer or member should not disclose it to any other person except in the circumstances set out in paragraph 2.3 and, where the person is a member of the Commission staff or Board, that person understands that the restriction in 2.3 also applies to them.

3. Risks to regulatory objectives

3.1. The Commission has several regulatory objectives set out in the Securities and Exchange Commission Act 1993. These are:

- (a) The correct issue of securities
- (b) Protection of the interests of investors in securities and
- (c) To develop and control the capital and securities market

It could be implied that by ascribing to IOSCO principles the objectives of the commission include to:

- i) Ensure the safety and soundness of capital market intermediaries and infrastructure entities;
- ii) ensure the highest standards of conduct of business by capital market participants;
- iii) Ensure the fairness, efficiency and orderliness of the capital market;
- iv) stability of the financial system; and
- v) reduction and deterrence of financial crime.

Achievement of the above objectives will result in the protection of investors. This procedures manual addresses issues related to the objectives and more particularly the protection of investors.

3.2. As part of a risk based supervisory model the Commission should consider the risks to its regulatory objectives and should review the risks at least annually. The following paragraphs in this section represent a starting point for that review.

Malpractice and poor service creating risks to the investor

3.3. The investor may be disadvantaged by inadequate service. Investors use Bangladesh intermediaries for a variety of reasons, including execution of orders to subscribe for, buy or sell securities, for investment advice, and for portfolio management (individually or through a Collective Investment Undertaking (mutual fund)). The risk of inadequate service could encompass:

- (a) failure to ascertain the investor's financial position, risk tolerance or time horizons ('fact find');
- (b) the provision of inaccurate or inappropriate investment advice;
- (c) the exercise of discretion by a portfolio manager in a way that does not suit the investor's objectives or risk appetite, or the agreed mandate for a mutual fund;
- (d) misunderstandings between the investor and the intermediary as to the nature of the services that are to be provided and the actions that are required by both investor and service provider;
- (e) failure to respond properly to complaints;
- (f) failure to meet legal obligations on time – such as the payment of settlement obligations or submission of subscription applications in Bangladesh or elsewhere; and

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- (g) failure to make payments to the client on time.
- 3.4. The investor's assets may not be adequately safeguarded. The investor may entrust their funds or assets to the intermediary and the risks include the following:
- (a) the intermediary may dispose of the assets without the client's consent (that is, steal them) and use the proceeds for purposes unauthorised by the investor;
 - (b) the investor's assets may in other ways be misappropriated through fraud, embezzlement or theft either by the intermediary or its staff or perpetrated on the intermediary;
 - (c) discretion, when exercised on behalf of an investor may fail to take account of all relevant criteria or may be based on irrelevant criteria and, in either case, lead to investor loss;
 - (d) in particular, the intermediary may advise the investor (of in the case of discretionary portfolio management or mutual fund use that discretion) in a way that is in the interests of the intermediary rather than the investor – this may include front running, churning, inappropriate investments in assets in which the intermediary has a direct or indirect interest or in other ways;
 - (e) payments, disposals or other actions taken in respect of client assets may not be undertaken properly or at all;
 - (f) the investor's title to assets purchased for it by the intermediary may not be properly secured;
 - (g) one investor's assets may be commingled with assets of an intermediary or with assets of other investors and subject to claims by creditors of the intermediary or other investors; and
 - (h) an intermediary's records may not adequately record an investor's assets or the legal documents relating to an investor's assets may not be properly safeguarded.
- 3.5. The licensee's financial resources may be inadequate
- (a) The intermediary's financial resources and professional indemnity insurance and, in particular in relation to compliance with rules on working capital and segregated client accounts, may not meet the regulatory requirements;
 - (b) The resources may be inadequate to meet the risks of the business; and
 - (c) The presentation of accounts may not meet the requirements of the Financial Reporting Act and the International Standards of Auditing as applied in Bangladesh according to the Bangladesh Institute of Accountants. Further audited financial statements should meet IFRS applicable at the reporting date to Bangladesh.
- 3.6. The investor may be disadvantaged by other improper behaviour of the intermediary.
- (a) The intermediary may fail to maintain adequate working capital and be tempted to use client assets to meet its obligations;
 - (b) The intermediary may mislead the client as to the nature, performance, status or cost of an investment or fail to explain associated risks;
-

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- (c) The intermediary may mislead the client as to the nature and scope of its expertise and its licence and may undertake activities in relation to that client for which it does not hold the required licence or may recommend an investment which is not eligible to be offered to that client;
- (d) The intermediary may fail to report on the client's account and transactions as required or may fail to act upon client instructions;
- (e) The intermediary may fail to keep timely, accurate and full records of client business;
- (f) The intermediary's lack of capital may cause it to fail (see below); and
- (g) The intermediary may use funds deposited with it to trade on its own account at the client's risk.

3.7. The investor may be disadvantaged by the failure of an intermediary. Intermediaries have long term relationships with investors, may have control of their assets and will have other close links with the interests of investors. If an intermediary becomes insolvent, there is a risk to the investor's interests including the possibility of:

- (a) claims against the intermediary being exercised against investor assets;
- (b) key actions required to safeguard investor interests being overlooked; and
- (c) inconvenience being caused by the transfer of functions to another intermediary.

Risks to fair and orderly markets

3.8. The Commission is responsible for the oversight of the two exchanges, DSE and CSE. The Commission is also responsible for the central Depository of Bangladesh (CDBL) further referred to herein as the CSD. These organisations can act in a way that poses risks to the Commission's objective of protecting fair and orderly markets.

3.9. At this time the clearing and money settlement functions are performed by the two exchanges but it is intended that a joint Clearing corporation will be formed in the near future (2015). For the purposes of these guidelines the Clearing and Settlement function will be referred to as (C&S)

3.10. Inadequate risk management by the CSD and C&S. The CSD is responsible for transferring title to securities between investors and the C&S function giving instructions to the settlement bank for the payments relating to those transfers of ownership of securities. The current arrangements give rise to very substantial risks to the continuation of fair and orderly markets.

- (a) Settlement obligations are bilateral, between brokers, leaving brokers in the position that they are making trades with, and subjecting themselves to credit exposures and risks of which they may not be able to properly control;
- (b) if an intermediary cannot meet its net settlement obligations, the C&S Settlement Fund is used to meet the obligations and acquire the securities bought by the defaulting broker, (prior to the securities being sold and the Settlement Fund made good), creating the risk that a fall in the price of securities then sold could lead to a permanent loss to the Settlement Fund;
- (c) in the event of the default outlined above, the broker will not receive the securities bought; its client (who may have paid for the securities) will not receive ownership of

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securities as expected and this may have implications for other obligations the investor may have;

- (d) if the intermediary's failure is such that the Settlement Fund cannot meet the outstanding obligations, it would be necessary to cancel and unwind an entire day's trading, undermining the principle of settlement finality on which the DSE & CSE deals are based;
- (e) unwinding a day's trading would force the brokers to seek payment direct from other brokers and create substantial cost and disruption; and
- (f) insofar as some intermediaries did not receive payments owed to them, their clients would have neither the securities they had sold nor the funds they were expecting and this could lead them to make further defaults with implications across the entire capital and financial markets.
- (g) In essence the exchanges are exposed to default risks by TRECs

3.11. The Stock Exchange Rules may not be appropriate for the market.

- (a) The two exchanges have or are implementing new exchange trading systems and surveillance of activity via systems is performed at both the Commission and the exchanges supposedly with the TRAPETS system although the DSE has yet to completely move to use TRAPETS.
- (b) The DSE and CSE both have caps on price movements during the day, thus creating the risk that, at any one time, the price of securities in the market may not reflect the full knowledge available relating to the price;
- (c) Many stocks are very illiquid, creating the risk that intermediaries or other insiders may manipulate the price for their own purposes;
- (d) Investors are not permitted to borrow securities and sell them short, again limiting liquidity and exacerbating the risk at (C) above; and

3.12. Inadequate financial risk management by intermediaries

- (a) There is a risk that licensees may not have sufficient financial resources to provide a buffer for compensating investors, or even to withstand downturns in business levels; and
- (b) If intermediaries fail, they may create risks for the stability for the financial system.
- (c) The Commission has developed a position paper via a Commission committee on risk based capital adequacy (RBCA) and the proposed requirements is to be implemented in phases starting in 2015

3.13. Inappropriate market practices relating to IPOs

- (a) The investment banking and broking community have hitherto insisted that all IPOs and bond issues must involve all brokers and investment banks as advisers and sponsors, thus increasing the cost of capital and reducing the attractiveness of the market for raising capital;

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- (b) Investors subscribing to new issues are required to place funds with their brokers rather than their receiving banks, thus increasing the risk that the funds will be misused;
 - (c) Investors may receive refund cheques via their brokers and may be inappropriately be persuaded to endorse the cheques to the brokers, exacerbating the risks described above; and
 - (d) The reconciliations between funds paid, applications made and allocations awarded in IPOs may not be completed sufficiently thoroughly, thus leading to the risk of error, fraud and abuse.
- 3.14. Inadequate disclosure by issuers. Issuers are required to make disclosures of information relating to the price of a security and may not do so in a timely or accurate manner:
- (a) Insofar as the information is known to insiders, this leads to the risk of insider dealing;
 - (b) So long as the information is not public, the price of the securities will not reflect the true value; and
 - (c) If investors believe that insider dealing is prevalent they will not invest in the market.
- 3.15. Inability to provide appropriate data on the nature of the business in Bangladesh. All regulatory authorities are expected to be familiar with the business of the regulated entities. The Commission needs to have ready access to data on the business of the intermediaries in order to be able to respond to general enquiries that do not breach customer confidentiality.
- 3.16. Unauthorised disclosure of information. While the Commission should be able to disclose information under the law, the fact remains that it has access to highly personal confidential information and should ensure that any information is properly safeguarded.
- 3.17. The Commission's regulatory focus will be directed at mitigating the risks identified in paragraph 3.3 to 3.16. The main areas that the Commission will wish to check, for each intermediary are as follows:
- (a) The integrity and competence of the intermediary and its key personnel;
 - (b) Corporate Governance and risk management
 - (c) The financial resource requirements;
 - (d) The handling of client assets;
 - (e) The relationship and conduct of business with the client and the handling of complaints;
 - (f) Rules and practices concerning conflicts of interest;
 - (g) The relationship with the Commission; and
 - (h) Record keeping.
- 3.18. Not all intermediaries will pose the same risks. Vulnerabilities will be different according to the nature of the intermediary business, the competence of the staff and the culture of the
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business. For this reason, the Commission will make a risk assessment of each intermediary to determine the focus of its supervisory action.

- 3.19. The risk assessment of each licensee will be set by the Reviewer of an application in consultation with a senior officer according to the procedure in Section 4. The assessment will be reviewed by the Supervisor and the senior officer annually.
- 3.20. In addition, the Commission will consider the following matters with respect to the DSE & CSE:
- (a) Relationship with Commission.
 - (b) Board Governance.
 - (c) Conflicts of Interest.
 - (d) Committees - Operation and determinations.
 - (e) Management / Organisation / Capacity.
 - (f) Membership.
 - (g) Anti Competitive Behaviour.
 - (h) Listing and disclosure.
 - (i) Market operations.
 - (j) Index calculation and information dissemination.
 - (k) Support Services.
 - (l) Finances - Use of levies (Budget).
 - (m) Systems Planning / Business Continuity.
 - (n) Primary market - Listings – continuous disclosure.
 - (o) The structure of the ATS – Micro Structure – Surveillance.
 - (p) Links to C&S and CSD – efficiencies.
 - (q) Bond Market Operations.
 - (r) Complaints.
 - (s) Development of a Settlement Grantee Fund and sufficient Investor Compensation Funds.
 - (t) Future Developments – New products – derivatives planning.
 - (u) Determination of fulfilment of SRO responsibilities.

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3.21. The following matters are to be considered with respect to the CSD:

- (a) Relationship with Commission.
- (b) Ownership.
- (c) Board Governance.
- (d) Conflicts of Interest.
- (e) Management / Organisation / Capacity.
- (f) Membership structure.
- (g) Capital Structure and support resources.
- (h) Finances - Use of levies (Budget).
- (i) Systems Planning / Business Continuity.
- (j) System Capacity – Reliability – Security.
- (k) Risk Review (Completion IOSCO Risk Matrix).
- (l) Settlement Processes.
- (m) Risk management.
- (n) Settlement times planning.
- (o) Settlement Bank issues.
- (p) Settlement Fund – Size – Use – requirement.
- (q) Depository Processes.
- (r) Security.
- (s) Links to registrars.
- (t) Any jumbo certificates custody arrangements.

3.22. The following matters are to be reviewed with respect to Issuers:

- (a) listed companies be of an adequate size and have sufficient shares in hands of the public to safeguard an orderly and fair market;
- (b) timely, and the widest possible disclosure of business and financial information materially affecting listed companies;
- (c) regular disclosure of financial information by listed companies; and,
- (d) disclosure to investors of the nature, risk and investment potential inherent in the traded financial products.

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- 3.23. Checklists for the review of the matters described above are at **Annexure A**.
- 3.24. The Board of the Commission should review the statement of risks in this manual each year. Should there be a change, this could require a corresponding change to procedures and checklists.

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4. Licensee Risk Assessment Methodology

Making a risk assessment at time of application

- 4.1. The likelihood that a business may be vulnerable to the risks described in Section 3 will primarily be determined by the nature of the business and the degree of compliance with the Regulations.
- 4.2. When making the risk assessment, the assessor should consider first the nature of the business. A more complex business creates a higher risk of failure or of error, which may lead to investor loss. On the other hand, a simple investment advisory business where the adviser does not handle client money should pose fewer risks.
- 4.3. An assessment of each licensee should be made in respect of the nature of the business and for each of the categories of compliance risks as set out in Section 3. When an assessment is made, the assessor should make a qualitative comment against each of these categories and should comment if it appears that there is a particular vulnerability to any of the risks in Section 3.
- 4.4. In the light of the assessment of each category, the assessor should make an overall assessment. This is not to be undertaken on a purely arithmetical basis but should be made according to the judgment of the highest risk areas. In respect of intermediaries, for example, the most important matters will be the financial resource requirements, the handling of client funds and the corporate governance.
- 4.5. The overall assessment will be that the risk attached to the licensee is “high” “medium,” or “low”. There is no quota for the number of licensees to be classified as “high”, “medium” or “low” risk but over time, it would be expected that there would be rather more in the “medium” category with about 10-15% of licensees in each of the other two categories.
- 4.6. Once an intermediary is licensed the Commission utilises a risk scoring methodology to assess the changing risk profile of the licensed entity.
- 4.7. The adopted methodology provides for the determination of a “Supervisory Attention Index” as shown in the (probability/impact) matrix below:

| Impact Rating | Impact rating | Impact index | Supervisory Attention Index | | | | |
|--------------------|--------------------|--------------|-----------------------------|--------------|--------------|------|---------|
| | Extreme | 250 | 16 | 35 | 63 | 142 | 253 |
| | High | 125 | 11 | 25 | 45 | 101 | 179 |
| | Upper Medium | 12.5 | 4 | 8 | 14 | 32 | 57 |
| | Lower Medium | 1.25 | 1 | 3 | 4 | 10 | 18 |
| | Low | 0.25 | 1 | 1 | 2 | 5 | 8 |
| | Probability rating | | Low | Lower Medium | Upper Medium | High | Extreme |
| Probability index | | | 1 | 5 | 16 | 81 | 256 |
| Probability Impact | | | | | | | |

- 4.8. At the time of application for licensed lack of operational activity and knowledge of actual controls and risks makes it unlikely that this risk scoring methodology will be useful at the time of license application.

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- 4.9. Section 7 below and a document titled the 'risk based supervisory model for capital markets' details further the risk scoring methodology.

Reviewing the risk assessment

- 4.10. The risk assessment should be completed on the basis of a license application. It should also be formally reviewed annually at an appropriate time. This will probably be on the basis of the assessment of each annual return provided by the licensee. Any other information received as a result of a desk-based review or on-site visit, should also be used to review the assessment.
- 4.11. When the risk assessment is completed on the basis of an application, there may be little or no experience of the operation of the licensee in practice. The assessor will have to make qualitative assessments on the basis of the application itself and the way in which the applicant approaches the application process, including their degree of cooperation with the Commission's requests for further information.
- 4.12. The risk assessment should also be reviewed in the light of certain trigger events. Trigger events would include:
- (a) Enquiries from Bangladesh or foreign authorities that suggest that questionable activity may be occurring within the intermediary business;
 - (b) Action taken by any Commission against an intermediary or any of its key persons; and
 - (c) A report from an auditor that qualifies the accounts or reports that compliance may not be satisfactory.
- 4.13. The Board of the Commission should review the trigger factors on an annual basis, along with the analysis of risks and the risk model.

5. Assessing Licence Applications

- 5.1. The Commission's licensing criteria are set out in the Licensing Regulations.
- 5.2. The objective of the application assessment procedure is to ensure that the applicant and key persons have the integrity, competence and financial standing to conduct intermediary business and to make the initial risk assessment of the licensee.

Receipt of application

- 5.3. On receipt, an application form should be passed to an Application Reviewer, who will open a file and give the application a number. The Reviewer will place a copy of the Review Worksheet (**Annexure B**) on the file.
- 5.4. The Reviewer should place the basic information on the file as required by the Worksheet at Annexure B, including the name and address of the applicant, whether or not the applicant is a joint applicant and the classes of licence applied for.
- 5.5. The Reviewer should diarise a fortnightly review date to ensure that the status of the application is reviewed and outstanding action followed up. On each review, the Reviewer should take note of the time left until the target date for application assessment is reached. When there is two weeks to go to completion, the Reviewer should make an assessment of the likelihood of completing the application in time and inform his or her line manager if it is likely to be missed.

The fee

- 5.6. The Reviewer should check that the application fee and first regulatory fee has been calculated correctly and the cheque properly completed and signed.
- 5.7. If the fee calculation is correct and the cheque has been completed correctly, the Reviewer should attach a note to the cheque indicating that it is correctly calculated and pass it to the finance officer for presenting to the bank. The Reviewer should then send an acknowledgement of the application form and the fee to the applicant. The acknowledgement should reserve the right of the Commission to seek further information. The acknowledgement should be sent within 2 days of receipt of the application form.
- 5.8. If the fee has not been calculated correctly or the cheque has not been completed properly, the cheque should be returned to the applicant, along with the acknowledgment of receipt of the application form. The acknowledgement should state what the correct fee should be (or draw attention to any error in the cheque) and state that the assessment of the application will not begin until the correct fee has been received. The Reviewer should remind the applicant after one month if a further cheque has not been received and again after a month. After two months the Reviewer should write to the applicant warning that the application will be rejected if the fee is not submitted within a further month. If the correct fee has still not been paid after three months from the date of the Reviewer's letter informing the applicant of the error, the Reviewer should, after consulting the senior officer, reject the application and write to inform the applicant.
- 5.9. If the applicant submits a further cheque which is correct, the Reviewer should follow the procedure at paragraph 5.7. If the resubmitted cheque is still not correct, the Reviewer should repeat the procedures at paragraph 5.8.

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- 5.10. The Reviewer should confirm on the Worksheet when the fee has been calculated correctly and banked, or when the application has been rejected because the fee has not been correctly submitted.
- 5.11. The Reviewer should then begin the assessment procedure.

Obtaining information

- 5.12. The procedure set out below may require the Reviewer to make further enquiries of the applicant and key persons. The Reviewer should attempt to avoid making a series of separate enquiries to the same applicant or key person. However, on the other hand, it would be wrong to delay all enquiries because of a delay in establishing if one or two small points need clarification. A judgment should be made on a case by case basis.

Initial assessment

- 5.13. The Reviewer should check that the applicant has included the applicant's name, address and trading name, the names of the all the key persons and the identity of the two persons who are nominated to have responsibility for running the business. This is often referred to as within "four eyes".
- 5.14. The Reviewer should check that the constituent documents of the licensee are submitted – such as the Articles of Association for a company.
- 5.15. The Reviewer should note on the Worksheet the proposed regulated activities of the applicant and check that it has applied for the appropriate class of licence.
- 5.16. The Reviewer should note on the Worksheet the ultimate beneficial owner of the business.
- 5.17. The Reviewer should determine if all aspects of the application form have been completed. It is particularly important to check that all the personal questionnaires have been completed in full and that all the declarations have been made, signed and dated by the applicant and by key persons as appropriate.
- 5.18. The Reviewer should check that the applicant has included all the references, verification or declarations to support any statements in the application form. Many of the statements are to the effect that there is no adverse matter (such as no conviction for fraud and dishonesty) and it is not possible to require an applicant to provide evidence of a negative matter of this kind. However, it would be reasonable to expect an applicant to provide certificates of qualifications of key persons, or membership of professional bodies. Employers' references should be provided to back up statements concerning experience. A bank reference relating to financial standing and creditworthiness should always be provided for the applicant and each key person. The Reviewer should make a judgment on a case by case basis as to whether the information provided has been properly verified.
- 5.19. If the application form has not been completed correctly, the Reviewer should write to the applicant to draw attention to the errors or omissions, and ask the applicant to complete the application correctly. The Reviewer should write to the applicant about errors and omissions, even if the error or omission is on a personal questionnaire submitted by a key person.

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- 5.20. A diarised note should be made by the Reviewer so that if the applicant has not submitted any of the corrected information after one month, the Reviewer should write to remind the applicant of the points outstanding. A similar note should be made to ensure that after two months, the Reviewer should write to warn the applicant that the application will be rejected if the information is not submitted after a further month. Again, a note is need for the Review to check if the corrected application form and information have not been supplied after three months from the date of the Reviewer's letter informing the applicant of the error or omission, and if so the Reviewer should, after consulting the line manager, reject the application and write to inform the applicant. The Reviewer and line manager may decide that there are extenuating circumstances justifying giving further time to the applicant.
- 5.21. If the applicant submits some but not all of the information required, the Reviewer should follow the procedure in paragraph 5.20, except that the reminder letters should acknowledge the information that has been received and remind the applicant of the information outstanding.
- 5.22. Once all the information has been received, the Reviewer should write to the applicant to acknowledge that the completed application has been received but reserving the right of the Commission to seek further information. The Reviewer should note on the Worksheet that the full information required by the application procedures has been obtained.
- 5.23. The Reviewer need make no further enquiries where the applicant has provided independent verification of information, except as described below.

The integrity of the applicant

- 5.24. In respect of the applicant, the following enquiries should be made, if the applicant entity has existed in some form prior to the submission of the application:
- (a) If the applicant has been subject to financial services regulation in another jurisdiction, the Reviewer should write to the relevant Commission checking that the facts given by the applicant are correct and asking if there have been any investigations, findings or other action that might affect an assessment of the applicant's fitness and properness to conduct financial services business.
 - (b) If the applicant has revealed information relating to investigations or findings by law enforcement, regulatory or professional bodies in the last ten years, enquiries should be made of the body concerned. The enquiries should check that the information given by the applicant is correct and ask if there have been any investigations, findings or other action that might affect an assessment of the applicant's fitness and properness to conduct financial services business.
 - (c) If the nature of a bank reference casts doubt on an applicant's creditworthiness, the Reviewer should seek further information from the bank and, as appropriate, the key person.
 - (d) The business and trading name of the applicant should be checked on Google or another internet search engine to see if there are any references (for example in newspapers) that might affect the applicant's fitness and properness. If such references are found, the Reviewer should write to any relevant Commission seeking further explanation and clarification.

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- (e) Enquiries should be made in Bangladesh of the Central Bank, the police, Bangladesh National Board of Revenue, Companies Registrar (RJSC), Customs and Ministry of Justice to see if they have any information relating to the fitness and properness of the applicant to conduct financial services business.

The integrity, competence and financial standing of the key persons

5.25. A key person is a director (or other person acting in the role of director), controller (any person with a direct or indirect interest of 15% or more of the shares in the applicant or who, in the opinion of the Commission has the ability to influence the applicant, the compliance officer and any person who provides advice to or investment management for, a client).

5.26. In respect of key persons¹ further enquiries should be made as set out below.

- (a) The key person's name should be checked on Google or another internet search engine to see if there are any references (for example in newspapers) that might affect the key person's fitness and properness. If such references are found, the Reviewer should write to any relevant Commission seeking further explanation and clarification.
- (b) If the key person has revealed information relating to investigations or findings by law enforcement, regulatory or professional bodies in the last ten years, enquiries should be made of the body concerned. The enquiries should check that the information given by the key person is correct and ask if there have been any investigations, findings or other action that might affect an assessment of the applicant's fitness and properness to conduct financial services business. The Reviewer may also consider if further information is required from the key person.
- (c) If the key person's career summary reveals gaps of more than two years for which no information is given, the key person should be asked to provide an explanation.
- (d) If the nature of a bank reference casts doubt on a key person's creditworthiness, the Reviewer should seek further information from the bank and, as appropriate, the key person.
- (e) If the key person has been bankrupt, the Reviewer should seek further enquiries from the key person as to the circumstances and timing. If necessary, further enquiries may be made of the court where the bankruptcy was ordered. If the key person has been a senior officer in a business that has been subject to Regulation, an enquiry should be made of the regulatory Commission concerned on similar lines to that described in paragraph (a).
- (f) The key person's qualifications should normally be verified by a certificate from the awarding body. The Reviewer should normally accept such a certificate but should check, using the Internet, that the awarding body exists and is competent to award the qualifications claimed.

¹ Key persons are the chief executive officer, directors, chief financial officer, company secretary, compliance officer and internal auditor of a market intermediary.

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- (g) If the key person is or has been a member of a professional body and is unable to provide a current certificate to that effect that confirms the membership is still valid, enquiries should be made of the professional body to establish if the information provided by the key person is correct and if there have been any investigations, findings or other action that might affect an assessment of the applicant's fitness and properness to conduct financial services business.
 - (h) Enquiries should be made in Bangladesh of the police, Bank of Bangladesh (BB), NBR and Ministry of Justice to see if they have any information relating to the fitness and properness of the key person to conduct financial services business.
- 5.27. In each case, the letter making enquiries to third parties should request a response within a month. The third party should be told that any information they supply may be shown to the applicant or key person unless the third party insists that it should not be. Letters seeking further information from key persons should request that information within a month.
- 5.28. A diarised note should be made to check responses, and where the third party has not responded within the deadline described in 5.27, the Reviewer should issue a reminder and, after a further week, telephone the recipient to establish if an answer will be forthcoming. Where it is clear that no answer is forthcoming, the Reviewer will probably have to accept that there is no further information and will have to make the assessment on the basis of the information available.
- 5.29. A diarised note should be made to check and if a key person or applicant does not respond within the deadline, the Reviewer should consult the line manager. If they conclude that the information requested is essential for the assessment of the application, the Reviewer should issue a reminder and, if no further information has been received within a month (a diarised note to check is needed), should warn the key person and the applicant that unless the key person can supply the information within a further month, the application will be rejected. Again a diarised note is needed to check that after three months from the request for information, the information has been received and if not the Reviewer should consult the line manager and, unless there are extenuating circumstances, should write to the applicant rejecting the application.
- 5.30. Information from a third party may contradict that given by an applicant or key person or may otherwise give the Reviewer cause to believe the application should be rejected. After consulting a senior officer, the Reviewer should provide the information to the applicant or key person and seek their comment. If the third party has requested that information should not be given to the applicant or key person, the Reviewer should consult a senior officer on how to proceed to make enquiries of the key person or applicant that make use of the third party information to make further enquiries of the applicant or key person without compromising the confidentiality of the information provided by the third party.
- 5.31. Key persons who are to be officers in the licensee will show their experience and qualifications. The Reviewer should determine if the qualifications are in line with the requirements of the licensing regulations. If they are not and the applicant has not made an application to the Commission to accept relevant experience of 10 years as an alternative, the Reviewer should draw attention to the absence of appropriate qualifications and ask if the applicant wishes to make an application in respect of relevant experience. If such an application is made, the Reviewer should note if the
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relevant experience is consistent with the regulations. The applicant should be given a month to respond. A diarised note is needed so the Reviewer checks this and if it does not do so, the Reviewer should follow the procedure set out in paragraph 5.29.

- 5.32. Where a key person has been found to have omitted relevant information or concealed relevant information from the Commission or has made a statement that is false or misleading, the Reviewer should invite the key person to comment. Unless the Reviewer is satisfied that the error was a genuine mistake, the key person should not normally be accepted.
- 5.33. A key person who has been disqualified from being a director of a company would not normally be acceptable. A key person who has had their practicing certificate revoked by a professional body would not normally be acceptable.
- 5.34. A key person who has been convicted of an offence involving dishonesty within the last ten years would not normally be acceptable. A key person who has been subject to investigation for an offence involving dishonesty should be invited to explain to the Commission the circumstances of the investigation and to convince the Commission that the investigation does not cast doubt on integrity.
- 5.35. An undischarged bankrupt would not normally be acceptable as a key person. A person whose bankruptcy was discharged more than five years previously would normally be accepted. Other cases will have to be considered on their merits.

The competence of the applicant

- 5.36. Once the Reviewer is satisfied that information provided by the key persons about their experience and qualifications is correct, it will be necessary to consider if the collective skills and experience of the key persons is sufficient to run the business of the applicant as proposed in the application and business plan. It is possible that the key persons have integrity and certain skills and qualifications but that they do not have, in their totality, all of the skills and experience necessary for the business proposed by the applicant.

Four eyes

[NB: This section assumes there is a requirement for two independent persons in each business – that is there should be no sole traders]

- 5.37. The Reviewer should pay special attention to the control of the business. It is not acceptable for an intermediary to be under the control of a single person. The requirement is that there should be at least two directors both of which should be in a position to run the business (although in practice one will be the chief executive) and that the more junior director has the skills and experience to challenge the actions of the chief executive.
- 5.38. The two independent directors should be genuinely independent of each other. Two members of the same family, whether man and wife, father and son, mother and daughter, for example should not be regarded as independent. Moreover, where it is apparent that one director is considerably more dominant than the other, either by virtue of experience, skills or personality such that the Reviewer is not satisfied that there is genuinely a reasonable expectation that the more junior director would challenge the actions of the more senior, then they should not be regarded as meeting the four eyes criterion.

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- 5.39. The two independent directors must be genuinely acting together in running the business. It may be that a sole trader will seek to join forces with another sole trader or with another company in order to meet the four eyes criterion. However, in such cases, there is a danger that the association will be entirely nominal. The reality may be that two businesses are, in fact being carried on separately with the association having no impact on the running of the business. Signs that this may be so include:
- (a) Separate offices;
 - (b) No or separate procedures manuals and policies;
 - (c) Separate investor lists;
 - (d) Separate filing systems;
 - (e) Frequent absences from a shared office by one or more of the supposed partners; and
 - (f) No senior management or board meetings.
- 5.40. Not all of these factors necessarily demonstrate that the “four eyes” arrangement is a sham but if most of these factors are present, the Reviewer may well judge that there is no effective joint management of the business. It is important to establish there is genuinely joint management of the business as a whole by the two independent directors.
- 5.41. If the Reviewer is not satisfied that the two independent directors have the necessary skills and experience, the Reviewer should consult the senior officer and inform the applicant of the Commission’s conclusion.

Ownership

- 5.42. The Reviewer should also consider the beneficial owner. It is not necessary that the beneficial owner have particular skills or experience (unless he or she are filling executive roles). However, the Reviewer should consider information relating to the integrity of the beneficial owner.
- 5.43. Where the applicant challenges the Commission’s view that key persons, shareholders, beneficial owners or independent directors are not acceptable, the Reviewer should consider the representations made and consult the line manager. However, if the Commission remains of the view that the persons are not acceptable in their roles, the Reviewer should write to the applicant stating if those persons are filling those roles, the application will be rejected.

Financial resources and professional indemnity insurance

[NB: This Section is to be used when there is a requirement for professional indemnity insurance]

- 5.44. The Reviewer should carefully study the business plan and intended operations of the applicant so that the required financial resources should be related to the risks of the business. The financial resources should be calculated according to the Financial Resources Rules (FRR). (Note the FRRs are as yet to be drafted based on the recommendations of the RBCA Committee.)

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- 5.45. The Reviewer should ensure that the calculation is correct and establish if there are any further enquiries that should be made, for example into off balance sheet and other liabilities. The Reviewer should establish if the financial information has been countersigned by the applicant's auditor. The Reviewer should make a similar assessment of the professional indemnity insurance.
- 5.46. If there are errors in the calculation but the correct total still exceeds the minimum required by the Regulations, the Reviewer should note this fact on the Worksheet, draw the attention of the applicant to the revised calculation and invite the applicant to confirm that it agrees with the revised calculation.
- 5.47. If there are errors in the calculation that have the result that the applicant does not meet the financial resources requirements, the applicant should be informed and invited to review its financial resources. The assessment should continue while the applicant considers this issue, unless the applicant states that it can or cannot find sufficient resources. If it cannot, the applicant should be asked to confirm that it is withdrawing the application. The applicant should be given a month to respond for which a diarised note should be made. If it does not do so, the Reviewer should follow the procedure set out in paragraph 5.29.

Business plan

- 5.48. The Reviewer should assess the Business Plan to ensure that the future financial projections show that the financial resource requirements will continue to be met and are unlikely to be jeopardised. If the Business Plan is credible and suggests that financial resources will be met, no further action should be taken unless there is other information in the Business Plan which suggests that the business may not be viable. If the financial resources are not met, or if the Business Plan is clearly not viable, the Reviewer should draw this to the attention of the applicant and invite the applicant to resubmit the Business Plan. The applicant should be given one month to do so. A diarised note should be made to check and if it has not done so, the Reviewer should follow the procedure set out in paragraph 5.29.
- 5.49. Where the applicant is an existing business and supplies audited accounts for the previous three years, the Reviewer should check to ensure that they demonstrate business viability and solvency. If they do not, the applicant should be invited to comment.
- 5.50. The Reviewer should also check that there have been no adverse auditors' reports and that the audit has been satisfactorily completed. If not, the Reviewer should seek information from the auditor to establish whether or not there is any reason to doubt the business's ongoing viability. The auditor should be given one month to respond and a diarised note made to check this; if it does not do so, the Reviewer should follow the procedure set out in paragraph 5.28.

Auditor

- 5.51. The Reviewer should check that the auditor has the necessary qualifications and that there is no reason to suppose the auditor is unable competently to undertake the audit. If there are grounds for believing that the auditor is not competent, for example because of lack of experience in dealing with businesses of the complexity of the applicant, or evidence of lack of independence or integrity on the part of the auditor, the Reviewer should consult the line manager and require the applicant to change the auditor. If the applicant objects, the Reviewer should consider the grounds for the objection but, if, having consulted the senior officer, remains of the same view as to

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the auditor's competence, the Reviewer should inform the applicant that, unless the auditor is changed, the application will be rejected.

Final assessment

- 5.52. The Reviewer should make the final recommendation in the light of all the information received and the application criteria in the licensing regulations.
- 5.53. The Reviewer should also make the first risk assessment of the applicant according to the methodology at Section 4. It will not be possible to assess all the matters in the checklist at Annexure A but the Reviewer should make the best assessment possible on the basis of the information provided in the application.
- 5.54. The Reviewer should convene a meeting of three people to make the final assessment. The meeting should include the Reviewer, line manager and one other person. An applicant and key person should be accepted unless there are grounds for refusal. The Reviewer should note that any refusal could be subject to appeal and the Commission's grounds will need to be given in public. Records of such meetings should be kept with this factor in mind.
- 5.55. The meeting should make the licensing recommendation for submission to the Chief Executive Officer for submission to the Board and, if a licence is recommended, should assign an initial risk rating to the licensee.
- 5.56. The members of the meeting should be described on the Worksheet and the final decision signed off by the Reviewer and Chief Executive Officer/Board.

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6. Desk-Based Supervision of Intermediaries

- 6.1. The purpose of desk-based supervision is to maintain a degree of understanding of the licensee and to update the risk assessment according to the methodology at Section 4.
- 6.2. Each regulated business should be the responsibility of an officer of the Commission. That officer is responsible for ensuring that desk-based supervision takes place on a timely basis. In this section, the officer is called the Supervisor.
- 6.3. The main advantage of desk based supervision is that it is cheaper in terms of resources and allows for more considered reflection of the information received. Such reflection can include consultation with experts within the Commission. However, the disadvantage of the desk-based supervision is that it is reliant on the information provided by the licensee. Such information may be inaccurate or false. On-site inspections can check on the reliability of data. However, there is also scope for checking on the data supplied by cross checking against other data relating to the intermediary that could be obtained, for example from the DSE & CSE or the CSD.

Enforcing the requirement to make returns

- 6.4. Licensees are required to make the following periodic reports:
 - (a) Quarterly reports and accounts within fifteen days of the end of each calendar quarter;
 - (b) Half yearly reports and accounts within thirty days of the end of each half-year;
 - (c) Audited annual accounts in the prescribed form within three months following the closure of the stockbroker or dealer's financial year.
- 6.5. The Supervisor should diarise the dates on which periodic returns from the regulated businesses are due.
- 6.6. If a licensee fails to make a periodic return on time the Supervisor should issue a reminder after one month (in the case of annual or six monthly returns) or one week (in the case of monthly or quarterly returns) and follow the enforcement procedure set out in Section 11. **It is absolutely vital that this procedure is followed with determination and consistency.** Once the licensee believes that failure to make returns on time is accepted, compliance with the reporting procedure will rapidly decay and it will be very difficult to bring compliance back to a satisfactory standard.
- 6.7. In addition to diarising and monitoring the submission of specified periodic returns by licensees, there is advantage in calling for information at other times where the Commission considers that this is necessary to ensure that obligations (particularly minimum financial requirements) are being met consistently and not just at the time of periodic returns. Where there are obligations on an intermediary to make daily calculations (for example of the reconciliations of segregated client accounts or of risk-based financial requirements) there is no serious additional burden placed on an intermediary by asking for such daily returns to be submitted from time to time other than in the normal cycle of periodic returns.
- 6.8. Depending on the nature of the return, the Supervisor should check that the following information has been supplied **[NB: It is recognised that not all periodic returns**

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include all this information. However, the information described below should be supplied at least on an annual basis with certain information (such as financial information and information about complaints) supplied more frequently]:

- (a) The name, legal form, registered office, contact details and principal activities of the licensee;
 - (b) The names and addresses of its key persons, their main duties and the organisational structure of the licensee;
 - (c) The Annual Report and Accounts, together with an auditor's report;
 - (d) A calculation of the total financial resources and a comparison with the risk-based financial requirements;
 - (e) A calculation of working capital and its comparison with the regulatory requirements;
 - (f) The licensee's current forward Business Plan;
 - (g) Any internal audit reports;
 - (h) The total number of complaints it received from investors in each quarter since the licensee was licensed or since the last return, whichever is the later and the number of complaints which remain unresolved more than three months after being submitted;
 - (i) The total number of investors and the total that have been accepted in the past twelve months;
 - (j) The total number of suspicious activity reports that have been filed with the Financial Intelligence Agency;
 - (a) A declaration that the licensee is in compliance with the requirements of the Act and Regulations, including evidence that it is in compliance with the financial resource requirements;
 - (b) Any changes to the investment mandate, prospectus, trust deed or constituting document of a mutual fund;
 - (c) Any difficulties that may have been experienced in performing the pricing and valuations of a mutual fund;
 - (d) Any suspensions of the redemption rights of a mutual fund; and
 - (e) Occasionally there will be other notifications from the licensee in accordance with the Regulations.
- 6.9. If the information has all been submitted, the Supervisor should write to the licensee to acknowledge receipt of the annual return.
- 6.10. If the licensee submits an incomplete annual return the Supervisor should write to the licensee within one month in the case of annual or six monthly returns and one week in the case of quarterly and monthly returns), drawing attention to the omissions and
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asking that they should be rectified within one month. A diarised note should be made to check if the licence has done so and if it fails to do so, the Supervisor should follow the enforcement procedure set out in Section 11.

Initial assessment

- 6.11. The Supervisor should check that the information supplied about the licensee's name and address, its legal form, the business it undertakes, the identity of the key persons, shareholders, beneficial owners, directors and compliance officers and the organisation structure is consistent with that already held on file.

[The next section assumes that risk-based capital requirements have been introduced - see Annexure F]

- 6.12. The Supervisor should then check the financial information. The check should establish if:
- (a) The level of financial capital and the working capital has been correctly calculated;
 - (b) Adjustments for the nature and liquidity of assets held as part of the financial resources have been correctly calculated;
 - (c) The minimum risk-based financial requirements are met in line with the requirements listed at **Annexure F**; and
 - (d) The final calculations are consistent with the last return, in that they do not suggest a dramatic unexplained improvement or any serious deterioration in capital.
- 6.13. If the calculations of financial requirements are incorrect, the Supervisor should write to the licensee drawing its attention to the errors and seeking a recalculation within a week. A diary note should be made to check this is received. Depending on the seriousness of the errors, it may be necessary to take enforcement action as described in Section 8 and/or undertake an immediate inspection to check on the adequacy of financial record keeping.
- 6.14. If the information in the annual return is inconsistent with the previously held information, the Supervisor should establish whether or not the new information should have been supplied at an earlier stage, according to the requirements for notifying the Commission. If it should have been, the Supervisor should consult the senior officer and write to the licensee drawing attention to the breach of Regulations and warning that any further breach of this nature will result in enforcement action. If the breach is a repeat offence, the Supervisor should consult the senior officer about the appropriate enforcement action.
- 6.15. The FRRs set out minimum reporting required and what actions and reports need to be made at what frequency if the firm is not in compliance with its FRR obligations.
- 6.16. If there was no requirement to submit the revised information beforehand, the Supervisor should write to the licensee, drawing attention to the fact that the information has changed substantially and seeking confirmation that the new information is correct.

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- 6.17. In the case of changes that should have been notified to clients (or unit holders of a mutual fund) the Supervisor should seek confirmation that the notifications have been made. If they have not, the Supervisor should tell the licensee to make the notifications and consider enforcement action as described in Section 8.
- 6.18. The Supervisor should consider if the information supplied in the annual return suggests that there may have been a breach of the Regulations. If it does, the Supervisor should consult the senior officer about the appropriate enforcement action.
- 6.19. If the information supplied in the annual return raises questions about the licensee that do not suggest a breach of Regulations, the questions should be followed up with the licensee or with another Commission if this is appropriate. The Supervisor should write to the licensee accordingly.
- 6.20. The Supervisor should examine data from the DSE & CSE and the CSD concerning the trading activity of the licensee and make a judgment about whether that data is consistent with the information in the returns. If it is not, the Supervisor should follow this up and, if appropriate, write to the licensee to seek an explanation of any discrepancy.
- 6.21. The Supervisor should seek further information from the FIA, the Ministry of Justice, NBR, and the Police, inviting them to state whether they have had any enquiries relating to the licensee or to entities within the control of the licensee.

Reviewing the risk assessment

- 6.22. The Supervisor should consider the nature of the business of the licensee and determine if it has changed in a way that alters the risks. In particular, the Supervisor should examine if there has been any change in the:
- (a) Legal form or incorporation documents of the licensee;
 - (b) number of investors being serviced by the licensee, such that the scale of the business has changed substantially;
 - (c) nature of the services being offered;
 - (d) handling of client assets;
 - (e) other client relationship issues;
 - (f) ability to meet financial capital requirements;
 - (g) ability to meet working capital requirements; and
 - (h) ability to ensure that investment mandates are being met.
- 6.23. If such changes have occurred, the Supervisor should consider whether or not the changes create new risks and, if so, consider whether an on-site visit should be brought forward so as to assess if the licensee is properly addressing the new risks.
- 6.24. The Supervisor should then review the risk assessment, using the checklists at Annexure A (insofar as information is available) relating to the main risk categories:

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- (a) The licensee's financial resources and professional indemnity insurance, the presentation of accounts and, in particular compliance with rules on working capital and segregated client accounts;
- (b) The licensee's integrity and competence and, in particular compliance with requirements on staff training, communications and internal controls;
- (c) The licensee's management and corporate governance and risk management;
- (d) The licensee's knowledge and treatment of its customers;
- (e) The licensee's trading practices, especially the defences against front running, insider dealing, market manipulation and unauthorised staff trading;
- (f) The licensee's controls and procedures for minimising conflicts of interest
- (g) The licensee's books and records;
- (h) The licensee's internal management information systems relating to financial requirements and trading practices;
- (i) The licensee's compliance with agreements made, including the investment mandate from portfolio management clients and unit holders of a mutual fund; and
- (j) The licensee's advertising.

Licensees on mitigation programmes

- 6.25. Some licensees will be on special programmes as a result of previous findings of on-site visits or for other reasons.
- 6.26. Where this is so, the Supervisor should check that the annual return demonstrates that the licensee is correctly implementing the programme.
- 6.27. If the annual return shows that the licensee is correctly implementing the programme the Supervisor need take no further action beyond noting this on the file.
- 6.28. If the annual return suggests that the mitigation programme is not being pursued, the Supervisor should make further enquiries of the licensee. If the licensee's response is acceptable, the Supervisor should, after consulting with the senior officer, accept the explanation and note the file accordingly. If the response is not acceptable, the Supervisor should consult the senior officer about the appropriate remedial regulatory action including enforcement action or an immediate on-site visit. The action should be noted on the file and taken as appropriate.

Complaints

- 6.29. The licensee is required to include, in their quarterly returns, data on complaints against the licensee. The Supervisor should compare the information with other similar sized licensees and with the licensee's former returns.
- 6.30. The Supervisor should consider if the number of complaints give rise to any concerns about the management of the licensee:

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- (a) A high (relative to others) or increasing number of complaints suggest that internal controls may not be operating correctly; and
 - (b) An increasing number of complaints outstanding after three months may mean that customers do not believe they are being treated fairly.
- 6.31. The Supervisor need only respond when a trend has been established. The appropriate response to any concerns should be to note on the file that the number of complaints should be considered at the next on-site visit. If the complaints give rise to serious concerns, the Supervisor may consider altering the risk assessment and bringing forward the date of the next on-site visit.

Completing the desk-based assessment

- 6.32. The Supervisor should complete the assessment with a comment on whether the list of potential vulnerabilities (according to the intermediary risk assessment in Section 1) has changed. If the Supervisor considers that the annual return suggests that the overall risk assessment has changed, the amendment should be made and submitted to the senior officer for confirmation. On receiving that confirmation, the risk assessment should be amended.
- 6.33. In the light of the assessment, the Supervisor should determine:
- (a) If the next scheduled on-site visit of the licensee should go ahead on time or should be brought forward;
 - (b) The focus of the next visit, according to the different options set out in the Section 1 of the Manual; and
 - (c) Whether there are any immediate steps the licensee should take (for example with respect to financial resources, control of segregated client accounts or professional indemnity insurance).
- 6.34. The Supervisor should mark the results on the file.
- 6.35. Where it is necessary to insist on immediate measures, the Supervisor should consult the senior officer and write to the licensee describing the measures that should be taken and by when. The Supervisor should require the licensee to acknowledge the remedial steps and provide an undertaking to abide by them and make a diary note to check that required measures have been taken when required.

Maintaining the Commission's database

- 6.36. The data included in annual return is primarily for the purpose of maintaining an up to date risk assessment of the licensee. However, the information is also useful in maintaining the Commission's understanding of the overall nature of business in Bangladesh. The Supervisor should therefore extract the information from the annual return and enter it into the Commission's general database. In particular, the database should be updated with respect to the following matters:
- (a) The legal name and address of the licensee;
 - (b) The key persons of the licensee and the organisation structure;
 - (c) The nature and scope of activities conducted by the licensee;
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- (d) The licensee's banking arrangements;
 - (e) The licensee's auditors; and
 - (f) Any mitigation measures to which the licensee is subject.
- 6.37. The Supervisor should ensure that the information that relates to a single licensee should be kept confidential and that only aggregate data is released, other than in accordance with the provisions of the Act on disclosure.

Changes in key persons, beneficial owners and auditors

- 6.38. Licensees are required to submit changes in key persons, beneficial owners, the independent directors, compliance officers and auditors to the Commission in advance and to seek permission for certain changes.
- 6.39. In some cases, an existing shareholder will become a new beneficial owner. In such circumstances, the Commission will already have information on the shareholder. If the Commission has information about the person that raises doubts about his or her suitability as beneficial owner, the Supervisor should consult the senior officer. Unless the reasons for the person's unsuitability can be disclosed publicly and the Commission can defend them on appeal, permission should be given. The Supervisor should write to the licensee giving permission and noting the change in beneficial owner on the Worksheet and on the database.
- 6.40. Where information about new key persons or beneficial owners is received without the required supporting information such as the personal questionnaire, the Supervisor should write to the licensee, within the statutory deadline, informing the licensee that the proposed changes cannot take place until the Commission has given approval, that the Commission will need to have a personal questionnaire from the person concerned before giving that approval and that any statutory deadline for giving a Commission decision will not begin until all relevant information is received.
- 6.41. Once the personal questionnaire has been received, the Supervisor should check that it has been properly completed. If it has not been, the Supervisor should draw the licensee's attention to any errors or omissions, invite the licensee to correct them and remind the licensee that the appointment cannot be made until the Commission has given permission and that any statutory deadline will not begin until all relevant information is received.
- 6.42. If the personal questionnaire is completed correctly, the Supervisor should acknowledge it and inform the licensee that further enquiries must be made by the Commission and that any statutory deadline does not begin until those enquiries are complete. The Supervisor should then proceed in respect of the key person or shareholder as described in paragraphs 5.25 to 5.32. The Supervisor should ensure, even if individual key persons are acceptable, that the licensee retains a balance of skills and experience for the purpose of running the business. Once the Supervisor is satisfied and permission has been granted, the new information should be entered on the Worksheet and the database.
- 6.43. Where there are changes to the two independent directors (the "Four eyes"), the Supervisor should establish if the new independent director(s) are already key persons. If they are, the Supervisor should be satisfied that the two directors both have the skills and experience to run the business and to challenge any action that might be inappropriate. If the Supervisor is not so satisfied, he or she should consult

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the senior officer and write to the licensee refusing to give permission for the new director. If the Supervisor is satisfied, the licensee should be informed and the new information entered on to the Worksheet and database.

- 6.44. Where the licensee proposes to change its auditor, the Supervisor should write to the licensee enquiring as to the reason for the change if these have not been given already. The Supervisor should remind the licensee that any statutory deadline for Commission permission does not begin until the Commission has received all the information it requires. The Supervisor should also write to the former auditor to enquire if the auditor wishes to make any comment about the reason for the licensee's decision. In respect of the new auditor, the Supervisor should proceed as described in paragraph 5.51. Once the Supervisor is satisfied and permission has been granted, the new information should be entered on the file Worksheet and the database.
- 6.45. It may become clear that the licensee has, in fact, appointed new key persons, independent directors, compliance officers or auditors without the Commission's permission. New beneficial owners or shareholders may have acquired interests without permission. In respect of the appointments, even if they have already been made, the Supervisor should follow the procedures set out in Section 5 before giving approval.
- 6.46. If the Supervisor is satisfied that the change is acceptable, the Supervisor should write to the licensee stating that it is giving its approval. The Supervisor should note the new information on the Worksheet but annotate it to the effect that the change took place on without permission (and give the date when this occurred). The Supervisor should note that the changes should have been notified to the Commission in advance and warn the licensee that there should be no repeat of the failure to give notice. If the failure is the second or further offence of this kind, the Supervisor should consult the senior officer and consider the appropriate enforcement action.
- 6.47. If the Supervisor does not consider the change is acceptable, the Supervisor should consult the senior officer and write to the licensee requiring it to remove the key person or invite the unacceptable shareholder or beneficial owner to divest themselves of their shareholding. In the event that a licensee refuses to remove the key person, the Supervisor should warn the licensee that the Commission will issue a direction requiring the removal of the person. If this is necessary, the Commission should follow the procedures for ensuring compliance set out in Section 11.
- 6.48. The position in respect of unacceptable shareholders or beneficial owners is more complex, since the applicant may not be in a position to require them to divest themselves of their shareholdings. The Supervisor should consult the senior officer to determine the appropriate action. If the risk is sufficiently great, the Commission may wish to consider revoking the license of the licensee. If not, it will be necessary to note the risk assessment of the problems associated with the beneficial owner or shareholders and ensure that the licensee is monitored to establish if its behaviour is affected by the unacceptable shareholders and beneficial owners.

Change in name and registered office

- 6.49. Where a licensee gives notice of a change in name, the Supervisor should be satisfied that there is no danger of the licensee being confused with another entity. If there is such a danger, the Supervisor should consult the senior officer and consider refusing permission. If the licensee fails to comply, the Commission should issue a direction requiring the licensee to revert to their original name or find an acceptable

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one. If the licensee continues to fail to comply, the Commission should follow the procedure for ensuring compliance set out in Section 11.

- 6.50. If the change of name is acceptable, the Supervisor should write to the licensee instructing the licensee to inform its customers of the change of name if it has not already done so. If the licensee refuses, the Supervisor should consult the senior officer and should start follow the procedure set out in Section 11.
- 6.51. When the Supervisor is satisfied that the change of name is acceptable and has been properly communicated to customers, the Supervisor should note the change on the file Worksheet.

Other information from or about licensees

- 6.52. There is a wide range of information that the Supervisor may receive. This information could come from the licensee or from third parties. The information could relate to convictions, investigations or other findings that could cast doubt on the integrity of the licensee or any key person, or their compliance with the Act or Regulations. In particular, there could be a report from an auditor to the effect that the licensee is in breach of the Act or Regulations.
- 6.53. When such information is submitted to the Commission, the Supervisor should review it to determine if it casts doubt on the integrity of the licensee or a key person or whether there may have been a breach of the Act or Regulations. This judgement will have to be on a case by case basis.
- 6.54. Where the Supervisor considers that the integrity of the licensee or key person is in doubt he or she should consult a senior officer. The Supervisor should consider if the appropriate action is an investigation (for which see Paragraphs 10.9 – 10.19), or it may be appropriate to move directly to one of the following:
- (a) the removal of a key person;
 - (b) a limitation on the activities of the licensee by means of a direction or licence condition;
 - (c) close monitoring of a licensee; and
 - (d) the revocation of a licence.
- 6.55. Having chosen the appropriate course, the Supervisor should inform the licensee (unless the Commission considers that to inform a licensee of an investigation would prejudice that investigation). The appropriate course (other than monitoring) can, if necessary be imposed by following the procedures for the appropriate action set out in Section 11.
- 6.56. Where the appropriate action is enhanced monitoring, the Supervisor should note the file to this effect and state what monitoring is necessary and make a diary note of any future action required. The Supervisor should amend the risk assessment.
- 6.57. Information concerning breaches of the Act or Regulations, investigations or findings relating to the licensee or key persons and other matters relating to fitness and properness may come from a third party, rather than from the licensee. If substantiated, the failure of the licensee to provide this information to the Commission may be an offence. The Supervisor should write to the licensee seeking an

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explanation for the failure to provide the information establishing a deadline for response. A diary note should be made to check if the response is received. If the explanation is not acceptable or if a response is not received by the deadline, the Supervisor should consult the senior officer and consider what enforcement action is appropriate.

- 6.58. So far as the substance of the information is concerned, the Supervisor should follow the procedure in paragraph 6.53.

Requiring a licensee to provide a report

[NB: This section cannot apply until the Commission has the power to require a licensee to appoint a skilled or professional person to undertake a study and prepare a report – a power that the Commission should have.]

- 6.59. The Commission has the power to require a licensee to Commission a report a matter related to its regulated activity. The report can be required:
- (a) to enable the Commission to satisfy itself that the licensee is in compliance with this Act or the Regulations; and
 - (b) where the Commission does not have the technical expertise or the internal resources to investigate the matter within the required time.
- 6.60. The Supervisor should compile a report to the Commission where they consider there is information (whether from annual returns, third parties or an on-site visit) that gives rise to a concern that the licensee may not be operating effectively in full compliance. The power should not normally be used as a substitute for an inspection but would most properly be used when there is an event (such as a revelation that the licensee is failing to segregate client assets, is using them improperly or is failing to meet financial requirements) and the Commission wants to be satisfied that the licensee's policies, procedures and controls are sufficient to prevent a recurrence.

Complaints to the Commission against licensees

- 6.61. The Commission receives complaints about the service provided by a licensee. Complaints provide useful information to the Commission. They may give indications of regulatory breaches or provide evidence of inappropriate behaviour by licensees. They may also demonstrate gaps in the regulatory regime. A high number of complaints against a licensee (whether or not justified) is usually an indicator of poor management. In short, a complaint may affect the Commission's regulatory objectives.
- 6.62. On receiving a complaint concerning a licensee, the Supervisor's approach should be:
- (a) to encourage the complainant firstly to resolve the matter with the licensee if that has not already been done;
 - (b) to find out the facts of the case from the licensee and invite the licensee to comment on the complaint;
 - (c) to determine if the complaint indicates a breach of the regulatory regime, if necessary (and if the seriousness of the case justifies it) by mounting an investigation;

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- (d) to use its enforcement powers if there has been a breach of the regulatory regime;
 - (e) to suggest ways in which the licensee and complainant may resolve the complaint; and
 - (f) to use its powers to require restitution if appropriate.
- 6.63. The actions of the Supervisor will depend on the nature of the complaint and the seriousness of any regulatory breach (if there is one).
- 6.64. The Supervisor should take care when suggesting ways in which the complaint may be resolved since it is possible that any suggestions made by the Commission could be made public in an ensuing civil suit. Any suggestions for a resolution should therefore be firmly grounded in the BSEC Act and Regulations or relevant financial services law and be supported by the facts.

7. Current Routine Inspection

- 7.1. The current Routine Inspection will be conducted based on:
- a) turnover of the stock brokers/dealers
 - i. at least top 50 stock brokers from Dhaka Stock Exchange (or any number as determined by the Commission) in a calendar year; and
 - ii. at least top 30 stock brokers from Chittagong Stock Exchange (or any number as determined by the Commission) in a calendar year
 - b) considering length of time between inspections
 - c) selection through lottery from rest of the stock brokers of DSE and CSE
 - d) any other criteria as introduced by the Commission
- 7.2. Final approval request of routine inspection should contain the followings:
- a) Last 3 (three) years business data
 - b) Last 3 (three) years position of financial statement
 - c) Compliance data of earlier inspection
- 7.3. Special purpose or Surprise Inspection to be conducted on the basis of
- a) an assessment of risk factors
 - b) Factors indicating a higher possibility of customer risks or compliance problems
 - c) Customer/clients complaints
 - d) Prima-fecy evidences, if any.
 - e) Newspapers reporting
 - f) as assigned by the Commission

8. Transition to implementing an inspection programme on a “Risk Based Supervision” (RBS) Approach

- 8.1. The Supervision and Regulation of Intermediaries Department (SRI) should as part of its annual planning agree with the Commission’s Board the thematic approaches for oversight inspection for each year to ensure that the inspections proposed in any year are based on a systematic selection process but necessarily ensure concentration of effort to activities and functions that are perceived to carry the highest risk to overall market integrity and the protection of investors.
- 8.2. The SRI has to make an assessment of what licensed entity activities, either based on previous inspection activity or arising from its own surveillance activity or investor complaints, pose the most important threats to investor protection and overall market integrity.
- 8.3. In addition any new Risk Based Capital Adequacy (RBCA) regulations for market intermediaries the Commission’s commitment to a RBS approach will place additional burdens on supervision by SRI.
- 8.4. As part of an RBS approach, SRI needs to carefully determine an appropriate cycle of reviews to ensure that intermediaries are in compliance with the appropriate regulations and that they are not posing either systemic, market or reputational risk to the Bangladeshi capital markets.
- 8.5. As a foundation to a RBS approach the Commission needs to have in place sufficient market based data to form an intelligent view of where the risks might lie. Thus it is essential that the SRI build and maintain strategic informational databases of listed company activity, market activity, mutual funds and the capital adequacy of intermediaries as well as appropriate data of individual share and aggregate market volatility and liquidity to ensure informed choice is made of the risk areas to be addressed in each year’s inspection cycle.
- 8.6. The same required market data is part of the TRAPET’s system to monitor possible market abuse or insider trading activity.
- 8.7. In relation to the DSE, CSE and CSD each inspection should concentrate on two to three activities of high importance and possibly two or three activities of perceived lower risk.

Risk Scoring Methodology²

- 8.8. A risk scoring assessment will be completed for each regulated business.
- 8.9. The adopted methodology provides for the determination of a “Supervisory Attention Index” as shown in the (probability/impact) matrix below:

² A separate paper is attached as Annexure G which addresses the RBS Framework and Risk profiling Scoring.

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| Impact Rating | Impact rating | Impact index | Supervisory Attention Index | | | | |
|--------------------|--------------------|--------------|-----------------------------|--------------|--------------|------|---------|
| | Extreme | 250 | 16 | 35 | 63 | 142 | 253 |
| | High | 125 | 11 | 25 | 45 | 101 | 179 |
| | Upper Medium | 12.5 | 4 | 8 | 14 | 32 | 57 |
| | Lower Medium | 1.25 | 1 | 3 | 4 | 10 | 18 |
| | Low | 0.25 | 1 | 1 | 2 | 5 | 8 |
| | Probability rating | | Low | Lower Medium | Upper Medium | High | Extreme |
| | Probability index | | 1 | 5 | 16 | 81 | 256 |
| Probability Impact | | | | | | | |

8.10. The attention index and qualitative comments considered for each business will determine:

- (a) The frequency of on-site visits. Businesses with a “Remedial Action” risk rating will be visited once every 3-6 months; those with a “Watch List” risk rating should be visited annually and those with a “Normal” risk rating should be visited every two years;
- (b) The focus of visits.
- (c) Not all visits will be full reviews and the risk scoring process will help determine the subject of a focussed review.
- (d) There are four types of on-site review, namely:
 - i. Routine inspection;
 - ii. Special inspection;
 - iii. Thematic inspection; and
 - iv. Prudential visit.
- (e) Different inspection checklists and programs have been developed to cover the different business activities conducted by licensed entities, which will be used as guidance only as the scope and depth of each review is tailor-made to suit the specific circumstances of each case, thereby maximising the effectiveness of SRI's supervision.
- (f) Routine inspection
 - i. All licensed entities are subject to SRI's routine inspections. These inspections are general checks on the firms' systems and controls, as well as their compliance with the relevant rules and regulations, in the area(s) of relatively high importance. Typically, before the inspection is due to commence, the inspection team will identify the key potential risk areas and formulate an inspection plan.
 - ii. SRI should aim to ensure a balanced top-down and bottom-up approach is adopted which is set to assess the overall effectiveness of a licensed entity's systems and controls for ensuring compliance with key legal and regulatory requirements applicable thereto.

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- iii. First it will be necessary to gain a high-level understanding of the licensed corporation's business activities, operations, systems and controls, as well as future aspirations, based on information collected and analysis prepared as part of off-site monitoring work and through discussions with senior management; and
- iv. Then taking appropriate inspection steps to ascertain how the firm's systems and controls have been implemented in practice, – through on-site inspection and discussions
- v. Performing walk-through tests on key control procedures and processes;
- vi. Reviewing selected underlying documentation (such as bank and custodian statements to confirm the existence and valuation of assets held) and performing sample compliance tests; and
- vii. Interviewing relevant staff to assess the control environment of the firm.

(g) Special inspection

- i. Special inspections will be performed on licensed entities suspected to pose imminent risks to the market or to their customers, for example, where there is reason to suspect misappropriation of client assets. In this case, inspection steps are tailor-made to cater for the specific circumstances of each case. Normally, a special inspection will involve carrying out detailed substantive testing and forensic reviews to assist in gauging any potential losses to investors.
- ii. Special inspections should also be performed on a licensed entity if its financial position is considered vulnerable. In this case, an on-site inspection should be arranged as soon as practicable to assess its latest financial and liquidity positions, as well as determine if client interests may be at risk, so that the Commission can move to ring fence the licensed entity if necessary.

(h) Thematic inspection

- i. Thematic inspection will be the primary tool used to assess the scale and nature of a particular market sector risk mitigation initiative, which may be triggered upon the Commission identifying trends, emerging risks and compliance lapses that require prompt regulatory response. A sample of licensed entities will be selected for review in each round of thematic inspection. The review steps are normally tailor-made, which typically revolve around analysing certain sector-specific business aspects, activities or practices. An example may be determining the extent of client liabilities not covered by client cash balances.

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- (i) Prudential visits
 - i. Prudential visits will be part of the SRI's continuous supervisory process. Through visiting the office of the licensed entity and meeting with their management team the SRI can obtain a high level understanding of the licensed entity's latest business developments, business outlook and how it manages the challenges it faces. In particular, information on both firm-specific events and significant market / industry events would be discussed during the meeting to assist the SRI to ascertain their impact on the licensed firm and the industry as a whole. Such visits will also serve as a platform that enables the SRI to build rapport with the senior management of the licensed entities. They provide an opportunity for sharing views on the market and regulatory environment and discussing any regulatory issues or concerns.
- (j) The use of specific regulatory tools. Businesses that are seen as high risk are likely to be the subject of specific programmes designed to mitigate the risks. Such programmes would include certain actions required of the regulated person which may be imposed by means of a direction under Sections XX of the BSEC Act or a licence condition under the Act. **[BSEC to make appropriate adjustment.]**
- (k) Reporting Requirements. Businesses with a high risk are also likely to be subject to reporting requirements designed to satisfy the Commission that a mitigation programme is being followed. Moreover, businesses with low risks may be required to file additional reports to justify the lower frequency of on-site visits.

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9. Management, organization of inspection teams and maintenance of oversight working papers and peer review

- 9.1. The choice of inspection theme, the areas of activity to be reviewed and the nature of the work to be undertaken will determine the combination of SRI staff required, who should between them have the requisite skills.
 - 9.2. The lead team member should be of sufficient status to have the respect and Commission to both represent the Commission and command respect of the inspection team and the entity being inspected. Thus the leader should have an excellent understanding of both the regulatory requirements and the practical aspects of capital markets operations.
 - 9.3. There may be one or two teams under the direction of the leader and these sub-teams may have cross membership depending on the multidisciplinary skills of each staff member. Teams may also be wholly internal SRI desk-based or field-based or a combination. The aim should be to ensure that a team is not entirely reliant on just one or two persons but that it can survive and disruptions that may be caused by reassignment or illness of individual staff.
 - 9.4. Sufficient time should be allocated to the debriefing of the teams to ensure there is a good understanding of both the aim and proposed execution of the “inspection programme”. This needs to be broken down between those activities undertaken a pre-visit desk preparation and those which will be undertaken in the field.
 - 9.5. Composition of skills required and activity to be reviewed should be such that a team can cope with the proposed inspection given the size of intermediary being visited, for the CSD and DSE & CSE teams may comprise many SRI staff members.
 - 9.6. One team member and an assistant should be appointed to maintain the overall oversight working paper files which should be arranged and cross referenced to the inspection programme developed.
 - 9.7. Oversight work papers should adequately document oversight work performed by the SRI staff member. Management of the SRI should review these work papers to ensure the objectives of the oversight work are achieved. Oversight work papers should accurately record the information obtained and the analyses performed, and should support the bases for any findings and recommendations to be reported to management.
 - 9.8. Oversight work papers generally serve to:
 - (a) Provide the principal support for the SRI department report;
 - (b) Aid in the planning and performance of the oversight work;
 - (c) Document whether the oversight objectives were achieved;
 - (d) Facilitate third party reviews;
 - (e) Provide a basis for evaluating the SRI’s quality assurance program;
 - (f) Provide support, in circumstances such as market abuse and insider trading cases, and lawsuits; and
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- (g) Aid in the professional development of the oversight staff.
- 9.9. The organization, design, and content of the oversight work papers will depend on the nature of the oversight audit. Oversight work papers should document the following aspects of the inspection process:
- (a) The planning process, which includes, but is not limited to: discussions with management, an overall review of the activities under review, an analyses of the operational control environment, performance of a risk assessment, identification of the system of internal controls, and the development of an oversight work program.
 - (b) The inspection and evaluation of the adequacy, efficiency and effectiveness of the system of controls.
 - (c) The detailed overview procedures performed, the information obtained, the analyses made and the conclusions reached.
 - (d) The review by SRI management.
 - (e) Any follow-up that the management of the SRI deems necessary.
- 9.10. Oversight work papers should be complete and include support for oversight review conclusions reached. Oversight work papers may include, but are not limited to:
- (a) Notes and memorandums resulting from interviews;
 - (b) Organizational data, such as organizational charts and job descriptions;
 - (c) Copies of important contracts and agreements particularly related to IT;
 - (d) Information about operating policies;
 - (e) Planning documents and oversight work programs;
 - (f) Risk control questionnaires (RCQs), flowcharts, checklists, and narratives;
 - (g) Results of operational control evaluations and assessments;
 - (h) Letters of confirmations and representation;
 - (i) Results of analytical overview procedures; and
 - (j) The oversight report and management's responses.
 - (k) Oversight correspondence if it documents the oversight review conclusions reached.
- 9.11. Oversight work papers may be in the form of paper, tape, disks, diskettes, film, or other media. If oversight work papers are in the form of media other than paper, backup copies should be maintained.
- 9.12. If reviewer(s) are reporting on financial information, the oversight work papers should document whether the accounting records agree or reconcile with such financial information.
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- 9.13. Oversight work papers should be categorized as either **Permanent** or **Current** working papers.
- (a) Permanent oversight work papers refer to any documentation, which would be useful to an inspector in a future inspection or review.
 - (b) Current oversight work papers refer to documentation for the latest or most current inspection file and should only pertain to the oversight work being performed at a particular point in time.
 - (c) Each oversight work paper should contain a heading. The heading usually consists of the:
 - i. name of the organization and the activity being reviewed;
 - ii. a title or description of the contents or purpose of the work paper; and
 - iii. date or period covered by the review.
- 9.14. Each individual oversight work paper should reference the reviewer(s) who created or obtained the documentation by his/her initial. In addition, the Oversight work paper should document the date the work paper was prepared. Oversight documents should be prepared immediately following oversight activities.
- 9.15. Each oversight work paper should contain an index or reference number relating and cross referencing the work performed back to the Oversight work program.
- 9.16. Oversight verification symbols (tick marks) should be adequately explained.
- 9.17. Sources of data should be clearly identified.
- 9.18. The SRI management should review all oversight work papers to ensure that they properly support the oversight findings and recommendations; and that all-necessary oversight procedures have been performed.
- 9.19. Management of the SRI provides evidence that the oversight work papers have been reviewed by initialling and dating the individual oversight work papers. The director of SRI has overall responsibility for review but may designate appropriately experienced members of the SRI to perform this review.
- 9.20. Evidence of supervisory review should consist of the reviewer(s) initialling and dating each work paper after his/her review.
- 9.21. Other review techniques that provide evidence of supervisory review include completing an Oversight Work Paper Review Sheet and/or preparing a memorandum specifying the nature, extent, and results of the review. Reviewers may make written record (review notes or documentation by the use of an Oversight Work Paper Review Checklist) of questions arising from the review process. When clearing review notes, the management of the SRI should be careful to ensure that the work papers provide adequate evidence that questions raised during the review have been resolved. Acceptable alternatives with respect to disposition of review notes is as follows:
- (a) Retain the review notes as a record of the questions raised by the reviewer and take appropriate steps toward their resolution.
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- (b) Discard the review notes after the work papers have been amended to provide additional information requested.
 - 9.22. Oversight work papers are the property of the Commission and should generally remain under the control of the SRI. Oversight work papers should be accessible only to authorized personnel (e.g. external auditors, Commission inspectors, by order of a court).
 - 9.23. Management and other members of the organization may request access to the oversight work papers. Such access may be necessary to substantiate or explain review findings or to use oversight documentation for other regulatory purposes. These requests for access should be subject to the approval of the director of SRI.
 - 9.24. Access to oversight work papers by inspector(s) should be subject to the approval of the director of SRI.
 - 9.25. The director of SRI should develop an adequate file retention schedule for all the SRI's work. This retention schedule should be consistent with the organization's guidelines and any pertinent legal or other requirement. At a minimum, the SRI should maintain its files within the SRI for a period of 3 years (Current year and the previous 2 years). After that, files should be sent to an off-site storage facility for a period of 4 years. Files and documents older than 7 years then can be destroyed.
 - 9.26. A quality assurance program should be developed within SRI to include the following elements:
 - (a) Supervision;
 - (b) Internal reviews; and
 - (c) External reviews.
 - 9.27. Supervision
 - (a) Supervision of the work of oversight teams should be carried out to assure conformity with oversight inspection standards, departmental policies, and inspection programs. Adequate supervision is the most fundamental element of a quality assurance program. As such, it provides a foundation upon which internal and external reviews can subsequently be built. Supervision is a process that begins with planning and continues throughout the inspection, evaluation, report, and follow-up phases of the oversight assignment.
 - 9.28. The SRI manager is responsible for ensuring that appropriate oversight supervision is provided. Guidelines for effective supervision are as follows:
 - (a) Ensuring that the staff assigned possesses the requisite knowledge and skills.
 - (b) Providing appropriate instructions during the planning of the inspection and approving the inspection program.
 - (c) Seeing that the approved inspection program is carried out unless changes are both justified and authorized.
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- (d) Determining that oversight working papers adequately support the inspection findings, conclusions, and reports.
- (e) Ensuring that inspection reports are accurate, objective, clear, concise, constructive, and timely.
- (f) Ensuring that inspection objectives are met.
- (g) Providing opportunities for developing staff knowledge and skills.
- (h) Appropriate evidence of supervision should be documented and retained.
- (i) The extent of supervision required will depend on the proficiency and experience of oversight staff and the complexity of the inspection assignment.
- (j) Appropriately experienced oversight staff may be utilized to review the work of other departmental members.
- (k) All oversight assignments, whether performed by or for the SRI, remain the responsibility of its Manager. The Manager is responsible for all-significant professional judgments made in the planning, inspection, evaluation, report, and follow-up phases of the inspection assignment. The director should adopt suitable means to ensure that this responsibility is met. Suitable means include policies and procedures designed to:
 - i. Minimize the risk that professional judgments may be made by SRI staff or reviewers, or others performing work for the SRI, that are inconsistent with the professional judgment of the Manager such that a significant adverse effect on the oversight assignment could result.
 - ii. Resolve differences in professional judgment between the director and oversight staff members over significant issues relating to the assignment. Such means may include:
 - discussion of pertinent facts;
 - further inquiry and/or research; and
 - documentation and disposition of the differing viewpoints in the oversight working papers.
 - iii. Supervision extends to staff training and development, staff performance evaluation, and similar administrative areas.

9.29. Internal Reviews

- (a) Internal reviews should be performed periodically to appraise the quality of the oversight work performed. These reviews should be performed in the same manner as any other oversight work.
 - i. Formal internal reviews are periodic self-assessments of the SRI. These reviews generally are performed by the director SRI.

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- ii. Feedback from those the subject of oversight (in addition to that from personal contact) through the use of questionnaires or surveys, either routinely after selected oversight reviews.
- iii. This process will elicit licensed entity, exchange, and CSD management's perception of the Commission's work and may result in suggestions to make it more effective and responsive to management needs.

9.30. External reviews

- (a) External reviews of the SRI should be performed to appraise the quality of the department's operations. These reviews should be performed by qualified persons who are independent of SRI and who do not have either a real or apparent conflict of interest. Such reviews should be conducted at least once every three years. On completion of the review a formal, written report should be issued. The report should express an opinion as to the department's compliance with the standards outlined herein and the objectives detailed in this manual and, as appropriate, should include recommendations for improvement.
- (b) External reviews can have considerable value to the Manager of the SRI and other members of the department. Another important purpose of external reviews is to provide independent assurance of quality to senior management and the Board of the Commission.
- (c) The manager of the SRI should discuss with senior Commission management the nature of an external review in the context of the overall quality assurance program and should involve them in the selection of an external reviewer.
- (d) Upon completion of an external review, the review team should issue a formal report containing an opinion as to the department's compliance with the appropriate standards. The report should also address compliance with the department's charter and other applicable standards and include appropriate recommendations for improvement. The report should be addressed to the Commission's Board. The Manager of SRI should prepare a written action plan in response to the significant comments and recommendations contained in the report of external review. Appropriate follow-up is also the Manager's responsibility.
- (e) External reviews should be conducted at least once every three years.

9.31. External review is an important element of the program for achieving quality assurance. However, if resources are limited, or for other reasons previously noted, the SRI may be currently unable to obtain an external review. In these circumstances, more emphasis should be placed on supervision, periodic internal reviews, and other quality assurance methods that are available to the department. It is the responsibility of the Manager of SRI to annually assess the conditions, which restrict an external review.

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10. Inspection visits

- 10.1. This section of the manual sets out the steps to be taken when conducting a routine on-site visit to a licensee.
- 10.2. Special, thematic and prudential visits will have ad-hoc requirements based on specific concerns.
- 10.3. The key elements of routine inspection visits are adequate planning, assessment, testing, and recording, reporting and following up.
- 10.4. This manual sets out the steps the Commission and the Market Supervision Department (SRI) will take. At many of the stages, the visit will go better if there is cooperation from the licensee. However, some licensees will be unfamiliar with the concept of an on-site visit and may not cooperate. Where this occurs the Inspector should follow the procedure set out in Section 11.

Preparing for an inspection

- 10.5. Every visit must be planned. The depth of the planning procedure will depend on the size and complexity of the entity and scope of the visit.
- 10.6. The first step is to determine the scope of the work. The scope is defined as the areas of the business under inspection and the obligations (as set out in Regulations) whose compliance is subject to review. When determining the appropriate scope of the visit, the Inspector should:
 - (a) review the Commission's risk scoring assessment to ascertain the areas of vulnerability;
 - (b) review the financial information available to establish if they show a willingness and capability to maintain appropriate financial resources and whether they reveal further areas of risk;
 - (c) review the licensee's file to ensure knowledge of current issues;
 - (d) review the last desk-based review and annual return to ensure that the inspector is up to speed with the details of the business and whether there are any outstanding gaps in the information supplied;
 - (e) review the information concerning complaints and consider if there is a matter that is becoming of substantial or increasing concern;
 - (f) review the last report of the assessment of the last annual return and the last on-site visit, the action plan following the report and any information on follow up;
 - (g) review the licensee's annual report and audit;
 - (h) review the licensee's web site; and
 - (i) the scope of a visit will normally be to determine the compliance by the licensee using the checklists at Annexure A and the methods outlined in **Annexure E**.

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The following is an overall guide to good inspection and risk assessment process

Preparation for inspection

- 10.7. Every inspection begins with the staff's preparation in the Commission's offices. Advance preparation for an inspection is essential for effective field work. Advance preparation includes research in regulatory records and other automated data libraries, review of the licensee's financial and other filings with the Commission, review of customer complaints received by the Commission, review of past inspection history and reports, and formulation of the problem areas likely to be found.
- 10.8. The better prepared the staff, the more effectively it can focus on areas of true compliance risk. Licensees often can help speed the inspection and eliminate any misunderstandings by providing the staff, at the outset of the inspection, with copies of their most current reports and other materials which explain their practices or place them in an appropriate context.
- 10.9. In particular, the inspector should first become acquainted with and take relevant copies of documents within the licensed entity's file at the Commission. The inspector must determine the sample period for inspection, or the sample accounts to review. The inspector must be prepared in advance of the commencement of the on-site inspection with documents, sample trades or contracts of execution, active accounts, account activity, complaints, and the financial filings.
- 10.10. The degree and thoroughness of preparation conducted prior arriving on-site to the target firm will greatly impact an inspection's effectiveness. Careful preparation ensures that fieldwork review is targeted to areas of greatest risk and that staff resources are deployed most efficiently and effectively.
- 10.11. Among other things, pre-inspection preparation should include: (1) searches of Commission files and other regulatory and business databases; (2) review of firm financial reports and annual reports/audits; (3) obtaining any customer complaints received by the Commission; and (4) study of prior inspection reports and work-papers.
- 10.12. Inspectors should also check with any other relevant BSEC department (such as the Legal & Policy division once established) to ensure that there are no pending issues within these areas. The inspector should also check for current and prior enforcement actions against the firm, private litigation and disciplinary actions against officers and/or associated persons of the firm.
- 10.13. Prior to the commencement of the on-site inspection, the inspector shall review the relevant documents in the file of the licensed entity. For example, if the upcoming inspection is a cycle or routine inspection, it might occur a year or so after the previous routine inspection. Therefore, the inspector should review the findings, report, and work-papers of the previous inspection, any financial and other documents filed between the previous inspection and this upcoming one, and any complaints or disciplinary actions against this licensed entity.
- 10.14. The inspector should review any results of off-site reviews or inspections during this interim period. If for example, the upcoming inspection is a focused inspection, one that does not review all activities, but just a focus on trading practices (for a Brokerage Firm), or net asset valuations (for a mutual fund), or the approval process of

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cancelling trades (for a stock exchange), the inspector shall review all documentation specifically related to that focused area in the licensed entities file.

Scope

10.15. Each licensed firm is responsible for making and preserving books and records, establishing and maintaining certain policies and procedures (e.g., policies and procedures for the prevention of insider trading), as well as setting internal control policies applicable to its business. Licensed firm inspections are conducted to review the sufficiency of the firm's books and records, the adequacy of the firm's policies and procedures and the efficacy of its internal controls. The scope of an inspection is not necessarily limited to the specific areas listed on the introductory letter or Inspection Modules.

10.16. Scope of an inspection may be based on areas such as:

- (a) Licensing of entity.
- (b) Books and records, including financials.
- (c) Sales practices.
- (d) Trading.
- (e) Operations.
- (f) Financial Risk.
- (g) Risk Management.
- (h) Supervision.

Entry Interview

10.17. During the initial interview with the CEO or Director of the licensed firm, the inspectors should outline:

- (a) Reason for inspection.
- (b) What functions will be reviewed.
- (c) Sample period (trade and related documents and records for that period).
- (d) Need for a place to work.
- (e) Specific paperwork, documents, forms required.
- (f) That copies may be taken to bring back to the Commission's office (originals left at member's office)

Other information which may be requested by Inspectors:

- i. Names of key personnel and supervisors, and names of personnel who might assist during inspection.

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- ii. Organization chart, with names, channels of communication, staff responsibilities.
- iii. Names of authorized traders, and what they trade (Plus the name of any other authorized person for access on and use of the Trading System).
- iv. Customer Complaint and Advertising Files.

Copies of various agreements, reports, procedures:

- i. Customer information or account opening form.
- ii. Customer agreement/contract.
- iii. Auditor's report (and Quarterly report).
- iv. Supervisory, Compliance, or operating procedures and Manuals.
- v. Trading and trade processing procedures, particularly regarding Block, Principal, and Cross trades.
- vi. Order/trade ticket or trade information form.

Re-licensing procedures along with Licensing Files

- 10.18. List of Member's principal trading accounts and customer accounts, particularly discretionary and active accounts:
- (a) Account names.
 - (b) Account numbers.

Document Requests

- 10.19. The review of records is a critical part of the inspection process. In conducting inspections, the inspection staff is entitled to examine all records maintained by the licensed firm relating to the business that is licensed. The inspectors also possess the Commission to make or require copies of such records from the licensed firm.
- 10.20. Licensed firms must promptly furnish the required records to inspectors of the Commission. Prompt furnishing means "almost immediately". Inspectors should make reasonable efforts to limit their need for copies of these records and should cooperate with reasonable requests by firms concerning procedures for obtaining and photocopying books and records that do not unduly delay the progress of the inspection. If inspection staff see documents that have not been offered to them, such as items on employees' desks or bulletin boards, inspectors should promptly bring the records to the attention of the firm's compliance manager or supervisor to request copies thereof. Similarly, if inspection staff believes licensed firm records are contained in file cabinets or desks to which access has not been conveyed, staff should ask a compliance manager or supervisor to describe the records that are contained in such areas and then request access to the records. Documents seen in file cabinets, desks, on computers or other media or areas to which the inspector has not been given access should not be removed or copied without asking a top executive of the licensed firm.

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- 10.21. If a firm refuses to comply with reasonable requests for records in an inspection, the inspector should determine the reason for the refusal and immediately report the facts to management. Protracted efforts to obtain records requested in an inspection should also be reported, and inspection staff should consider making Enforcement referrals for licensed firms that do not comply with inspection requests.

Exit Interview

- 10.22. Exit interviews should be conducted in most cases. The purpose of an exit interview at on-site inspections is to give the firm's management the opportunity to address any factual discrepancies that may exist affecting inspection findings and to clarify facts which may impact the inspector's analysis and the ultimate conclusion of whether violations occurred. In this regard the process greatly assists the inspector in preparing accurate inspection reports, deficiency letters and/or enforcement referrals. Some of the "findings" of deficiencies may be explained away and therefore clarified, providing additional documentation or deeper, better explanations.
- 10.23. The procedures and timing of exit interviews should be determined based upon the circumstances of each inspection, taking into consideration the firm's location, level of cooperation, severity of findings, and potential for referral to enforcement. Exit interviews may not be appropriate in the cause inspection setting, e.g., in possible manipulation or fraud cases; consult with the Legal division (once appointed) in these situations.
- 10.24. The inspector should require management and/or the Compliance Officer of the firm to sign and date the List of Inspection Findings at the close of the exit interview. All later conversations will stem from the items in this list. These signatures ensure adequate supervisory attention to the results and finding of the inspection process. The signed list also provides documentation that supervisors must now use as benchmark for changes of internal procedures and provides a formal list from which the firm's management can direct remedial and corrective actions. The inspector should provide the firm's managers with a signed copy of this document.

Analysis (at Commission office) and organization of work-papers

- 10.25. Work-papers are records (gathered and kept by the inspector) of the purpose, scoping, procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached during the inspection. Examples of work-papers are the inspection checklists, analyses, memoranda, letters of confirmation and representation, abstracts of licensee documents or records, and schedules or commentaries prepared or obtained by the inspector. Work-papers serve mainly to (1) provide the principal support for the inspector's report, including his/her representation regarding compliance with the standards of fieldwork and (2) to aid the inspector in the conduct and supervision of the inspection.
- 10.26. The inspector prepares and maintains work-papers and determines their form and content. The quantity, type, and content of work-papers vary with the circumstances of the inspection, but they must adequately evidence the work performed. The information contained in work-papers constitutes the principal record of the work that the inspector has done and the conclusions that he/she has reached concerning significant matters.
- 10.27. Work-papers should include documentation showing that:
- (a) The work has been adequately planned and supervised.

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- (b) A sufficient understanding of the firm's business has been obtained to plan the inspection and to determine the nature, timing, and extent of tests to be performed.
- (c) The inspection evidence obtained, the examining procedures applied, and the testing performed have provided sufficient, competent, evidential matter to afford a reasonable basis for the conclusions stated in the inspection report.
- (d) Work-papers should be organized, identified, dated and tied to specific tests or type of reviews conducted. For example, the inspector should choose to identify each test by a number in a sequence, and place the same sequential number on the related work-papers. Thus, the number identified on the inspector's checklist will conform to the number placed on the related work-papers.

Inspection Report

10.28. The inspection report may serve two purposes:

- (a) To describe the businesses and activities performed by the licensed member or person, description of the process and methodology of the inspection, the description of the findings of deficiencies, and recommendations for action to be taken. Inspectors are fact finders, and where necessary, any notes or reports of deficiencies must be supported by work-papers and other forms of evidence. All of this background information will be saved in the department's file for the licensed member and serve as a historical data base. Inspectors will access this file (hard and soft copy documents) as needed and when preparing for the next inspection at the specific licensed firm.
- (b) To serve as a notification of the findings of the inspection in a letter to the licensed firm. Findings should be isolated, edited, and then incorporated into a letter sent to the licensed firm. Note that only the findings of deficiencies should be sent to the firm, not general descriptions of the firm's business, as the firm already knows this. The letter should not discuss any areas of compliance or compliant activity and should not discuss the areas where no findings of deficiencies were made. Only findings of deficiencies will be mentioned in the letter.

10.29. In the letter of findings to the licensed entity, the inspector must request a response due within a reasonable period, possibly 2 weeks and should make a note to check receipt of said response within the deadline and chase it up if necessary. The firm's response should contain their confirmation of the findings of deficiency, the firm's actions correcting the deficiencies, the firm's schedule of correcting the deficiencies not already corrected, and the firm's acknowledgement that the deficiencies shall not recur. The Commission may also ask for evidence for the corrected deficiencies, and based on the resources of the Commission, may conduct a "Follow Up" inspection to ensure corrective and compliant actions.

10.30. The inspector should complete the drafting of the report as soon as possible after the completion of the on-site inspection while facts are fresh in the inspector's mind. Inspections themselves may take hours, days, or weeks, again depending on the nature of the inspection (or investigation). This period of time may also be sporadic rather than sequential. Complicated and detailed inspections, such as those for

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market manipulations or fraud, may take a prolonged period of time. Depending on the follow up analyses needed or further off site inspection and review of the licensed entity, the inspector may take a relatively long time for completion of the report.

- 10.31. The inspector will review the completed report with his/her supervisor for accuracy and fairness. The inspector may even have the findings reviewed by his/her supervisor during the drafting of the report, to ensure no other findings or evidence of findings are needed to support the deficiency claims. **However, it is most important that the deficiency findings of the inspection be formally communicated to the licensed entity (by letter) as soon as possible after the inspection and the completion of the report.**

Organization of the Report

- 10.32. A cover page (or 2) should be used to provide general descriptions of the type of inspection conducted, the types of findings (deficiencies), and additional general comments among other general descriptions. The cover pages serve as a ready reference to the contents of the report. A sample cover page is at **Annexure C**.

Minimum Elements of Inspection Reports

- 10.33. The following minimum elements for inspection reports are intended to ensure that the SRI is presented with certain key information regarding the inspections they review:
- (a) The inspection's purpose, scope, conclusions and disposition.
 - (b) The risk factors which determined the inspection scope.
 - (c) The facts which formed the basis for the inspector's conclusions.
 - (d) The specific statutes and rules or violated (correctly cited).
 - (e) A brief summary of the significant violations and disposition (recommended action) of the inspection should be provided at the beginning of the inspection report. A disposition or recommended action should be reflected covering all deficiencies and violations noted in the report. If the inspection results in more than one recommended action, each action should reference which violation or group of violations is covered.
 - (f) A description and history of the firm should include the following information:
 - i. Firm's name, address, and Commission file number.
 - ii. Commission license date.
 - iii. Licence category.
 - iv. Principal types of business, total revenues, and breakdown of revenues by product or division (expressed in money amounts and as a percentage of total revenues) for the most recent twelve months or calendar year.
 - v. Form of ownership, name(s) of sole or majority shareholders that directly own the firm or name of holding company and its majority ownership, if not public.

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- vi. Affiliations and business relationships with other financial institutions.
 - vii. Number of monthly transactions and approximate breakdown between principal and customer transactions.
 - viii. Number of total employees (if available), licensed sales agents and branch locations.
 - ix. Number and type of active customer accounts (retail cash/margin, retail discretionary, institutional).
 - x. Serious disciplinary actions taken against the firm, senior officers, directors or principal supervisors that were relevant to the current inspection selection or scope.
 - xi. Significant findings raised in previous inspections that were relevant to the current inspection selection or scope.
- (g) Brief description of any current or pending investigations (identify Enforcement action case name and case number) against the firm or associated persons that impacted the scope of the inspection.
- (h) Inspection Purpose and Scope:
- i. The purpose and scope of the inspection should include the following information:
 - Type of inspection (regular, prudential/oversight, thematic or “for cause”).
 - Basis for selection.
 - Reason for cause inspection, if applicable.
- (i) Inspection scope and areas of greater emphasis.
- i. Any limiting factors, such as records not available or not current, any attempts by management to limit the inspection scope, or avoidance of areas subject to Enforcement investigation.
- (j) Risk Assessment
- i. The risk assessment should describe the risk factors that affected the inspection scope. Later discussions of financial or sales practice reviews or other issues should correlate with the risk assessment by describing how the identified area of risk was examined and what conclusions were drawn.
- (k) Inspection Findings
- i. Inspection reports should contain discussions of the results of reviews of significant financial and operational requirements. For example, net capital, any reserve formula and possession and control are the fundamental financial and customer protection
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requirements to which licensed firms are subject and, as such, the results of these reviews should be discussed whether or not deficiencies were cited. However, reviews of less significant financial and operations areas (eg record-keeping, annual audit and regulatory financial reporting) need not be discussed in inspection reports if no deficiencies were noted.

- ii. Discussion of sales practice reviews may be limited to those areas in which deficiencies or regulatory concerns were noted. Additionally, inspection reports may include discussion of extraordinary inspection efforts; novel issues which were analyzed; or the use of new or unique inspection techniques. Non-substantive sales practice reviews, such as customer new account documents and confirmations, need not be discussed in reports if deficiencies or concerns did not arise. For inspection reports that contain findings that are complex and lengthy, try to discuss the most serious violations first.
- (l) Net Capital (subject to establishment of FFR as proposed by RBCA committee)
 - i. If the firm's financial condition or net capital was examined, the inspection report should note adjustments to net capital and whether these were material. In a table or similar form of comparison, present the inspection staff's computations vs. the firm's computations of net capital, required net capital, excess net capital and differences. Each significant adjustment made by the inspection staff should be described in either a footnote or itemized beneath the computation.
 - ii. If the inspection staff's computation reflects that the firm has not met its minimum capital requirement or violated an early warning parameter, the report should reflect what corrective actions were taken by the firm.
- (m) Internal Controls
 - i. The inspection report should indicate whether an extended review of internal controls was conducted in financial and operational areas or sales practice reviews. The report should detail any weaknesses identified in the firm's internal control systems, policies and procedures. It is expected that internal control reviews will entail descriptions of interviews and procedures in order to present the basis for findings of internal control weaknesses and inspection staff recommendations.
- (n) Supervisory Review and Approval
 - i. The names of inspectors, reviewing supervisors, and higher-level approving officials should be listed at the beginning or end of inspection report. The report should be dated as of the most senior official's approval.

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- 10.34. The following paragraphs will discuss the reasons for conducting various types of inspections by regulators. The main types of inspection are routine, for cause, thematic, and follow-up inspections.
- 10.35. Inspections require strong technical understanding of the material being reviewed and require inspectors to dig into the details of a particular issue or concern.
- 10.36. While the primary purpose of the inspection is to identify potential 'problem' areas or concerns, the process need not result in enforcement action. A better result may be the prompt adoption of corrective measures by the firm and the good faith intent to avoid repeat deficiencies.
- 10.37. Whilst some aspects of oversight can be accomplished in the office of the Commission, on-site reviews provide a means to determine how a firm is actually conducting its business by allowing the inspector to verify facts, rather than simply relying on the firm's representations. While conducting an on-site inspection the inspector will be able to observe and verify the actual operating environment through the use of sampling, review sales practices, trading activity, financial compliance, supervisory control, and resolution of customer complaints.

Routine Inspections

- 10.38. All licensees should be examined on a periodic basis according to schedules devised by the Commission. The inspection cycle is important in that it conveys to all firms, regardless of their size, age, or quality of operation that they are subject to inspection and oversight. The deterrent effect of knowing that one is subject to an effective inspection at any time should not be underestimated.
- 10.39. The inspection staff should inspect newly licensed intermediaries for compliance with applicable prudential rules within six months of being licensed, and for compliance with all other regulatory requirements within twelve months. These inspections would be performed on-site. Thereafter, the inspection staff should inspect licensed entities on a periodic basis, taking into account the type of business conducted by the entity and its compliance, disciplinary, and inspection history.
- 10.40. The Commission should until it is familiar with firms and completes proper risk profiling and prudential calculations treat all firms as high risk, demanding a full inspection at least every year. This will continue until the Commission gains increasing confidence that, at least some of the entities have appropriate procedures for controlling their financial affairs so that they consistently meet the financial requirements, for segregating and controlling their client funds properly and for gaining appropriate knowledge of their customers.
- 10.41. Summary of reasons for a routine inspection include:
- (a) New licensee.
 - (b) New management or controlling shareholder.
 - (c) Regular cycle based on risk-based schedule.

Special Purpose Inspections

- 10.42. Special purpose inspections will generally result from applying risk-based criteria, including: (1) analysis of financial reporting data for significant changes in financial condition between reporting periods; (2) any questionable practices or change in

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trading patterns/business activity noted; (3) an increasing number of complaints from investors or (4) significant changes to licensing as reported to the Commission.

- 10.43. Special purpose inspections can be conducted on a narrow scope based on the reason for initiation or can cover all areas normally included in a cycle inspection. Special purpose inspections can also be used in special projects and sweeps to conduct targeted reviews of certain practices by licensees or to determine whether the firms are in compliance with selected rules.
- 10.44. Summary of reasons for a special purpose inspection include:
- (a) Change in financial condition.
 - (b) New business areas.
 - (c) Changes to operational systems.
 - (d) Change in number or nature of complaints.
 - (e) Media or other information suggesting violations of regulations.
 - (f) Prior inspection findings revealing particular areas of control weakness.
 - (g) Evaluation of a new law or regulation.
 - (h) Evaluation of new trend in industry.
- 10.45. An inspection should also be categorized as a special purpose inspection, rather than a routine inspection, when the focus of review is targeted to a specific event alleged to involve violations of regulations. Inspections for special purposes may include customer complaints, evidence of manipulative or fraudulent stock trading, repeated settlement failures or tips and informants. Such an inspection may rapidly evolve into a formal investigation if the allegations prove to be well founded. Investigations require a different and specialised approach and are discussed separately below.

Follow-Up Inspections

- 10.46. Follow-up inspections should be performed when the Commission requires certain remedial actions to take place at the licensed/inspected entity, or when that entity states that remedial actions have been implemented. The firm might state this in a response letter to the Commission, responding to deficiencies found during an inspection. The Commission would then inspect the licensed entity to ensure that the remedial action has taken place. As with oversight inspections, follow-up inspections should take place on a sporadic basis, unless the Commission has reasons to believe that remedial actions have not taken place as stated.

Oversight Inspections

- 10.47. In recent years, any inspection activity undertaken by the DSE & CSE as an SRO has been completed independently of the Commission. There are considerable advantages in the Commission working with the DSE & CSE on the supervision of the licensed entities. The supervision can be delegated, at least in part, to the BSE, provided that the Commission undertakes an active oversight role regarding the effectiveness of the DSE & CSE supervisory process.
- 10.48. IOSCO Principle 6 states that “The regulatory regime should make appropriate use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, to the extent appropriate to the size and complexity of the markets.”
- 10.49. Furthermore, IOSCO Principle 7 states that “SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when

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exercising powers and delegated responsibilities.” Oversight inspections would normally take place a short time after the DSE & CSE conducts an on-site inspection. The purposes of the oversight inspection performed by the Commission are to confirm the findings of the BSE, to find deficiencies in the inspection findings of the BSE, and/or to discover other deficiencies at the broker or investment bank that the DSE & CSE did not uncover.

10.50. To perform its task effectively, the DSE & CSE will need:

- (a) The will to regulate and enforce.
- (b) The capacity and resources to regulate and enforce.
- (c) Appropriate rules to prevent fraud and to promote just and equitable principles of trade.
- (d) A working arrangement, preferably spelt out in a MoU, with the Commission on the approach to be adopted and the relative responsibilities.
- (e) Disciplinary and arbitration (i.e., dispute resolution) procedures and rules.

10.51. Advantages of an SRO partnership in regulation include:

- (a) Technical expertise.
- (b) Flexibility.
- (c) Responsive to new developments or activities.
- (d) Greater acceptance to rules.
- (e) Cost savings and greater resources for Commission.

10.52. Disadvantages of an SRO partnership in regulation include:

- (a) Conflicts of interest, ie disciplining members.
- (b) Possibility of less-than-sufficient effectiveness of regulation.

Outsourcing

10.53. The use of the DSE & CSE as a self-regulatory organisation is one example of outsourcing – ie the delegation of certain functions to another agency subject to appropriate controls and oversight. In particular, the Commission could use firms of accountants or other professionals to undertake inspections.

10.54. In order to make outsourcing work properly, it is necessary for the Commission to sign a service agreement or contract with the third-party outsourcing person or company, incorporating such provisions concerning:

- Limitations or conditions, if any, on the service provider's ability to subcontract, and, to the extent subcontracting is permitted, obligations, if any, in connection therewith.
- Client confidentiality as to both the client data and BSEC records and information.
- Defining the responsibilities of the outsourcing firm and the responsibilities of the service provider and how such responsibilities will be monitored.
- Responsibilities relating to IT security.
- Payment arrangements.
- Liability of the service provider to the outsourcing firm for unsatisfactory performance or other breach of the agreement.
- Settlements and indemnities.
- Obligation of the service provider to provide, upon request, records, information and/or assistance concerning outsourced activities.

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- Mechanisms to resolve disputes that might arise under the outsourcing arrangement.
 - Business continuity provisions.
 - With respect to outsourcing on a cross-border basis, choice of law provisions.
 - Termination of the contract, transfer of information and exit strategies.
 - Schedule of deliverables or activities.
- 10.55. The Inspector should consider the appropriate scope for an on-site inspection and determine whether it will be a routine full inspection, a special purpose “for cause” inspection, a follow up or a prudential/oversight inspection. The Inspector should also consider the extent to which outsourcing of the process will take place.

Planning the Inspection

- 10.56. The Inspector should then obtain the information necessary to conduct the visit. This will usually be on the Commission’s files as a result of the desk-based work. It will include the information reviewed when the Inspector was determining the scope of the visit as discussed in paragraph 10.6 above. However, depending on the scope of the visit, it may be necessary to seek additional information from the licensee and other authorities, including the DSE & CSE and CSD.
- 10.57. For each kind of visit, there will be a need to determine priorities. The Inspector should consider which of the following areas are to be regarded as priorities for inspection:
- (a) Corporate governance, Board processes, policies, procedures, risk assessment, staff training, compliance procedures, management information systems, controls and evaluation;
 - (b) Customer relationships, including customer acceptance, customer agreements, disclosures, consistency of treatment with agreement etc;
 - (c) Dealing rules, including staff dealing, client order confirmation;
 - (d) Enforcement of dealing rules, including especially time stamping of orders and chronological records of deals made;
 - (e) Financial accounts, including daily reconciliations, calculations of resource requirements maintenance of minimum financial resource requirements;
 - (f) Record keeping;
 - (g) Complaints and correspondence;
 - (h) Handling of agents;
 - (i) Marketing and advertising;
 - (j) Compliance with investment mandates;
 - (k) Box management of mutual funds where relevant;
 - (l) Safekeeping of assets, including custodial arrangements; and
 - (m) Segregation of client funds.
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- 10.58. Unless there are good reasons for acting otherwise, the licensee should be given a minimum of four weeks' notice of a visit. On occasions, however, it may be necessary to make unannounced visits.
- 10.59. When informing the licensee, in writing, that a visit is to take place, the Inspector should explain the purpose of the visit to the licensee. The Inspector should ask the licensee for any further information that may be necessary prior to the visit and invite the licensee to provide any further information that the licensee may consider is relevant. Any failure to co-operate should be dealt with in accordance with Section 11.
- 10.60. The licensee should be asked to confirm that there will be space available at the premises from which the Inspector can work. If specific members of staff are required to respond to questions, the licensee should be asked to confirm that they are available. The Inspector should schedule a meeting with the compliance officer and give the chief executive officer an opportunity to meet the Inspector at the commencement of the visit if he or she wishes.
- 10.61. The Inspector should inform the licensee that he or she will need access to a telephone (unless he or she proposes to use a mobile phone) and there will also need to be electricity supply for the inspector's laptop computer.
- 10.62. The licensee may wish to arrange a different time for a visit and this should be accommodated unless the Inspector believes the licensee is simply seeking to postpone the visit indefinitely.
- 10.63. The Inspector should record the steps taken to prepare for a visit.

Ensuring cooperation

- 10.64. If the licensee fails to cooperate, it is essential that the response be firm, consistent and effective. There are a number of possible scenarios for non- cooperation, including a refusal to accept a time for a visit; refusal to supply preparatory information, refusal to supply facilities, refusal to agree to meetings, refusal to provide access to investor files or a failure to respond in any way to notice of inspection.
- 10.65. Where the lack of cooperation takes place during the preparation for the visit in correspondence, the Inspector should proceed as described in Section 11.
- 10.66. Where the refusal to cooperate takes place during a visit, the Inspector should calmly, politely and formally restate the request that has led to the refusal. Assuming this has no effect, the Inspector should withdraw and consult the senior officer immediately. The matter that is the subject of the lack of cooperation should then be pursued by correspondence in accordance with Section 11. If the Inspector having consulted the senior officer concludes that the visit should go ahead, the correspondence with the licensee should make clear that the Commission stands by the request that has been refused and will pursue it. Other matters that are the subject of the visit can be pursued. However, it may be that the lack of cooperation is such that the visit cannot usefully go ahead, until the question of the refusal to cooperate is settled.

Conducting the visit

- 10.67. Much depends on the scope of the visit. What follows is a description of a full routine inspection of a licensee. However, the procedures would be equally valid where there is a focussed visit, with the emphasis being on the matters relevant to the area under inspection.

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10.68. However, there are some general principles that should apply in all inspections. The Inspector should remain polite and calm but firm; assert the Commission's right to information but be sensitive to the need to avoid excessive disruption to the business. The following principles are worth following:

- Keep calm, polite, professional and relaxed;
- Keep discussion factual;
- Ask one question at a time;
- Do not lecture;
- Let the other person finish talking;
- Be friendly without being too familiar;
- If your question causes uneasiness or uncertainty, formulate it differently;
- Involve all participants;
- Use only appropriate gestures/expressions;
- Keep your personal opinion to yourself;
- Never be side tracked;
- Avoid arguments; and
- Never discuss personalities, politics or religion.

Entry Interview

10.69. The inspection will begin with an entry interview with the compliance officer and other senior officers. This will be true for all inspections except where there is a focus on a particular breach that may lead to an investigation. For all other inspections, it will be helpful to give a general introduction, to set the tone and to explain how the licensee can make the inspection go well. The Inspector will give some but not detailed indications of the information he or she is likely to want to see.

Information to be obtained

10.70. The precise information that an Inspector will wish to see will depend on the nature of the visit. However, it is likely that the Inspector will wish to see:

- (a) Board agendas and minutes of meetings discussing the matters that are the subject of the inspection;
- (b) The licensee's procedures manual;
- (c) The officers responsible for the area of work to be examined and details of their qualifications;
- (d) Financial records, sufficient to enable the Inspector to reconstruct a calculation of financial resource requirements, working capital requirements and the state of the client account on days selected at random;
- (e) Complaints files;
- (f) Files on the training given to staff, including the way training needs are determined and the relationship with the business plan, risk management and business objectives of the intermediary;
- (g) Records of the nature of the licensee's risk assessment, where this is relevant to the matter being examined;

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- (h) Trading rules and controls;
- (i) The systems, controls, authorisation rules and reporting arrangements that are relevant;
- (j) Portfolio accounting records where relevant;
- (k) Client records including accounting records and in particular information on client bank accounts and arrangements;
- (l) the firm's books and records particularly relating to its capital; and
- (m) The management information systems, especially the financial management system.

10.71. The absence of any or all of the above listed items would normally be contrary to the Regulations and would, of itself, be a matter of comment. In such circumstances, the Inspector should speak to the compliance officer to determine the reason for the absence of these essential items. The Inspector should seek an explanation of how the licensee achieves an acceptable and consistent outcome in the absence of these items.

Factors to be examined

10.72. The Inspector should further consider what areas are to be reviewed or evaluated on a regular basis and at least annually. The Inspector should establish the form of the review and the extent to which the Board or senior management is involved in the review and evaluation process – for example by reading and discussing reports on the evaluations. Where there is no such review or evaluation process, the Inspector should ask the licensee what arrangements are made to keep the matters described in paragraph 9.70 up to date. Where the licensee claims that there are reviews, the Inspector should also consider what evidence there is that the reviews and evaluations take place – for example whether there are reports, minutes of discussions or circulars within the licensee's business.

10.73. The Inspector will need to consider whether or not he or she should take copies of information that is found. As a matter of general principle, copies should be taken rather than the originals.

10.74. It is important to establish whether or not what the licensee states about the matters described in paragraph 9.70 actually happens in practice. This is achieved by taking a sample of files and determining how the action taken has been influenced by the risk assessment policies, procedures and controls.

10.75. The Inspector should examine, in particular, whether:

- (a) The risks associated with the activity were understood and that this understanding affected the behaviour of the licensee;
 - (b) The procedures of the licensee were understood and followed by staff;
 - (c) There was sufficient knowledge of the customer and a customer agreement was in place;
 - (d) The actions taken were in line with the investor agreements and mandates;
-

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- (e) Any decisions made or discretion exercised, together with the reasons, were properly recorded;
 - (f) Any action taken was undertaken by a appropriately qualified or experienced officer (in line with the procedures) and subject to the appropriate degree of single or multiple authorisations;
 - (g) Where information was required, for example about the investor or about the legality of the action or the appropriateness of advice given, this was obtained and recorded;
 - (h) Staff training takes place according to a recorded plan; and
 - (i) There will be further matters to check, depending on the area under inspection.
- 10.76. It is not for the Inspector to second guess the decisions taken and the discretion exercised by the licensee, unless such decisions appear to be manifestly inappropriate or if there are investor complaints that do not appear to have been resolved. The Inspector should focus on the manner in which decisions are taken and discretion exercised so as to determine if they are consistent with the Regulations and with corporate governance best practice, are based on relevant information, are properly recorded and authorised and are likely to result in a consistent and accurate approach over time.
- 10.77. In addition to examining the matters described in paragraph 10.70, the Inspector will wish to probe further into the substance of the area or areas that are the subject of the on-site visit. Checklists for various matters are at Annexure A.

File sampling

- 10.78. In most cases, it will be necessary to take a sample of files to consider how the policies and procedures work in practice. The size of a sample is a matter of judgment but a 5% sample is a reasonable starting point. If the Inspector considers that the sample reveals serious weaknesses, the sample should be extended. The Inspector should record his or her findings. The Inspector should also record his or her comments on the matters found and the reasons for considering them adequate or inadequate to meet the Regulations.
- 10.79. How to choose the sample depends on the nature of the work undertaken. For client files, it may be helpful to take the top ten most active accounts as well as a sample of the rest. For financial statements, it would be helpful to take the intermediary's most active trading days (to be verified using DSE & CSE and CSD data) as well as a sample of other days over a period to be determined. For the conduct of business of a mutual fund, examining all records for transactions both in the mutual fund units and in mutual fund assets for a certain day may be appropriate.
- 10.80. Where there are conflicts of interest, this may lead the Inspector to focus on those files where the conflicts are most acute.

Documenting Findings

- 10.81. It is essential that there should be detailed documentary evidence of any weaknesses identified by the examining officer.

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- 10.82. When the Inspector has finished the assessment, it should be discussed with the inspector's senior officer prior to the final meeting with the licensee.
- 10.83. One important value of an inspection is the scope it gives for mutual learning. The Commission may learn more about the development of the business and the licensee may learn more about the developments in regulation, interpretation and best practice. The Inspector should take the opportunity for discussion to maximise the scope for such learning.
- 10.84. The Inspector should not be afraid to ask questions about new business and new developments.

The final meeting with the licensee

- 10.85. The Inspector should be accompanied by the senior officer of the Commission to the final meeting. The final meeting should take place with the chief executive officer of the licensee.
- 10.86. In preparation for the final meeting, it will be necessary to list all the initial findings arising from the work done and ensure there is appropriate documentary evidence to support each finding. Those findings should be documented and summarised for use by the senior officer at the final meeting.
- 10.87. The objective is not to provide the firm with definite conclusions and recommendations. The objective is primarily to convey the initial findings from the visit, to fill any remaining knowledge gaps and to resolve any inconsistencies identified. It is also an opportunity for management of the firm to raise issues, concerns or disagreements they may have with the initial findings.

Checklist of Work Undertaken

| | | |
|--|--|---|
| Brokerage Firm Name: | | |
| Membership No.: | | |
| Type of Organization: | <input type="checkbox"/> Bank Owned | <input type="checkbox"/> Corporate <input type="checkbox"/> Partnership |
| Membership: | <input type="checkbox"/> DSE | <input type="checkbox"/> CSE |
| Number of employees: | Number of Branch Offices: | |
| Number of total Authorised Representatives(AR): | Inspection Start Date: Inspection End Date: | |
| Date of previous inspection: | | |
| Quoted major violations in the previous inspection reports with reasoning: | | |
| Registration certificate renewal date: | | |

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| | | | |
|---|-----------------------------------|------------|----|
| Paid up capital: | | | |
| MODULES PERFORMED | Particular of checked item/sample | Compliance | |
| A. CUSTOMER RELATED INFORMATION AND TRADING PRACTICES | | Yes | No |
| Customer Account Information Form dully filled in as per 8(1) (ccc) of SER, 1987); if any deficiencies found please attached supporting | | | |
| <i>Customer Identification (KYC)</i> | | | |
| <i>Introducers information</i> | | | |
| <i>Authenticity of Client's Signature & Photo (To be examined by CEO/MD or any authorised person)</i> | | | |
| Client Agreement | | | |
| Written Buy/Sale Orders from clients as per clause 4 (1) of SER, 1987; | | | |
| Trade Confirmations to the Customers as per 4 (5) of the SER, 1987 | | | |
| Customers' Account Statements as per Rule 8 of SER, 1987 | | | |
| Customer Complaints Record | | | |
| Un-authorized Transactions | | | |
| Telephonic Orders properly recorded & signed as per Rule 4(1) of SER, 1987 | | | |
| B. SUPERVISORY MANAGEMENT | | Yes | No |
| Appointment of Supervisor/Compliance Authority | | | |
| Internal Written Policies and Procedures of internal | | | |

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| | | | |
|---|--|-----|----|
| control system | | | |
| Operational Review | | | |
| Supervision of New Customer Account | | | |
| Supervision of Daily Transaction | | | |
| Review & Handling of Customer Complaints | | | |
| C. BOOKS AND RECORDS | | Yes | No |
| Maintenance of Cash Book, Bank Book, General Ledger and Clients Financial Ledger as per Rule 8 of SER, 1987 | | | |
| Maintenance of Stock Register/Book as per Rule 13 of the wmwKDwiwUR I G-†PÄ Kwgkb (óK-wWjvi, óK-†eªvKvi I Aby†gvw`Z cÖwZwbwa) wewagvjv, 2000. a) Script wise and b) Client wise | | | |
| Maintenance of Client Register as per Rule 13 of the wmwKDwiwUR I G-†PÄ Kwgkb (óK-wWjvi, óK-†eªvKvi I Aby†gvw`Z cÖwZwbwa) wewagvjv, 2000 | | | |
| Other Items, if any (mentioned); | | | |
| D. BUSINESS AND RECORDS | | Yes | No |
| Statement of Transaction in Dealer Account with realized/unrealized gain/(loss) for 1 (one) year; | | | |
| Statement of margin loan provided by the stock broker to their clients on a specific date | | | |
| Statement of daily trade volume, commission and other charges (if any) for 1 (one) year | | | |
| Statement of commission and other charges (if any) transferred from customer consolidated account to | | | |

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| | | | |
|--|--|-----|----|
| company account for 1 (one) year | | | |
| E. FINANCIAL RISK AND COMPLIANCE | | Yes | No |
| Last years audited Financial Statements as per Rule 13(4) of the Companies Act, 1993 (১৩(৪) নং কোম্পানী আইন, ১৯৯৩) wewagvjv, 2000 | | | |
| Net Capital balance as per Rule 3(2) of Securities and Exchange Commission Rules, 1987 | | | |
| Aggregate Liabilities on an specific date | | | |
| Compliance of rule 3 of the Margin Rules, 1999 | | | |
| Exposure to single client as rule 5 of the Margin Rules, 1999 | | | |
| Maintenance of consolidated customers account) as per Rule 8A of SER, 1987: | | | |
| Compliance of Rule 15 of SER, 1987 (Risk based Capital Adequacy i.e. net Capital balance and Aggregate liabilities maximum 1:20): | | | |
| Statement of Cash Receipts & Payments (period as required by Inspecting officers) | | | |
| Maintenance of Money Receipt Note and Payment Voucher | | | |
| Reconciliation of availability of fund in consolidated customers bank account with all Receivables/Payables and all other related transaction on a particular date | | | |
| Reconciliation of stock balance of all client with BOISIN holding report of CDBL on a particular date | | | |
| Reconciliation of Company Account and discrepancies | | | |

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| | | | |
|---|--|-----|----|
| if any; | | | |
| Any irregularities in Clients Payments/settlements | | | |
| Any client agreement with any other Financial Institution | | | |
| F. CDBL law matters (clearing account settlement) | | Yes | No |
| <i>B/O Account Opening Form</i> | | | |
| <i>Pay in Transfer form</i> | | | |
| <i>Pay out Transfer form</i> | | | |
| <i>Statement of Clearing Account</i> | | | |
| <i>Availability of different Forms of CDBL</i> | | | |
| G. Company Status | | Yes | No |
| <i>Minutes of last Board of Directors Meeting</i> | | | |
| <i>Latest Form-XII of RJSC</i> | | | |
| <i>No. of Board Meeting in last year</i> | | | |
| <i>Holding of AGM in every calendar Year</i> | | | |
| <i>Number of Authorized Representative</i> | | | |
| <i>Number of Work Station</i> | | | |
| H. Other matters/violation of Orders/Notification/Directives | | Yes | No |
| Details of previous violation of SEC laws (if any) | | | |

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| | | | |
|---|--|--|--|
| <i>Short Sale</i> | | | |
| <i>Purchase of non-marginable securities violating Margin Rules, 1999</i> | | | |
| <i>Maintaining Margin agreement</i> | | | |
| <i>Money netting in "z" category shares</i> | | | |
| <i>Non-compliance of BSEC Orders/Notifications</i> | | | |
| <i>Branch opening permission letter & agreement</i> | | | |
| Comments/violations:(please enclosed supporting or attached sheet) | | | |

Signature of Inspecting officers:

Date:

Name:

Signature of inspecting officer:

Date:

Name:

Signature of Managing Director/CEO of the Date:
Brokers/Dealers:

Name:

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Review and final report

SAMPLE INSPECTION REPORT COVER PAGE

| | | | | |
|---|--|---|--|---------------------------------------|
| Type: | <input type="checkbox"/> New Firm | <input type="checkbox"/> Cycle/Routine | <input type="checkbox"/> Surveillance | <input type="checkbox"/> Cause |
| Joint: | <input type="checkbox"/> Yes | <input type="checkbox"/> No | Date of Report: | |
| Licensee Name: | | | | |
| SRI File Number: | | | | |
| Type of Organization: <input type="checkbox"/> Broker <input type="checkbox"/> Investment Bank <input type="checkbox"/> FM <input type="checkbox"/> Invest.Advisor | | | | |
| Sample Period Reviewed: | | Inspection Start Date: | Inspection End Date: | |
| MODULES PERFORMED | | WORKPAPERS SECTION REFERENCE | DEFICIENCIES IDENTIFIED | |
| A: REGISTRATION, BOOKS AND RECORDS | | | | |
| <input type="checkbox"/> Firm and Agent Registration | | | <input type="checkbox"/> YES <input type="checkbox"/> NO | |
| <input type="checkbox"/> Books and Records | | | <input type="checkbox"/> YES <input type="checkbox"/> NO | |
| <input type="checkbox"/> Other Items | | | <input type="checkbox"/> YES <input type="checkbox"/> NO | |
| B: SALES PRACTICES | | | | |
| <input type="checkbox"/> Advertising and Marketing | | | <input type="checkbox"/> YES <input type="checkbox"/> NO | |

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| | | |
|--|--|--|
| <input type="checkbox"/> Customer Accounts and Contracts | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Suitability | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Confirmation Disclosure | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Fees | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Client Referrals | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Other Items | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| C: TRADING OPERATIONS | | |
| <input type="checkbox"/> Order execution | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Short-selling | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Churning | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Insider trading | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Market Manipulation | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Fraud | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Unauthorized Transactions | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Other Items | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| D: FINANCIAL RISK AND COMPLIANCE | | |
| <input type="checkbox"/> Financial Statements | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Litigation | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Custody | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Other Items | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| E: SUPERVISION | | |

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| | |
|---|--|
| <input type="checkbox"/> Supervisory Practices | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Other Items | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| Recommended Action: | <div style="display: flex; justify-content: space-between;"> <div style="width: 60%;"> <input type="checkbox"/> No Further Action <input type="checkbox"/> Deficiency Letter <input type="checkbox"/> Enforcement Referral </div> <div style="width: 35%;"> Date Letter Sent: Date Letter Sent: Referral Date: </div> </div> |
| Comments: | |
| Signature of Inspector: Name: | Date: |
| Signature of Supervisor: Name: | Date: |

- 10.88. After the visit the Inspector should bring together the information gathered from pre-visit and on-site work for the purpose of forming a judgement on the adequacy of the matters described above as they affect the areas of business within the scope of the on-site visit.
- 10.89. A review of all working papers must take place. The work of the Inspector should be reviewed by another officer with relevant experience.
- 10.90. The Inspector should, within two weeks, prepare a draft report in a form that would be suitable for the licensee. This may merely be a letter highlighting weaknesses found or a more detailed report with findings, conclusions and recommendations for action. Whatever the form, it must contain a clear expression of opinion(s), based on assessment of conclusions drawn from findings based on evidence obtained in the course of the visit. The Inspector should also prepare a covering report for the Commission, setting out more detail and explaining any issues that need to be resolved before the report can be issued.
- 10.91. It is essential that, for each finding, documentary evidence sufficient to support that finding is obtained and kept on the working paper files. Such an audit trail is necessary to demonstrate work done, the rationale for the finding and subsequent conclusions or recommendations made. It would not normally be necessary to include all documentation in the report to the licensee. However, sufficient detail should be

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included within the report to the licensee to enable the licensee to understand the point being made.

- 10.92. For the purposes of the Commission's own records, the working papers should demonstrate that:
- (a) The work has been adequately planned and supervised.
 - (b) A sufficient understanding of the firm's business has been obtained to plan the inspection and to determine the nature, timing, and extent of tests to be performed.
 - (c) The inspection evidence obtained, the examining procedures applied, and the testing performed have provided sufficient, competent, evidential matter to afford a reasonable basis for the conclusions stated in the inspection report.
- 10.93. The Commission will review the report and, if content, submit it to the licensee. It should be issued to the licensee within ten working days of the end of the visit. Where there are weaknesses identified, the licensee should be invited to comment and to draw up an action plan to remedy any deficiencies. The licensee should be informed that the action plan will need to include detailed responses to the findings and dates by which changes will be in place. The letter should be delivered to the licensee's office by hand and a receipt obtained. The licensee should be given one month to respond to the Commission.
- 10.94. The Inspector should ensure that the risk assessment of the licensee is updated in the light of the findings.

Follow up

- 10.95. The licensee will be expected to respond to the Commission with comments and a follow up action plan within one month of receiving the Commission's letter. A diary note should be made to check that this is received and chase it up, if not.
- 10.96. When the licensee's response is received, it should be examined to ensure the response is reasonable. If it is, the Inspector should note the dates of the milestones in the action plan and diarise an appropriate time to make a further visit to check that action is being taken. Such a visit could be a full visit according to the procedures in this manual, or a less formal visit, designed to discuss progress with the compliance officer. The Inspector should determine which is appropriate in the light of the significance of the steps that are to be taken.
- 10.97. If the licensee does not respond, the Commission should proceed as described in Section 11.
- 10.98. If the licensee's response is inadequate, the Commission should write to the licensee, stating the opinion that the response is inadequate and inviting the licensee to provide a further response. So far as is possible, the Commission should give detail of what is expected. A diary note should be made to check the response being received.
- 10.99. If the licensee does not respond, the Commission should proceed as described in Section 11.

11. Enforcement

Ensuring cooperation with the Commission

- 11.1. For the most part, the Commission should seek to proceed by agreement with the licensee. Licensees should be expected to cooperate with the Commission, to respond to requests for information in a timely manner and to meet other requests for action.
 - 11.2. Many licensees will act in this way. However, a number of future licensees have been operating without effective regulation for many years and may not easily move into a normal cooperative relationship with the Commission. The Commission will not always wish to be threatening sanctions against licensees. However, the move to a normal cooperative relationship will take place more quickly if the Commission shows determination, courtesy and consistency in its approach. When it insists on action being taken, it must follow through. It follows that the Commission should not impose a requirement on a licensee that it is not prepared to enforce with sanctions if necessary.
 - 11.3. In many places in this manual, the Commission's officers will be asking the licensee to take action, often by correspondence. The action will often be the supply of information or it may be to take remedial action of some kind. In some cases, there may be examples of non-cooperation that take place during an on-site visit. In the latter case, the on-site inspector should politely repeat the request and, if the licensee refuses, should take no further action beyond stating that the Commission will be consulted. Thereafter, the matter should be resolved by correspondence, so that there is a clear record of the actions by the Commission.
 - 11.4. The Commission's approach should always be tailored to the circumstances of the case. However, the Commission also needs to show consistency and should adopt the following procedure unless there is a good reason for acting otherwise.
 - (a) The Commission should write to the licensee setting out clearly what is expected of them and stating by when action should be taken. For the supply of information, the deadline should normally be a month. The letter should seek an acknowledgement that the letter has been received and action will be taken within the required timescale.
 - (b) Where the acknowledgement is not received within a week, the Commission should issue a reminder and repeat the deadline for action. The Commission should continue to do this until the deadline has been reached.
 - (c) Where the licensee responds with a request to vary the action or information or asks for more time, the Commission should consider this sympathetically and respond, giving reasons for the Commission decision.
 - (d) Where the deadline is reached and the licensee has failed to respond, the Commission should immediately write again, reminding the licensee of the action required and imposing a further deadline of a month. The letter should point out that the Commission has **a power of direction** (???Act) and will use it to require the licensee to take the action, if the revised deadline is not met.
 - (e) If the licensee gives a response that persuades the Commission that the direction would be unreasonable, or persuades the Commission that the licensee will now comply, the Commission should proceed no further but
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(where compliance is promised) should tell the licensee that it will be monitoring compliance and will revive the direction if the licensee fails to comply in full and in accordance with a revised timetable that the Commission should set.

- (f) The Commission under **Section ??** can require an intermediary to provide an enforceable undertaking to correct or desist from certain actions or take remedial actions and where a further deadline is reached and the licensee has failed to respond (or has responded in a way that does not convince the Commission that it should not go ahead with the direction or it has not met the intentions of the enforceable undertaking), the Commission should use its powers under **Section ??** and issue a direction to the licensed entity. The direction should make clear that compliance is still required and set a deadline for that compliance.
- (g) If the licensee still refuses to comply by the time of the deadline in the direction, the Commission should inform the licensee that it proposes to make a public statement about the behaviour of the licensee. The procedure for issuing a public statement is set out below. The Commission should state that it still requires the licensee to comply and should set a deadline. It should state that failure to comply by the given deadline will result in a direction for the removal of the chief executive.
- (h) If the licensee continues to refuse to comply, the Commission should draft a direction for the removal of the chief executive of the licensee. Again the Commission should inform the licensee that it is still required to comply with the original request. The Commission should warn that any further failure to comply will result in a licence condition prohibiting it from taking on new customers.
- (i) The Commission should then proceed with a licence condition prohibiting the licensee from taking on new customers using the procedure set out below. If the licensee still refuses to comply, the Commission should begin the process of cancelling the licence.

Transferring Cases from Market Supervision to Enforcement

- 11.5. Enforcement action may arise as a result of breaches of the regulations discovered through inspection visits. Such inspection visits may have arisen as a result of allegations or complaints.
- 11.6. Financial crimes are criminal offences under Bangladesh Law. People who are subject to investigations that may lead to criminal sanctions are entitled to protections under the law. In particular, they are entitled, at a certain stage in the investigation, to be informed of the allegations against them and to be cautioned as to their rights. They are also entitled to representation.
- 11.7. None of these rights apply to licensees who are the subject of inspections but licensees would be entitled to these rights once they start to be the subject of an investigation. The point at which the process of inspection becomes an investigation may not always be easy to determine and therefore officers in the market supervision department should be very aware that, as soon as they believe there is prima facie evidence of a regulatory breach that may lead to criminal sanctions, the matter should be handed to the Enforcement Department for a proper investigation.

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11.8. Transmittal of matter to enforcement:

From: Compliance **To:** Enforcement **Date:**
Mr./Ms. _____
Copies to: ☐ Permanent File ☐ Surveillance

| |
|---|
| Firm Name: |
| Commission File Reference: |
| Date of Inspection: |
| Nature of Inspection: <input type="checkbox"/> New Firm <input type="checkbox"/> Routine/Cycle <input type="checkbox"/> Surveillance <input type="checkbox"/> Cause |
| Inspector Responsible: |
| Potential Statute/Rule Violations: |
| Our recent inspection of the above firm has revealed deficiencies and violations that may merit Enforcement action. The information below itemizes the relevant findings. A copy of the Inspection Report cover sheet is attached. The full report is available from compliance department records. |
| Comments: |
| Referral Prepared by: _____ Extension: _____ |

To be completed by Enforcement and returned to Inspections:

| |
|--|
| Case Number Assigned |
| Enforcement Staff Assigned: _____ Extension: _____ |

Investigations

- 11.9. In most cases, it will be necessary to mount an investigation prior to taking enforcement action. The purpose of the investigation is to establish the facts in an objective and impartial manner. Responsibility for enforcement lies with the Manager of the Legal Department.
- 11.10. The Commission may ask a licensee **under the Act** for any information but in practice should confine requests to matters relating to:

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- (a) the licensee's regulated activities; or
 - (b) the licensee's integrity, competence, financial standing or organisation; or
 - (c) the licensee's compliance with this Act or the Regulations or with a licence condition imposed on the licensee's licence.
- 11.11. When the Commission considers that grounds for enforcement action may exist, it should normally appoint a person to carry out the investigation. An appointee may be a lawyer and may, if the circumstances justify the matter, employ the services of other professional advisers, including forensic accountants. Investigations are time consuming and a major investigation will often divert the resources of existing Commission staff. This alone is often a good reason for appointing an external inspector. Moreover, the appointment of an investigator should help to demonstrate that the investigation will be conducted impartially and according to the principles that govern investigations that could lead to criminal action.
- 11.12. The inspector should be given clear terms of reference that describe the scope and purpose of the investigation. The terms of reference should, in addition, provide scope for the inspector to recommend amendments to the terms of reference if these are justified by the investigation. The Commission should also draft a statement of appointment that will provide proof of appointment.
- 11.13. The person subject to the investigation should be informed of the appointment of the inspector, unless the Commission considers that this will prejudice the investigation. If the Commission takes this view, it should document the decision and the reasons for it.
- 11.14. The Commission should agree with the inspector the arrangements for reporting back on progress with the investigations.
- 11.15. The inspector may need to interview individuals in the course of the investigation. All those subject to interview should:
- (a) be entitled to be represented by a legal or other adviser; and
 - (b) receive a copy of a record of the interview.
- 11.16. A person who is the subject of an investigation may also need to be given the right to remain silent and be warned of the consequences of breaking this right. The precise position will be dependent on circumstances and the Commission may wish to seek advice on this matter.
- 11.17. Where a licensee is under investigation, some staff of the licensee may choose to be represented by the same legal adviser who is representing the licensee. In such circumstances, the inspector should:
- (a) draw the attention of the person being interviewed that there may come a time when the interests of the licensee diverge from those of the interviewee (for example if the licensee seeks to demonstrate that the person was responsible for any breach and acted beyond his or her instructions);
 - (b) ask the legal adviser in whose interests he or she would be acting if the licensee's interests diverged from those of the licensee and whether or not the legal adviser is satisfied that there is no conflict of interest;
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- (c) ask the legal adviser if he or she proposes to report to the licensee on the conduct of the interview and, if so, whose interests would be served by so doing; and
 - (d) suggest to the interviewee that he or she should consider carefully whether or not their interests are always to be served by using a legal adviser who is paid for by the licensee, would be reporting back to the licensee and who would be acting for the licensee in circumstances where the interests of the licensee and the interviewee diverged.
- 11.18. If the interviewee continues to use the same legal adviser as the licensee, the inspector should accept this.
- 11.19. Where the inspector considers that a person being interviewed may be the person who has committed a breach of the Act or Regulations and where that breach would be a criminal offence, the inspector should consider the extent to which a caution should be offered to the interviewee. The terms of the caution should be drafted by the Commission's legal adviser. Moreover, the Commission should consider whether or not to seek the advice of the Attorney General when investigating a matter which could give rise to a criminal prosecution, so as to avoid prejudicing a future criminal case.

Procedures for determining Enforcement Action

- 11.20. When the inspector has completed his or her report, he or she should make a report to the Manager of Legal Affairs.
- 11.21. It should normally be the case that the Commission should not consider the imposition of a sanction until it has given the licensee every chance to comply. In most cases, this will involve writing formally to the licensee requesting that the relevant action must be done (or ceased as the case may be) and giving a deadline. If the deadline passes without a satisfactory response, the Commission should repeat its request, give another month for compliance and warn of the consequences of noncompliance. Only if the second deadline is passed without satisfactory action should the Commission consider enforcement action as described below. Where the licensee makes representations as to why compliance is unreasonable, the Commission should consider those representations carefully and document its conclusions.
- 11.22. Affected persons shall be given reasonable opportunity to be heard before enforcement action is taken. Invitations to affected persons to make submissions prior to enforcement action shall be issued under the hand of the Chief Executive Officer. Submissions by affected persons may be made orally or in writing at the discretion of the Commission.
- 11.23. The decision to impose the condition, issue the direction or publish the statement should be taken by the Board or the CEO on the basis of a report – in many cases this will be the report of the independent inspector. The report should make clear the legal basis and the reasons for the decision. It should include legal advice as to whether the imposition of the sanction is consistent with the terms of the Act. The Board or CEO must demonstrate in its documentation that it has taken account of all relevant matters, including those required by the Act (such as the matters described in relation to a public statement). It should not take account of any irrelevant matters.
- 11.24. The manager Legal Affairs (MLA) shall submit to the Chairman an assessment of whether the report discloses sufficient grounds and provides adequate evidence for
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enforcement. Where the MLA considers that the investigation report shows sufficient grounds and provides adequate evidence for enforcement action, the MLA shall in the enforcement report recommend appropriate action.

- 11.25. Where the enforcement action recommended is within the scope of the Commission, the submissions by affected persons shall be considered by a management committee appointed by the Chairman for that purpose which committee shall be chaired by the chairman or his delegate. The decision taken shall be documented, along with reasons and the target of the investigation shall be informed of the outcome.
- 11.26. Where the enforcement action recommended is outside the scope of the Chairman's delegated Commission, the submissions by affected persons shall be considered by the Board. Following consideration of submissions, the Board shall make a recommendation on the action to be taken to the chairman or the Board as the case may be and the Chairman shall take action as recommended or as he deems fit.
- 11.27. The decision to take enforcement action should be taken by the Board or the Chairman on the basis of a report. The report should make clear the legal basis and the reasons for the decision. It should include legal advice as to whether the imposition of the sanction is consistent with the terms of the Act. The Board or Chairman must demonstrate in its documentation that it has taken account of all relevant matters, including those required by the Act (such as the matters described in relation to a public statement). It should not take account of any irrelevant matters.
- 11.28. The action taken by the Chief Executive Officer shall be disclosed to the Board and the reasons for it documented on the file.
- 11.29. Communication of enforcement actions to affected parties shall:
- (a) be in writing;
 - (b) be signed by the Chief Executive Officer or person duly appointed to act in that capacity;
 - (c) specify the provisions of the law in respect of which default has taken place; and
 - (d) contain brief reasons for the action.
- 11.30. Communication of enforcement actions shall be served on affected persons by delivering or tendering the communication to the person or their duly authorized agent or by sending it to the person by registered post to the last known residence or place of business.
- 11.31. Where it is not possible to serve the communication of enforcement action as indicated due to distance or cost, the communication may be effected by public notice in at least two dailies with nationwide circulation.
- 11.32. Where an enforcement report recommends and the Chief Executive Officer is satisfied that an infringement justifies pursuit of civil or criminal sanctions, the Chief Executive Officer shall refer the matter to the Board for determination.
- 11.33. The Chairman shall on consideration of the report and if satisfied that the infringement justifies pursuit of civil or criminal sanctions:
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- (a) Refer the same to the Attorney General for investigation and prosecution where the matter is of a criminal nature.
 - (b) Refer the matter to an advocate from the Commission's panel of advocates where the matter is of a civil nature.
- 11.34. The Chief Executive shall communicate to the Board and to the Attorney General or Advocate so appointed and shall ensure that they receive all the assistance necessary to enable them expeditiously conclude the matter.
- 11.35. The MLA shall be responsible for liaising with the office of the Attorney General or advocate so appointed to act on a day to day basis and shall ensure that a report of on-going cases are made to the Board at least quarterly.
- 11.36. Where judgment is made against the Commission, the Manager responsible for enforcement shall make a recommendation as to whether to appeal the decision for consideration by the Chief Executive Officer.
- 11.37. Where the Chief Executive Officer is satisfied that there are sufficient grounds to appeal the decision the Chairman in consultation with the Board if acceptable shall write the Attorney General or the Advocate acting on behalf of the Commission accordingly and make a report of the same at the Board meeting immediately following the decision to appeal.

Procedures Relating to Specific Enforcement Actions

Licence conditions, directions and public statements

- 11.38. The Commission may impose a condition and issue a direction and publish a statement (or any combination of these acts, if it chooses) in any one instance. The procedure should be as set out below.
- (a) The Commission should draft a licence condition, direction or public statement. It should also draft a covering letter which states the reasons for using the power and the date on which the condition or direction will take effect or the statement will be published:
 - i. A draft licence condition should state what action must or must not be taken in order to maintain the licence.
 - ii. A draft direction should state precisely what action is required and by when. The draft direction should state that failure to comply is an offence.
 - iii. The draft public statement should state the action or inaction by a licensee or other person that has given rise to the Commission's decision and state that the Commission is thereby giving notice that the action or inaction is the subject of censure.
 - iv. It should normally be a part of the licence condition or direction that the licensee should inform all its investors of the condition or direction. In the case of a public statement, the licensee should be requested to inform all its investors that the statement has been issued. If the licensee refuses, the Commission should issue a direction requiring the licensee to do so.

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- (b) The Commission should write to the licensee stating that it proposes to impose the licence condition, issue the direction or publish the statement and send a copy to the licensee. The Commission should inform the licensee of the rights given in the law, in particular the right to comment within 14 days (unless the Commission has decided not to give notice) and the right to appeal to the court if the Commission imposes a condition or issues a direction. The Commission should inform the licensee of the consequences of failing to abide by the terms of the condition or direction. **[NB: This is a criminal offence for a licence condition but not for a direction].**
- (c) If the licensee responds, the Commission should consider the response carefully. The Board should consider any representations and document its decision and the reasons for that decision. If the licensee wishes to make oral representations to the Board and to be accompanied by a legal adviser when doing so, the Board should accept that request and arrange a suitable time, provided that it does not involve undue delay.
- (d) The Commission should then write to the licensee giving the Board's decision. If the decision is to go ahead with the condition, direction, or public statement, whether or not amended in the light of the Board's consideration of the licensee's representations, the licence condition, direction or statement should be finalised and checked by the Commission. It should be signed by the licensee's Supervisor and by the Commission. A list of all the documents should be included on the covering letter to the licensee. Two witnesses should observe the licence condition, direction or public statement being placed, along with the covering letter and any other accompanying documentation, in an envelope and the witnesses should sign a note to that effect. The envelope should be delivered by hand and proof of delivery obtained. A photocopy (not a reprinted copy) of the documents sent to the licensee should be dated and countersigned as being true copies and placed on the file.
- (e) The licensee's compliance with the condition or direction should be monitored and reviewed no later than at the time of the next desk-based review of the annual return or on-site visit, whichever is sooner. The Supervisor should note the file to ensure that this is done and, in particular that the licensee has informed its investors.

11.39. Information about licence conditions, directions or public statements should be placed on the Commission's web site.

Revocation of a licence

11.40. The consequences of a decision to cancel a licence are potentially more severe than any of the other sanctions. Not only does a licensee lose his or her livelihood but also, the investor's affairs may not be properly managed and the Commission should consider these very carefully before going ahead. Where a decision to cancel a licence is taken, the Commission should consider what actions it can take to mitigate the adverse effects on investors.

11.41. The steps leading up to the cancellation of a licence are similar to those for any other sanction. The decision to cancel the licence should be taken by the Board on the basis of a report by the Commission. The report should make clear the legal basis and the reasons for the decision. It should include legal advice as to whether the

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cancellation of the licence is consistent with the terms of the Act. The Board must demonstrate in its documentation that it has taken account of all relevant matters, including those required by the Act.

- 11.42. The Commission should, in consultation with its legal advisers, draft a formal statement cancelling a licence. It should also draft a covering letter which states the reasons for cancellation and the date on which the cancellation will take effect.
- 11.43. The Commission should write to the licensee stating that it proposes to cancel the licence. The Commission should inform the licensee of the rights given in the law, in particular the right to appeal to the Tribunal and from the Tribunal to the High Court. The Commission should ask the licensee for a plan for protecting the investors in the event of cancellation.
- 11.44. If the licensee responds, the Commission should consider the response carefully. The Board should consider any representations and document its decision and the reasons for that decision. If the licensee wishes to make oral representations to the Board and to be accompanied by a legal adviser when doing so, the Board should accept that request and arrange a suitable time, provided that it does not involve undue delay.
- 11.45. The Commission should then write to the licensee giving the Board's decision. If the decision is to go ahead with the cancellation of the licence, the cancellation statement should be finalised and checked by the Commission. Two witnesses should observe the cancellation statement being placed, along with any accompanying documentation, in an envelope and the witnesses should sign a note to that effect. The envelope should be delivered by hand and proof of delivery obtained.
- 11.46. The Commission will need to monitor the licensee's adherence to the plan for protecting investors. Such a plan would need to involve:
- (a) providing information to the investors about the cancellation and inviting them to seek other service providers;
 - (b) taking on no new business;
 - (c) resigning as trustees and directors as the case may be of investor entities; and
 - (d) providing assistance to investors in appointing replacement trustees.
- 11.47. The Commission may consider imposing a direction to enforce the plan to protect investors. Such a direction could, if the Commission considered it appropriate, include the appointment of an accountant, nominated by the Commission, to oversee the winding down of the business.
- 11.48. If the direction fails to result in an acceptable plan for winding down the business and protecting investors, the Commission may have to consider appointing a manager.

Appointment of a statutory manager

- 11.49. The Act allows the Commission to appoint a manager under Section 73.
- 11.50. The costs of the manager are likely to fall on the Commission, since there is unlikely to be sufficient resources within the licensee's business. Moreover, the manager's
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costs are likely to be high, given the relative lack of familiarity with the business. The Commission should therefore regard the appointment of a manager as a last resort.

- 11.51. The Commission may wish to consider seeking a suitable candidate for appointment as a manager before a case arises, since the need to appoint a manager may arise quickly.
- 11.52. The decision to apply to the court should be taken by the Board on the basis of a report by the Commission. The report should include legal advice on whether the decision would be appropriate in the circumstances. Should the Board decide to go ahead, the Board's legal adviser should be engaged to draft the appointment application.
- 11.53. The application should provide for regular reporting to the Commission and to the court by the manager, for amendments to the manager's terms of reference, and for the termination of the appointment.

Determining the appropriate sanction

- 11.54. The appropriate sanction for different offences is described below in **Annexure D**.

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Annexure A: Regulatory Compliance Checklists (Licensing, Inspection and Prudential Oversight)

| 1. Integrity and Competence | |
|---|--|
| 1.1. Have the key persons signed declarations on the absence of any investigation by law enforcement or tax authorities or conviction relating to matters connected with fraud and dishonesty? | |
| 1.2. Have the key persons signed declarations regarding disciplinary investigations or penalties from professional associations, the DSE & CSE or any other Commission? | |
| 1.3. Does the experience of the Commission with regard to regulatory compliance cast doubt on integrity of the key persons? | |
| 1.4. Is there any evidence of attempts to escape from the obligations of the Act or Regulations? | |
| 1.5. Is there information from other authorities or enquiries from other authorities that cast doubt on declarations or otherwise cast doubts on the licensee's integrity? | |
| 1.6. What are the policies and procedures for screening new employees who are not key persons | |
| 1.7. Do the procedures involve the verification of identity, employment record and qualifications? | |
| 1.8. Are there any background checks on credit worthiness, convictions and regulatory investigations or findings? | |
| 1.9. Are new employees expected to make declarations about convictions and disciplinary action? | |
| 1.10. Are the procedures for new employees monitored and recorded? | |
| 1.11. Does the licensee have effective procedures for ensuring the proper fulfilment of obligations such as the prompt payment of settlement obligations, preparation of accounts, segregation of client assets and the correct calculation of financial resource requirements? | |
| 1.12. What are the qualifications and experience of the key persons and do they match the requirements of the business? | |
| 1.13. Are the qualifications required for each employee documented? | |
| 1.14. What is the policy for required professional qualifications or experience for investor advisers, Compliance Officer and MLRO and other staff? | |
| 1.15. What are the continuing professional development requirements? Is compliance documented? | |
| 1.16. Is there a formal training needs analysis or other form of training plan? | |
| 1.17. Does the record of training include all training, including self directed learning, reading and distance learning, as well as external or internal courses? | |
| 1.18. Is there a minimum amount of training expected from each staff member? | |
| 1.19. Is there regular training on AML matters? | |
| 1.20. Is there a system for monitoring training that is undertaken and a limit on the proportion of training that can be supplied by personal reading? | |
| 1.21. Does the monitoring of training include assessments of the quality and effectiveness of training? | |

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|--|--|
| 1.22. Are there arrangements for monitoring the performance of staff? | |
| 1.23. Are the staff subject to annual appraisals? | |
| 1.24. Are the results of appraisals properly recorded? | |
| 1.25. Is there any evidence of actions taken in agreement with other stockbrokers? | |

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2. Management and Corporate Governance:

| | | |
|----------|--|--|
| 2.1. | Is there a Board of Directors, which includes at least one person with the standing and Commission to be able to run the business in the absence of the CEO and the ability to challenge behaviour that is not consistent with the Act or Regulations? | |
| 2.2. | Does the Board have rules of procedure and protocols to cover its operation? | |
| 2.3. | How often does the Board meet? | |
| 2.4. | Is there a statement of delegations or a statement of matters reserved to the Board? | |
| 2.5. | Is there an Audit Committee with terms of reference? | |
| 2.6. | Are there other Board Committees with terms of reference? | |
| 2.7. | Are there records of corporate decisions being made and documented – such as minutes of Board or other meetings and are they properly signed and dated? | |
| 2.8. | Is there evidence of action agreed and followed up? | |
| 2.9. | Is there a risk assessment for the business of the licensee? | |
| 2.10. | Does the risk assessment also record risk mitigation measures? | |
| 2.11. | Is there a Business Plan that appears to be viable? | |
| 2.12. | Does the Board discuss, at least once annually: | |
| 2.12.1. | risk assessment, | |
| 2.12.2. | business plan, | |
| 2.12.3. | compliance matters, | |
| 2.12.4. | internal and external audit reports, | |
| 2.12.5. | complaints, | |
| 2.12.6. | financial resources, | |
| 2.12.7. | staff performance, | |
| 2.12.8. | training | |
| 2.12.9. | IT, | |
| 2.12.10. | business strategy, | |
| 2.12.11. | the performance of any outsourced activities and agents | |
| 2.12.12. | contingency planning | |
| 2.13. | Are senior officers' responsibilities (including formal approval / sign off powers) documented? | |
| 2.14. | Are there clear reporting lines? | |
| 2.15. | Is there a clear organisation chart? | |
| 2.16. | Are key persons, officers' responsibilities and details of ownership consistent with the Commission records? | |
| 2.17. | Is there a compliance officer? | |
| 2.18. | Does the compliance officer have sufficient resources? | |
| 2.19. | Does the compliance officer have direct access to the Board or senior management? | |
| 2.20. | Is the compliance officer independent of any conflicts of interest? | |
| 2.21. | Does the compliance officer prepare a regular report to the Board on compliance matters? | |
| 2.22. | Are there policies and procedures covering the main areas of the business? | |
| 2.23. | Are the policies and procedures monitored and reviewed? | |
| 2.24. | Are the staff aware of them? | |
| 2.25. | Is there disciplinary action for failure to comply? | |

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| 2.26. Do staff have job descriptions or other documentation that detail their responsibilities and document which decisions are within their Commission / discretion and which require approval? | |
| 2.27. Are staff actions monitored to ensure they remain within their area of discretion? | |
| 2.28. Do the files demonstrate that decisions are taken within the limits of assigned Commission / discretion? | |
| 2.29. Are there reporting arrangements that allow senior management to review the performance of staff and ensure actions are undertaken according to the licensee's policies and procedures? | |
| 2.30. What are the procedures for making payments – for the business or on behalf of investors? Who has to approve commitments and actual payments? | |
| 2.31. Is there documentation that the policies are applied? | |
| 2.32. Are any functions outsourced? | |
| 2.33. Is there an outsourcing service level agreement containing performance standards, objectives and targets? | |
| 2.34. Is performance monitored? | |
| 2.35. Are there any conflicts of interest involved in the outsourcing? | |
| 2.36. How are conflicts of interest with outsourcers monitored and controlled? | |
| 2.37. Are any outsourcing arrangements disclosed to clients – particularly clients of mutual funds where the investment management is outsourced? | |
| 2.38. Does the intermediary have formal agreements with agents? | |
| 2.39. Does this agreement demand adherence to the intermediary's customer acceptance procedure? | |
| 2.40. How does the agreement deal with the safeguarding of client funds? | |
| 2.41. How does the agreement safeguard the integrity of the intermediary's order acceptance and recording process? | |
| 2.42. Is the performance of agents monitored? | |
| 2.43. Is there a contingency plan for disaster recovery? | |
| 2.44. What does the plan cover? | |
| 2.45. Is it tested regularly? | |
| 2.46. Is it sufficiently comprehensive? | |

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3.Financial Resources

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| 3.1. | Have the financial statements been submitted to the Commission properly signed and dated by a director of the licensee? | |
| 3.2. | Where the financial statements record the principal activities of the licensee, are they consistent with the licence? | |
| 3.3. | Are the required minimum assets available and in the correct form? | |
| 3.4. | Has the calculation of assets been appropriately discounted to allow for the risk of each asset? | |
| 3.5. | Are the liabilities correctly recorded? | |
| 3.6. | Are off balance sheet items allowed for in the calculation of liabilities? | |
| 3.7. | Are the discounted financial resources requirements 120% of the minimum capital requirement and 120% of the working capital requirement? | |
| 3.8. | Have the resources ever fallen below 120% of the minimum levels without the Commission being informed? | |
| 3.9. | Are the financial resource requirements calculations carried out properly and daily? | |
| 3.10. | Are the financial resource requirements more than 50% lower than at the last reporting period? | |
| 3.11. | Does the Board review the cash flow and financial resources? | |
| 3.12. | Is there adequate professional indemnity insurance (PII), covering the required items? | |
| 3.13. | Is the amount of PII coverage sufficient? | |
| 3.14. | Is there an excess on the PII that may cast doubt on its effectiveness in practice? | |
| 3.15. | Is the accounting period established (and no more than 12 months)? | |
| 3.16. | Do the accounts record transactions adequately? | |
| 3.17. | Is the auditor the same as that recorded by the Commission? | |
| 3.18. | Have the financial statements been submitted to the auditor no later than three months after the financial year? | |
| 3.19. | What accounting standards are used and have they changed during the accounting year? | |
| 3.20. | Have the accounts been audited? | |
| 3.21. | Is the licensee's declaration of compliance properly completed and signed? | |
| 3.22. | Have there been any compliance failures that need to be followed up (for example because they were substantial, repeated or not addressed by the management)? | |
| 3.23. | Is the auditor's report satisfactory? | |
| 3.24. | Do the financial accounts cause any concern eg with respect to sharp changes such as falling profits or rising losses, a questions about future solvency? | |
| 3.25. | Does the level of legal expenses give rise to a concern that there may be litigation? | |
| 3.26. | Does the level of creditors or debtors suggest that there may be management problems or credit problems in the | |

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| company? | |
| 3.27. Does the level of bad debts suggest concerns about the investor or nature of the business? | |
| 3.28. Is there are a high level of loans made either to directors or by directors to the licensee? | |
| 3.29. Are the loans to directors within the regulatory limits? | |
| 3.30. Are there any investments or subsidiaries that may affect the licensee's solvency? | |
| 3.31. Is the licensee a member of a group and are there consolidated group accounts? | |

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4. Handling Client Assets

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| 4.1 | How many bank accounts does the intermediary have? | |
| 4.2 | Are they clearly designated as between client assets and office assets? | |
| 4.3 | Are the intermediary's accounts with the settlement bank clearly designated as client accounts? | |
| 4.4 | Does the intermediary have a record of the name and address of the bank holding the client account(s) with their proper designation? | |
| 4.5 | Has the bank documented that it is aware that the funds in the client account (including the settlement account) are held in trust and cannot be used to offset the intermediary's obligations? | |
| 4.6 | Does the intermediary have a proper record of each client's beneficial interest in the client account? | |
| 4.7 | Do those records show every transaction relating to the client account with respect to each client? | |
| 4.8 | Do the funds in the client account meet the total obligations to clients? | |
| 4.9 | Does the intermediary undertake daily reconciliations of the client account with client obligations? | |
| 4.10 | Have there ever been days on which the total funds did not meet the client obligations? | |
| 4.11 | What controls are in place to ensure that funds in client accounts always meet client obligations? | |
| 4.12 | Has any client account been overdrawn at any point in the period under review without the Commission being informed? | |
| 4.13 | Are the client accounts subject to independent audit? | |
| 4.14 | What are the procedures for receiving funds prior to making orders? | |
| 4.15 | What are the procedures for paying clients their receipts from sales of securities? | |
| 4.16 | What controls are in place that restrict the unauthorised use of client assets by members of the staff? | |
| 4.17 | Is compliance with these procedures monitored? | |
| 4.18 | Are the procedures complied with? | |
| 4.19 | Where the intermediary is responsible for fund management (a mutual fund or a portfolio manager), has a custodian been appointed? | |
| 4.20 | Is the custodian independent of the investment manager? | |
| 4.21 | Is there a written agreement with the custodian? | |
| 4.22 | Is the custodian responsible for assessing whether or not investment instructions are consistent with the investment mandate (or information memorandum)? | |
| 4.23 | Does the custodian provide reports on performance according to the agreement? | |
| 4.24 | Are there comprehensive registers of assets held for clients? | |
| 4.25 | Are there procedures for ensuring that the investor has proper title to any asset he or she acquires? | |
| 4.26 | Does the licensee give credit to the investor? | |
| 4.27 | Under what circumstances is credit given? | |
| 4.28 | Is there an appropriate credit assessment process? | |
| 4.29 | Is the credit assessment procedure monitored? | |

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5. Knowledge of and Treatment of the Customer

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| 5.1 | Does the licensee have an investor acceptance procedure? | |
| 5.2 | Are there investor agreements? | |
| 5.3 | Are investment agreements kept up to date? | |
| 5.4 | Do the agreements show | |
| 5.4.1. | the services to be provided, | |
| 5.4.2. | the basis of the fees to be charged, | |
| 5.4.3. | the respective obligations of investor and licensee, | |
| 5.4.4. | the duration of the agreement and | |
| 5.4.5. | procedures and circumstances for termination of the agreement? | |
| 5.5 | Are the agreements adhered to in practice? | |
| 5.6 | What procedures does the licensee have to ensure that this is so? | |
| 5.7 | Does the licensee disclose to customers | |
| 5.7.1. | The qualifications and experience of the key persons and relevant customer relationship manager? | |
| 5.7.2. | The performance of the intermediary? | |
| 5.7.3. | Any relevant factors concerning disciplinary actions or convictions of the intermediary or key staff? | |
| 5.7.4. | The licence held from the Commission | |
| 5.7.5. | Does the stationery show that the licensee is regulated by the Commission? | |
| 5.8 | What procedures does the licensee undertake to ensure that disclosures are accurate? | |
| 5.9 | Is there evidence on the files that the licensee knows: | |
| 5.9.1. | the investor's identity – ie the name, address, date of birth, nationality/citizenship and (where the client is a company), copies of memorandum and articles of association and certificate of incorporation? | |
| 5.9.2. | the beneficial owner of the investor (where it is not an individual) and any investor entity? | |
| 5.9.3. | the business of the investor and beneficial owner? | |
| 5.9.4. | the purpose of the investor and beneficial owner in doing business with the licensee? | |
| 5.9.5. | the nature of the business that will be undertaken? | |
| 5.9.6. | the source of funds and wealth of the investor and beneficial owner? | |
| 5.9.7. | the risk appetite of the investor? | |
| 5.9.8. | the investor's financial situation and classification as an expert client or otherwise and justification for such classification? | |
| 5.10 | Has the licensee taken reasonable steps to verify this information? | |
| 5.11 | Does the licensee have procedures to ensure that there is no activity undertaken for the investor until the investor due diligence information is collected and verified? | |
| 5.12 | Has the licensee taken reasonable steps to ensure that it knows if any of this information changes? | |
| 5.13 | Does the licensee have a best execution rule? | |
| 5.14 | How is the best execution rule controlled and monitored? | |
| 5.15 | Where the investor operates on an execution only basis, is there a written confirmation of the order, showing the price limit, | |

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| | duration of the order and a record showing the customer understands all the constituent parts of an order? | |
| 5.16 | Does the intermediary have a procedure for reviewing the order when it is more than one month old or when market movements make the order inappropriate? | |
| 5.17 | Does the intermediary have procedures for ensuring that the investor has the funds or securities available for an order? | |
| 5.18 | Are the orders always undertaken in chronological order? | |
| 5.19 | Is the order always time stamped? (If not, how does the intermediary ensure chronological order is maintained?) | |
| 5.20 | Are dealers' records maintained showing the name of the client, the order and time and the details of execution? | |
| 5.21 | Where the intermediary is responsible for fund management, is there an agreement, mandate or information memorandum setting out investment objectives? | |
| 5.22 | With reference to 5.21, what procedures are in place for ensuring decisions are made in accordance with the mandate and the information held concerning the client? | |
| 5.23 | With reference to 5.21, is performance monitored? | |
| 5.24 | Does the intermediary accept third party instructions for clients? | |
| 5.25 | If so, does the intermediary have the procedures in place for verifying that the instructions are in line with the client's wishes, including a written authorisation and instructions to remit funds only to a specified bank account? | |
| 5.26 | Has the licensee built up a profile of likely investor activity? Is it documented? | |
| 5.27 | Is actual activity monitored against the profile and is the profile reviewed and kept up to date? | |
| 5.28 | Does the licensee have special procedures for politically exposed persons? | |
| 5.29 | Does the number of suspicious transaction reports (STRs) filed suggest that the licensee is not sufficiently knowledgeable about the activities of the investor? (NB: STR should be introduced into Bangladesh as part of any market surveillance oversight introduced) | |
| 5.30 | Has the licensee made a risk assessment of the investor? | |
| 5.31 | Does that assessment affect the customer acceptance procedure? | |
| 5.32 | Does the risk assessment affect intensity of activity monitoring? | |
| 5.33 | Does the risk assessment affect the frequency of reviews of the investor's circumstances? | |
| 5.34 | What action does the licensee take to identify and manage conflicts of interest with the investor? | |
| 5.35 | Is there a complaints procedure? Is it documented and available to a client? | |
| 5.36 | Is there an easily accessible register of complaints? | |
| 5.37 | Does the complaints procedure include deadlines for acknowledging a complaint and providing a substantive response? | |
| 5.38 | Does the complaints procedure ensure that a substantive reply is authorised by a person other than the person about whom the complaint is made? | |
| 5.39 | Is there provision for an appeal relating to a complaint to the chief executive? | |
| 5.40 | Can the licensee ensure that complaints outstanding for more | |

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| than 3 months are reported to the Commission? | |
| 5.41 Does the Board review complaints, including trends and topics? | |
| <i>Additional Requirements for asset managers</i> | |
| 5.42 Has the asset manager ever: | |
| 5.42.1. placed an order to purchase or sell a security for the account of a client upon instruction of a third party without first having obtained written third-party authorization from the client? | |
| 5.42.2. exercised any discretionary power in placing an order for the purchase or sale of securities for a client without obtaining written discretionary Commission from the client? | |
| 5.42.3. induced trading in a client's account that is excessive in size or frequency in view of the financial resources, investment objectives, character of the account? | |
| 5.42.4. misrepresented to any advisory client, or prospective advisory client in relation to qualifications, the nature of the advisory services being offered, fees to be charged, or omitted to state a material fact necessary? | |
| 5.42.5. provided a report or recommendation to any advisory client prepared by someone other than the investment adviser without disclosing that fact? | |
| 5.42.6. failed to disclose to clients in writing before any advice is rendered any material conflict of interest relating to the asset manager or any of the asset manager's employees, which could reasonably be expected to impair the rendering of unbiased and objective advice? | |
| 5.42.7. made compensation arrangements connected with advisory services to clients in addition to receiving compensation from such clients for such services? | |
| 5.42.8. charged a client an advisory fee for rendering advice when a commission for executing securities transactions pursuant to such advice would be received by the asset manager or his employees? | |
| 5.42.9. guaranteed a client that a specific result will be achieved arising from the advice which will be rendered? | |
| 5.42.10. published, circulated or distributed any advertisement which does not comply with the Regulations? | |
| 5.42.11. disclosed the identity, affairs, or investment of any client to any third party unless required by law, court order or a regulatory agency to do so, or unless consented to by the client? | |
| 5.42.12. enter into, extend or renew any investment advisory contract unless such contract is in writing and disclosed in substance all the information required? | |
| 5.43 Has the asset manager provided, once in the year, every client with statements for the period that ended not more than three months before the date on which such accounts or statements are submitted? | |
| 5.44 Does the report include the following: | |

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| 5.44.1. | the asset manager's capital resources. Ensure these are adequate? | |
| 5.44.2. | the opening and closing total market value of the various securities included in the client's portfolio, and the value of each of those securities expressed in terms of the total market value of the client's portfolio? | |
| 5.44.3. | such securities in relation to the investment guidelines? | |
| 5.44.4. | the amounts of interest and dividends and any other income for distribution which have accrued to the underlying securities in the client's portfolio and how it has been or intended to be allocated? | |
| 5.44.5. | the amount of any realised or unrealised capital gains in the period and any other accruals and receipts of a capital nature? | |
| 5.44.6. | Purchases and sales of securities in the reporting period and the price per security acquired or sold and the number of securities acquired or sold | |
| 5.44.7. | the asset manager's income derived from asset management indicating the sources and the amount derived from each source and its net profit or loss? | |
| 5.45 | Are copies of the accounts and statements kept at the registered office of the asset manager? | |

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6. Rules and Practices Concerning Conflicts of Interest

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| 6.1 | Has the intermediary identified the potential conflicts of interest that may arise in the course of business? | |
| 6.2 | Is the assessment sufficiently comprehensive? | |
| 6.3 | Are there policies regarding the handling of conflicts of interest? | |
| 6.4 | Do the policies state the circumstances where a conflict will be handled by disclosure, refusal to act or internal controls? | |
| 6.5 | Where the conflicts of interest are handled by internal controls, do they ensure that the interests of the client will always come first? | |
| 6.6 | Where the handling of conflicts of interest depends on information barriers within the intermediary, what controls are in place to make sure they are observed? | |
| 6.7 | Is compliance with the policies monitored? | |
| 6.8 | Does the intermediary apply its policies in practice? | |
| 6.9 | What rules are in place to prevent the illegal use of knowledge of customer orders for the benefit of trading by staff? | |
| 6.10 | What rules are in place on the allocation of bulk trades between customers and the intermediary's own dealers | |
| 6.11 | Do those rules include time stamping of orders, dealer's records of the times of orders? | |
| 6.12 | Is the implementation of the rules subject to internal audit and compliance officer review? | |
| 6.13 | Are there procedures to prevent staff of the intermediary from manipulating the market by spreading false rumours, engaging in price ramping, engaging in wash trades or otherwise creating a false market? | |
| 6.14 | Are the procedures enforced? | |
| 6.15 | What procedures are in place to prevent inappropriate trading to the benefit of an intermediary earning commission but which is unnecessary for the client (or mutual fund) – ie churning? | |

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7.The Relationship with the Commission

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| 7.1 | Does the licensee have a clear understanding of information that should be supplied to the Commission at the time of each periodic report? | |
| 7.2 | Does the licensee maintain data so as to be in a position to supply the required information? | |
| 7.3 | Does the licensee have a clear understanding of the matters that need to be reported to the Commission if they occur? | |
| 7.4 | What procedures does the licensee have to ensure that notifiable matters are in practice notified? | |
| 7.5 | Is the information currently held by the Commission up to date? | |

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8. Record Keeping

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| <i>Requirements for all licensees</i> | |
| 8.1 | Are records held securely in cabinets that are locked and fire proof? |
| 8.2 | Are back-ups of computer discs made frequently and regularly? |
| 8.3 | Are back up copies held off site? |
| 8.4 | Where there are records held in archive by a third party, is there a proper agreement as to security and retrievability and is adherence to the agreement monitored? |
| 8.5 | Are records held for a minimum of 7 years? |
| 8.6 | Are the records of investors held for 7 years from the date the relationship ceases? |
| 8.7 | How is this rule enforced by the licensee? |
| 8.8 | Is record keeping properly supported by IT? |
| 8.9 | Are the staff trained in record keeping and IT and do they think training is adequate? |
| 8.10 | Do the records show the qualifications and experience of staff and the continuous professional development in which they are engaged? |
| 8.11 | Do the records show the identity of the beneficial owner, the other key persons and the roles and responsibilities of senior management? |
| 8.12 | Do the books and records appear sufficient to prepare financial statements in line with legal obligations? |
| 8.13 | Can they be reconciled with bank statements, securities records and other verifiable documentation? |
| 8.14 | Do the records show that investor acceptance procedures are followed? |
| 8.15 | Do the records show that there are investor agreements with each of the investors and that the identity and classification of the investor, beneficial owner, business of the investor, source of funds and wealth are known and recorded? |
| 8.16 | Are the records sufficient to show how investor assets are segregated and can be reconciled with transaction information? |
| 8.17 | Do the records show that there has been a risk assessment, with risk mitigation policies and that these have been properly reviewed? |
| 8.18 | Do records show that decisions are made by those with appropriate discretion, that appropriate advice has been taken and that internal approval policies have been followed? |
| 8.19 | Do the records show how complaints are handled? |
| 8.20 | Do the records show that advertisements are properly reviewed for compliance with the Regulations? |
| <i>Additional Records to be held by Stockbrokers/Securities Dealers</i> | |
| <i>NB Other licensed entities should keep records relevant to each of their activities</i> | |
| a. | Journals (or other records of original entry) containing an itemized daily record of all purchases and sales of securities, all receipts and deliveries of securities (including certificate numbers), all receipts and disbursements of cash and all debits and credits. These records should show the account for which each such transaction was effected, the name and amount of securities, the unit and aggregate purchase or sale price (if any) the trade date and the name or other designation of the person from whom purchased or received or to whom sold or delivered; |
| b. | the records at (a) should be sufficient to reconstruct all transactions; |
| c. | ledgers, (or other records) reflecting all assets and liabilities, income, |

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| expense and capital accounts; | |
| d. detailed records for nominee accounts; | |
| e. all cheque books, bank statements, cancelled cheques and bank reconciliation accounts; | |
| f. clients' accounts (or other records) itemizing separately each account of a client, all purchase, sales, receipts and deliveries of securities and all other debits and credits; | |
| g. a memorandum of each client's order received for the purchase or sale of securities. The memorandum should show orders in chronological sequence, the time of receipt, the terms and conditions of the order or instructions and of any modification or cancellation thereof, the account for which entered, the time of entry into the market for execution, the price at which executed and, to the extent feasible, the time of execution or cancellation; | |
| h. copies of confirmation of all purchases and sales, notices of all other debits and credits for securities and other items for the account of client; | |
| i. records on all commissions earned on account of equities, bonds and others; and contract books or records, showing details of all contracts entered into with members or associate members of a securities exchange and duplicates of memoranda of confirmation issued to such other members. | |
| j. Client records should be kept containing the following information: | |
| a. where the client comes through an investor agent, in the agent sub-account and where the client has been attended to by the supervisor or employee of the stockbroker authorized to attend to clients, in the broker's account, the client's name, date of birth, address, nationality or citizenship, identification, written instructions of the client, price limit, duration of the instructions and date of order and the name and address of the investor agent (where applicable) and where the client is a company, certified copies of memorandum and articles of incorporation and certificate of incorporation. | |
| b. if the stockbroker, or any of its agents has made any recommendations to the client to purchase or sell any security, the record of such client should include the client's occupation, identification, investment objectives, other information concerning the client's financial situation and needs which the stockbroker or its agents considered in making the recommendation, and the signature and name of the agent who made the recommendation to the client and the date when any order was given to the stockbroker or its agent and any price limit given. | |
| k. A record or records with respect to each discretionary account, including: | |
| a. the client's written authorization to the stockbroker to exercise discretionary power or Commission in the client's account; | |
| c. the reason given by the client for granting discretionary power or Commission in his account | |
| e. the written approval of the stockbroker's designated supervisor of each transaction in such account indicating the exact time and date of such approval | |
| l. a separate record of all securities transactions by the stockbroker's or dealer's employees and directors in their own name or under nominees accounts; | |

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| m. a separate record of all securities transactions between the stockbroker or dealer, and all listed companies in which the directors of the brokerage or dealer have an interest. | |
| <i>Additional records to be kept by asset managers</i> | |
| a. a journal or journals, including cash receipts and disbursements records and any other records or original entry forming the basis of entries in any ledger; | |
| b. general and auxiliary ledgers, (or other comparable records) reflecting assets, liabilities, reserve, capital, income and expense accounts; of the firm | |
| c. a record or memorandum of each order given for the purchase or sale of securities; of any instruction received from the client concerning the purchase, sale, receipt or delivery of a particular security and of any modification or cancellation of such order or instruction, and the record shall: | |
| i. show the terms and conditions of the order, instruction, modification or cancellation; | |
| ii. identify the person connected with the asset manager who recommended the transaction to the client and the person who placed such order; | |
| iii. show the account for which entered, the date of entry, and the stockbroker by or through whom the order was executed, where appropriate; | |
| iv. show orders entered pursuant to the exercise of discretionary power on account of management of investment portfolios in which case a record of details of such contracts with clients, constituents of the portfolio, transaction fees agreed with the client and value of the portfolio. | |
| d. all cheque books, bank statements, cancelled cheques and cash reconciliations; | |
| e. all bills or statements (or copies thereof), paid or unpaid relating to the business of the asset manager; | |
| f. originals of all written communication received from clients and copies of all written communications sent by the asset manager relating to- | |
| i. any recommendations made or proposed to be given; | |
| iii. any receipts, disbursement or delivery of funds or securities; | |
| v. the placing or execution of any order to purchase or sell any security. | |
| g. a list or other record of all accounts in which the asset manager is vested with any discretionary power with respect to the funds, securities or transactions of any client; all evidences of granting of any discretionary Commission by any client; | |
| h. all written agreements entered into by the asset manager with any client relating to the its business; | |
| i. a copy of each notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication/ recommending the purchase or sale of a specific security circulated to ten or more persons; | |
| j. a record of every transaction in a security in which the asset manager or any of the employee acquires any direct or indirect beneficial ownership stating the title and amount of the security involved, the date, whether the transaction was a purchase or sale or other acquisition or disposition, the price at which it was affected, and the name of the broker with or through whom the transaction was affected; | |

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| k. a copy of each written statement, the amendment or revision thereof, given or sent to any client or prospective client of such fund manager and a record of the dates that the same was given or offered to be given. | |
| l. all minutes, statements of accounts and resolutions in respect of each client's investment portfolio. | |
| <i>Additional Records to be kept by investment advisers</i> | |
| a) Evidence that sufficient information about the client and the client's circumstances has been obtained to ensure that the services provided are consistent with those circumstances | |
| b) Records of advice given to the customer | |
| c) Reasons for advice given to the customer | |
| <i>Additional records to be kept those who have custody of client assets</i> | |
| a. Evidence of prompt notification of clients of the opening of a custodian account and the rules governing that account and the use of one or more nominee accounts where relevant | |
| b. Evidence of quarterly statements issued to clients listing assets held on behalf of that client | |
| c. Evidence of controls over access to client assets that are reasonably designed to prevent misappropriation or misuse of those assets | |
| d. Evidence of systems or procedures to assure prompt detection of any misuse, and evidence of taking appropriate action if any misuse does occur | |
| e. Evidence of conducting background and credit checks on employees who will have access (or could acquire access) to client assets to determine whether it would be appropriate for those employees to have such access | |
| f. Evidence of regular reconciliation of custodian accounts with accounts of market intermediaries for those clients | |
| g. Evidence of policies to ensure that only permitted fees are deducted from custody accounts | |

Annexure B: Review of application for intermediary licence

1. Basic Information

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| Date correct application form received | |
| Target date for completion of assessment | |
| Name and address of Applicant: | |
| Trading name and address, if different | |
| Any other addresses used by the applicant | |
| Legal Form of Applicant <i>(check that legal constituent documents are supplied)</i> | |
| Proposed regulated activities of the applicant | |
| Contact name and details for applicant | |
| Name of Reviewer | |

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| Classes of licence applied for: <i>(check that this is consistent with the proposed regulated activities)</i> | |
|--|--|

| | |
|-------------------|--|
| Applicant Number: | |
|-------------------|--|

| | |
|--|--|
| Acceptance of application form | |
| Date licensee informed of errors or omissions | |
| Date licensee reminded | |
| Date revised application form received | |
| Date application form accepted as correct and acknowledgement sent to licensee | |

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2. Fee Calculation and Submission

| | |
|---|----------|
| Fee calculation for:- | |
| <u>Application Fee:</u> | BWP |
| <u>Licence Fee:</u> | BWP |
| Total: | BWP |
| Correctly Calculated | Yes / No |
| Payment Made? | Yes / No |
| Date correct fee received | |
| Date fee banked | |
| Date application fee and application form been acknowledged | |

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3 Key Persons

| Number of Key Persons including shareholder controllers | | |
|---|-----------------------------|-------------------------------------|
| Names of Key Persons | Address and contact details | Have PQs been submitted and signed? |
| | | Yes/No |
| | | Yes/No |
| | | Yes/No |
| | | Yes/No |

| Qualifications of key persons | | | |
|-------------------------------|---------------|----------------------|-----------------------|
| Name and Qualification | Awarding Body | Certificate supplied | Awarding body checked |
| | | Yes/no | Yes/no |
| | | Yes/no | Yes/no |
| | | Yes/no | Yes/no |
| | | Yes/no | Yes/no |
| | | Yes/no | Yes/no |
| | | Yes/no | Yes/no |

| Enquiries of Regulatory and other authorities | | | |
|---|-----------------------|-------------------|------------------------|
| Name of key person | Regulatory Commission | Date Enquiry Made | Date Response received |
| | | | |
| | | | |
| | | | |
| | | | |

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Comment on response from regulatory authorities

| | | | | | |
|---|--------|-----|-----|------|-----|
| Enquiries of domestic authorities (enter date enquiry made and response received from each Commission) | | | | | |
| Name of key person | Police | BOB | FIA | BURS | MoJ |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| Comment on responses from domestic authorities | | | | | |

Other enquiries (eg of banks or bankruptcy courts)
(enter date enquiry made and response received)

| Name of key person | Name of Commission | Date |
|--------------------|--------------------|------|
| | | |
| | | |
| | | |
| | | |

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Comment on responses received

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4. The Applicant's Governance

| | |
|---|----------|
| Names of two independent directors | 1. 2. |
| Comment on compliance with policy on two independent controller | |

| | |
|---|--|
| Name of Beneficial Owner(s) of the Applicant? | |
| Address | |
| Ownership structure | |
| Business of the beneficial owner | |

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5. “Fit & Proper” Determination

| | |
|---|-----------------------|
| Summary of information on the application form concerning investigations or findings by regulatory authorities, professional bodies or law enforcement relating to the applicant or key persons | |
| Summary of information held by the Commission in respect of the applicant and key persons' fitness and propriety | |
| Summary of information re qualifications and experience of key persons (excluding shareholder controllers) | |
| Results from enquiry on the internet into the applicant and key persons | |
| Result of enquiries from Bank of Bangladesh, FIA, BURS and MoJ, concerning the applicant and key persons | |
| Result of enquiries of regulatory Commission in country of residence in last ten years (if not Bangladesh) of each key person | |
| If the application form gives any details of investigations or findings by a regulatory Commission, law enforcement Commission or professional body, results of enquiries from the body concerned | |
| Comment on Bank Reference | |
| Result of any other enquiry, including court or bankruptcy records or professional association | |
| Assessment of adequacy of qualifications & experience of each key person (excluding shareholder controllers) | |
| Comments on the integrity of the applicant and key persons. State whether there is any information that casts doubt on integrity. | |
| Comments on the collective skills and experience of all key persons of applicant in connection with the business | |
| State Conclusion: Does the applicant have the integrity and competence to be granted a licence (If more information required state what further enquiries) | Yes / No more info |
| Does each of the shareholders/controllers have the integrity and financial standing to be permitted to be shareholders / controllers? | Yes / No more info |
| Does each of the key persons (excluding shareholder / controllers have the competence to be permitted to be shareholder controllers? | Yes / No more info |
| Is there any information about the beneficial owner that suggests that he or she may have an undesirable influence on the licensee? | Yes / No more info |

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| | |
|---------------|--|
| Other comment | |
|---------------|--|

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6. Financial Resources and Personal Indemnity Insurance

| | |
|---|----------|
| Minimum Financial resources required | |
| Working capital required | |
| Comment on form in which financial resources are held and whether appropriate discount has been applied | Comment: |
| Does applicant meet financial resources? | Yes/No |
| If appropriate: Date applicant told to review calculation of financial resources. | |
| Date revised application received | |
| Level of PII | |
| PII confirmed to be in accordance with requirement in Regulations. | (Yes/No) |
| If appropriate, date applicant informed that PII is insufficient and invited to arrange further cover | |
| Date revised PII cover notified. | |

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7. Business Plan and viability

| | |
|---|--------|
| Is Business Plan submitted? | Yes/No |
| Does Plan suggest financial resources will be available over plan period | Yes/No |
| Comment on viability of Business Plan | |
| If appropriate, date applicant informed that Business Plan suggests lack of viability and invited to supply amended plan. | |
| Date revised Business Plan supplied. | |

| | |
|--|--------|
| Are audited accounts submitted? | Yes/No |
| Do accounts suggest financial resources and viability are in question? | Yes/No |
| Have there been any adverse auditor's comments or qualified accounts? | Yes/No |
| Comment on audited accounts | |
| If appropriate, date applicant informed that audited accounts suggest lack of viability and invited to comment | |
| Date comment received. | |
| If appropriate, date auditor invited to comment on qualified accounts | |
| Date comment received | |

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8. Auditor:

| | |
|---|--------|
| Name and address of Auditor | |
| Does the auditor have the appropriate qualifications | Yes/no |
| Has auditor indicated willingness to serve in writing in case of new appointment? | Yes/no |
| Comment on suitability of auditor | |
| If appropriate, date applicant invited to change the auditor | |
| Date of applicant's response. | |

Comment on overall assessment of fitness and properness and on suitability for a licence.

| | |
|--|--------|
| Conclusion: Should licence be approved. If negative, give main evidence that will be disclosed to applicant | Yes/No |
|--|--------|

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10. Risk Rating (to be compiled after completing Risk Profiling Worksheet)

| | |
|--|---|
| Risk Score (Supervisory Attention index) | Score: <input type="checkbox"/> Normal <input type="checkbox"/> Watch List <input type="checkbox"/> Remedial Action or Restructure |
| State Key Vulnerabilities | |

| | |
|--------------------------|--|
| Date diarised for review | |
|--------------------------|--|

| | |
|------------------|--|
| Name of Reviewer | |
|------------------|--|

| | |
|-----------------------|--|
| Signature of Reviewer | |
|-----------------------|--|

Signature of SRI Manager

Determination meeting held on

| |
|--|
| |
| |

Summary of meeting:

Attendees

Name
Signature

Position
Date

Name
Signature

Position
Date

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Annexure C: Sample Inspection report cover page

Type: ☐ New Firm ☐ Routine ☐ Prudential ☐ For Cause

Joint: ☐ Yes ☐ No Date of Report:

Licensee Name:

Commission File Number:

Type of Organization: ☐ Securities dealer ☐ Custodian ☐ Asset manager ☐ Invest. Adviser

| | | |
|-------------------------|------------------------|----------------------|
| Sample Period Reviewed: | Inspection Start Date: | Inspection End Date: |
|-------------------------|------------------------|----------------------|

| MODULES PERFORMED | WORKPAPER SECTION REFERENCE | DEFICIENCIES IDENTIFIED |
|---|-----------------------------|--|
| A: LICENSING, BOOKS AND RECORDS | | |
| <input type="checkbox"/> Firm and Agent Licensing | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Books and Records | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Other Items | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| B: SALES PRACTICES | | |

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| | | |
|---|--|--|
| <input type="checkbox"/> Advertising and Marketing | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Customer Accounts and Contracts | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Suitability | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Confirmation Disclosure | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Fees | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Client Referrals | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Other Items | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| C: TRADING OPERATIONS | | |
| <input type="checkbox"/> Order execution | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Churning | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Insider trading | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Market Manipulation | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Fraud | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Unauthorized Transactions | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Reconciliation failures | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Failure to segregate client assets | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Misuse of client assets | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Breach of client mandate | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Front running | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Failure to allocate trades fairly | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Other Items | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| D: FINANCIAL RISK AND COMPLIANCE | | |
| <input type="checkbox"/> Financial Statements | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Litigation | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Custody | | <input type="checkbox"/> YES <input type="checkbox"/> NO |

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| | | |
|--|--|--|
| <input type="checkbox"/> Other Items | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| E: SUPERVISION | | |
| <input type="checkbox"/> Supervisory Practices | | <input type="checkbox"/> YES <input type="checkbox"/> NO |
| <input type="checkbox"/> Other Items | | <input type="checkbox"/> YES <input type="checkbox"/> NO |

| | | |
|----------------------------|---|-------------------|
| Recommended Action: | <input type="checkbox"/> No Further Action | Date Letter Sent: |
| | <input type="checkbox"/> Deficiency Letter | Date Letter Sent: |
| | <input type="checkbox"/> Enforcement Referral | Referral Date: |

| |
|------------------|
| Comments: |
|------------------|

Signature of Inspector:

Date:

Name:

Signature of Supervisor:

Date:

Name:

Annexure D: Enforcement Sanctions (BSEC to develop guidelines as to sanctions to be imposed based on the new tribunal's operation as either criminal or civil process.)

Enforcement Sanctions

(BSEC to develop guidelines as to sanctions to be imposed based on the new tribunal's operation as either criminal or civil process.)

Annexure E: Some Inspection Techniques

Records Required to be Maintained

ITEMS OF ORIGINAL ENTRY

Order Tickets

Order Tickets (or Records of Orders; Order Book Entries; Contracts for Orders; Contract Notes) are the first items of formal record-keeping generated by a firm with respect to a (securities) transaction. All order tickets, whether executed, unexecuted, or cancelled must be maintained. Each order ticket must reflect the terms and conditions of the transaction including, among other things, the following: (1) name of account for which entered; (2) whether the order is an agency or principal transaction; (3) the terms and conditions of the order; (4) whether the order is entered pursuant to discretionary power; and (6) the date and time of acceptance, entry, as well as execution.

An inspector should review the control and monitoring activities over customer orders to purchase and sell securities to determine that authorized orders are directed to the proper marketplace, executed, and accurately recorded. It should be noted here that all orders tickets for orders (or entries into the Order Book, properly indicated) that are cancelled must also be maintained. The reason for the cancellation as well as a time and date stamp must be completed on the cancelled order ticket. (Note that the Order Book requirements are the same as described above. Some brokerage firms may keep order tickets as well as the order book; the latter is a requirement.)

Confirmations

A confirmation is a written acknowledgment of a purchase or sale transaction sent to a customer describing all of the details of the transaction. Confirmations should be mailed no later than the business day after a trade takes place, however, any transmission to the client (e.g., by fax or email) may suffice. Most brokerage firms send confirmations the business day following the trade date to ensure prompt payment by the customer, since the confirmation also serves as an invoice indicating the amount due in the transaction. The minimum information to be contained in the confirmation is as follows:

- a. name of the client;
- b. date of settlement of the transaction;
- c. type of transaction (buy or sell);
- d. the name of the security transacted;
- e. quantity and price of the securities that were subject to the transaction;
- f. all costs on the basis of the concluded transaction borne by the client (commissions, fees, taxes etc.) and
- g. signature by an authorized person of the firm (recommended).

Purchase and Sales Blotter or Order Book

The Purchase and Sales (P&S) Blotter, which chronologically lists all of the firm's purchases and sales of securities is one of the most varied records found in the securities industry. Although the P&S blotter may differ in the methods of preparation, content and appearance, it must be maintained and must contain certain essential information. The minimum requirements are information specifying: (1) trade date; (2) account name and number identification; (3) number of shares and/or money amount; (4) unit price; and (5) aggregate price. This Blotter, along with the other blotters, is kept in chronological order. Brokerage Firms may keep the Order Book, which takes the place of the Purchase and Sales Blotter.

Cash Receipts and Disbursements Blotter/Record

The Cash Receipts and Disbursement Blotter is a record of original entry which must reflect on a daily basis every receipt and disbursement of cash or checks relating to the brokerage firm's business. Regardless of how a blotter is prepared, it must contain the following information for each transaction: (1) date that monies were received or disbursed; (2) person from whom received or to whom disbursed; (3) account to be debited or credited; (4) total BWP. debited and credited

Securities Received and Delivered Blotter/Record

The Securities Received and Delivered Blotter is a record of original entry which must reflect on a daily basis every receipt and delivery of securities. It must contain the following information for each transaction: (1) date of securities receipt or delivery; (2) person from whom received or to whom delivered; (3) account for which receipt or delivery was made; (4) security name; (5) number of shares or units of security; (6) Number of shares or units of security; and (7) ISIN.

(NOTE: As securities are kept in dematerialized form at the Depository, physical form securities will not be received nor delivered. Because of this, the purchase and sales blotter should suffice for this blotter. In addition, the position record should also be used as a back up. However, due to less than 100% dematerialized securities, the firm may in fact receive physical securities.)

Customer Ledger

A customer ledger must be maintained for each customer by the brokerage firm reflecting all securities transactions and related activities. These records should be separated as to each (margin and cash) account for every customer of the brokerage firm that transacts business in securities. The following information is required: (1) customer's full name or account number; (2) date of all customer's purchases, sales, receipts, and deliveries of securities; (3) number of shares bought or received in the account; (4) number of shares sold or delivered out of the account; (5) name of the securities; and (6) money debits or credits. This ledger, as with other ledgers, is kept in chronological order.

Fails to Deliver and Fails to Receive Ledger (for Brokerage Firms)

A fail-to-deliver is a situation where the brokerage firm on the sell side of a contract has not delivered securities to the brokerage firm on the buy side. A fail-to-deliver is usually the result of a brokerage firm not receiving delivery from its selling customer or the result of an error placed on the trading system by the brokerage firm. As long as a fail-to-deliver exists, the seller will not receive payment. A

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fail-to-deliver is recorded as an asset on brokerage firm's books.

A fail-to-receive is a situation where the brokerage firm on the buy side of a contract has not received delivery of securities from the brokerage firm on the sell side. As long as a fail-to receive exists, the buyer will not make payment for the securities. A fail-to-receive is recorded as a liability on brokerage firm's books.

For fails-to-deliver, the ledger must reflect: (1) name of the security; (2) number of shares; (3) sale price; (4) brokerage firm to whom the securities are due; (5) fail date (the settlement date on which delivery of securities was due not made); and (6) date the securities were finally delivered. In this case, the brokerage firm may utilize securities lending facilities set up at the Depository, if the brokerage firm is approved to do so.

For fails-to-receive, the ledger must reflect: (1) name of the security; (2) number of shares; (3) purchase price; (4) brokerage firm from whom the securities are due from; (5) fail date (the settlement date on which receipt of securities was not made); and (6) date the securities were finally received.

The fails-to-deliver and fails-to-receive ledger contains information that originates from records of original entry as a result of securities transactions. A brokerage firm may separate its fail-to-deliver and fails-to-receive into different ledgers.

Most brokerage firms have automatic fail systems, which generate pending files containing all unsettled securities after the trade date. As securities are settled, they are removed from the pending files. Any unsettled trades remaining on the day following the settlement date are transferred to fail files. Blotters of all open fails are forwarded to the cashiering department daily to be controlled and monitored.

Fails are forwarded for entry to the stock record (securities) and general ledger (money). Normally an updated file of open fails is produced daily. When a fail is cleared (securities having been either received or delivered versus payment), the date of clearance is noted and the fails position is cleared from the brokerage firm's records. A fail position may require the brokerage firm to buy in the security if the fail is outstanding longer than a reasonable time period or specified by the Exchange.

The cashiering department is generally responsible for resolving fails as quickly as possible because of the market risk exposure and financing implications involved. Brokerage firms should continuously monitor their fail exposure. A brokerage firm has exposure if the contract value is less than the market for a fail-to-receive. Brokerage firms mark their fail positions to market value to determine their exposure and calculate net capital charges. In addition to its market risk exposure, a brokerage firm is concerned with securities in its possession that it has failed to deliver because it must finance its receivables by other means, such as bank loans.

Securities Position Record (For Brokerage Firms, and Asset Managerst)

The securities position record, also called the stock record or position record, is a double-entry accounting system for shares or principal amounts of debt by security issue. It is a record of accountability reflecting all securities for which the firm has custodial responsibility or proprietary ownership. The stock record should balance much as a general ledger balances: debits and credits should equal in the general ledger; likewise long positions should equal short positions.

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A long position in the stock record indicates ownership of the security or the right of possession. The most common positions on the long side of the securities position record include: (1) customer (securities owned by the customer); (2) firm (securities held in inventory for the brokerage firm's own account and risk); (3) reverse repurchase agreements (also known as resale agreements or reverse repos); (4) securities borrowed from another brokerage firm or customer.

A short position in the stock record indicates either the location of the securities or the responsibilities of other parties to deliver them to the brokerage firm. Every security owned or held by the brokerage firm must be accounted for its location. The most common locations include: (1) transfer (securities are at a transfer agent being licensed); (2) fail-to-receive (the brokerage firm has purchased securities which have not yet been received); (3) securities loaned (securities have been loaned to another brokerage firm); (4) customer short (a customer sold securities but delivery has not yet been made); (5) firm short (brokerage firm sold a security it does not own); (6) repurchase agreements; and (7) bank loan (securities are held on deposit at a bank and pledged as collateral for a loan).

The securities position record should contain: (1) name of the security; (2) name or designation of the account for the position is carried; (3) location of all securities long and offsetting position of all securities short (long refers to ownership, short refers to location); and (4) number of shares or units or par amount for each account or location.

SUBSIDIARY LEDGERS AND ACCOUNTS

Subsidiary ledgers and accounts are secondary records and are not records of original entry. The information on these records comes from the various blotter and other records of original entry. Generally, the information on these records is posted daily. Some subsidiary ledgers found at brokerage firms include:

- Securities Transfer Ledgers
- Dividends and Interest Ledgers
- Securities Borrowed and Loaned Ledgers
- Monies Borrowed and Received Ledgers
- Securities Difference Account
- Repurchase and Reverse Repurchase Agreements

GENERAL LEDGER

Information carried from the journals and blotters is posted to the General Ledger, which reflects all asset, liability, income, expenses, and capital accounts of a firm. The general ledger is used to prepare the trial balance, balance sheets, income statements and other statements of financial condition.

TRIAL BALANCE

The Trial Balance is a statement of open money balances (debit or credit of all general ledger accounts). The trial balance acts as a verification to ensure the accuracy of the general ledger

accounts and also helps keep brokerage firms informed of their current net capital position. Profit and loss statements and balance sheets are prepared from the trial balance.

BALANCE SHEET

The Balance Sheet or Statement of Financial Condition should be in a format and on a basis consistent with the totals reported on the statement of financial condition, which is consistent with the accounting laws and practices of Pakistan.

INCOME STATEMENT

The Income Statement or Statement of Operations should disclose separately the sources of a licensed firm's revenues (such as commissions, trading and investment gains or losses, underwriting profits or losses, fee income, dividends, interest, etc.).

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Sample Checklist Regarding Financial Statements

Objectives:

- ☐ ☐ Verify that the firm's subsidiary and general ledger account balances have been accurately posted to the trial balance and accurately summarized on the firm's balance sheet.
- ☐ ☐ Verify records relating to
 - ☐ Cash
 - ☐ Fails to receive and fails to deliver
 - ☐ Securities borrowed and loaned
 - ☐ Customer omnibus accounts
 - ☐ Clearing organization accounts
 - ☐ Customer receivables and payables
 - ☐ Inventory and investments
 - ☐ Other assets
 - ☐ Bank loans
 - ☐ Other liabilities
- ☐ ☐ Review the income statement for trends indicative for volatile activity
- ☐ ☐ Perform adjustments to (net) capital, if necessary.

NOTE: The Inspector should review financial statements for compliance with existing Capital Requirements.

Inspection Procedures:

| Item | Inspection Procedure | Workpaper Reference |
|--|---|---------------------|
| BALANCE SHEET AND TRIAL BALANCE | | |
| 1. | Obtain adjusted trial balances, the general ledgers, balance sheet, income statement and net capital computation for the most recent month end or other selected time period. | _____ |
| 2. | Compare the accuracy of the roll-up from the final trial balance to the balance sheet. | _____ |
| 3. | For any out-of-balance situation that occurred, determine what caused the condition and how it was corrected. Review for "plug accounts" that may have been used to correct an out-of-balance situation and forced the trial balance into balance. Such plug account balances need to be analyzed and reversed if they caused an overstatement of assets or understatement of liabilities. Carry forward adjustments for inappropriate plug accounts and out of balance amounts to the net capital computation. | _____ _____ |
| 4. | Obtain the firm's unadjusted trial balance(s), adjusting journal entries, worksheet adjustments (made directly to trial balances without passing through the general ledger) and worksheets of other adjustments made to prepare the final trial balance. | _____ |

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| Item | Inspection Procedure | Workpaper Reference |
|------|---|---|
| 5. | <p>Evaluate accuracy and appropriateness of worksheet adjustments and journal entries made to the unadjusted trial balance to prepare the final trial balance.</p> <ul style="list-style-type: none"> <input type="checkbox"/> Obtain supporting documentation for large or unusual adjustments. Documentation will vary depending on the type of adjustment, but may include trade confirmations for trades that were executed but posted late and/or clearance statements or fund transfers for fails that were resolved but posted late. <input type="checkbox"/> Reverse any adjustments if they cannot be satisfactorily explained and supported with documentation and carry forward to net capital calculation. <input type="checkbox"/> For any out-of-balance situation that occurred, determine what caused the condition and how it was corrected. <input type="checkbox"/> Review further for "plug accounts" on the trial balance and any "plug entries" made through journal entries or worksheet adjustments. Such plug accounts and entries need to be analyzed and reversed if they caused an overstatement of assets or understatement of liabilities. <input type="checkbox"/> Carry forward adjustments for inappropriate plug accounts and out of balance amounts to the net capital computation. | <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> |
| | CASH | |
| 6. | <p>Interview the principal (treasurer, head of cashiering) responsible for overseeing financial matters of the Firm. For branch offices, focus on handling of checks received from customers. For main offices, gain a clear understanding of the Firm's cash management procedures, including operation of branch deposit, concentration, zero balance, and segregation-offset bank accounts. Ensure all client cash (and securities) accounts are segregated from those of the firm proprietary accounts.</p> | <p>_____</p> |
| 7. | <p>Obtain a trial balance of all bank accounts. Select significant bank accounts for review and testing. Select bank accounts where customer receipts and loan proceeds clear, all clearing accounts, concentration accounts and a sample of other accounts with the greatest activity.</p> | <p>_____</p> |
| 8. | <p>Obtain bank statements and the reconciliations for all accounts selected for review and perform the following:</p> <ul style="list-style-type: none"> <input type="checkbox"/> Trace balances per books (e.g., checkbook registers or cash ledgers) to the trial balance. <input type="checkbox"/> Verify balances by reviewing the reconciliations and supporting details (perform a balancing test). <input type="checkbox"/> Verify significant reconciling items, focusing on items that increase cash balances. For deposits in transit, trace to deposit slips and subsequent bank statements. <input type="checkbox"/> Note any reconciling items that have remained unresolved for 30 business days. These items should not be allowed for net capital computation. <input type="checkbox"/> Determine if any other reconciling item should be reflected to adjust cash balances. <input type="checkbox"/> If aged outstanding checks are added back to cash balances, verify that a 100% reserve was established. If a reserve was not established or a | <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> |

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| Item | Inspection Procedure | Workpaper Reference |
|------|--|---------------------|
| | liability recorded, the asset should not be allowed for net capital computation. | |
| 9. | Determine whether each account selected for review is unrestricted (i.e., demand deposit, money market account, or Certificate of Deposit) or whether any third party has a claim to funds in the account (in relation to a liability recorded or unrecorded on the books and records of the firm). | _____ |
| | If the account is restricted, the balance should be treated as a non-allowable asset in the net capital computation. | _____ |
| | If any third party has a claim to the funds, the balance should be treated as a non-allowable asset in the net capital computation to the extent of the related liability to the third party. | _____ |
| 10. | Review for large idle bank balances, time deposits, and/or investments in the bank's Certificate of Deposits or commercial paper. This may indicate the existence of a formal or an informal arrangement between a bank and the firm for compensating balances. This is a situation where banks require offsetting deposits (compensating balances) for loans made to the brokerage firm or to its affiliates. To the extent that the deposit is a compensating balance it is restricted and should not be allowed for net capital computation. | _____ |
| | Particular attention should be paid to situations where an affiliate or parent with little or no assets of its own makes substantial subordinated or unsecured loans to the firm. Review the parent or affiliate's records to determine the source of the funds for the loans. If the firm maintains cash or other assets at the same bank that loaned the money to the parent or affiliate, these assets may be a compensating balance and should be considered non-allowable. | _____ |
| | Moreover, if the firm co-signs or guarantees a loan from the bank to the affiliate, the amount of the loan should be a charge to net capital. | _____ |
| 11. | Review for month-end cash transfers between the firm and affiliated persons and companies. Determine the reason for each transfer and discuss in the inspection work-papers the basis for each transfer. | _____ |
| 12. | Review bank debit and credit advices or bank statements to determine whether the firm may be receiving funds and failing to record liabilities, particularly intra-month. If the firm's (net) capital is at or near the required minimum perform an intra-month calculation booking the liability to the same date as credit advice(s). | _____ |
| 13. | Request actual cancelled cheques for a specific time period (e.g., six months). Review cancelled cheques for: <ul style="list-style-type: none"> <input type="checkbox"/> Unusual significant payments <input type="checkbox"/> Unusual cheques drawn to affiliates, officers, and employees. Double endorsements <input type="checkbox"/> Commission rebates <input type="checkbox"/> Payments to unregistered personnel, consultant. <input type="checkbox"/> Patterns of cheques to employees being cashed | _____ |

Capital Markets Inspection Procedures Manual and Guidelines

| Item | Inspection Procedure | Workpaper Reference |
|------|--|---------------------|
| 14. | Carry forward classifications of non-allowable assets and adjustments for aged reconciling items and suspense items to the net capital computation. | |
| | FAILS TO DELIVER/FAILS TO RECEIOVE | |
| 15. | For a broker, obtain the firm's fails ledger and trace the total contract values to the trial balance and general ledger control accounts. | |
| 16. | Verify significant adjustments (e.g., fails added or cleaned up) made after the ledger was run by tracing to supporting records. For fails that were added to the records, obtain comparisons and trade tickets. For fails that cleaned up, obtain clearing statements, securities receipt/delivery tickets, or funds transfers. | |
| 17. | Select a sample of significant fails and aged fails. Trace the contract value and settlement date to supporting documentation such as trade tickets, comparisons from the counterparty, and confirmations received for quarterly verifications. Obtain explanations and consider expanding the sample if there are any discrepancies. | |
| 18. | Identify aged fails (more than 5 days), calculate mark-to-market deficits and apply haircuts to securities. Deduct market value of security, plus loss (amount contract value exceeds market value) or minus gain (amount market value exceeds contract value) up to amount of haircut. | |
| 19. | Carry forward classifications of non-allowable assets, exclusions from aggregate indebtedness and deficit charges to (net) capital computation. | |
| | SECURITIES BORROWED/SECURITIES LOANED | |
| 20. | Obtain the firm's securities borrowed/loaned ledgers. | |
| 21. | Verify significant adjustments made after the ledger was run (i.e., securities borrowed/loaned added or cleaned up) to supporting records. For securities borrowed or loaned that were not recorded in the ledgers, obtain comparisons/confirmations, securities received or delivered tickets, or funds transfers. For securities borrowed or loaned that were returned, obtain securities received/delivered tickets or funds transfers. | |
| 22. | Select a sample of significant securities borrowed and loaned positions and trace the entered contract value and interest rate or rebate to comparisons of the counterparty. | |
| 23. | Note that ledgers may contain securities borrowed collateralized by other securities and by letters of credit. These are not included in the contract values carried forward to the general ledger or trial balance, as they do not represent money receivables. Such transactions are off balance sheet. (However, collateral deficits must be identified for net capital purposes.) | |
| 24. | Trace the total contract values from the ledgers and adjustments to the control accounts in the firm's general ledger. Make any necessary | |

Capital Markets Inspection Procedures Manual and Guidelines

| Item | Inspection Procedure | Workpaper Reference |
|---|---|---------------------|
| | adjustments to the firm's trial balance based on the above reviews. | _____ |
| 25. | Compare the contract value to the market value of collateral. Securities borrowed must be marked to the market each business day, as of the prior day's close, and the amount of collateral held for securities loaned which exceeds the current market value of the securities borrowed from the same counterparty must be determined. | _____ |
| 26. | Carry forward classifications of non-allowable assets to net capital computation. | _____ |
| OMNIBUS (GROUP) ACCOUNT RECEIVABLES/PAYABLES | | |
| 27. | For a brokerage firm o obtain a reconciliation of the firm's omnibus (i.e., compilation or joint accounts, e.g., customer cash accounts) accounts, both of money balances and security positions and perform the following procedures. | _____ |
| | <input type="checkbox"/> Trace money balance per books to trial balance and balance per clearing brokerage firm to clearing brokerage firm's statement. | _____ |
| | <input type="checkbox"/> Compare selected security positions as listed on the statement of the carrying brokerage firm to the stock record of the brokerage firm. | _____ |
| | <input type="checkbox"/> Balance the reconciliations and supporting details. | _____ |
| | <input type="checkbox"/> Verify significant reconciling items, focusing on items that increase a receivable, increase a long security position, decrease a payable, or decrease a short security position. Supporting documents include trade tickets, confirmations/comparisons, and funds transfers. | _____ |
| | <input type="checkbox"/> Note any items reconciling the money balances or securities positions that have remained unresolved for 7 business days for purposes of net capital charges. | _____ |
| | <input type="checkbox"/> Determine if any other reconciling item should be reflected to adjust cash balances or securities positions. | _____ |
| 28. | Carry forward classifications of non-allowable assets to net capital computation. | _____ |
| CLEARING AND SETTLEMENT ORGANIZATION ACCOUNTS RECEIVABLE/PAYABLE | | |
| 28. | Obtain the statements for clearing and settlement organization receivables and payables and perform the following procedures. | _____ |
| | <input type="checkbox"/> Trace money balance per books to trial balance and balance per clearing organization to clearing statement. | _____ |
| | <input type="checkbox"/> Compare selected security positions as listed on the clearing statement to the stock record of the brokerage firm. | _____ |
| | <input type="checkbox"/> Balance the reconciliations and supporting details. | _____ |
| | <input type="checkbox"/> Verify significant reconciling items, focusing on items that increase a receivable, increase a long security position, decrease a payable, or decrease a short security position. Supporting documents include trade tickets, confirmations/comparisons, and funds transfers. | _____ |
| | <input type="checkbox"/> Note any items reconciling the money balances or securities positions | _____ |

Capital Markets Inspection Procedures Manual and Guidelines

| Item | Inspection Procedure | Workpaper Reference |
|--------------------------------------|--|---------------------|
| | that have remained unresolved for 7 business days for purposes of net capital charges. | |
| | <input type="checkbox"/> Determine if any other reconciling item should be reflected to adjust cash balances or securities positions. | |
| 30. | Carry forward classifications of non-allowable assets and charges for unreconciled items to net capital computation. | _____ |
| CUSTOMER RECEIVABLES/PAYABLES | | |
| 31. | Obtain a subsidiary trial balance of customer receivables and payables. | _____ |
| 32. | Trace the trial balance totals of money balances of customer receivables and payables to the general ledger control accounts. | _____ |
| 33. | Determine the firm's policies and procedures for paying, posting and accruing interest earned on free credit balances. Verify that interest payable was posted to accounts and, if necessary, accrual was made to accounts payable for accrued interest subsequent to the date interest was last credited to accounts. | _____ |
| 34. | Carry forward classifications of non-allowable assets and deficit charges to net capital computation. | _____ |
| INVENTORY AND INVESTMENTS | | |
| 35. | Obtain the Firm's marked-to-market inventory summary. | _____ |
| 36. | Trace summary totals for each inventory account to the trial balance or general ledger control totals. | _____ |
| 37. | For securities inventory summaries: <input type="checkbox"/> Balance selected pages. <input type="checkbox"/> Select a representative sample to test. <input type="checkbox"/> Ascertain that long positions are not overstated by tracing quantities of significant long positions per summaries to supporting schedules. <input type="checkbox"/> Ascertain that short positions are not understated by tracing quantities of significant short positions per supporting schedules to inventory summaries. | _____ |
| 38. | Verify the securities market price. | _____ |
| 39. | Verify the existence of a ready market. The brokerage firm has the burden of proving the existence of a "ready market" for its security positions. A brokerage firm that is unable to prove that a "ready market" exists for a particular security position must deduct from net capital 100% of the value of that security. | _____ |
| OTHER ASSETS | | |
| 40. | Obtain general and subsidiary ledgers for other assets. Review subsidiary detail records and determine that the subsidiary record totals agree with general ledger control accounts. | _____ |

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| Item | Inspection Procedure | Workpaper Reference |
|------|---|---------------------|
| 41. | <p>Have the following receivables, if treated as allowable assets, been outstanding for 30 calendar days or less from the date they arise?</p> <p><input type="checkbox"/> Dividends receivable (from the date the dividend was payable). <input type="checkbox"/> Interest receivable (from the date the interest was payable). <input type="checkbox"/> Commission receivable from other brokerage firms (other than syndicate profits). <input type="checkbox"/> Mutual fund concessions receivable from the fund or its distributor.</p> <p>If the above receivables were outstanding over 30 days, these receivables should be treated as non-allowable assets.</p> | _____ |
| | BANK LOANS | |
| 42. | Obtain a subsidiary trial balance of all outstanding loans and trace the total money balance to the general ledger trial balance. | _____ |
| 43. | Compare the balance and title of each loan per the firm's books and records to supporting documentation (i.e., bank loan advices, confirmations, loan statements, bank statements, etc.) | _____ |
| 44. | Review loan activity statements per lenders' statements or bank statements and determine that all intra-month activity is posted to the Firm's books and records. If certain activities are not recorded, there may be a books and records implication and the possibility that the firm is not aware of loan transactions entered into on its behalf by an employee or officer. | _____ |
| | OTHER LIABILITIES | |
| 45. | Obtain an understanding of the Firm's procedures for recording and paying accrued expenses and other liabilities. | _____ |
| 46. | Obtain supporting schedules and/or documentation for all accrued expenses and other liabilities. Other liabilities include all of the accounts reported on the balance sheet for drafts payable, accounts payable, income taxes payable, deferred taxes, accrued expenses, other borrowings not qualified for net capital, and notes and mortgages payable. | _____ |
| 47. | Investigate any material change in accrued expenses and other liabilities currently as compared to the last inspection date and the last annual audit date. | _____ |
| 48. | Make inquiry of management as to possible unrecorded liabilities from Lawsuits and/or contingencies and inter-company payables. | _____ |
| | INCOME STATEMENT | |
| | <p>Note: If the inspector is reasonably assured that assets and liabilities have been correctly stated on the balance sheet and recorded in subsidiary ledgers, the income statement should correctly represent revenues and expenses on an accrual basis. The inspection of the income statement can thus be focused on:</p> | |

Capital Markets Inspection Procedures Manual and Guidelines

| Item | Inspection Procedure | Workpaper Reference |
|--|---|---------------------|
| | <ul style="list-style-type: none"> ➤ Understanding the firm's primary sources of revenue for targeting ➤ Sales practice reviews ➤ Detecting potential sales practice problems through the review of legal and professional fees, write-offs, and reserves for litigation and bad debts. ➤ Trend analysis of significant revenues and expenses to gauge the ➤ The Firm's financial condition. | |
| 49. | Review income and expense trial balance for any unusual and/or significant items, such as revenues from the sales of special products, reserve for contingencies, bad debt expenses, legal and professional fees, and other unusual income and expense items. | _____ |
| 50. | Re-compute and ascertain the adequacy of the provision for income taxes. | _____ |
| 51. | Trace year-to-date earnings to the retained earnings or owner's equity section of the balance sheet. | _____ |
| | Review income and expense items for significant fluctuations from the comparative prior period. Obtain an explanation for the significant fluctuations. | _____ |
| 52. | Note the major revenue producing items on the income statement for use when determining the scope of the sales practice inspection. | _____ |
| END OF INSPECTION PROCEDURE SECTION | | |

Compliance Assessment:

| Item | Compliance Issue | Determination |
|---|--|--|
| BALANCE SHEET AND TRIAL BALANCE | | |
| 1. | Was the trial balance accurately prepared? Timely? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 2. | Was the balance sheet accurately prepared? Timely? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| Note: If no to either Item #1 and/or #2, compute the errors and carry forward to the net capital computation. | | |
| CASH | | |
| 3. | Are unreconciled and aged reconciling items properly identified? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 4. | Is supporting documentation satisfactory for reconciling items? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 5. | Are cash balances accurately reconciled? | YES <input type="checkbox"/> NO <input type="checkbox"/> |

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| Item | Compliance Issue | Determination |
|------|---|--|
| 6. | Are cash balances free of restriction, liens, or guarantees? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 7. | Did the firm properly state cash on hand, in bank, or in transit on its balance sheet? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| | Note: If no to any Items #3-7, describe the inaccuracy and required adjustments to the net capital computations in the inspection report and work-papers. | |
| | FAILS TO DELIVER/FAILS TO RECEIVE | |
| 8. | Is supporting documentation satisfactory for all adjustments to fails ledger balances? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 9. | Is supporting documentation satisfactory for significant fails? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 10. | Did the firm properly state the contract values of fails to deliver and fails to receive? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 11. | Did the firm properly identify deficits on aged fails for net capital computation purposes? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| | Note: If no to any Items #8-11, describe the inaccuracy and required adjustments to the net capital computations in the inspection report and work-papers. | |
| | SECURITIES BORROWED/SECURITIES LOANED | |
| 12. | Is supporting documentation satisfactory for all adjustments to securities borrowed/loaned balances? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 13. | Is supporting documentation satisfactory for significant securities borrowed/loaned? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 14. | Did the firm properly state the contract values of securities borrowed and loaned? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 15. | Did the firm properly identify deficits on securities borrowed and loaned for net capital computation purposes? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| | Note: If no to any Item #12-15, describe the inaccuracy and required adjustments to the net capital computations in the inspection report and work-papers and carry forward to the net capital computation. | |
| | OMNIBUS ACCOUNT RECEIVABLES/PAYABLES | |
| 16. | Are unreconciled and aged reconciling items properly identified? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 17. | Is supporting documentation satisfactory for reconciling items? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 18. | Are omnibus receivable/payable balances accurately reconciled? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 19. | Are securities positions accurately reconciled? | YES <input type="checkbox"/> NO <input type="checkbox"/> |

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| Item | Compliance Issue | Determination |
|--|---|--|
| 20. | Did the firm properly state the receivable/payable and securities positions in omnibus accounts? Note: If no to any Items #16-20, describe the inaccuracy and required adjustments to the net capital computations in the inspection report and work-papers. | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| CLEARING ORGANIZATION ACCOUNTS RECEIVABLE/PAYABLE | | |
| 21. | Are unreconciled and aged reconciling items properly identified? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 22. | Is supporting documentation satisfactory for reconciling items? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 23. | Are omnibus receivable/payable balances accurately reconciled? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 24. | Are securities positions accurately reconciled? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 25. | Did the firm properly state the receivable/payable and securities positions in clearing accounts? If no to any Item #21-25, describe the inaccuracy and required adjustments to the net capital computations in the inspection report and work-papers. | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| CUSTOMER RECEIVABLES/PAYABLES | | |
| 26. | Were there any variances between the subsidiary trial balance and the general ledger control account for customer receivables and payables or between the selected customer account statements and the subsidiary trial balance? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 27. | Is margin interest receivable or payable properly reflected in customer accounts? Is margin interest accrued on a current basis? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| INVENTORY AND INVESTMENTS | | |
| 28. | Were the Firm's inventory positions properly stated as to quantity and price? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 29. | Was the firm able to prove that a ready market exists for the selected positions? If no to Item 29, deduct the exception from net capital computation. | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 30. | Did the firm properly compute haircuts on inventory positions? If no to Item #30, re-compute and enter correct deduction. | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| OTHER ASSETS | | |
| 31. | Were there any material differences noted between subsidiary records and general ledger control accounts for other allowable assets? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 32. | Was the firm able to furnish all necessary supporting data for those other allowable assets selected for testing? | YES <input type="checkbox"/> NO <input type="checkbox"/> |

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| Item | Compliance Issue | Determination |
|--------------------------------|---|--|
| 33. | Did your review of other allowable assets result in any net capital adjustments? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 34. | If yes to Item #33, carry forward the adjustment to the net capital computation. | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| BANK LOANS | | |
| 35. | Are the firm's non-customer or unsecured loans collateralized in a manner that does not improperly encumber customer securities? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 36. | Are the non-customer, firm and unsecured loan agreements free from any language that could improperly encumber customer securities? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 37. | Are all loans properly stated and classified (e.g. customer, non-customer, firm or unsecured) on the books and records of the firm? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| OTHER LIABILITIES | | |
| 38. | Are the firm's procedures for recording and paying accrued expenses and other liabilities adequate? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 39. | Did the firm properly accrue and record all unpaid expenses and other liabilities as of the inspection date? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 40. | Do the adjustments have any material impact on the firm's computation of net capital? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| INCOME STATEMENT | | |
| 41. | Is the Firm's provision for income taxes properly computed and recorded? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 42. | If no to Item #41, re-compute and explain the deficiencies. | |
| 43. | Were any unusual and/or significant items noted during the review of the income statement? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 44. | If yes to Item #43, determine the impact of these items on the firm's net capital computation and carry forward. | |
| NET CAPITAL COMPUTATION | | |
| 45. | Begin with stated ownership equity. | _____ |
| 46. | Include any adjustments made to the firm's balance sheet/trial balance based on errors noted for Items #1 and/or 2. | _____ |
| 47. | Subtract any adjustment required for: | |
| | CASH | _____ |
| | FAILS TO RECEIVE AND FAILS TO DELIVER. | _____ |
| | | _____ |

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| Item | Compliance Issue | Determination |
|------|---|--|
| | SECURITIES BORROWED AND LOANED | _____ |
| | CUSTOMER OMNIBUS ACCOUNTS. | _____ |
| | CLEARING ORGANIZATION ACCOUNTS. | _____ |
| | CUSTOMER RECEIVABLES AND PAYABLES. | _____ |
| | INVENTORY AND INVESTMENTS | _____ |
| | OTHER ASSETS | _____ |
| | BANK LOANS | _____ |
| | OTHER LIABILITIES | _____ |
| | INCOME STATEMENT ERRORS | _____ |
| | ENDING NET CAPITAL COMPUTATION | _____ |
| 48. | Based on the required (net) capital for the firm, the stated capital and any adjustments made, is the firm in compliance with the (net) capital requirements? | YES <input type="checkbox"/> NO <input type="checkbox"/> |

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Sales Practices: Confirmations

Sales Practices: Confirmation Disclosure

INTRODUCTION

Confirmations are written acknowledgments from a firm sent to a customer providing the details of any transactions effected for his/her account. All purchase or sale transactions in securities effected with or for customers must be confirmed (in writing as recommended, or by some other means of transmission, e.g., email; fax) at or before settlement of the transaction. The confirmation serves a basic investor protection function by: (1) conveying information allowing investors to verify the terms of their transactions; (2) alerting investors to potential conflicts of interest with their firms; (3) acting as a safeguard against fraud; and (4) providing investors the means to evaluate the costs of their transactions and the quality of their brokerage firm's execution. A report of the trade should be sent to the customer no later than the next business day after trade date.

PURPOSE OF THE INSPECTION MODULE

The Confirmation Disclosure Inspection Module is designed to:

- ☐ Determine the firm's compliance with the disclosure requirements relating to confirmations.
- ☐ Determine the firm's compliance with confirmation delivery obligations for accounts.

DISCUSSION

Licensed firms must give or send to each customer a confirmation detailing any transactions executed in the customer's account at or before the completion of the transaction. The following disclosures must be made on the confirmation:

- a. Date and time of the transaction, and the identity, price, and number of shares or units (or principal amount) of the security bought or sold.
- b. Firm's capacity (whether the brokerage firm is acting as agent for the customer, as agent for some other person, as agent for both the customer and some other person, or as principal for its own account).
- c. For a transaction in a debt security effected exclusively on the basis of price, the confirmation must include: (i) the price at which the transaction was effected; and (ii) the yield to maturity calculated from the price.
- d. For a transaction effected on the basis of yield, the confirmation must include: (i) the yield at which the transaction was effected, including the percentage amount and its characterization and (ii) the price calculated from the yield at which the transaction was effected.

For accounts managed by a third-party fiduciary, the confirmation delivery requirement allows confirmations to be sent to the third party fiduciary, under certain circumstances.

For accounts where a fiduciary has discretion over the customer's account, confirmation may be sent to the fiduciary if:

- a. The firm obtains from the customer a written agreement that the fiduciary will receive the immediate confirmation; and

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- b. The firm sends to the customer a periodic report, not less frequently than quarterly, containing the same information that would have been contained in an immediate confirmation. The customer may not waive the right to the periodic report.

For accounts where a custodian is authorized to receive securities and disburse funds for the customer, the confirmation may be sent to the custodian provided that:

- a. The custodian does not hold itself out as a brokerage firm or investment adviser, is not affiliated with the brokerage firm or investment adviser, and does not have any role in choosing the brokerage firm or investment adviser;
- b. The securities orders are placed by the customer or the customer's investment adviser, not the custodian;
- c. The customer retains the right to request that the confirmation be sent directly to the customer at no extra charge by the custodian or the brokerage firm; and
- d. The custodian does not choose to receive a periodic report in place of an immediate confirmation.

Sample Checklist Regarding Confirmations

Objectives:

- ☐ ☐ Determine the firm's compliance with the disclosure requirements relating to confirmations.
- ☐ ☐ Determine the firm's compliance with confirmation delivery obligations for accounts managed.

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Inspection Procedures:

| Item | Inspection Procedure | Workpaper Reference |
|------|--|---------------------|
| 1. | Obtain a sample of confirmations selected from the Order Book (purchase and sales blotter), inventory account statements, or customer statements. Choose a representative sample of agency and principal transactions in both equity and debt securities. | _____ |
| 2. | <p>Review the selected confirmations for adequate disclosure in the following areas: (also compare details on confirmation to those on the executed order tickets, e.g., same prices; same quantity, and to the trades recorded on the records of the KSE, ISE, and LSE)</p> <p> <input type="checkbox"/> Security Identity <input type="checkbox"/> Amount <input type="checkbox"/> Buy/Sell <input type="checkbox"/> Firm's Capacity [Principal/Agency/Customer Crossing] <input type="checkbox"/> Commission/Mark-up <input type="checkbox"/> Other Remuneration Received </p> | _____ |
| 3. | Obtain samples of the firm's written agreement with customers where a fiduciary has discretion over the customer's account, e.g., Investment Advisor; third party. | _____ |
| 4. | Identify the accounts in which the confirmations are sent to the custodian or other fiduciary. | _____ |

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Compliance Assessment:

| Item | Compliance Issue | Determination |
|--|---|--|
| <i>Were the following items disclosed on the confirmations as required?</i> | | |
| 1. | The customers' names and addresses or an adequate identification of the accounts? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 2. | The trade date/settlement date? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 3. | An adequate description of the security, the number of shares or units (or principal amount of a debt security purchased or sold by the customer), and the price at which the transactions were effected? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 4. | Whether the brokerage firm is acting as agent for the customer, agent for some other person, or agent for both the buying customer and the selling customer on the same transaction (dual agency), or as principal (or dealer) for its own account? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| <i>If the brokerage firm was acting as agent, do the confirmations disclose:</i> | | |
| 5. | The source and amount of any commission or other remuneration received, or to be received, by the brokerage firm and the net or gross amount? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 6. | Commission rebates to customers? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 7. | If the brokerage firm was acting as principal (or dealer) for its own account, do the confirmations disclose the pricing and markup/markdown data? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 8. | Select a sample of the confirmations reviewed. Compare those confirmations with the original purchase and sales memoranda. Was the transaction executed in a timely manner and in accordance with the customer's instructions? Compare the details of the trade on the confirmation to those from trade data generated from the Stock Exchange to ensure proper amounts and prices, as well as priority and preference given to the customer. | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 9. | Do the confirmations contain appropriate disclosure of control where required? [Securities dealers should disclose to a customer prior to entering an order to purchase or sale of a security whether it is in a control relationship with the issuer of the security.] | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 10. | In the case of a transaction in a debt security, do the confirmations disclose whether the security is subject to redemption before maturity and that such a redemption would affect the yield represented, the yield | |

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| Item | Compliance Issue | Determination |
|------|--|--|
| | to maturity, the price at which the transactions were effected, and that additional information is available upon request? <i>Recommended</i> | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 11. | In the case of a transaction in a debt security affected exclusively on the basis of a price, do the confirmations disclose the price at which the transaction was executed, and the yield to maturity calculated from the price? <i>Recommended</i> | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 12. | In the case of a transaction in a debt security affected on the basis of yield, do the confirmations disclose the yield at which the transaction was effected, including the percentage amount and its characterization? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 13. | Does the firm have written consent for a fiduciary to receive the immediate confirmation? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 14. | Does the customer receive periodic reports, not less than monthly (or quarterly?), which contain all of the information that will have been contained in the immediate confirmations? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 15. | Does the customer maintain the right to request that the confirmation be sent directly to him at no extra charge by the custodian or the firm? | YES <input type="checkbox"/> NO <input type="checkbox"/> |

Brokerage Firms: Trading Operations: Insider Trading

Trading Operations: Insider Trading

INTRODUCTION

Insider trading is a term that refers to the act of trading securities while in the possession of material, non-public information. The prohibition against insider trading is premised upon ensuring public confidence that trading in the securities markets is fair and equitable. This premise rests on the assumption that the public will perceive it unfair for an insider of a company to have an advantage over others simply because his/her employment affords access to non-public information about the company.

PURPOSE OF THE INSPECTION MODULE

The purpose of the Insider Trading Inspection Module is to:

- Determine whether the firm maintains adequate policies and procedures to control and prevent the dissemination of non-public information and detect any potential insider trading violations.
- Determine whether there are any indications of insider trading transactions.

INTERNATIONAL DEFINITIONS RELATED TO INSIDER TRADING

Chinese Wall: (also referred to as “information barriers”.) A set of internal written policies and procedures designed to control and prevent the dissemination of non-public information acquired by one department of a Member firm to other separate departments within a brokerage firm. For example, it is common and good practice for a securities company to keep information confidential within the Research Department and certainly not to “leak” information on its recommendations for purchasing or selling securities to the Trading or Sales Department of the firm.

Insider: Officers, directors, and key employees of an issuer, as well as their relatives and any others in a position to capitalize on material, non-public information.

Insider trading: A term of art that refers to the illegal act of trading securities while knowing or possessing material, non-public information about a company whose shares are publicly traded. Also illegal is the passing on of such inside information.

Restricted list: A confidential list of securities in which proprietary, employee, and some solicited customer transactions are restricted or prohibited. For example, most firms prohibit employee trading for up to five days in securities in which the firm has issued a research report. This list is generally widely disseminated throughout the firm to apprise employees of those securities that the employees are restricted or prohibited from recommending or trading in.

Watch list: Also called a “gray list.” A confidential list of securities that do not carry trading restrictions, but whose trading is subject to close scrutiny by the brokerage firm’s compliance or legal department because the brokerage firm may have confidential information about the issuer (typically a list of securities on which the investment banking department has confidential information). The list has a limited circulation and is usually used to monitor employee and proprietary trading.

DISCUSSION

Brokerage firms should establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material, non-public information by employees and proprietary accounts. These policies should include certain minimum elements of adequate brokerage firm control and supervision systems. These minimum elements include: (1) exercising substantial

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control (preferably by the compliance department) of relevant interdepartmental communications; (2) review of employee trading; and (3) review or restriction of proprietary trading while in possession of material, nonpublic information.”

Where relevant, the firm’s policies should also include the use of a “Chinese Wall” technique to limit the spread of confidential information held by the firm for legitimate reasons. These procedures should have the following characteristics:

1. Formalized, organized and incorporated within a firm’s procedural and/or policy manuals.
2. Require documentation of any actions taken.
3. Explain why, when, and how a security should be placed on and deleted from a restricted or watch list and which activities are prohibited or restricted when a security is placed on either list.
4. Address how the brokerage firm will monitor employee and proprietary trading in securities on the restricted or watch list outside of the brokerage firm.
5. Contain an obligation to reasonably investigate possible misuse of material, non-public information by employees or the brokerage firm’s proprietary accounts.
6. Require documentation of all reviews, inquiries, and/or investigations.
7. Limit or contain the necessary flow of material, non-public information to employees who have a “need to know.”

The brokerage firm should document and maintain written records of all instances where an employee has been brought “over the Wall.” (An employee who is brought over the Wall is treated as a temporary insider of the investment banking department possessing material, non-public information for Chinese Wall surveillance purposes.) The documentation should include: (i) the name of the employee brought over the Wall; (ii) the employee’s department; (iii) the date; (iv) the name of the issuer(s) involved; and (v) the name of the person requesting that the Wall be crossed.

A brokerage firm should also establish procedures assuring that every employee is apprised of the brokerage firm’s policy regarding the use of material, non-public information. In addition, a brokerage firm must require each employee to sign an attestation of his knowledge and understanding of the brokerage firm’s policies in this matter. Finally, brokerage firms have an obligation to update employees and conduct continuing education and/or training on these issues.

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Sample Checklist Regarding Insider Trading

Objectives:



- (i) Determine whether the firm maintains adequate policies and procedures to control and prevent the dissemination of non-public, price sensitive information and detect any potential insider trading violations.



- (ii) Determine whether there are any indications of insider trading transactions.

Inspection Procedures:

| Item | Inspection Procedure | Workpaper Reference |
|------|---|---------------------|
| 1. | Obtain all written policies and procedures (e.g., written supervisory procedures, compliance manual, memoranda) used by the firm to detect and avoid insider trading. | _____ |
| 2. | Ascertain whether the firm's written supervisory procedures, compliance manual, and other memoranda contain policies and procedures to: | |
| | (a) Restrict communication of non-public information. | _____ |
| | (b) Monitor the dissemination of non-public information. | _____ |
| 3. | Determine whether the firm maintains watch, and/or restricted lists. Obtain a copy of each list for the previous 12 months. (Note: these lists would be distributed to the brokers and traders, regarding those securities that should NOT be traded) | _____ |
| 4. | Determine whether the firm provides continuing education programs or provides training materials concerning insider trading and the dissemination of material, non-public information. Obtain copies of prepared materials. | _____ |
| 5. | Determine whether the firm requires employees to conduct personal security transactions through the firm or whether the firm allows employees to maintain brokerage firm accounts with other brokerage firms. | _____ |
| 6. | Determine whether the firm collects security holding statements and/or conducts interviews of its employees concerning employees' personal | |

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| Item | Inspection Procedure | Workpaper Reference |
|------|---|---------------------|
| | stock ownership and trading activities. | _____ |
| 7. | Obtain samples of all exception reports designed to detect insider trading. Obtain an understanding of how the firm uses these reports to monitor for insider trading. You may want to ask for specific ones later. | _____ |
| 8. | Determine the interval upon which the firm conducts its monitoring of proprietary and arbitrage accounts, employees accounts, and insider customers accounts (<u>i.e.</u> , is the monitoring of accounts done daily, weekly, or monthly?). | _____ |
| 9. | Ascertain whether policies or procedures are adequate to ensure that confidential information is transmitted on a need-to-know basis only to appropriate personnel. | _____ |
| 10. | Determine whether the firm has a policy or procedure for further inquiring into suspicious transactions. | _____ |
| 11. | Determine whether the firm is a publicly traded company. If so, determine whether the firm has special monitoring procedures for transactions by the firm or its directors and employees concerning the firm's publicly traded securities. | _____ |
| 12. | Request a tour of the firm's facilities. Determine whether the firm uses physical barriers and other mechanisms or devices to restrict the flow of material, non-public information from one department to another. Are there "Chinese Walls", for example, set up between the Research and Trading department to stem the flow of information between the two departments? | _____ |
| 13. | Obtain from the firm a list of all issuers for which the firm provided investment banking and/or corporate finance services during the previous 12 months. Select sample engagements for review of insider trading activities. | _____ |
| 14. | Obtain from the firm copies of all substantial research reports prepared by the firm that were disseminated to the public during the previous 12 months. | _____ |
| 15. | Obtain from the firm all restricted and watch lists during the previous 12 months. Review the lists to determine whether the companies that are the subject of the selected engagements or are profiled in the selected research reports appear on the lists. | _____ |
| 16. | Obtain from the firm purchase and sales blotters or other trading records (<u>i.e.</u> , Order Book) for the relevant time periods. Review the records for indications of insider trading in the issues related to the firm's investment banking and/or corporate finance department's engagements. | _____ |
| 17. | Obtain from the firm account statements for the relevant time periods for all proprietary and arbitrage, employee, and officer accounts. Review the account statements and the purchase and sales blotters or other trading | _____ |

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| Item | Inspection Procedure | Workpaper Reference |
|------|---|---------------------|
| | records for suspected transactions effected on inside information. | _____ |
| 18. | During the normal review of customer accounts and officer and employee accounts, make notes of any large block purchases or sales. Obtain the original purchase price of such securities and the subsequent sale price and determine if a large profit resulted from such trade. (Note: Prior to inspection, at Commission office, note "unusual" (i.e., high volume) trades in securities just prior to public news announcements. Obtain this information from trade runs of the Exchange. | _____ |
| 19. | Obtain and review compliance exception reports that disclose large concentrations of securities positions by account, large block trades by account, and equity trades generating large profits. | _____ |
| 20. | For any securities transaction in question, determine, by reviewing financial publications and news retrieval databases, if such trade was affected prior to public disclosure of any significant event or information that may have resulted in a material price increase or decrease. Any positive correlation could indicate illegal trading on non-public inside information. Obtain a price history of the security and note any relevant price fluctuations. | _____ |
| 21. | Request detailed trading information for all suspicious transactions noted. | _____ |

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Compliance Assessment:

| Item | Compliance Issue | Determination |
|------|--|--|
| 1. | Are the written supervisory written policies and procedures adequate to detect and avoid insider trading, and are such procedures being followed by the firm? This is an indication of good supervisory procedures in place. | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 2. | Is there a written procedure whereby the securities laws, regulations, rules, and the firm's policies and procedures relating to the use of material, non-public information are provided to each employee? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 3. | Is continuing education/training held? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 4. | Do the firm's written policies and procedures provide for physical segregation and restricted access to files, offices and computers that may contain material, non-public information? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 5. | Is such information actually segregated and safe? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 6. | Do the firm's policies and procedures require personnel to conduct their securities trading through in-house accounts or require that any trading in outside accounts be reported to the firm? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 7. | Do the firm's policies and procedures prohibit trading of securities listed on the firm's restricted and watch lists? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 8. | Do the firm's policies and procedures provide for centralized control by the legal/compliance department of interdepartmental communications? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 9. | Do the firm's policies and procedures provide for adequate assurances that confidential information is transmitted on a need-to-know basis only to appropriate personnel? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 10. | Do the firm's policies and procedures provide for review by the legal/compliance department of employee and proprietary trading against the watch and restricted lists? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 11. | (a) Are the reviews adequate? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| | (b) Any breaches in the firm's policies and procedures? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 12. | Are the firm's information barrier policies and procedures pertaining to training, physical barriers, trading restrictions, centralized control, and review of trading written in the policy or procedure manual? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 13. | Does the firm maintain documentation of its analyses and investigations of employee and proprietary trading? | YES <input type="checkbox"/> NO <input type="checkbox"/> |

Supervision: Supervisory Practices

INTRODUCTION

The securities laws (*should*) impose a duty upon licensed firms and their supervisory personnel, not only to comply with the securities laws, but also to make reasonable efforts to ensure that persons subject to their supervision also comply with such laws. Firms and Principals that fail to reasonably supervise can be subject to sanction by the Commission.

There is no definition of what constitutes a failure to reasonably supervise. But as a matter of policy there is an affirmative defence if the firm and/or principal can demonstrate that they (i) established both procedures and a system for applying the procedures that was reasonably be expected to detect and prevent a securities law violations by a person subject to the firm's or principal's supervision, and (ii) the firm and/or principal reasonably discharged the duties and obligations imposed by the procedures and system without having reasonable cause to believe that the procedures and system were not being followed.

As long as certain minimum standards are followed, brokerage firms can implement systems best designed for the type and size of their particular businesses. However there are certain basic characteristics that any qualifying supervisory system must possess.

The firm's complaints, litigation, and arbitration files help determine the effectiveness of the firm's compliance and supervisory system with respect to these matters. It is critical to carefully review these files in order to successfully complete the inspection of sales practices.

PURPOSE OF THE INSPECTION MODULE

The purpose of the Supervisory Policies and Procedures Module is to:

1. Determine the adequacy of the firm's written supervisory procedures.
2. Determine if adequately qualified persons are performing the supervision.
3. Determine whether new account documents are being approved.
4. Determine the firm's compliance with the requirement to review and approve daily transactions.
5. Determine the firm's compliance regarding review of agent correspondence.
6. Determine the firm's compliance with the requirement to approve advertising and sales literature.
7. Review customer complaints, litigation, arbitration, and dismissals of agents to determine the effectiveness of the firm's compliance and supervisory system with respect to these matters.
8. Determine the adequacy of the firm's review of its branch offices. Determine the adequacy of supervision of customer accounts.
9. Determine the adequacy of supervision of discretionary accounts.

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DISCUSSION

The content and operation of a firm's supervisory system is up to the discretion of the brokerage firm. However, in order to meet best practices, the policies and procedures should meet the following criteria.

Assignment of Supervisors

Firms should designate an appropriately registered principal(s) with the Commission to carry out the supervisory responsibilities of the brokerage firm for each type of business in which it engages for which brokerage firm licensing is required

Firms should designate of a supervisory principal for each branch office.

Firms should assign for each agent a principal who is responsible for supervising that person's activities.

The firm should make reasonable efforts to determine that all supervisory personnel are qualified by virtue of experience or training to carry out their assigned responsibilities.

Overall, it is recommended that each brokerage firm appoint a supervisor as "Compliance Officer" of the firm, to ensure compliance with the securities laws, regulations, and rules, as well as ensuring compliance with the firm's own policies and procedures. As well, the Member should have a "Written Supervisory Policies and Procedures" Manual, relevant to all securities departments and activities.

Written Policies and Procedures

The firm must adopt and maintain a system to supervise the activities of each agent that is designed to achieve compliance with applicable securities laws and regulations. *Final responsibility for proper supervision rests with the brokerage firm.* A brokerage firm's supervisory system must provide, at a minimum, for the following:

1. Listing of the titles, licensing status, and locations of the required supervisory personnel and the responsibilities of each supervisory person as these relate to the types of business engaged in. In addition, the brokerage firm should maintain on an internal record the names of all persons who are designated as supervisory personnel and the dates for which the designation is or was effective.
2. Maintaining a copy of the brokerage firm's written supervisory procedures in each location where supervisory activities are conducted on behalf of the brokerage firm.
3. Amending the written supervisory procedures as appropriate within a reasonable time after changes occur in applicable securities laws and regulations, and as changes occur in its supervisory system; and each brokerage firm must be responsible for communicating amendments through its organization.

Review of Activities

The firm should conduct a review, at least annually, of the businesses in which it engages, designed to assist in detecting and preventing violations of and achieving compliance with applicable securities laws and regulations.

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The firm should review the activities of each office, including the periodic inspection of customer accounts, to detect and prevent irregularities or abuses and at least an annual inspection of each branch office.

Each branch office of the brokerage firm must be inspected according to a cycle which must be set forth in the firm's written supervisory and inspection procedures.

The firm should conduct a meeting by principals at which relevant compliance matters are discussed. Such meeting should be conducted at least once a year and may occur in conjunction with the discussion of other matters and at a central location or at the representative's place of business.

Operational Review by Principals

The firm's procedures should contain a requirement for the review and endorsement by a registered principal in writing, on an internal record, of:

1. all accounts (as new on opening; for suitability)
 - ☐ all transactions.
 - ☐ all incoming and outgoing written and electronic correspondence of its agents with the public.
 - ☐ all advertising and sales literature used, prior to use.

For example, in reviewing all transactions, a principal might notice a high number of requests for cancelled and revised (orders or) transactions that may indicate a particular broker within the firm (trying to) placing better executions with "preferred" client accounts, or attempting to generate a "reward" for execution of a client's order at a better price than an indicated limit. During the inspection process, the inspector should review all cancelled and revised orders and transactions to determine if there are any conflicts or sales practice violations.

Evidence that these supervisory procedures have been implemented and carried out must be maintained and made available upon request. Evidence might be in the form of the supervisor initialling trade records (bulked daily) or the order book; initialling every new account information form; and initialling correspondence and advertising.

Hiring Process

The firm's procedures should contain a requirement that the hiring principal thoroughly investigate agent applications and history before hiring.

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Sample Checklist Regarding Supervision

Objectives:

- | | |
|--------------------------|--|
| <input type="checkbox"/> | <input type="checkbox"/> Determine the adequacy of the firm's written supervisory procedures. |
| <input type="checkbox"/> | <input type="checkbox"/> Determine if adequately qualified persons are performing the supervision. |
| <input type="checkbox"/> | <input type="checkbox"/> Determine whether new account documents are being approved. |
| <input type="checkbox"/> | <input type="checkbox"/> Determine the firm's procedure (or compliance with the requirement) to review and approve daily transactions. |
| <input type="checkbox"/> | <input type="checkbox"/> Determine the firm's procedure (or compliance) regarding review of agent correspondence. |
| <input type="checkbox"/> | <input type="checkbox"/> Determine the firm's compliance with the requirement to approve advertising and sales literature. |
| <input type="checkbox"/> | <input type="checkbox"/> Review customer complaints, litigation, arbitration, and dismissals of agents to determine the effectiveness of the firm's compliance and supervisory system with respect to these matters. |
| <input type="checkbox"/> | <input type="checkbox"/> Determine the adequacy of the firm's review of its branch offices. Determine the adequacy of supervision of customer accounts. |
| <input type="checkbox"/> | <input type="checkbox"/> Determine the adequacy of supervision of discretionary accounts. |
| <input type="checkbox"/> | |

Inspection Procedures:

| Item | Inspection Procedure | Workpaper Reference |
|------|---|---------------------|
| 1. | Obtain a copy of the firm's written supervisory procedures manual. | _____ |
| 2. | Review the manual to determine that procedures have been prepared for all types of business or products that the firm handles. | _____ |
| 3. | Review the manual to determine the adequacy of the procedures for each of the major revenue sources of the firm and the areas and products focused on in this inspection. | _____ |
| 4. | Review the procedures for written documentation of the assignment of every agent to a specific supervisory person. | _____ |
| 5. | Determine if an appropriate registered principal has been designated with the Commission to carry out the supervisory responsibilities for each type of business the firm conducts. | _____ |
| 6. | If there are no procedures for the specific areas or products, or if the procedures are inadequate, discuss the deficiency with the appropriate person at the brokerage firm. In some instances, there may be written procedures separate from the written supervisory procedures manual. | _____ |
| 7. | Request that the firm provide a Schedule of Supervisory Personnel and a Schedule of Branch Offices, including the name of the Compliance Officer | _____ |
| 8. | Obtain a copy of Registrations, which also should provide an accurate record of branch offices. | _____ |

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| Item | Inspection Procedure | Workpaper Reference |
|------|---|---------------------|
| 9. | Branch offices with will need to have a licensed broker/Branch Manager. | |
| 10. | Test for compliance by selecting some of the supervisors of sales practice areas, such as retail sales and trading departments. Research to confirm that the selected supervisors have passed the required supervisory exam. Perform the same test for selected branch managers. | |
| 11. | Review the documentation for written approval of new accounts. | |
| 12. | Also note if customer background is suitable for type of trading activity. It may be necessary to refer to the Suitability Inspection Module. | |
| 13. | (a) Determine who reviews trades on a daily basis and what documents are reviewed. Generally, the documents reviewed will be either the order tickets or the trade blotter or Order Book. Evidence of initials or signatures should be found, either on individual trade tickets, or on each page of the trade blotter or Order Book. (b) Are all securities that are traded by the Member performed or entered on the trading system of a stock exchange? | |
| 14. | Request documents for a selected time frame, depending on the amount of trading. If the sales practice review has indicated deficiencies involving trades executed during a certain time frame and there is some question as to the adequacy of supervision exercised, select that time frame for review. | |
| 15. | Review the documents to verify that the firm is documenting its approval on a daily basis. | |
| 16. | If it is noted that there are numerous trade corrections or cancellations, determine whether the firm has documented supervisory approval for account name or number change. Excessive trade changes may indicate unauthorized trading. | |
| 17. | Test correspondence files for evidence of written supervisory approval. Suggest reviewing correspondence files of agents targeted for sales practice review due to such things as customer complaints or large production. | |
| 18. | Request file copies of correspondence for reasonable time frame, based on extent of correspondence and reason for reviewing that particular correspondence. Note: Many agents have very little outgoing correspondence. They spend their time selling over the phone. | |
| 19. | Review for evidence of supervisory approval on all outgoing agent correspondence. | |
| 20. | Obtain a sample of advertising files and product files, if applicable. | |
| 21. | Review for evidence of supervisory approval of advertising, sales literature, and any other generally distributed communication. | |
| 22. | Determine the firm's procedures for cataloging and/or filing complaints, litigation, and dismissal of agents. Make copies where necessary. | |

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| Item | Inspection Procedure | Workpaper Reference |
|------|---|---------------------|
| 23. | From the above sources, review files for indications of possible sales practice abuses. | |
| | (a) Determine what analysis was made by the firm. | _____ |
| | (b) Obtain details for other accounts serviced by the same agent or branch office that exhibit common characteristics (<u>e.g.</u> low priced securities, unusual strategies, high turnover). | _____ |
| | (c) Review the Commission's database for any recent disciplinary manners not disclosed above and obtain supporting files and documents. | _____ |
| 24. | Review the firm's trial balance for any general ledger account used to record potential losses from customer complaints, arbitration, litigation awards, and dismissal of agents. | |
| | (a) Review and schedule the larger entries made to the above account. | _____ |
| | (b) Obtain from the firm the analysis of the make-up of the ending balance for the above account. | _____ |
| | (c) Obtain explanation, files, or other documents for the above. Determine if items recorded in the litigation reserve account indicate a pattern of sales practice abuses not previously known. | _____ |
| | (d) Determine if the loss reserves are adequate for complaints, litigation, and arbitration. | _____ |
| 25. | Obtain from the firm the litigation letter issued by its outside counsel and reviewed by its independent auditors in connection with the year-end audit. Also, obtain and review the firm's Board of Director's minutes for at least a twelve-month period. | _____ |
| | (a) Review the above litigation letter and board minutes for matters not previously disclosed to you and obtain supporting files and documents where necessary. | _____ |
| | (b) Determine if the financial exposure to the firm from the matters listed in the above documents has been recorded to the firm's reserve for litigation account or some other such reserve for loss account. | _____ |
| 26. | Select for review an appropriate sample of complaints, litigation, and arbitration files, and recent dismissals of agents. Make this selection based upon the seriousness of the complaint, allegation, or lawsuit, and/or the amount of the customer's claim for monetary damages, and/or the repetitiousness of customers' complaints. Review these items to: | _____ |
| | (a) Determine if there is any pattern to the complaints, litigation, and arbitration matters. | _____ |
| | (b) Determine the firm's response to the above. | _____ |

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| Item | Inspection Procedure | Workpaper Reference |
|------|---|---------------------|
| | (c) Determine if the above is an on-going problem at the firm. | |
| | (d) Determine if the firm's supervisory procedures were deficient with respect to the problems listed in the above complaint or lawsuits. | |
| 27. | Check then names of agents dismissed to whether they are licensed with other brokerage firms. Limit search to those agents terminated for cause. Perform this review back at Commission office. | |
| 28. | Request a copy of the firm's inspection or audit schedule of its branch offices and review to determine whether the schedule has been met. | |
| 29. | Obtain copies of the written supervisory procedures of the retail sales manager. | |
| 30. | Determine the responsibilities of the supervisor or manager or compliance officer to review customer accounts on a periodic basis. | |
| 31. | Determine whether the written responsibilities are being carried out adequately by requesting documentation verifying the periodic reviews. | |
| 32. | Discuss results of your review and analysis of exception reports, such as an active account report. If the firm does not have exception reports, determine what procedures are implemented in place of such reports. | |
| 33. | Discuss exceptions found by the inspector in review of the separate modules. | |
| 34. | Obtain a list of discretionary accounts from the firm. | |
| 35. | Test a number (or all) of discretionary accounts, preferably those with some trading, to ensure that the customer has provided written authorization and that the firm has approved it in writing. Review for churning. | |
| 36. | Verify there are written supervisory procedures for discretionary accounts. | |
| 37. | Test some order tickets to ensure that prompt approval in writing is placed on each discretionary order. Note: There may be some non-discretionary orders placed in discretionary accounts. | |
| 38. | Determine what kind of frequent or periodic supervisory review is made by the supervisor/manager/compliance officer. | |

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Compliance Assessment:

| Item | Compliance Issue | Determination |
|------|--|--|
| 1. | Does the firm have a written supervisory procedures manual? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 2. | Are the firm's written supervisory procedures adequate and being followed? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 3. | Has the firm designated and registered a supervisor for each department or branch? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 4. | Has the designated supervisor passed the appropriate supervisor's test? YES <input type="checkbox"/> NO <input type="checkbox"/> | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 5. | Does each designated supervisor have the appropriate background to be adequately qualified to supervise his or her particular area? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 6. | Did the firm provide new account forms for all accounts requested? If not, the books and records requirements may have been violated. | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 7. | Did all of the new account forms have appropriate written approval? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 8. | Can the firm provide the order tickets, order book, or blotters you requested? If not, the books and records requirements may have been violated. | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 9. | Do the documents consistently show written approval? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 10. | Do all copies of agents' outgoing correspondence have evidence of supervisory approval? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 11. | Do all copies of agents' outgoing correspondence pertaining to solicitation of a trade have evidence of supervisory approval? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 12. | (a) Are there any letters that might contain misleading disclosures or violations of advertising rules? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| | (b) Are there any letters that indicate other potential serious sales practice problems that should be investigated? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 13. | Do advertising files indicate supervisory approval of ads and other sales and marketing literature? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 14. | Are the firm's procedures adequate for cataloging and/or filing complaints, litigation, and agent dismissal forms? If not, please describe in the work-papers and consider discussing with the firm. | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 15. | Are any special supervisory procedures in place with respect to an individual agent? If so, describe in the work-papers what are they and why are they in place? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 16. | Did the review disclose any specific patterns of sales practice abuses with any particular agent, branch office, or group of customer accounts? If yes, in the work-papers, list the customer accounts and | |

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| Item | Compliance Issue | Determination |
|------|---|--|
| | obtain copies of all relevant documentation. | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 17. | Has firm examined all of its branch offices annually? Is there a licensed broker at each branch office? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 18. | Does the firm have adequate written supervisory procedures for supervision of customer accounts? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 19. | Does the supervisor/manager/compliance officer carry out these responsibilities? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 20. | Is there documentation verifying the supervision? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 21. | Based on your discussions with the manager or supervisor about exceptions or questionable activity found in the course of the exam, were explanations credible and documentation provided adequate? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 22. | Does the firm have any discretionary or Portfolio Management accounts? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 23. | Were written authorizations on file for all of the customers tested? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 24. | Were all of the tested customers' written authorizations approved by the firm? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 25. | Are there written procedures for handling discretionary accounts? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 26. | Do the discretionary orders that were tested have written approval on them? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 27. | Does the manager periodically review the accounts? | YES <input type="checkbox"/> NO <input type="checkbox"/> |
| 28. | Is the frequent or periodic review evidenced in writing? | YES <input type="checkbox"/> NO <input type="checkbox"/> |

Questions for Possible Inclusion on Checklists for Inspections of Exchanges and Clearinghouses

1. Does the exchange have a mechanism in place that is intended to monitor and evaluate continuously the risk of open positions or credit exposures that are sufficiently large to expose a risk to the market or to a clearing firm that includes:

a) Qualitative or quantitative trigger levels appropriate to the market for the purpose of identifying large exposures, continuous monitoring and an evaluative process?

b) Access to information, if needed, on the size and beneficial ownership of positions held by direct customers of market intermediaries?

c) The power to take appropriate action against a market participant that does not provide relevant information needed to evaluate an exposure (e.g., requires liquidation of positions, increase margin requirements and/or revoke trading privileges)?

d) The general power to take appropriate action, such as to compel market participants carrying or controlling large positions to reduce their exposures or to post increased margin?

2. Do arrangements, whether formal or informal, exist to enable markets and regulators to share information on large exposures of common market participants or on related products with regulators and markets:

a) In the domestic jurisdiction?

b) In other relevant jurisdictions?

Default Procedures – Transparency and Effectiveness

3. Does the exchange make its default procedures available to market participants, including specifically information concerning:

a) The general circumstances in which action may be taken?

b) Who may take it?

c) The scope of actions which may be taken?

4. Do default procedures and/or national law permit markets and/or the clearing and settlement system(s) promptly to isolate the problem of a failing firm by addressing its open proprietary positions and positions it holds on behalf of customers or otherwise protect customer funds and assets from an intermediary's default under national law?

5. Is there a mechanism by which market authorities for related products can consult with each other in order to minimize the adverse effects of market disruptions?

IOSCO Principle 7 relates to Self Regulatory Organizations being subject to oversight and observing the standards of fairness and confidentiality.

Authorization

1. As a condition of authorization, the legislation or the regulator should require an

SRO to demonstrate that it:

- a) Has the capacity to carry out the purposes of relevant governing laws, regulations and SRO rules, and to enforce compliance by its members and associated persons subject to those laws, regulations, and rules.
- b) Treats all members of the SRO and applicants for membership in a fair and consistent manner.
- c) Develops rules that are designed to set standards of behaviour for its members and to promote investor protection.
- d) Submits to the regulator its rules for review and/or approval, as the regulator deems appropriate, and ensures that the rules of the SRO are consistent with the public policy directives established by the regulator.
- e) Cooperates with the regulator and other SROs to investigate and enforce applicable laws and regulations.
- f) Enforces its own rules and imposes appropriate sanctions for noncompliance.
- g) Assures a fair representation of members in selection of its directors and administration of its affairs.
- h) Avoids rules that may create anti-competitive situations.
- i) Avoids using the oversight role to allow any market participant unfairly to gain advantage in the market.

Oversight

2. Oversight should be on-going to ensure that:

- a) An SRO meets the conditions of its authorization on an ongoing basis.
- b) The government regulator retains the Commission to inquire into matters affecting investors or the market.
- c) Where the powers of an SRO are inadequate to investigate, or otherwise to address, alleged misconduct or where the SRO has a conflict of interest, the regulator conducts any necessary investigation rather than the SRO.
- d) An SRO provides information to the regulator that allows matters requiring regulatory intervention to be identified at an early stage.

The Commission must review and verify that the SRO's audit trails and computerized surveillance systems for accurate and useful. In particular, the Commission should analyze the parameters the SROs use in their computerized surveillance systems to assure that the systems provide meaningful results. The Commission also should review surveillance files to assure that investigations are conducted appropriately and referred for further action as necessary.

Professional Standards

3. The SRO should adopt standards of confidentiality for its staff and standards of procedural fairness applicable to its members comparable to those for the regulator.

Conflicts of Interest

4. The SRO should have procedures in place to address potential conflicts of interest.

Authorization or Delegation Subject to Oversight

1. Does the Exchange:
 - a) enforce compliance by its members and associated persons subject to securities laws, regulations and rules?
 - b) procedures in place to meet the conditions of authorization, and ongoing and effective execution of such programs?
 - c) Treat all members of the SRO, applicants for membership and similarly situated market participants subject to its rules in a fair and consistent manner?
 - d) Develop rules that are designed to set standards for its members and to promote investor protection?
 - e) Submit to the regulator its rules, and any amendments thereto, for review and/or approval, as the regulator deems appropriate, and ensures that the rules of the SRO are consistent with the public policy directives established by the regulator?
 - f) Cooperates with the regulator and other domestic SROs to investigate and enforce applicable laws, regulations and rules?
 - g) Imposes appropriate sanctions for non-compliance with its own rules?
 - h) Where applicable, e.g., a mutual organization, assures a fair representation of members in selection of its board of directors and administration of its affairs?
 - i) Avoid rules that may create anti-competitive situations?
 - j) Avoid using the oversight role to allow any market participant unfairly to gain an advantage in the market?

Stock Market Principles of the World Federation of Exchanges

In 2002, the international organization of the World Federation of Exchanges set out *minimum level* best practices for securities exchanges. The following excerpts (bold emphasis added in areas that need attention) are addressed by the WFE and should help the Commission in developing Inspection Manuals and Checklists, as well as regulations for Securities Exchanges:

Organisation and Operations

Exchanges should have available and maintain adequate organisational infrastructure and operational resources to enable them to offer the proper tools for trading in securities.

a. Legal Status

The exchange should have the legal status...

1. Statutes

The exchange should have properly drafted Statutes, at a minimum covering its governance, the composition of the governing body, indications for constituents from which council members are appointed/elected, its mission, and its rules and regulations.

2. Market participants

The requirements for market participants should cover: objective qualifications, experience, structure, capital adequacy rules, disciplinary issues, and rights and obligations. Foreign market participants should normally be allowed, adopting mutual recognition of World Federation of Exchanges member market participants. Traders should be authorised to act only at the end a structured training process and after having passed a qualifying exam.

3. Monitoring of Market participants

On an on-going basis, the exchange should have infrastructure place for the supervision for which is has responsibility, indicating the frequency of monitoring, the scope of its Commission, actions to be taken in case of non-compliance, etc. The financial and trade reporting obligations of market participants should have their formal basis here. The exchange's oversight should encompass capital adequacy, position limits, collateral quantity and quality, internal compliance rules, market conduct and behaviour, etc. (for example, all rules of the Exchange must be enforced by the Exchange, including the keeping of an Order Book in time and date order)

4. Organisational Structure

The organisational structure of the exchange should be formal and allow for the correct management of financial market operations. The staff of the exchange needs to be fit and properly qualified for the job.

5. Regulatory Infrastructure

At a minimum, the official exchange rules should include information on: trading, including transparency and reporting, listing, market participation, discipline and sanctions, clearing and settlement, and recourse procedures. (note with these rules, there must be regulation and enforcement by the Exchanges)

6. Systems

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The exchange should have systems in place that are of sufficient capacity to ensure the operation of an orderly market and to handle its business activities.

7. Funding of the Organisation

The financial soundness of exchange should be the result of a sound business plan.

Access to the Market

The market should be designed to operate in a manner equitable to all who access it. Any differences in treatment among users, regardless of the means of access (electronic or other) must not be tolerated. Access to the market should not be arbitrarily granted, and no discrimination should be shown. Procedures should be established such that market participants adhere to the competence, integrity, financial soundness and Commission, and that adequate supervision be in place.

Exchange rules and regulations must stipulate:

1. terms and conditions for equal access to the market, including those to do with financial integrity and business ethics;
2. the professionalism of intermediaries and their employees; minimum capital requirements and solvency of intermediaries;
3. compliance instruments that safeguard the standing and credit worthiness of intermediaries;
4. enforcement and disciplinary procedures, including the sanctions to be applied; and, management of conflicts of interest among and within market users.

Listing of and disclosure on traded financial products

Exchanges should require:

1. that listed companies be of an adequate size and have sufficient shares in hands of the public to safeguard an orderly and fair market;
2. timely, and the widest possible disclosure of business and financial information materially affecting listed companies;
3. regular disclosure of financial information by listed companies; and,
4. disclosure to investors of the nature, risk and investment potential inherent in the traded financial products.

Exchanges should work towards:

1. regulatory co-ordination among markets where financial products are jointly listed, in order that there be a synchronised disclosure of information; and,
2. the support of cross-border listing and trading.

The listing procedures, time schedule for the processing of the dossier, costs for the company, minimum size of capitalisation, and other requirements should be compiled in one rulebook, which is publicly available. In case listing responsibilities are shared with the supervisory agency, it should be clear where the ultimate decision in the listing process lies. Foreign issuing companies should be subject to the same rules as the domestic ones. The procedure to gain listing should be sufficiently long to assure that all the requirements of the Exchange have been fully complied with, but not so long as to impair access to the capital market.

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Trading

- ☐ The accountability of the Exchange to market users should be described, especially in any agreements that seek to modify the distribution of responsibilities among participants.
- ☐ Transaction audit trails should be available to investors and regulators; only the information to regulators will include non-public information. Pre- and post-trade information should be provided on a timely basis. (that is, the Exchanges need to keep data on orders and quotes, not just trades)
- ☐ The Exchange should be able to demonstrate to the regulator that the processing, queuing, and display of prices and quotations within the market are equitable to all classes of participants.
- ☐ The transparency of the market is a crucial element of fairness and must be assured at all times. Although markets may offer different degrees of transparency depending upon the balance struck between transparency and liquidity, nevertheless, whatever the structure transactions must be reported immediately to the exchange, with details as to price and volume.

Exchanges should undertake:

- ☐ to promote well balanced transparency by publicly disclosing transaction data;
- ☐ to establish and maintain trading rules to protect investors, such as “best execution” rules, regulatory trading halts, etc. (need to ensure all orders are entered in order book, and entered on trading system in given proper priority)
- ☐ to create transparency with respect to the capacity in which the intermediaries operate.

The market should allow for cross-border trading.

Clearing and Settlement

The clearing and settlement facilities provided by the Exchange, its subsidiaries or others must provide for the efficient, safe and prompt settlement of transactions within the internationally accepted standards of the G-30 and ISSA, or be better.

The Exchange will:

- ☐ make adequate arrangements for safe and timely clearing, and correct and final settlement of the transactions concluded on the market ;
- ☐ see to it that cross-border clearing and settlement activities are facilitated ;
- ☐ be instrumental in the development of national central securities depositories, immobilisation, dematerialisation of securities, lending and borrowing contracts and arrangements;
- ☐ contribute to the standardisation and implementation of securities industry processes;
- ☐ assure that ownership of securities should be explicitly embedded in national law. A well-defined system of laws relating to property, contracts, securities, trusts, bankruptcy and taxation should exist.

Technical Infrastructure

The market IT systems should maintain adequate capacity to meet the needs of market users. Back-up systems and contingency procedures to be followed in the event of an operational failure are to be maintained on a current, ready basis. Before implementation and on a periodic basis thereafter, the market and system interfaces should be subject to an objective risk assessment to identify vulnerabilities, which may exist in the system design,

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development, or implementation. These would include the risk of unauthorised access, internal failures, human errors, attacks and natural catastrophes.

Risk Management

Regulators and the Exchange should consider any risk exposures pertinent to the system, including those arising from interaction with related financial systems, domestic or abroad. This would include the foreign exchange markets, derivative markets, the banking market and payment systems. To assure the financial integrity of the market and the ability of its participants to fulfill their obligations as users, the Exchange should have in place risk management tools, such as position limits, margin requirements, minimum capital requirements, mark-to-market systems, etc.

The Settlement of Disputes, dealing with Complaints of Investors, and Arbitration Facilities

The Exchange should put facilities in place which offer effective treatment of disputes and complaints from investors regarding the behaviour and business conduct of intermediaries. These should be as simple and expeditious as possible, within the limitations of national law.

Supervision, Surveillance & Enforcement

The Exchange must assure that mechanisms are in place to ensure that the information necessary to conduct adequate surveillance of the market for supervisory and enforcement purposes is available on a timely basis. The securities regulatory agency must be established with broad inspection and enforcement Commission, and adequate oversight over the players in the market. Its enforcement of applicable regulations must be transparent. In case of a division of regulatory responsibilities between the Exchange and the regulator, the responsibilities and powers of each party should be formalised and cover the entire area to be supervised.

Markets, which have a separate banking supervisor, should have a clear separation of responsibilities, in the event that banks may be actors on the securities markets. Regulatory co-ordination between the regulators should be fostered.

The Exchange should report to the regulator when it becomes aware that reasonable grounds exist to suspect that a market user may have violated the jurisdiction's laws, or its internal rules and regulations. Records made or received by the Exchange stemming from the operation of its trading system, relating to financial statements, and data regarding indications of market interest, quotations, orders, and trades in the system itself should all be preserved for a reasonable period of time, in most instances meaning many years. These should be furnished promptly upon request by the relevant regulator.

Investor Protection

Specific rules and regulations, like on disclosure and transparency, that serve to protect investors should be in place. These include guarantees such as compensation funds, insurance policies or their equivalent. If the Exchange or a related organisation holds or safeguards funds intended to guarantee the clearing of trades, or to compensate investors in the event of the insolvency of a member of the market, procedures and controls should be implemented to assure the availability of those funds. These funds are on stand-by as a lender of the last resort to the market.

A specific regime should be in place for staff of the Exchange and the clearinghouse/depository, to avoid conflicts of interest and insider trading. Comparable rules should be in place for all other users of the market. Insider trading and other forms of unfair markets should be prohibited, either by law or code of conduct, with adequate enforcement

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tools available. Brokers and banks must assure absolute segregation between clients' money and their own accounts, and respect the priority in which client orders are executed

Business Conduct

One of the most important parameters for regulated markets is the level of investor confidence achieved through both the national legal environment and the market regulatory infrastructure. An important element of investor confidence is the fair treatment of the customer. This section elaborates the IOSCO International Conduct of Business Principles (the IOSCO Principles) and puts them in the context of markets, their participants and customers. It aims at offering a benchmark of best practice against which members which have existing codes or formal regulations could test their practice and perhaps revise their codes. Obligations that may be imposed on listed companies, their employees, or investors are not covered here.

Honesty and Fairness

A stock market's pricing system being its key function, members of the financial community should honour the integrity of the price formation mechanism. Market participants should go further than avoiding misleading or deceptive acts or representations. They should refrain from any action that would hinder or disrupt the fair and orderly functioning of the market. They should not spread groundless or false information about listed issuers and refrain from any activities designed to mislead others about the true state of the market. Therefore, consideration should be given to outlawing specific manipulative practices, such as trades that involve no change of beneficial ownership or trades that give a false appearance of activity. Although manipulation of prices (including insider dealing) may be prohibited by statutory law as well as exchange rules, specific trading strategies may not be interdicted. In permitting new trading strategies, stock markets should take into consideration the integrity of their pricing mechanisms, provided, however, that such consideration should not be an excuse for anti-competitive decision-making.

Diligence

The diligence required in effecting securities transactions is best execution of customer orders. This involves executing agency orders promptly, and if a market order, at the best available price. Charges should be an agreed upon, or else be based on a customary, commission that is fully disclosed. Diligence also involves executing net trades or principal orders at a price closely related to the market price, especially where off-market trading is permitted and disclosing, as may be appropriate to the marketplace, the basis of the mark up or mark down to the customer. Whether the firm is acting in its capacity as principal or agent should also be disclosed to customers (and to the market when entered on the trading systems). Recommendations by market participants or their employees to customers as to the purchase or sale of securities should be based on adequate and reliable information about the issuer and the nature of the financial instrument. An underwriter should exercise due diligence with regard to an issuer's business affairs and financial condition when preparing an offering. Where an involuntary sale of a customer's securities must be made (due to an unanswered margin call or for other reasons), the market participant should conduct that sale with skill and due care to follow market pricing.

Capabilities

Consideration should be given to what qualifications Exchanges should impose for membership, and for the qualifications of employees. At the very least, individual market participants or their employees should be fit and proper persons without any record of dishonest or seriously fraudulent activities. Professional training should be expected and competence appropriate to a person's professional position should be demonstrated (e.g., for Traders).

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Exchanges should have financial responsibility rules for market participants. Market participants should adhere to such rules in a manner that does not jeopardise customer funds or securities held as custodian or the ability of a market participant to complete transactions with other market participants. Market participants should be required to monitor and calculate their financial position with sufficient frequency to remain in compliance with market rules on capital adequacy and solvency.

Information about Customers

This principle should embrace not only the requirement to obtain such information as may be necessary to recommend suitable investments to a customer, but Exchanges may wish to specify the type of the documentation to fulfill such a requirement. This is particularly important where the client has a fiduciary role, for example, a trust or estate or pension fund. Circumstances under which firms exercise discretionary trading powers should be defined, and it should be made explicit that such trading gives rise to other special fiduciary obligations.

Information for Customers

A confirmation of each transaction should be sent to customers, including note of such information as may be appropriate to confirm fair dealing. There should be disclosure of such facts as may impair a firm's independence in its dealings with customers. Market participants should keep and maintain a detailed record of each trade, in order to be able to respond to customers or the Exchange concerning best execution.

A market participant should disclose its financial condition to customers upon request.

Conflicts of Interest

The increased complexity and sophistication of the securities business, along with the deregulation of the industry, has led to more numerous conflict of interest situations. Conflicts need to be managed in such a way that customers are not at a disadvantage. The most common conflicts include those between a market participant's investment banking, trading, research, mergers and acquisitions advisory business, and lending activities. Where feasible, conflicts should be managed by obtaining the informed consent of customers to a transaction. In addition, the management of conflicts may be ameliorated by the creation of appropriate Chinese walls. Market participants should be especially sensitive to the conflicts that may exist between their trading activities and other commercial operations. Recommendations to customers must be based on the interests of customers and not be made to increase or reduce a market participant's trading position. Market participants and their employees cannot be permitted to effect trades for their own accounts ahead of customers' orders (this is front-running and illegal; Exchanges need to require indications of 'P' for a Principal trade and 'A' for an Agency trade; Members need to keep chronological Order Books, that are accurate, complete, and up to date).

Compliance

Market participants should ensure that their partners or officers and directors are sufficiently active in the affairs of the firm (i.e., supervision) to demonstrate their compliance with statutory and self-regulatory obligations. Firms should develop systems for the supervision of accounts of employees and compliance with applicable regulations. Rules of conduct for Exchange staff members as well as employees from market participants should be formulated. A system for reporting of employee securities transactions should be put in place by Exchanges and market participants. Such a system should include the need for prior consent by market participants for employees to maintain accounts of any other market participant.

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Market participants should keep accurate and detailed records and ensure that all reports to be made are honest. Market participants should conform to the just and equitable principles of conduct embodied in exchange rules and commonly practised in the marketplaces in which they conduct business.

Transparency

a. Statistics

The market should have a statistics function which allows it to gain insights into the trading activity, activity on the primary market, indices, etc. The methodology used in compiling the statistics should be clearly explained.

b. Market Information

The Exchange should have systems and procedures in place assuring that important information related to listed companies and of a price-sensitive nature be distributed as soon as possible to all market participants. Pre- and post-trade information should be available for market participants and supervisors. Selected market data should be available to the public, either through the traditional media or using modern communication tools.

c. Trading

The trading methodology should be transparent, in accordance with principles of fairness and equality and principles for the protection of investors. Principles like “time/price” priority, equitability and integrity must be adhered to. The trading activity should be checked constantly by audit trails, stock watch systems, etc. on a real-time basis if possible. Investors should have access to public data, in order to verify that their orders were executed at a fair price.

Foreign Investment

In the event that foreign investors are not allowed to trade domestic securities, and domestic investors are unable to trade foreign securities, a time plan should exist for the abolition of existing restrictions, including the authorities concerned. There should be no approval needed for foreign investment; no inward or outward foreign exchange remittance restrictions that cause delays; no special classes of shares for foreign investors; no or minimal restrictions on the foreign ownership of home market securities.

The entire financial market must observe banking and other financial rules and regulations that exist for the prevention of money laundering and similar misuse of the financial markets to the detriment of their integrity and honesty.

Compliance with the Federation Recommendations

Members and candidates for membership of World Federation of Exchanges are obligated to bring their business operations in line with these recommendations as rapidly as is feasible, and to assure that they remain in line or become even better.

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Collective Investment Schemes

Poor Practices to be Prevented by Compliance Procedures and Commission Inspectors

- Violation of investment restrictions;
- Window dressing and portfolio pumping (falsely stating valuations);
- Unfair allocation of securities, including initial public offerings;
- Cherry picking (picking best executions);
- Failure to obtain best execution;
- Failure to periodically and systematically review execution quality and to route and reroute orders accordingly;
- Use of an affiliated broker-dealer;
- Failure to clearly disclose to clients the use or amount of their fees;
- Market timing, insider trading, front-running or other abusive personal or proprietary trading;
- Untimely or failure to report personal or related party securities transactions;
- Violations of the codes of ethics;
- Failure to properly identify and monitor trading by all access persons.
- Inaccurate or misleading performance numbers;
- Inadequate supporting documentation for performance claims;
- Misleading advertisements;
- Improper or inadvertent access to client assets;
- Unauthorized trading in clients' accounts;
- Improper disclosure of client account information;
- Delivery of false custodial statements to clients; and
- Discrepancies between the records of the firm and custodian.
- Failure to maintain and have accessible all required books and records, including emails;
- Failure to protect records and information from unauthorized access and manipulation;
- Maintaining inaccurate books and records - e.g., revenue and expense numbers are not accurate or timely;
- Failure to produce business records required by inspection staff.
- Failure to disclose or inadequate disclosure of solicitation arrangements;
- Failure to disclose payments to employees for referrals;
- Illiquid or fair-valued assets not valued appropriately, or not back-tested;
- Inaccurate computation of fees, or fees based on inaccurate computation of client assets;
- Failure to safeguard the privacy of clients;
- Failure to notify clients of policies on safeguarding;
- Lack of verification that client data is compiled accurately;
- Integrity of client data is not protected from unauthorized changes;

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- Failure to protect records from unplanned destruction;
- Inaccurate Net Asset Value calculations or valuations;
- Failure to value a position correctly;
- Failure to record or delete a position subsequent the purchase or sale;
- Inaccurate number of shares outstanding;
- Failure to monitor and timely value illiquid positions;
- Failure to charge appropriate sales charges, including providing all discounts;
- Failure to ensure that sales of funds and fund share classes are suitable for the investor, that prospectuses are delivered, and that information provided to investors is accurate;
- Failure to execute orders and redemptions in a timely manner;
- Discrepancies between the number of shares on subsidiary and general ledgers;
- Improper or excessive payment of fees;
- Improper purchase or sale of securities;
- Loans to affiliated persons;
- Improper joint transactions; and
- Participation in an affiliated underwriting without compliance with requirements.
- Inappropriate and unauthorized disclosure of portfolio holdings, pending transactions or trading strategies to third parties;
- Access persons' trading on non-public information;
- Failure to perform all responsibilities required by the Act and applicable rules;
- Lack of independence of directors;
- Board's financial or Audit expert is not actually an expert;
- Content of board minutes are vague or inadequate to record that fiduciary duty was met;
- Inadequate attendance at meeting; and
- Failure to review and monitor proxy voting policies and procedures.
- Good corporate governance policies and procedures would dictate that a fund compile and preserve an accurate and complete record of board meetings. With respect to board minutes and records, "the less said" is not the better course. In the absence of minutes and records that document board members' performance of their statutory and fiduciary responsibilities, our inspectors will have to assume that little or no discussion was held;
- Inconsistencies between disclosure and actual practice; and
- Failure to ensure that investment policies are policed and applied;

Best Practices from IOSCO Public Document Number 156:

Off-Site monitoring by the regulator (i.e., Commission) of marketing by the mutual fund (Collective Investment Scheme) operator:

(i) Does the regulator as a matter of routine sample check adverts in the national and trade press or sample check prospectuses/promotional literature? (It is possible in some jurisdictions that other

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regulatory bodies are responsible for the review of advertising material). Does this review also cover any advertising by the intermediary of the mutual fund?

(ii) Is the advertising by the mutual fund operator or intermediary show any trends?

Exaggerated claims of past performance? Poor risk warnings?

(iii) How clear is the advertising? Does it promote product understanding, highlight important information and consider the customer needs?

(iv) Are certain mutual fund operators and/or intermediaries appearing more than others?

And are certain mutual fund operators and/or intermediaries known for "cutting corners" with their literature (such operators might be known by the regulator to have a poor understanding of the rules)?

These questions are designed so as to increase the monitoring of those operators/intermediaries by the regulator.

(v) Are incorrect product comparisons being made? This would suggest a mutual fund operator/intermediary is trying to exaggerate the product's performance?

(vi) Are specialised mutual fund being offered that seem unusual in the current climate?

Again this must raise a question in the regulator's mind as to why the mutual fund operator/intermediary is confident of the product's success even though the market conditions suggest otherwise.

(vii) Does the advertised mutual fund product make "sense" when the mutual fund operator is identified? For instance a mutual fund operator with no experience in a particular market would not normally be expected to launch new funds in those markets.

(viii) Are all forms of advertisement covered e.g. radio, internet? It is important that the regulator covers all forms of product promotion.

(ix) Can internet offerings be purchased without the customer viewing the risk warnings?

(x) Does the regulator monitor customer complaints? Does the mutual fund operator have to inform the regulator of the complaints it receives and has resolved or those that remain unresolved? If complaints arise from the action of intermediaries does this highlight poor training of staff?

(xi) Do the mutual fund returns appear unnaturally successful? This could highlight those mutual fund operators that are not following the market trend and the regulator should establish why this is.

(xii) Is there a high turnover of sales staff?

(xiii) Are there unusual inducements offered to the intermediaries by the operator, e.g. transfer payments from the management fees biased by the mediated unit volume on a currently repeated basis (in other words rewards for intermediaries heavily biased towards volume of sales)?

Advertising/ Promotional literature/Prospectus review

(i) Does the firm have an advertising policy? How is this policed and reviewed?

(ii) Are there approved procedures? [Ensure approval by an authorised person or entity].

(iii) How is compliance with legal/regulatory obligations checked?

- Do the advertising staff understand mutual fund products and thus appreciate how to describe the risks?
- Similarly does the mutual fund operator seek legal advice regarding the drafting of its literature?

(v) Are complaints recorded, followed up and satisfactorily dealt with? Are trends identified?

(vi) Is the level of complaints unusual for the industry?

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- (vii) Is the language used clear and unambiguous?
- (viii) How is the material made available to investors?
- (ix) How are cancellations dealt with?
- (x) Are unusual incentive payments offered by the operator?

Sales Force review

- (i) What are the procedures for recruitment? Are proper references taken up? How is competency assessed at the interview?
- (ii) What are the training procedures adopted by the operator?
- (iii) How are the training needs assessed?
- (iv) What are the on-going evaluation procedures?
- (v) Is there a regular assessment of competence? Inspections? Both conducted by the mutual fund operator? Does the mutual fund operator have appropriate measures in place to ensure that the sales force are adequately supervised, monitored and trained and have satisfactory organisational expertise?
- (vi) Does training conducted or supervised by the mutual fund operator cover technical skills as well as legal and regulatory obligations?
- (vii) Does the mutual fund operator have an active, organised and focused compliance/internal audit regime covering the sales force activities including that done by intermediaries/and their on-going competency)?
- (viii) Are complaints against the sales force monitored and followed up by the mutual fund operator?
- (ix) Are there unusual inducements offered to the sellers by the operator, e.g. transfer payments from the management fees biased by the mediated unit volume on a currently repeated basis (in other words rewards for salesmen heavily biased towards volume of sales)?

Risk Indicators suggesting false/misleading financial promotion

- (a) mutual fund operator has inadequate advertisement vetting procedures. The mutual fund operator fails to have adequate systems and controls so as to prevent inappropriate financial promotion taking place.
- (b) mutual fund operator has a record of misleading adverts or is very creative in approach to promotion.

The regulator will have a view and maybe a detailed past history identifying the mutual fund operator as one which often breaches the advertising rules or is overly aggressive in its financial promotions. This could include aggressive cold calling and the offering of incentives such as gifts. Examples of evidence of a possible non-compliant or unduly risky mutual fund operator could be:

- Product literature/advertising fails to meet legal/regulatory requirements
 - Product literature is out of date, inaccurate, incomplete or inappropriate
 - Disclosures and risk warnings are obscure or in very small print
 - Financial promotion on the internet allows customers to bypass warnings
 - Product description is poor and unclear (possibly masks fraudulent activity)
 - Past performance figures are exaggerated
 - Future return promises are unrealistic
-

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- Misleading product comparisons are made
- Investment advice is poor, unclear or possibly fraudulent
- Pressure selling techniques such as unsolicited telephone calls
- Offering of incentives to buy that are not actually delivered
- "Bait" advertising (advertising claims such as price that are unlikely to be delivered)

(c) Adverts target "vulnerable" groups

The mutual fund operators deliberately target those investors who are likely to be poorly educated or advised and hence are more likely to buy unsuitable products.

(d) High level of customer complaints

A high level of complaints could signify misleading adverts leading to investor loss.

(e) mutual fund operator has a weak system for tracking investor subscription

The potential here is that through poor systems and controls and/or incompetence, investor loss occurs at the subscription stage.

(f) mutual fund operator is using mutual fund assets for marketing the mutual fund (here the operator might have been extracting a charge from the mutual fund to promote his activities, such charge being over and above that standard charge levied by the operator), or if a jurisdiction permits mutual fund assets to be used for the financing of the distribution of its shares then this has been carried out without appropriate corporate oversight and/ or has been carried out without adequate disclosure. Misuse of mutual fund assets could lead to compensation payable by the mutual fund operator.

(g) mutual fund operator has a large advertising budget and is aggressive

A mutual fund operator with a large advertising budget and an aggressive approach to financial promotion could lead to exaggerated promotional claims and hence misleading adverts.

mutual fund operators as a minimum should have the following in place:

(a) A sound set of procedures and controls concerning their advertising. Such work should be carried out by competent staff and be reviewed by an independent and capable review team. Procedures should encompass all legal and regulatory requirements as well as ensure any promotional literature is fair, clear and not misleading.

(b) Similarly there needs to be procedures in place to ensure that any prospectus or promotional material is legal. This might require the assistance of external experts e.g. lawyers.

(c) A sound and clear set of procedures and controls regarding the recruitment and on-going training of sales forces.

(d) Systems and controls regarding the recording and handling of complaints.

Trends should be identified and a clear and appropriate remedial programme should be instituted.

(e) An independent review function should be operating that is aware of current legal and regulatory developments.

**Annexure F: Financial Resource Requirements (To be drafted by
BSEC when new Capital Adequacy requirements are approved)**

Financial Resource Requirements

(To be drafted by BSEC when new Capital Adequacy requirements are approved)

Appendix 1.6: Oversight Review Manual: Dhaka and Chittagong Stock Exchanges; and Central Depository of Bangladesh Limited (November 2014)



বাংলাদেশ সিকিউরিটিজ অ্যান্ড এক্সচেঞ্জ কমিশন
Bangladesh Securities and Exchange Commission

ADB TA-8228 BAN: Enhancing Efficiency of the Capital Market

OVERSIGHT REVIEW MANUAL

DHAKA AND CHITTAGONG STOCK EXCHANGES; AND CENTRAL DEPOSITORY OF BANGLADESH LIMITED

November 2014



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Oversight Review Manual

Dhaka and Chittagong Stock Exchanges; and Central Depository of Bangladesh Limited

1. Introduction

- 1.1. The Bangladesh Securities and Exchange Commission (BSEC) proposes to implement an oversight inspection and this document provides guidelines to the undertaking of such a program.
- 1.2. The BSEC has established a Security Regulation Market Infrastructure Department (SRMIC). This unit will be required to undertake the majority of work envisioned by these guidelines. However, the inspection teams may be supported from time to time by appropriate staff from the other BSEC departments.
- 1.3. The organisations that are to be reviewed by the BSEC are the Dhaka and Chittagong Stock Exchanges (DSE & CSE); and the Central Depository of Bangladesh (CDBL).
- 1.4. The manual covers the following matters:
 - International developments including the Bank of International Settlements Principles for financial market infrastructures of April 2012 and the IOSCO revised methodology and Principles of 2011;
 - The existing securities legislative framework providing authority for the BSEC's inspection program;
 - Recording and Safeguarding of information;
 - Implementing an inspection program on a "Risk Based Supervision" (RBS) Approach;
 - Management, Organisation of Inspection teams and maintenance of oversight working papers;
 - The Oversight Inspection (Audit) Program;
 - Selection of the Areas to review on each inspection cycle;

- Pre-Inspection preparation and desk- based supervision;
 - Allocation of resources and time to different functional areas;
 - Technology systems, security and planning including disaster recovery;
 - Trading systems and market information dissemination review;
 - Issuance and Disclosure Management;
 - Market Surveillance Activities;
 - Membership, Member Surveillance, and Capital Adequacy
 - Miscellaneous areas of review: (Record Retention, Complaints Handling);
 - IT Systems, Settlement Process and Settlement methodology;
 - Risk Management and [Support Guarantee Fund];
 - Physical and System Security Aspects of the CDS;
 - Issuance of inspection findings and follow-up for completion and rectification;
 - Transparency of reports and action programs; and
 - Enforcement relating to key recommendations.
- 1.5. The manual should be periodically reviewed and updated by the SRMIC to reflect changes in oversight objectives, policies, methodology and standards as well as changes in the BSEC's operations and oversight responsibilities. The SRMIC director and the Chairman of BSEC should approve any updates.
- 1.6. The Director of the SRMIC will be the controller of the manual. The controller will develop procedures for maintenance, using, updating and distributing this manual.
- 1.7. Contents of the manual are confidential and must not be disclosed to any unauthorised persons inside or outside BSEC. The BSEC may appoint external persons to assist the BSEC in the exercise of their oversight functions and permit such persons access to this manual however the manual remains the property of the BSEC and confidential.

2. Revised Methodology For Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation¹

- 2.1. The IOSCO principle of particular relevance to this oversight manual are as follows:

Part A: Principles for Self-Regulation

Principle 9:

“Where the regulatory system makes use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, such SROs should be subject to the oversight of the Regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities”.

Part I: Principles for Secondary Markets

Principle 33:

“The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight”

Principle 34:

“There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants”

Principle 35:

“Regulation should promote transparency of trading”

Principle 36

“Regulation should be designed to detect and deter manipulation and other unfair trading practices”

Principle 37

“Regulation should aim to ensure the proper management of large exposures, default risk and market disruption”

Part J: Principles relating to clearing and settlement

Principle 38

“Securities settlement systems and central counterparties should be subject to regulatory and supervisory requirements that are designed to ensure that they are fair, effective and efficient and that they reduce systemic risk”

¹

2011

2.2. In summary the main functions covered by the DSE & CSE are as follows:

Member (Broker-Dealer) Regulation

- Membership or registration of members or participants
- Compliance, supervisory and internal control policies and procedures
- Capital adequacy regulations (net capital and margin requirements)
- Financial examinations
- Books, records, and accounts requirements
- Business conduct and sales compliance rules
- Duties to clients
- Compliance examinations
- Customer complaint handling and dispute resolution

Market Regulation

- Qualifications for access to trading by firms and traders
- Market conduct rules (market integrity and ethical standards)
- Trading rules (operational and trading system “business rules”)
- Market quality rules (for example, market-maker obligations)
- Market surveillance
- Market investigations

Listings Standards and Rules

- New and continuing listing standards rules²
- Corporate disclosure rules
- Corporate governance rules
- Shareholder protection rules (for transactions that affect public or minority Shareholders)
- Reporting requirements

Enforcement

- Formal investigations
- Emergency powers
- Disciplinary procedures

2.3. The DSE & CSE also operates the Clearing and Settlement (C&S) as an integral departments within the DSE & CSE and whose functions are mainly concerned with systemically important risk management functions such as:

- Settlement Process:
 - Settlement Bank methodology;
 - Risk Management; and

² The BSEC has the legal responsibility for the approval of prospectuses in IPO's but the DSE & CSE has the legal responsibility under the Securities Law to make listing “conditions” or rules.

- Support Guarantee Fund.

2.4. A recent World Bank Working Paper on SRO models and oversight for securities regulation³ provides some useful benchmarks. It notes that an SRO should be required to meet this IOSCO list of standards or conditions and must do the following:

- Have the capacity to carry out the purposes of governing laws, regulations, and SRO rules;
- Be able to enforce compliance by its members and associated people with those laws, regulations, and rules;
- Treat all members of the SRO and applicants for membership in a fair and consistent manner;
- Develop rules that are designed to set standards of behaviour for its members and to promote investor protection;
- Submit its rules to the regulator for review and/or approval, as the regulator deems appropriate, and ensure that the rules of the SRO are consistent with the public policy directives established by the regulator;
- Cooperate with the regulator and other SROs (where applicable) to investigate and enforce applicable laws and regulations;
- Enforce its own rules, and impose appropriate sanctions for noncompliance;
- Ensure a fair representation of members in selection of its directors and administration of its affairs;
- Avoid rules that may create uncompetitive situations; and
- Avoid using its regulatory role to allow any market participant unfairly to gain advantage in the market.

2.5. The regulator for its part in meeting the objectives of IOSCO principles would:

- Ensure that the SRO has appropriate corporate governance policies and procedures and that it observes them;

³ Self-Regulation in Securities Markets - Working Paper for World Bank Financial Sector Policy Group, August 2010

- Ensure that the SRO's rules cover its regulation responsibilities and are fair and balanced;
- Assess whether the SRO's regulation, responsibilities and risk management responsibilities have been met, including that its systems and processes meet appropriate standards;
- The regulator should ensure that the SRO has effective compliance, supervision and enforcement programs;
- Ensure that identified conflicts of interest have been addressed; and
- Identify any shortcomings or needs that require a response from the SRO.

2.6. In addition, the supervising regulator should ensure that an SRO continues to meet all the conditions of its license and other obligations imposed on the SRO by other laws⁴ or regulation.

2.7. The World Bank paper noted that an **oversight** program would likely have elements as follows:

| <u>Oversight process</u> | <u>Purpose</u> |
|---|---|
| 1. Corporate governance standards and review | <ul style="list-style-type: none"> • Ensure that an SRO meets high standards of corporate governance. • Ensure that an SRO is responsive to all stakeholders and its public interest mandate. |
| 2. Rule review and approval | <ul style="list-style-type: none"> • Ensure compliance and consistency with the law and conditions of license. • Ensure that SRO rules are consistent with its regulatory mandate and objectives and with securities regulations. • Ensure that SRO rules are fair and balanced, having regard to the interests of all stakeholders. • Ensure SRO rules are consistent with the public interest |

⁴ The PSE is a limited company and as such subject to the requirements of company law

| | |
|---|--|
| 3. Monitoring of SRO reports | <ul style="list-style-type: none"> • Maintain awareness of status of SRO programs, activities, and financial condition, as well as current regulatory matters. • Provide ongoing supervision and advice. • Help in coordination of activities with an SRO. |
| 4. SRO self-assessment of its performance and operations | <ul style="list-style-type: none"> • Ensure sound management and governance of the SRO. • Provide input to regulator in developing its targeted examination of an SRO. • Establish how the SRO measures and rates its own performance. • Identify areas of risk and areas for improvement. |
| 5. Examination of an SRO | <ul style="list-style-type: none"> • Provide an independent assessment of the SRO's performance. • Review how well the SRO is meeting its responsibilities. • Review adequacy of the SRO's regulatory programs and resources. • Ensure that conflicts of interest are managed appropriately. • Identify significant risk areas. • Identify findings that require changes or other responses from an SRO. |
| 6. Regular communication | <ul style="list-style-type: none"> • Maintain awareness of the SRO's and regulator's activities, rule proposals, and initiatives. • Ensure consistency in policy and regulatory approach. • Coordinate initiatives and activities. |

2.8. The BSEC has the direct authority and legal responsibility to oversee the management, organisational arrangements, company and supervisory board activities as well as corporate governance and conflicts of interest to ensure that the DSE & CSE is adhering to IOSCO's principles of regulation.

2.9. CDBL and the exchange settlement systems have unique risks associated with their function and design. While the nature and scope of activities performed by CSD and C&S departments vary based on jurisdiction and market practices, CSDs play a critical role in the protection of securities and

help ensure the integrity of securities transactions. Similarly, settlement systems play a critical role in mitigating principle risk by linking the final settlement of one obligation to the final settlement of another.

- 2.10. The Bank for International Settlements (BIS) has provided for central securities depositories and exchange-of-value settlement systems in their Principles for financial market infrastructures⁵.

Principle 11: Central securities depositories and settlement systems

“A CDS should have appropriate rules and procedures to help ensure the integrity of securities issues and minimise and manage the risks associated with the safekeeping and transfer of securities. A CDS should maintain securities in an immobilised or dematerialised form for their transfer by book entry”.

Principle 12: Exchange-of-value settlement systems

“If a Financial Market Infrastructure settles transactions that involve the settlement of two linked obligations (for example, securities or foreign exchange transactions), it should eliminate principal risk by conditioning the final settlement of one obligation upon the final settlement of the other.”

- 2.11. The key considerations when conducting an oversight review of a CSD are as follows:

- A CSD should have appropriate rules, procedures, and controls, including robust accounting practices, to safeguard the rights of securities issuers and holders, prevent the unauthorised creation or deletion of securities, and conduct periodic and at least daily reconciliation of securities issues it maintains;
- A CSD should prohibit overdrafts and debit balances in securities accounts;
- A CSD should maintain securities in an immobilised or dematerialised form for their transfer by book entry. Where appropriate, a CSD should provide incentives to immobilise or dematerialise securities;
- A CSD should protect assets against custody risk through appropriate rules and procedures consistent with its legal framework;
- A CSD should employ a robust system that ensures segregation between the CSD's own assets and the securities of its participants and segregation among the securities of participants. Where supported by

⁵ 2012

the legal framework, the CSD should also support operationally the segregation of securities belonging to a participant's customers on the participant's books and facilitate the transfer of customer holdings; and

- A CSD should identify, measure, monitor, and manage its risks from other activities that it may perform; additional tools may be necessary in order to address these risks.

2.12. The key consideration when conducting an oversight review of a settlement system is that the settlement system should eliminate principal risk by ensuring that the final settlement of one obligation occurs if and only if the final settlement of the linked obligation also occurs, regardless of whether the settlement is on a gross or net basis and when finality occurs.

3. Legislative authority for the BSEC's inspection program

3.1. The applicable legal framework regulations relating to this oversight manual relevant to the BSEC the time of writing are as follows:

- Securities and Exchange Ordinance 1969
- Securities and Exchange Rules 1987
- Securities and Exchange Commission Act 1993 (BSEC Act)
- SEC Prohibition of Insider Trading Rule 1995
- Margin Rules 1999
- Settlement of Stock Exchange Transaction Regulations 2013 (DSE & CSE)
- Settlement Guarantee Fund Regulations 2013 (DSE & CSE)
- Investor Protection Fund Regulations 1999
- TREC Holders Margin Regulations 2013 (DSE & CSE)
- Stock Broker and Stock Dealer Rules, 2014 (To be adopted)
- Any rules and regulations, and instruction or directions made under any of the above Laws.

4. Recording and Safeguarding Information

- 4.1. Each of the DSE, CSE, and CDBL should be allocated an oversight file on which all information and correspondence relating to the oversight function should be placed.
- 4.2. The applicable file should be marked Confidential and kept in a secure cupboard in SRMIC. Any sub records or filings within other BSEC departments relating to the oversight inspection program should also be filed in this master file. The cupboard should be locked and fireproof. Where information is secured electronically, it should be backed up on a daily basis and the back-up information should be stored off site. The off-site storage should be secure from theft or fire and flood damage. Where this storage is with an external service provider, the BSEC should have service agreements covering the security of the site and the information which should be checked no less frequently than annually.
- 4.3. No information concerning the respective entities should be disclosed except:
 - 4.3.1. to another officer of the BSEC staff or to a member of the BSEC Board, where that officer or member has a need to know the information in order to allow the BSEC to properly to carry out its functions; and
 - 4.3.2. where the BSEC Board authorises further disclosure for example to the BB as part of its oversight duties.
- 4.4. Where information is passed to another officer of the BSEC or a member of the BSEC Board, that officer or member should not disclose it to any other person except in the circumstances set out in paragraph 4.3 and, where the person is a member of the BSEC staff or Board, that person understands that the restriction in 4.3 also applies to them.
- 4.5. The following ethical standards should be observed by staff undertaking oversight inspections:

Integrity

Principle:

- The integrity of oversight staff establishes trust and thus provides the basis for reliance on their judgement.

Rules: Oversight staff shall

- Perform their work honestly, diligently, and responsibly;
- Observe the law and make disclosure expected by the law and the profession;

- Not knowingly be a party to any illegal activity, or engage in acts that are discreditable to BSEC; and
- Respect and contribute to the legitimate and ethical objectives of BSEC.

Objectivity

Principle:

- Oversight staff should exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined.
- Oversight staff should make a balanced assessment of all the relevant circumstances and are not unduly influenced by their own interests or by others in forming judgments.

Rules: Oversight staff shall

- Not participate in any activity or relationship that may impair or be presumed to impair their unbiased assessment. The participation includes those activities or relationships that may be in conflict with the interest of BSEC;
- Not accept anything that may impair their professional judgment; and
- Shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review.

Confidentiality

Principle:

- Oversight staff must respect the value and ownership of information they receive and do not disclose information without appropriate authority unless there is a legal, professional or, contractual or judicial obligation to do so.

Rules: Oversight staff shall

- Be prudent in the use and protection of information acquired in the course of their duties; and
- Not use information for any personal gain or in any manner that would be contrary to the law or service expectations of

BSEC or detrimental to the legitimate and ethical objectives of BSEC.

Competency

Principle

- Oversight staff should apply the knowledge, skills, and experience needed in the performances of oversight inspections.

Rules: Oversight staff shall

- Engage only in those activities for which they have the necessary knowledge, skills, and experience;
- Perform oversight inspections in accordance with the equivalent standards applicable for such duties⁶; and
- Continually improve their proficiency, effectiveness, and quality of their oversight skills.

⁶ For example accounting standards

5. Implementing an inspection program on a “Risk Based Supervision” (RBS) Approach

- 5.1. The SRMIC together with other applicable departments should as part of its annual planning agree with the BSEC Board the thematic approaches for oversight inspection for each year. It is intended that the BSEC Board should ensure that the inspections proposed in any year are based on a systematic selection process but necessarily ensure concentration of effort to activities and functions that are perceived to carry the highest risk to overall market integrity and the protection of investors.
- 5.2. The SRMIC has to make an assessment of what activities of any of the entities it oversees, either based on previous inspection activity or arising from its own surveillance activity or investor complaints pose the most important threats to investor protection and overall market integrity.
- 5.3. It is likely that not all aspects of the functioning of the entities to be supervised could be efficiently or effectively monitored in sufficient and appropriate detail each and every year.
- 5.4. In due course the BSEC’s proposed move to create new Risk Based Capital Adequacy (RBCA) rules for market intermediaries will demonstrate the BSEC’s commitment to a RBS approach.
- 5.5. As part of an RBS approach, SRMIC needs to carefully determine an appropriate cycle of reviews to ensure that the DSE & CSE, and CDBL are in compliance with the appropriate regulations and that they or their supervised members are not posing either systemic, market or reputational risk to the Bangladeshi capital markets.
- 5.6. As a foundation to such a RBS approach the BSEC needs to have in place sufficient market based data to form an intelligent view of where the risks might lie. Thus it is essential that the BSEC build and maintain strategic informational databases of listed company activity, market activity and the capital adequacy of intermediaries as well as appropriate data of individual share and aggregate market volatility and liquidity to ensure informed choice is made of the risk areas to be addressed in each year’s inspection cycle.
- 5.7. The same required market data will also assist in the regular market surveillance work undertaken by the SRMIC to monitor possible market abuse or insider trading activity.
- 5.8. Each inspection should concentrate on two to three activities of high importance and possibly two or three activities of perceived low risk.

6. Management, Organization of Inspection teams and maintenance of oversight working papers and peer review

- 6.1. The choice of inspection theme, the areas of activity to be reviewed and the nature of the work to be undertaken will determine the combination of BSEC departmental staff required who should between them have the requisite skills.
- 6.2. The lead team member should be of sufficient status and gravitas to have the respect and authority to both represent the BSEC and command respect of the audit team and the entity being inspected. Thus the leader should have an excellent understanding of both the regulatory requirements and the practical aspects of capital markets operations.
- 6.3. There may be one or up-to three teams under the direction of the leader and these sub teams may have cross membership depending on the multidisciplinary skills of each staff member. Teams may also be wholly BSEC desk based or field based or a combination. The aim should be to ensure that a team is not entirely reliant on just one or two persons but that it can survive and disruptions that may be caused by reassignment or illness of individual staff.
- 6.4. Sufficient time should be allocated to the debriefing of the overall and thematic sub teams to ensure there is a good understanding of both the aim and proposed execution of the “audit program”. This needs to be broken down between those activities undertaken as a pre-visit desk audit preparation and those which will be undertaken in the field.
- 6.5. One team member and an assistant should be appointed to maintain the overall oversight working paper files which should be arranged and cross referenced to the audit program developed covering the overall program of inspection.
- 6.6. Oversight work papers should adequately document Oversight work performed by the auditor. Management of the SRMIC should review these work papers to ensure the objectives of the Oversight work are achieved. Oversight work papers should accurately record the information obtained and the analyses performed, and should support the bases for any findings and recommendations to be reported to management.
- 6.7. Oversight work papers generally serve to:
 - Provide the principal support for the SRMIC department report;
 - Aid in the planning and performance of the oversight work;

- Document whether the oversight objectives were achieved;
- Facilitate third party reviews (e.g. by external auditors and BSEC investigators);
- Provide a basis for evaluating the SRMIC's quality assurance program;
- Provide support, in circumstances such as, market abuse and insider trading cases, and lawsuits; and
- Aid in the professional development of the oversight staff

6.8. The organization, design, and content of the oversight work papers will depend on the nature of the oversight audit. Oversight work papers should document the following aspects of the audit process:

- The planning process, which includes, but is not limited to: discussions with management, an overall review of the activities under review, an analyses of the operational control environment, performance of a risk assessment, identification of the system of internal controls, and the development of an oversight work program;
- The examination and evaluation of the adequacy, efficiency and effectiveness of the system of controls;
- The detailed overview procedures performed, the information obtained, the analyses made and the conclusions reached;
- The review by SRMIC management; and
- Any follow-up that the management of the SRMIC deems necessary.

6.9. Oversight work papers should be complete and include support for oversight review conclusions reached. Oversight work papers may include, but are not limited to:

- Notes and memorandums resulting from interviews;
- Organizational data, such as organizational charts and job descriptions;

- Copies of important contracts and agreements particularly related to IT;
 - Information about operating policies;
 - Planning documents and oversight work programs;
 - Risk control questionnaires (RCQs), flowcharts, checklists, and narratives;
 - Results of operational control evaluations and assessments;
 - Letters of confirmations and representation;
 - Results of analytical overview procedures;
 - The Oversight report and management's responses; and
 - Correspondence if it documents oversight review conclusions reached.
- 6.10. Oversight work papers may be in the form of paper, tape, disks, diskettes, film, or other media. If oversight work papers are in the form of media other than paper, backup copies should be maintained.
- 6.11. If reviewer(s) are reporting on financial information, the oversight work papers should document whether the accounting records agree or reconcile with such financial information.
- 6.12. Oversight work papers should be categorized as either **permanent** or **current** working papers.
- Permanent Oversight work papers refer to any documentation, which would be useful to an auditor in a future examination or review; or
 - Current Oversight work papers refer to documentation for the latest or most current audit file and should only pertain to the Oversight work being performed at a particular point in time.
- 6.13. Each Oversight work paper should include a listing of the following items:
- Each oversight work paper should contain a heading:
 - The heading usually consists of the:
 - name of the organization and the activity being reviewed;

- a title or description of the contents or purpose of the work paper; and
 - date or period covered by the review.
- 6.14. Each individual oversight work paper should reference the reviewer(s) who created or obtained the documentation by his/her initial. In addition, the Oversight work paper should document the date the work paper was prepared.
- 6.15. Each oversight work paper should contain an index or reference number relating and cross referencing the work performed back to the Oversight work program. Oversight verification symbols (tick marks) should be adequately explained and sources of data should be clearly identified.
- 6.16. The SRMIC management should review all oversight work papers to ensure that they properly support the oversight findings and recommendations; and that all-necessary oversight procedures have been performed.
- 6.17. Management of the SRMIC provides evidence that the oversight work papers have been reviewed by initialling and dating the individual oversight work papers. The director of SRMIC has overall responsibility for review but may designate appropriately experienced members of the SRMIC to perform this review.
- 6.18. Evidence of supervisory review should consist of the reviewer(s) initialling and dating each work paper after his/her review.
- 6.19. Other review techniques that provide evidence of supervisory review include completing an Oversight Work Paper Review Sheet and/or preparing a memorandum specifying the nature, extent, and results of the review. Reviewers may make written record (review notes or documentation by the use of an Oversight Work Paper Review Checklist) of questions arising from the review process. When clearing review notes, the management of the SRMIC should be careful to ensure that the work papers provide adequate evidence that questions raised during the review have been resolved. Acceptable alternatives with respect to disposition of review notes is as follows:
- Retain the review notes as a record of the questions raised by the reviewer and take appropriate steps toward their resolution; and
 - Discard the review notes after the work papers have been amended to provide additional information requested.
- 6.20. Oversight work papers are the property of the BSEC and should generally remain under the control of the SRMIC. Oversight work papers should be

accessible only to authorized personnel (e.g. external auditors, BSEC inspectors, by order of a Court).

- 6.21. Management and other members of the organization may request access to the oversight work papers. Such access may be necessary to substantiate or explain review findings or to use oversight documentation for other regulatory purposes. These requests for access should be subject to the approval of the director of SRMIC.
- 6.22. Access to oversight work papers by inspector(s) should be subject to the approval of the director of SRMIC.
- 6.23. The director of SRMIC should develop an adequate file retention schedule for all the SRMIC's work. This retention schedule should be consistent with the organization's guidelines and any pertinent legal or other requirement. At a minimum, the SRMIC should maintain its files within the SRMIC for a period of 3 years (Current year and the previous 2 years). After that, files should be sent to an off-site storage facility for a period of 4 years. Files and documents older than 7 years then can be destroyed⁷.
- 6.24. A quality assurance program should be developed within SRMIC to include the following elements:
- Supervision;
 - Internal reviews; and
 - External reviews
- 6.25. Supervision:
- 6.25.1. Supervision of the work of oversight auditors should be carried out to assure conformity with oversight inspection standards, departmental policies, and audit programs. Adequate supervision is the most fundamental element of a quality assurance program. As such, it provides a foundation upon which internal and external reviews can subsequently be built. Supervision is a process that begins with planning and continues throughout the examination, evaluation, report, and follow-up phases of the oversight assignment.
- 6.26. The SRMIC senior director is responsible for ensuring that appropriate oversight supervision is provided. Guidelines for effective supervision are as follows:
- Ensuring that the staff assigned possesses the requisite knowledge and skills;

⁷

These time periods can be adjusted to coincide with BSEC current requirements

- Providing appropriate instructions during the planning of the audit and approving the audit program;
- Seeing that the approved audit program is carried out unless changes are both justified and authorized;
- Determining that oversight working papers adequately support the audit findings, conclusions, and reports;
- Ensuring that audit reports are accurate, objective, clear, concise, constructive, and timely;
- Ensuring that audit objectives are met;
- Providing opportunities for developing staff knowledge and skills; and
- Appropriate evidence of supervision should be documented and retained.

6.27. The extent of supervision required will depend on the proficiency and experience of oversight staff and the complexity of the audit assignment. Appropriately, experienced oversight staff may be utilized to review the work of other departmental members.

6.28. All oversight assignments, whether performed by or for the SRMIC, remain the responsibility of its director. The director is responsible for all-significant professional judgments made in the planning, examination, evaluation, report, and follow-up phases of the audit assignment. The director should adopt suitable means to ensure that this responsibility is met. Suitable means include policies and procedures designed to:

- Minimize the risk that professional judgments may be made by SRMIC staff or reviewers, or others performing work for the SRMIC, that are inconsistent with the professional judgment of the director such that a significant adverse effect on the oversight assignment could result; and
- Resolve differences in professional judgment between the director and oversight staff members over significant issues relating to the assignment. Such means may include:
 - discussion of pertinent facts;
 - further inquiry and/or research; and
 - documentation and disposition of the differing viewpoints in the oversight working papers

6.29. Supervision extends to staff training and development, staff performance evaluation, and similar administrative areas.

6.30. Internal Reviews

Internal reviews should be performed periodically to appraise the quality of the oversight work performed. These reviews should be performed in the same manner as any other oversight work.

- Formal internal reviews are periodic self-assessments of the SRMIC. These reviews generally are performed by the director SRMIC; and
- Feedback from those the subject of oversight (in addition to that from personal contact) through the use of questionnaires or surveys, either routinely after selected oversight reviews. This process will enable BSEC to evaluate the work undertaken and may result in suggestions to make it more effective and responsive to management needs.

6.31. External reviews

6.31.1. External reviews of the SRMIC should be performed to appraise the quality of the department's operations. These reviews should be performed by qualified persons who are independent of SRMIC and who do not have either a real or apparent conflict of interest. Such reviews should be conducted at least once every three years. On completion of the review a formal, written report should be issued. The report should express an opinion as to the department's compliance with the standards outlined herein and the objectives detailed in this manual and, as appropriate, should include recommendations for improvement.

6.31.2. External reviews can have considerable value to the director SRMIC and other members of the department. Another important purpose of external reviews is to provide independent assurance of quality to senior management, the board of BSEC.

6.31.3. The director of SRMIC should discuss with senior BSEC management the nature of an external review in the context of the overall quality assurance program and should involve them in the selection of an external reviewer.

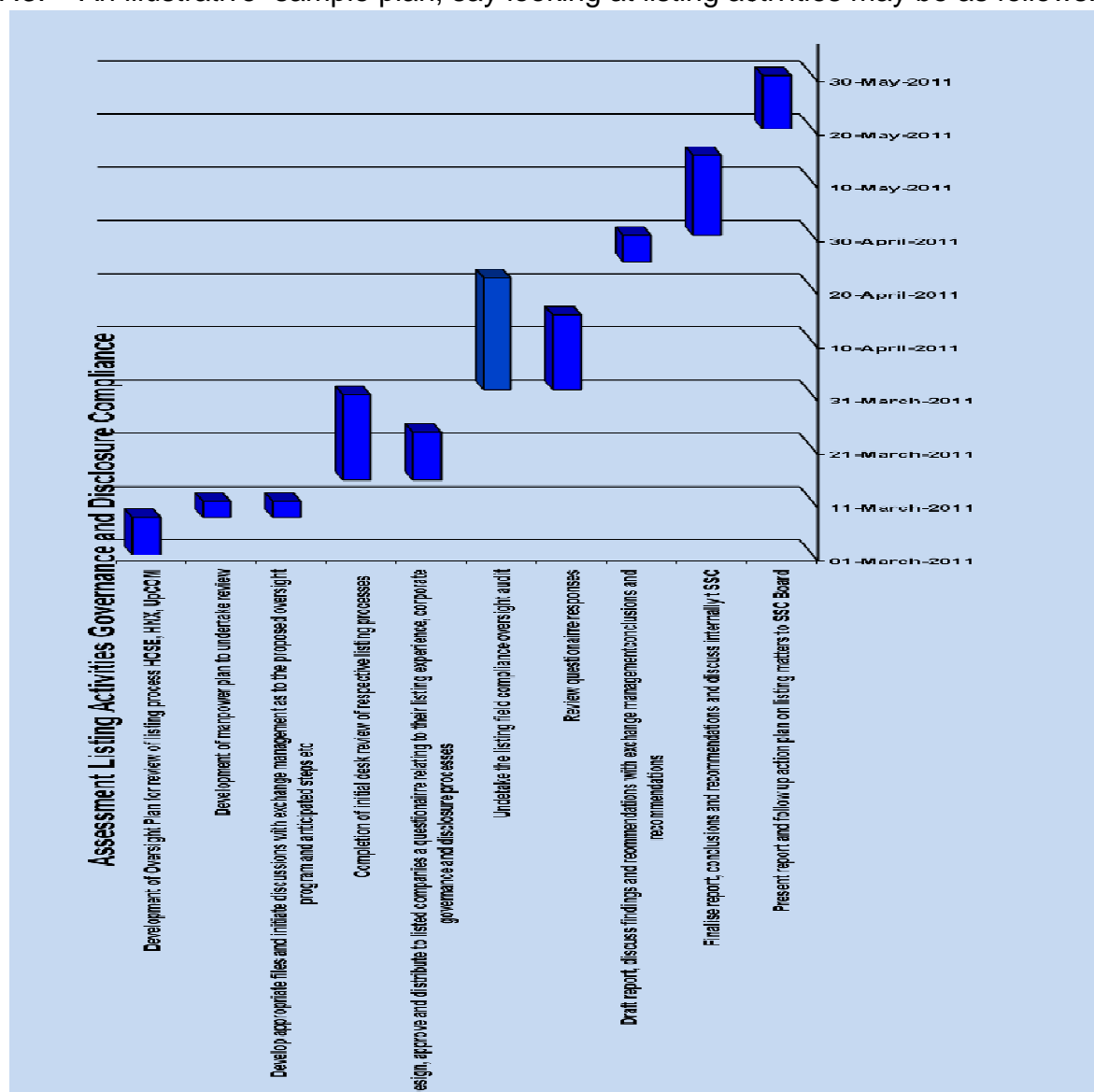
6.31.4. Upon completion of an external review, the review team should issue a formal report containing an opinion as to the department's compliance with the appropriate standards. The report should also address compliance with the department's charter and other

applicable standards and include appropriate recommendations for improvement. The report should be addressed to the BSEC Board of directors'. The director of SRMIC should prepare a written action plan in response to the significant comments and recommendations contained in the report of external review. Appropriate follow-up is also the director's responsibility.

- 6.31.5. External reviews should be conducted at least once every three years.
- 6.31.6. External review is an important element of the program for achieving quality assurance. However, if resources are limited, or for other reasons previously noted, the SRMIC may be currently unable to obtain an external review. In these circumstances, more emphasis should be placed on supervision, periodic internal reviews, and other quality assurance methods that are available to the department. It is the responsibility of the director of SRMIC to annually assess the conditions, which restrict an external review.

7. Oversight Inspection (Audit) program

- 7.1. For each function of the DSE & CSE, CDS and the custodians that is going to be the subject of an oversight review it is necessary to develop an overview audit program including an execution timetable and a manpower resource plan.
- 7.2. There will need to be time devoted to desk auditing, risk or performance questionnaires, field review, compilation of the draft oversight report and recommendations, review with exchange management and BSEC management as well as compilation if necessary of a follow up action program.
- 7.3. An illustrative sample plan, say looking at listing activities may be as follows:



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7.4. A typical overall audit program (note this sample program cover the normal SRO functions) may be as follows:

| A | Board of Directors | | | Activity | Who to undertake | Time Required |
|---|--------------------|-------------------------------|--|----------|------------------|---------------|
| | (i) | Minutes Review | | | | |
| | | | Scan minutes for evidence of independence | | | |
| | | | Check probity of decisions and deliberations | | | |
| | | | Review independence of management | | | |
| | | | Form an opinion as to relationship with Market Integrity oversight | | | |
| | (ii) | Governance Standards | | | | |
| | | | Ensure Governance standards with BSEC | | | |
| | | | Best practice requirements fulfilled? | | | |
| | | | How is Governance demonstrated? | | | |
| | (iii) | Professional Standards | | | | |
| | | | Confidentiality Agreements with Staff | | | |
| | | | Natural Justice to Participants | | | |
| | | | Procedural Fairness standards | | | |
| | (iv) | Ethics | | | | |
| | | | Is there an ethics policy | | | |
| | | | Does the board follow the ethics policy? | | | |
| | | | Do staff follow the ethics policy? | | | |
| | (v) | Independence | | | | |
| | | | Are independence requirements being met? How? | | | |
| | | | Is independence measured? | | | |
| | (vi) | Management Oversight | | | | |
| | | | Delegations | | | |
| | | | Reporting | | | |
| | | | Internal Audit | | | |
| | | | Compensation Committee | | | |
| | | | Risk Management | | | |
| | (vii) | Oversight Functions | | | | |
| | | (a) | Risk Management | | | |
| | | | Clearing and Settlement Operations | | | |
| | | | Large Position Oversight | | | |
| | | | Protection of Assets | | | |
| | | | Disaster Recovery | | | |
| | | | AML Operations | | | |
| | | | Default procedures documented and transparent | | | |
| | | (b) | Membership and Surveillance Oversight | | | |
| | | | Are activities monitored? | | | |
| | | | Are results discussed? | | | |

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| | | | | | | |
|----------|------------------------------------|------------------------|---|--|--|--|
| | | | Is their transparency of decisions? | | | |
| | | | | | | |
| | | (c) | Management Committee | | | |
| | | | Independence | | | |
| | | | Authorities | | | |
| | | | Adequate Reporting and discussion | | | |
| | | | | | | |
| | | (d) | Market Regulation Division | | | |
| | | | Knowledge of Actions | | | |
| | | | Review of Operations | | | |
| | | | | | | |
| | | (e) | Business Planning | | | |
| | | | Disaster Recovery Plans | | | |
| | | | Business Development Plans | | | |
| | | | | | | |
| | | (f) | Financial Planning | | | |
| | | | Financial Capacity | | | |
| | | | Future Funding | | | |
| | | | | | | |
| | | (g) | Technology Planning | | | |
| | | | Data warehousing | | | |
| | | | Trading System Development | | | |
| | | | Surveillance Systems | | | |
| | | | Disclosure Systems | | | |
| | | | Record Retention Policies | | | |
| | | | | | | |
| | | (h) | Internal Audit | | | |
| | | | Planning | | | |
| | | | Results | | | |
| | | | Independence from Management | | | |
| | | | Review of working papers for completeness | | | |
| | | | | | | |
| | | (i) | Issuer listing and Compliance | | | |
| | | | Waivers | | | |
| | | | Fines | | | |
| | | | Assessment of Adequacy | | | |
| | | | | | | |
| B | Market Integrity Activities | | | | | |
| | (i) | Activity Review | | | | |
| | | | Review minutes for content, approach and independence | | | |

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| | | | | | | |
|----------|--|---|---|--|--|--|
| | | | Tabulate attendance and compile statistics on issues by type and decision | | | |
| | (ii) | Decision Review | | | | |
| | | | Review the files of 5 Disciplinary matters | | | |
| | (iii) | Independence | | | | |
| | | | Assess the true independence of Decisions vis a vis the BOARD | | | |
| | (iv) | Board Discussion | | | | |
| | | | INTERVIEW a least two independent board members about the disciplinary process- its issues and role, assess whether this accords with powers and duties | | | |
| C | Chairman/CEO | | | | | |
| | | | Interview Chair/CEO as to his view and issues with the implementation of Demutualisation process - is it working what are the issues | | | |
| | | | What are forward plans and strategy for Exchange | | | |
| | | | What are key issues re management and relationship with BSEC | | | |
| D | Management committee (Mancom) or equivalent | | | | | |
| | (i) | Authorisation and Capacity | | | | |
| | | | Has Mancom got proper written authorities and sufficient distance from the Board | | | |
| | (ii) | Functioning and operation | | | | |
| | | | Do executive have a say in management | | | |
| | | | Are deliberations open | | | |
| | (iii) | Independence from Board in decisions | | | | |
| | | | Does Mancom properly manage independently from Board | | | |
| E | Market Regulation | | | | | |
| | (i) | Review existing agreements and rules | | | | |
| | | Structure/Framework | | | | |
| | | | Review of Arrangements and priorities Proposed rules -status and requirements | | | |
| | | | Staffing, capacity and organisation Should auditing be outsourced is it effective? | | | |
| | | | Delineation of respective staff and Board roles | | | |
| | | Budget and funding | | | | |
| | | | Is there proper funding of oversight activities Are there sufficient systems and resources for the task? | | | |

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| | | | | | |
|---|-------|---|---|--|--|
| | (ii) | Market Surveillance | | | |
| | | | Review Market Dynamics and Volatility | | |
| | | | Review of Surveillance System and Processes | | |
| | | | Review open and closed investigations | | |
| | | | Review of Actions taken | | |
| | | | Review of Adequacy Staff | | |
| | | | Review Conflicts with Market Operations Role | | |
| | | | Access to Beneficial Holders | | |
| | | | Access to Issuer disclosure | | |
| | | | Access to Intermediary Records | | |
| | | | Arrangements for sharing of information | | |
| | | | Domestic regulators | | |
| | | | Foreign regulators | | |
| | | | Assess cooperation and duplication with BSEC surveillance | | |
| | (iii) | Trading Participants' Compliance | | | |
| | | | Audit Arrangements in place | | |
| | | | Audit Results Overview | | |
| | | | Review five files for completeness | | |
| | | | Review RBCA System and returns | | |
| | | | Review eight returns for accuracy, completeness and sufficiency | | |
| | | | Assessment of adequacy and sufficiency | | |
| | | | | | |
| | (iv) | Prosecution & Enforcement | | | |
| | | | Review staff functions and adequacy | | |
| | | | Review decisions penalties and consistency of decisions | | |
| | | | Review complaint registers follow up and procedures | | |
| | | | Review linkages to BSEC | | |
| | | | Relationship with Issuer Disclosure | | |
| | | | | | |
| F | | Issuer Disclosure | | | |
| | | | Adequacy | | |
| | | | Independence | | |
| | | | Relationship with Member oversight | | |
| | | | Review of eight files for approach and adequacy of outcomes | | |
| | | | | | |
| G | | Technology | | | |
| | | | Operational Efficiency | | |
| | | | Major projects in Hand | | |
| | | | Systems capacity and planning | | |
| | | | Risk management | | |

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| | | | | | | |
|---|--------------------------|--|--|--|--|--|
| | | | Data Warehousing | | | |
| | | | | | | |
| H | New products and markets | | | | | |
| | | | Development of Indexes | | | |
| | | | Development of Derivatives | | | |
| | | | New product development and approval | | | |
| | | | | | | |
| I | Training / Education | | | | | |
| | | | Staff Training Availability and conditions | | | |
| | | | Appropriateness of Training | | | |
| | | | Directors Governance Training | | | |
| | | | Risk management and new product training | | | |
| | | | Member training | | | |

A full copy of this example is attached as **Annexure 1: Oversight Inspection (Audit) Program**.

- 7.5. The Director SRMIC should review each oversight function and develop appropriate plans and oversight audit programs for the functions to be reviewed. This process is very important and provides a discipline to ensure proper objectives, coverage and comprehensive planning is undertaken.

8. Selection of the Areas to review on each inspection cycle

8.1. There are several key functional areas that need to be addressed which are:

- Technology systems and planning;
- Trading systems and market information dissemination review;
- Issuance and Disclosure Management;
- Market Surveillance;
- Member Surveillance and Capital Adequacy;
- Miscellaneous areas of review: (Record Retention, Complaints Handling);
- Product development and for example Derivatives Product Approval process;
- Settlement; and
- Systemic Risk Functions.

8.2. The Director of the SRMIC should consider making a minimum a three year program to cover all the above areas and then address the combination of activities to be addressed in any year with a flexible approach in light of market developments.

8.3. It is suggested that two to three major areas together with a similar number of lesser important areas be addressed in each oversight cycle, some such as settlement failures or market abuse oversight may be addressed in every cycle if deemed appropriate.

8.4. The Director of the SRMIC should have the overall three year plan and current year plan approved each year by the Chairman of BSEC and it should be presented for endorsement by the BSEC Board. This process helps to reinforce its importance with BSEC management as well as the regulated bodies.

9. Pre-Inspection preparation and desk- based supervision

9.1. The more intelligence the BSEC gathers prior to a formal inspection the better prepared it will be. It is therefore very important to build SRMIC data bases of information gathered as well as develop a database to retain the information proposed to be gathered as part of the introduction of Risk Based Capital Requirements.

9.2. Key Data Sets are as follows:

- Market Participants:
 - Number;
 - Market Share;
 - Directors;
 - Staff (trading, Advising, Risk/compliance, Back Office;
 - Number of Accounts (Retail, Institutional, Foreign); and
 - Key Capital Adequacy numbers and ratios.
- Market Volumes, Number trades, Value Trading, Number Listed Companies;
- Share Prices on daily basis;
- Trade Data including bid/offer/cancelled trade data;
- Listed Company Data;
- Settlement Failures, Buy Ins and use of guarantee/support fund⁸;
- All daily settlement data;
- All depository data (percentage script held by depository, calculation free float available); and
- Volatility and liquidity assessment calculations for each listed company.

9.3. The data sets will be invaluable in the pre inspection analysis to research and determine unusual activity and determine the resources required to review transactions.

⁸ Whilst rules have been passed no funds have as yet been contributed to the guarantee funds of the DSE or CSE

- 9.4. The data should be loaded daily (or as appropriate) from the DSE & CSE, and CDBL files into the data base.
- 9.5. Desk preparation work ensures that the oversight team is well prepared with the metrics of the oversight function prior to arrival at the entity to be inspected. For example by studying the growth rate of transaction volumes and bid/offer/cancellation activity the oversight team can make informed judgements about transaction volumes etc related to trading and clearing system capacity and planning.
- 9.6. Another important function of pre-inspection desk work is to issue relevant questionnaires to participants, listed companies, investors or custodians and other market users to gain insight into the efficiency and appropriateness of exchange services to their customers and whether the exchange is responsive to the capital market and investor needs.

10. Allocation of resources and time to different functional oversight activities

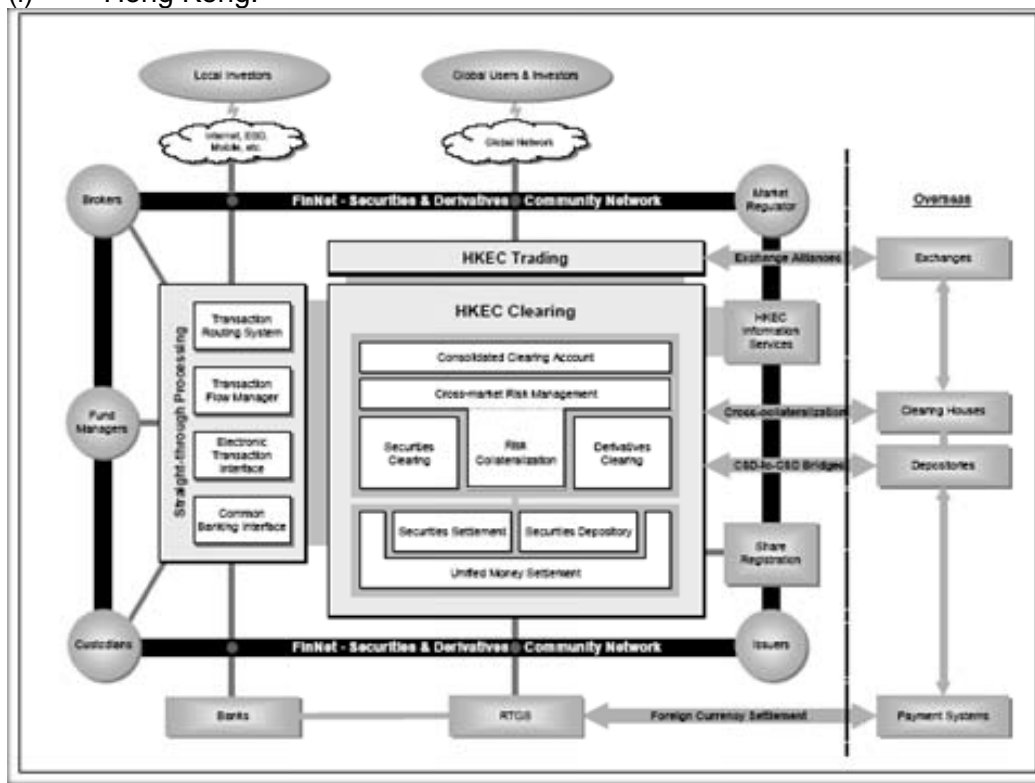
- 10.1. By utilising the metrics from the SRMIC data base and undertaking pre-inspection oversight desk work the Director SRMIC will have a better idea of the needs for staffing of the relevant oversight inspection team.
- 10.2. The SRMIC should seek to utilise modern auditing statistical sampling methods to ensure sufficient audit inspection of transactions, disclosure, trading processes is achieved.
- 10.3. This manpower estimation is important to ensure that adequate staff are allocated to the tasks at hand.
- 10.4. Some oversight inspection activities may take several months to complete and may involve numerous cross related tasks, involving many different skills and audit requirements.
- 10.5. It is also important to ensure that the SRMIC staff are adequately trained in statistical techniques and sampling methods. Staff should be able to utilise spread-sheet tools and relational databases to extract and manipulate data for oversight analysis.
- 10.6. The estimates of time and manpower should be matched with the oversight audit program and then this all utilised to produce the summary plan as envisaged in section 7 above.

11. Technology systems (Trading, Disclosure and Surveillance), security and planning including disaster recovery

- 11.1. The IT systems of the exchange cover all business activities but the BSEC will wish to concern itself primarily with surveillance. The trading, surveillance and listed company disclosure system are all inextricably linked to the surveillance requirements.
- 11.2. The SRMIC should develop for its permanent Oversight file an IT diagrammatic overview with key linkages of the DSE & CSE IT systems configuration together with the linkages to the CDS and custodians as well as subsystems for index calculation and links to data vendors for information dissemination.
- 11.3. Technology is at the heart of an exchange and its efficient operation is key to the Palestinian capital market reputation. IT oversight is a specialist skill and SRMIC may need to have secondment of BSEC IT personnel or even a profession IT audit firm to assist it initially develop its oversight skills. A number of regulators have gained on sight experience with the seconded help of IT specialists. With increasing use of algorithmic trading and high frequency trading supported by co-location of participant firm computers on exchange premises this issue is becoming a critical one for regulatory oversight.
- 11.4. Oversight audits need to test the exchanges IT security systems, ensure capacity, ensure secure, fast linkages utilising IT information exchange standard protocols. Disaster recovery plans also need to be reviewed and tested for thoroughness.
- 11.5. The following two diagrams (one for Hong Kong and the other for Vietnam) give provide examples of the possible linkages:

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(i) Hong Kong:

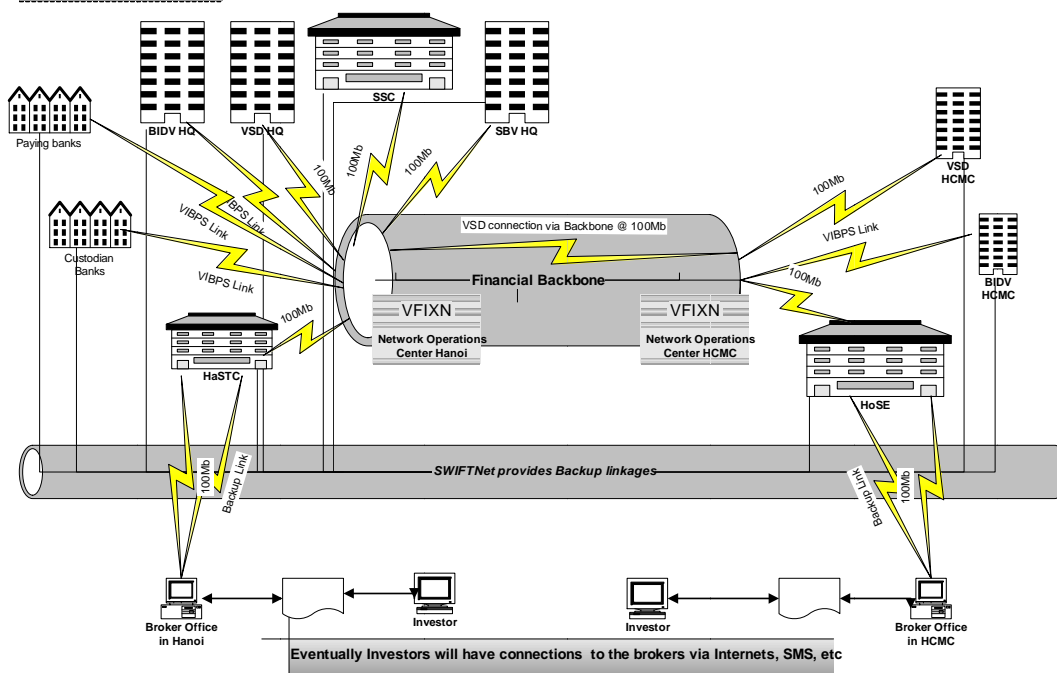


(ii) Vietnam

Note

Until a public digital signature process is legislated and adopted it may still be necessary to have paper copies signed, sealed and delivered to meet legal requirements or provision for a private digital signature process

Network Connections VFIXN
Vietnam Financial Information eXchange Network



11.6. The stability and security of these linkages and the underlying systems is of paramount concern for BSEC's oversight work.

11.7. The oversight review program therefore needs to cover all the above aspects.

11.8. A review program should include steps to cover the key issues which are:

- IT Policies, manuals and Operational Controls;
- Current Systems utilisation/redundancy and future capacity planning;
- Environmental facilities and controls, System Security and physical security of assets;
- Review of system logs and previous down time occurrences as well as the reasons therefore;
- System Back up and redundancy (mirrored databases and data recovery processes);
- Error correction and recovery procedures;
- Disaster Recovery plans;
- Physical testing of disaster recovery process and live trading system failure; and
- Adequacy and training of IT staff.

11.9. The review process should establish the existence, approval, current status and risks associated with the above key areas and a formal report should be compiled as to the quality, sufficiency and recommendations to take appropriate corrective action and or maintain the highest standards of system operation, preparedness and ensure to future operational stability is achieved.

12. Trading systems and market information dissemination review

- 12.1. A comprehensive review program should be devised for this critical oversight area.
- 12.2. The BSEC's oversight objective is to ensure that the DSE & CSE's operational systems are being properly run and maintained. In Section 11 above the overall IT functions were reviewed. In this section the BSEC is concerned that the operational trading systems are properly configured, maintained and have the capacity for surges in volume and activity due to market demands.
- 12.3. The BSEC is concerned with the impact arising from a trading systems failure, inadequate capacity planning or network failure on the capital market as a whole.
- 12.4. Thus the oversight review is concerned with ensuring policies and procedures are in hand and are being operational implemented. This is to ensure the systems are properly running and maintained with adequate consideration of future demand. In addition a review should be made of cross functional linkages necessary to ensure efficient data transmission to data vendors thus providing proper transparency of transactions undertaken, price formation or discovery and timely listed company disclosure.
- 12.5. Given the international trend towards algorithmic trading and collocation of trading servers with exchange servers this aspect of oversight should be carefully considered.
- 12.6. Oversight tools include the use of participant surveys, formal questionnaires to the DSE & CSE management for completion and on-sight review of data security, systems capacity planning and a formal review of the trading data warehouse arrangements and IT systems environment for linkages to participant trading terminals and data vendor services.
- 12.7. SRMIC should devise an appropriate oversight program, including the necessary questionnaires to fully cover the oversight requirements. The Director of the SRMIC should approve the oversight review program and content. IT specialist skills may be needed to be seconded to SRMIC to support their in-house skills.
- 12.8. A formal report covering all these areas should be compiled by the SRMIC staff and include any recommendations for corrective action or recommendations to ensure the objectives of the oversight program are met in future by the DSE & CSE.

13. Issuance and Disclosure Management

13.1. Thematic reviews should be selected to be carried out on listing. Themes could be issues such as:

- The opening trading of IPOs;
- monitoring of unusual price and volume movements; and
- dissemination of issuer information; or
- other selected themes.

13.2. The focus should be on reviewing the decision-making process and operational procedures in listing in order to review the regulation of listing matters.

13.3. Internationally the areas of review normally include:

13.3.1. the Initial Public Offers Department (the “IPO Department”) whose primary responsibility is to process new listing applications in respect of equity securities;

13.3.2. the Compliance and Monitoring Department (the “C&M Department”) which is responsible for monitoring listed companies compliance with the Listing Rules;

13.3.3. the Listing Enforcement Department (the “Enforcement Department”) which investigates suspected breaches of the Listing Rules and institutes disciplinary action for such breaches by companies and their directors; and

13.3.4. the Primary Market Information Section (the “PMI Section”) of the Listing Operations unit which is responsible for the dissemination of information concerning listing applicants/listed issuers and providing support for their regulatory filings.

13.4. In conducting the oversight review it is usual to consider:

- the relevant internal Exchange materials, written policies, procedures and processes documented any general practices that have not been documented;
- sample cases, including the internal reports and case files;

- information received from the DSE & CSE including its regular reports to BSEC and internal reports and case data;
- the DSE & CSE's annual report and any quarterly newsletters or media releases; and
- the DSE & CSE's published disciplinary procedures and any other decisions relating to its members or guidance.

- 13.5. It is particularly important to gauge the market perception of the DSE & CSE performance so as part of the oversight review process the BSEC should consider conducting a survey of market participants, including underwriters, legal advisers, accountants, investors and listed companies on a private and confidential basis.
- 13.6. The purpose of the survey is to establish how market participants view the DSE & CSE performance in its regulation of listed companies and any changes in the market's perception of that performance over a period of time.
- 13.7. The oversight review assessment of the DSE & CSE's performance should be the result of a combination of the on-site work, consultation with market participants and the BSEC's continuing interaction with the DSE & CSE.

14. Market Surveillance (MS) Activities

14.1. There are a number of key activities that should be reviewed in relation to market surveillance functions of DSE & CSE. The key review areas are:

- supervision of the equities (and bond) markets;
- supervisory reporting structure;
- interaction with other supervisory business units, particularly issuer disclosure;
- monitoring disclosure based listing rules;
- staffing levels;
- record-keeping; and
- implementation of any new MS alerting system.

14.2. An oversight review program would include:

- Review of MS policy and procedures;
- A “walk through” of the procedures against a case file;
- Review of collected exchange statistics on alerts, case files and investigation results;
- Review of overall Market Dynamics and Volatility;
- Review of the implemented Surveillance System and Processes;
- Review open and closed investigations for completeness and satisfactory conclusion;
- Review of Actions taken, timeliness and status of any pending matters;
- Review of Adequacy Staff;
- Review Conflicts with any Market Operational Role that the MS unit may have;

- Review of departments physical location, security access and staff duties segregation to ensure integrity of operations;
 - Access to Beneficial Holders;
 - Access to Issuer disclosure;
 - Access to Intermediary Records;
 - Review of linked Intermediary/Listed Company activity (e.g. broker is subsidiary of listed financial firm or itself is a listed entity); and
 - Arrangements for sharing of information with domestic or foreign regulators and any MoU's.
- 14.3. Initial oversight review work would include documenting the processes employed and developing a flow chart of the process so that its completeness and thoroughness can be assessed. This would be placed on the permanent oversight file for each exchange and updated regularly.
- 14.4. A considerable amount of pre on-site visit analysis should be undertaken using the SRMIC's own database records. This includes undertaking the calculation of the volatility of share prices and the apparent liquidity of shares traded. A key function will be to pre-identify, before on-site work, share counters with unusual price movements and unusual volume activity.
- 14.5. SRMIC should ensure that its own market intelligence gathering accords with the surveillance work of the two exchanges. Noting the disparities and researching why different results are being produced.
- 14.6. The DSE & CSE should have their own statistical records of alerts and the SRMIC research should be compared with alert statistics.
- 14.7. Unit Heads should be interviewed and a determination of the sufficiency, efficiency and effectiveness of the overall process should be made.
- 14.8. A sufficient sample of case files should be reviewed to ensure that the exchanges are fulfilling their surveillance responsibilities.
- 14.9. The BSEC has an MOU with the DSE & CSE and this should include who is responsible for different aspects of surveillance activity including the regular reporting of and sharing of information.
- 14.10. After the completion of the oversight review a meeting with the Head of Market Surveillance should be held and the review should include any of the DSE &

CSE's comments on both the factual matters and conclusions of the oversight report.

15. Membership, Member Surveillance, and Capital Adequacy

- 15.1. Risk based capital adequacy (RBCA) is in the process of being implemented by BSEC and this section will need updating as the planned implementation proceeds.
- 15.2. The objective of this section should be to ensure that the DSE & CSE are properly supervising their exchange participants and ensure the enforcement of their rules and regulations, including those required by the BSEC.
- 15.3. The SRMIC will need to address the following:
- Review of membership policy and procedures;
 - A “walk through” of the procedures against a case file for an application for membership and a typical member inspection;
 - Review of collected exchange statistics on member applications, field inspections by the exchange and investigation results;
 - Review of member market share of business, accounts held (domestic and foreign) as well as staffing levels split between management, sales/trading and back office functions;
 - Review of any membership Monitoring System and Process;
 - Review open and closed membership inspection files for completeness and satisfactory conclusion;
 - Review of Actions taken, timeliness and status of any pending follow up matters;
 - Review of Adequacy Staff to undertake the necessary workload;
 - Review of departments physical location, security access and staff duties segregation to ensure integrity of operations;
 - Retention and adequacy of Intermediary Records;
 - Review of trading activity and settlement statistics to determine whether a member poses risk issues to the exchange, or overall capital market;

- Review of linked Intermediary/Listed Company activity (e.g. broker is subsidiary of listed financial firm or itself is a listed entity); and
 - Arrangements for sharing of information with domestic or foreign regulators and MoU's.
- 15.4. Initial oversight review work would include documenting the processes employed and developing a flow chart of the process so that its completeness and thoroughness can be assessed. This would be placed on the permanent oversight file for each exchange and updated regularly.
- 15.5. The SRMIC should interview the exchange units that undertake the membership approval and monitoring.
- 15.6. As the requirements for RBCA are implemented the DSE & CSE should develop a system and database that provides relevant statistics for the easy monitoring of these oversight functions.
- 15.7. Some regulators will undertake thematic reviews of exchange members as part of their oversight exchange audits. These might cover a survey of risk management practices, the status and growth of member services like internet broking and other topical issues like algorithmic trading.
- 15.8. After the completion of the oversight review a meeting with the Head of membership/intermediary function should be held and the review should include any of the DSE & CSE's comments on both the factual matters and conclusions of the oversight report.

16. Miscellaneous areas of review: (Record Retention, Complaints Handling)

- 16.1. The DSE & CSE should have written implemented record retention policies and these should be reviewed and tested by the BSEC on a regular basis. The BSEC should develop a paper for its permanent oversight file that reviews the policies and flowcharts the record retention decision tree. The physical location and security of off-site archival records should be seen and commented on as to its condition and suitability. SRMIC should be concerned that any past records that may be needed for its own market surveillance duties are easily and quickly recoverable.
- 16.2. The SRMIC should also review the status and documentation of complaints to the DSE & CSE. These can be an important red flag as to brooding issues, particularly problems that may be developing at intermediary firms.
- 16.3. The Complaints written policy and procedures should be documented and placed on the permanent oversight review file for each entity being supervised. Internationally many exchanges have automated complaint recording systems, some linked to their web-sites.
- 16.4. SRMIC should document any concerns, discuss those with exchange management and if necessary bring the concerns to BSEC management and Board.
- 16.5. As the SRMIC undertakes oversight work, and exchange services and products expand there will be other functions that may need to be included for review.

17. IT Systems, Settlement Process, and Settlement Bank methodology

- 17.1. In this section three functions are considered together as they form the backbone of the DSE & CSE's systemically important risk management functions.
- 17.2. The importance of these functions is encapsulated in the work of IOSCO and BIS through their joint Committee on Payment and Settlement Systems (CPSS). The objectives of this work are stated as:
- To provide a consistent basis for the adequate regulation, supervision and oversight of securities clearing and settlement systems ;
 - To enhance the safety, soundness and efficiency of securities clearing and settlement;
 - To avoid systemic risk;
 - To build confidence in the markets by providing strong and reliable rules; and
 - To foster the protection of investors and, in particular, retail investors.
- 17.3. A copy of two BIS papers covering Settlement Systems are attached as **Annexure 2**.
- 17.4. The BIS papers provide a framework for assessment of the DSE & CSE meeting an internationally recognised standard and provides for a self-assessment questionnaire to be completed.
- 17.5. The BSEC should develop a review program that addresses the issues covered by the attached BIS paper.
- 17.6. This requires the BSEC to identify the risks associated with the clearing and settlement process and the parties responsible for the potential losses that those risks might create.
- 17.7. Ensure that the DSE & CSE measures the identified risks by use of industry standard risk measurement techniques that are accurate, understandable and comprehensive.
- 17.8. Design and implement controls to address the risks that:

- Provide an adequate and known level of coverage against losses for system participants while maintaining the efficiency and competitiveness of Bangladesh's securities markets;
- Require participants to bear responsibility for the risks that they bring to the system;
- Contain losses within individual settlement services and participant collateral;
- Pool/Credit Rings to eliminate the potential for risk "spill-over";
- Meet internationally recognized minimum standards for securities settlement systems, including:
 - Having a well-founded, clear and transparent legal basis in the relevant jurisdictions;
 - Rigorously controlling the risks when assuming the role of central counterparty;
 - Eliminating principal risk by linking securities transfers to funds transfers in a way that achieves Delivery Versus Payment (DVP);
 - Using a combination of collateral requirements and limits, ensure timely settlement in the event of the default of any participant up to and including the participant with the largest payment obligation;
 - Establishing minimum standards for participation that also permit fair and open access; and
 - Providing market participants with sufficient information for them to identify and accurately evaluate the risks and costs associated with using DSE & CSE services.

17.9. Initially the BSEC should concentrate on the risks associated with three areas:

- IT Systems risk;
- Clearing and settlement policies and procedures; and
- Settlement banking methodology;

17.10. Section 11 above sets out key oversight review functions for exchange systems and these requirements equally apply to its IT. Therefore a review

process similar to that in section 11 as well as section 12 above should be developed by SRMIC.

17.11. For oversight of the clearing and settlement activities the SRMIC should develop an oversight program that addresses the following:

- Review of clearing and settlement policies and procedures;
- A “walk through” of the procedures against a day’s trading transaction file;
- Review of collected settlement statistics on member settlements as well as failures, and investigation results;
- Review of member market share of settlement coverage, client accounts held (domestic and foreign);
- Review of any Settlement Monitoring System;
- Review open and closed settlement failure files for completeness and satisfactory conclusion;
- Review of Actions taken, timeliness and status of any pending follow up matters;
- Review of Adequacy Staff to undertake the necessary workload;
- Review of departments physical location, security access and staff duties segregation to ensure integrity of operations;
- Retention and adequacy of Settlement and Intermediary Records;
- Review of settlement statistics to determine whether a member poses risk issues to settlement or the overall capital market; and
- Arrangements for sharing of information with domestic or foreign regulators and MoU's.

17.12. In relation to settlement banking methodology the SRMIC should review all settlement failure, reconcile the accounts and compile statistics as to which intermediaries are posing settlement problems.

17.13. After the completion of the oversight review a meeting should take place to evaluate weakness identified and risk posed as well as possible solutions and remedial action and procedures.

18. Risk Management and Guarantee Fund

- 18.1. There are two aspects to Risk management, firstly the defined risk Appetite of the exchanges and the CDBL and the management of risks within the entities. BSEC should thoroughly review the regulation and risk management activities of the oversighted entities.
- 18.2. Secondly SRMIC should utilise the BIS paper to identify the risks associated with clearing and settlement and the key risk matrix questions. To assist the key risk matrix questions is attached as **Annexure 3**.
- 18.3. This entails reviewing prudential arrangements, systems and operational considerations to minimize risk of non-completion of transactions.
- 18.4. Identification and adequate management of risks needs to be gauged in order to ensure expeditious verification of a trade, information should be available which records the transaction and provides the basis for settlement.
- 18.5. The oversight process should be framed to check that procedures are in place to identify and monitor risks on an on-going basis.
- 18.6. Presently in Bangladesh there are no margin requirement that may be used in combination with other mechanisms to manage risk to market participants, including circuit breakers and risk management systems.⁹ The oversight program needs to identify the risks and influence the CDS to introduce improvements including margin collection to provide for a bolstered support fund.
- 18.7. The oversight work in this area should entail working with the CDS to develop a market activity model in order to quantify the possible largest call of funds from the support fund based either on the failure of the largest market intermediary or from a market “break” based on past historical levels of highest transactional activity and the largest market movements. In essence the stability, financial health and activities of participants of the clearing and settlement systems need to be monitored in order to minimize the risk of failure.
- 18.8. Regulators are increasingly developing stress test “Monte-Carlo” simulations to undertake such oversight assessments. SRMIC should also undertake such developments.
- 18.9. If there is a “guarantee” fund the oversight review should also consider the investment policy and procedures related to the investment of the support fund

⁹ Please check that we are right in this assumption

itself (assuming this is pre funded)¹⁰. The review should address issues such as:

- Investment Policy including suitable investments, duration and acceptable institutions to hold deposits;
- Formation and rules for an investment committee;
- Retainer of professional fund management advisers; and
- Publication of the fund balance and investment returns on a periodic basis.

¹⁰ Our understanding is that at present there is no “guarantee” fund

19. Physical and System Security Aspects of the CDBL

19.1. The SRMIC should develop an oversight program as follows:

- Review of depository policy and procedures;
- A “walk through” of the procedures against a case file for an application for membership by brokers and custodians as well as a typical membership approval;
- A “walk through” of the procedures against a case file for an application for a retail or foreign client account opening process;
- A “walk through” of the procedures against a case file for an application for a listed companies application for registry services;
- Review of collected statistics on member applications, account opening actions, company registrations and corporate actions;
- Review of Actions taken, timeliness and status of any pending follow up matters;
- Review of Adequacy Staff to undertake the necessary workload;
- Review of departments physical location, security access and staff duties segregation to ensure integrity of operations;
- Retention and adequacy of CDS records;
- Reconciliation of registry and CDS records to third party totals, e.g. share outstanding against BSEC records;
- Review of depository statistics to determine whether systems capacity poses any risk issues to the DSE & CSE or overall capital market; and
- Arrangements for sharing of information with domestic or foreign regulators and MoU's.

19.2. The oversight program should provide for a complete review of systems and physical security of premises and systems.

19.3. After the completion of the oversight review a meeting should take place to evaluate weakness identified and risk posed as well as possible solutions and remedial action and procedures.

20. Issuance of inspection findings and follow-up for completion and rectification

- 20.1. Following exit interviews of the respective units of the entities inspected the SRMIC together with other participating BSEC units should after approval of the BSEC Chairman issue a formal report with agreed actions incorporated on the recommendations.
- 20.2. The report should be fully cross referenced to all oversight review working papers and a copy of the report placed on both the annual and permanent oversight files.
- 20.3. The overall file should be approved as properly completed by the Director SRMIC ready for third party internal and if appropriate external review.

21. Transparency of reports and action programs

- 21.1. It is recommended that the report should be placed before the BSEC Board for notation and once the entities inspected have signed off and agreed their action plans on recommendations that the reports are placed on the BSEC website for public transparency.
- 21.2. Any non-public information can be removed before public publication.
- 21.3. Internationally this approach is being accepted as best practice.

22. Enforcement relating to key recommendations

- 22.1. Follow up to ensure implementation of agreed recommendations is essential and the entities should be subject to enforcement action for noncompliance with agreed programs of improvement.
- 22.2. Subsequent oversight reports should have a section setting out the fate and status of previous agreed actions and outline the reasons for any delays or noncompliance therewith.

Annexure 1: Sample of Oversight Audit Program

A Board of Directors

| Board of Directors | | Activity | Who to undertake | Time Required |
|--------------------|--|----------|------------------|---------------|
| (i) | Minutes Review | | | |
| | Scan minutes for evidence of independence | | | |
| | Check probity of decisions and deliberations | | | |
| | Review independence of management | | | |
| | Form an opinion as to relationship with Market Integrity oversight | | | |
| (ii) | Governance Standards | | | |
| | Ensure Governance standards with BSEC | | | |
| | Best practice requirements fulfilled? | | | |
| | How is Governance demonstrated? | | | |
| (iii) | Professional Standards | | | |
| | Confidentiality Agreements with Staff | | | |
| | Natural Justice to Participants | | | |
| | Procedural Fairness standards | | | |
| (iv) | Ethics | | | |
| | Is there an ethics policy | | | |
| | Does the board follow the ethics policy? | | | |
| | Do staff follow the ethics policy? | | | |
| (v) | Independence | | | |
| | Are independence requirements being met? How? | | | |
| | Is independence measured? | | | |
| (vi) | Management Oversight | | | |
| | Delegations | | | |
| | Reporting | | | |
| | Internal Audit | | | |
| | Compensation Committee | | | |
| | Risk Management | | | |
| (vii) | Oversight Functions | | | |
| (a) | Risk Management | | | |
| | Clearing and Settlement Operations | | | |
| | Large Position Oversight | | | |
| | Protection of Assets | | | |
| | Disaster Recovery | | | |
| | AML Operations | | | |
| | Default procedures documented and transparent | | | |
| (b) | Membership and Surveillance Oversight | | | |
| | Are activities monitored? | | | |
| | Are results discussed? | | | |
| | Is their transparency of decisions? | | | |
| (c) | Management Committee | | | |
| | Independence | | | |
| | Authorities | | | |
| | Adequate Reporting and discussion | | | |
| (d) | Market Regulation Division | | | |
| | Knowledge of Actions | | | |
| | Review of Operations | | | |
| (e) | Business Planning | | | |
| | Disaster Recovery Plans | | | |
| | Business Development Plans | | | |
| (f) | Financial Planning | | | |
| | Financial Capacity | | | |
| | Future Funding | | | |
| (g) | Technology Planning | | | |
| | Data warehousing | | | |
| | Trading System Development | | | |
| | Surveillance Systems | | | |
| | Disclosure Systems | | | |
| | Record Retention Policies | | | |
| (h) | Internal Audit | | | |
| | Planning | | | |

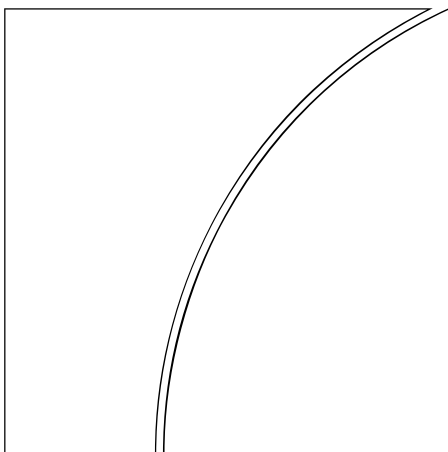
| | | | |
|----------|---|--|--|
| | Results | | |
| | Independence from Management | | |
| | Review of working papers for completeness | | |
| (i) | Issuer listing and Compliance | | |
| | Waivers | | |
| | Fines | | |
| | Assessment of Adequacy | | |
| B | Market Integrity Activities | | |
| (i) | Activity Review | | |
| | Review minutes for content, approach and independence | | |
| | Tabulate attendance and compile statistics on issues by type and decision | | |
| (ii) | Decision Review | | |
| | Review the files of 5 Disciplinary matters | | |
| (iii) | Independence | | |
| | Assess the true independence of Decisions vis a vis the BOARD | | |
| (iv) | Board Discussion | | |
| | INTERVIEW a least two independent board members about the disciplinary process- its issues and role, assess whether this accords with powers and duties | | |
| C | Chairman/CEO | | |
| | Interview Chair/CEO as to his view and issues with the implementation of Demutualisation process - is it working what are the issues | | |
| | What are forward plans and strategy for Exchange | | |
| | What are key issues re management and relationship with BSEC | | |
| D | Management committee (Mancom) or equivalent | | |
| (i) | Authorisation and Capacity | | |
| | Has Mancom got proper written authorities and sufficient distance from the Board | | |
| (ii) | Functioning and operation | | |
| | Do executives have a say in management | | |
| | Are deliberations open | | |
| (iii) | Independence from Board in decisions | | |
| | Does Mancom properly manage independently from Board | | |
| E | Market Regulation | | |
| (i) | Review existing agreements and rules | | |
| | Structure/Framework | | |
| | Review of Arrangements and priorities Proposed rules -status and requirements | | |
| | Staffing, capacity and organisation | | |
| | Should auditing be outsourced is it effective? | | |
| | Delineation of respective staff and Board roles | | |
| | Budget and funding | | |
| | Is there proper funding of oversight activities | | |
| | Are there sufficient systems and resources for the task? | | |
| (ii) | Market Surveillance | | |
| | Review Market Dynamics and Volatility | | |
| | Review of Surveillance System and Processes | | |
| | Review open and closed investigations | | |
| | Review of Actions taken | | |
| | Review of Adequacy Staff | | |
| | Review Conflicts with Market Operations Role | | |
| | Access to Beneficial Holders | | |
| | Access to Issuer disclosure | | |
| | Access to Intermediary Records | | |
| | Arrangements for sharing of information | | |
| | Domestic regulators | | |
| | Foreign regulators | | |
| | Assess cooperation and duplication with BSEC surveillance | | |
| (iii) | Trading Participants' Compliance | | |

| | | | |
|---|---|--|--|
| | Audit Arrangements in place | | |
| | Audit Results Overview | | |
| | Review five files for completeness | | |
| | Review RBCA System and returns | | |
| | Review eight returns for accuracy, completeness and sufficiency | | |
| | Assessment of adequacy and sufficiency | | |
| (iv) Prosecution & Enforcement | | | |
| | Review staff functions and adequacy | | |
| | Review decisions penalties and consistency of decisions | | |
| | Review complaint registers follow up and procedures | | |
| | Review linkages to BSEC | | |
| | Relationship with Issuer Disclosure | | |
| F Issuer Disclosure | | | |
| | Adequacy | | |
| | Independence | | |
| | Relationship with Member oversight | | |
| | Review of eight files for approach and adequacy of outcomes | | |
| G Technology | | | |
| | Operational Efficiency | | |
| | Major projects in Hand | | |
| | Systems capacity and planning | | |
| | Risk management | | |
| | Data Warehousing | | |
| H New products and markets | | | |
| | Development of Indexes | | |
| | Development of Derivatives | | |
| | New product development and approval | | |
| I Training / Education | | | |
| | Staff Training Availability and conditions | | |
| | Appropriateness of Training | | |
| | Directors Governance Training | | |
| | Risk management and new product training | | |
| | Member training | | |

Annexure 2: BIS papers (a) CPSS46 and (b) CPSS51 on oversight of clearing and settlement systems

Committee on Payment and
Settlement Systems

Technical Committee of the
International Organization of
Securities Commissions



Recommendations for securities settlement systems

November 2001



BANK FOR INTERNATIONAL SETTLEMENTS



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Foreword

Several international initiatives completed in the past few years have the goal of maintaining financial stability by strengthening the financial infrastructure. The International Organization of Securities Commissions (IOSCO) has developed the *Objectives and Principles of Securities Regulation* (IOSCO, 1998) and the Committee on Payment and Settlement Systems (CPSS) of the central banks of the Group of Ten countries has produced the *Core Principles for Systemically Important Payment Systems* (BIS, 2001). Building on the previous work, the CPSS and the Technical Committee of IOSCO aim to contribute further to this process by jointly issuing these *Recommendations for Securities Settlement Systems*.

The recommendations were developed by the Task Force on Securities Settlement Systems that the CPSS and the Technical Committee of IOSCO created in December 1999. The Task Force comprises 28 central bankers and securities regulators from 18 countries and regions and from the European Union. The Task Force's work has benefited greatly from input from other central bankers and securities regulators and from operators of, and participants in, securities settlement systems. In January 2000 the Task Force received input from central bankers and securities regulators who together represented about 30 countries, as well as from representatives of the International Monetary Fund and the World Bank. In January 2001 the CPSS and the Technical Committee of IOSCO released a version of this report for public comment. Nearly 90 comments were received, and the commenters included a wide variety of interested parties, mostly from Europe, but also from Asia, Africa and the Americas. As a result of these comments, several recommendations have been changed significantly and a new recommendation on cross-border links between settlement systems has been added.

The 19 recommendations and accompanying explanatory texts identify minimum standards that securities settlement systems (SSSs) should meet. The recommendations are designed to cover systems for all types of securities, for securities issued in both industrialised and developing countries, and for domestic as well as cross-border trades.

National authorities responsible for the regulation and oversight of SSSs are expected to assess whether markets in their jurisdiction have implemented the recommendations and to develop action plans for implementation where necessary. As an important first step towards establishing a comprehensive methodology for assessing implementation, the report includes key questions pertaining to each of the recommendations, answers to which would form the basis for assessments. The CPSS and the Technical Committee of IOSCO have directed the Task Force to complete development of the assessment methodology in 2002.

The CPSS and the Technical Committee of IOSCO are grateful to the members of the Task Force and its Co-Chairmen, Patrick Parkinson of the Board of Governors of the Federal Reserve System, Giovanni Sabatini of the Commissione Nazionale per le Società e la Borsa Italy (until May 2001) and Shane Tregillis of the Australian Securities and Investments Commission (from June 2001), for their excellent work in completing this report in a timely manner.

Tommaso Padoa-Schioppa, Chairman
Committee on Payment and Settlement Systems

David Brown, Chairman
Technical Committee, IOSCO

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1. Introduction

1.1 Securities settlement systems (SSSs) are a critical component of the infrastructure of global financial markets. In recent years, trading and settlement volumes have soared, as securities markets have become an increasingly important channel for intermediating flows of funds between borrowers and lenders and as investors have managed their securities portfolios more actively, in part because of declining transaction costs. Volumes of cross-border trades and settlements have grown especially rapidly, reflecting the increasing integration of global markets.

1.2 Weaknesses in SSSs can be a source of systemic disturbances to securities markets and to other payment and settlement systems. A financial or operational problem at any of the institutions that perform critical functions in the settlement process or at a major user of an SSS could result in significant liquidity pressures or credit losses for other participants. Any disruption of securities settlements has the potential to spill over to any payment systems used by the SSS or any payment systems that use the SSS to transfer collateral. In the securities markets themselves, market liquidity is critically dependent on confidence in the safety and reliability of the settlement arrangements; traders will be reluctant to trade if they have significant doubts as to whether the trade will in fact settle.

1.3 The potential for international standards to promote improvements in the safety and efficiency of SSSs was clearly demonstrated by the impact of the Group of Thirty's 1989 standards.¹ Although the G30's recommendations have not been fully implemented in all markets, they have unquestionably fostered very significant progress in many markets, both in industrialised countries and in emerging markets. Nonetheless, with the passage of more than a decade it has become apparent that some of the G30 standards are in need of updating. Moreover, they do not address some issues that subsequent experience has demonstrated to be quite important, such as the legal foundations of settlement arrangements, transparency, access, governance, and regulation and oversight. (The latter issues are becoming even more important with the trend towards consolidation of settlement systems, notably in Europe.) While various private sector groups (notably the International Securities Services Association (ISSA) and the Fédération Internationale des Bourses de Valeurs (FIBV)) have made suggestions for updating the G30 recommendations,² the 1989 recommendations remain the only standards that have achieved widespread support and official endorsement.

1.4 Within the public sector, the relevant international standard-setting bodies are the Committee on Payment and Settlement Systems (CPSS) of the central banks of the Group of Ten countries and the International Organization of Securities Commissions (IOSCO). Discussions between the CPSS and IOSCO's Technical Committee resulted in agreement that cooperative development of new recommendations for SSSs by securities regulators and central banks would facilitate further progress in making such arrangements safer and more efficient. Such an effort was seen as part of the broader efforts by the Financial Stability Forum (in which both the CPSS and IOSCO are represented) to strengthen financial systems by ensuring that gaps in international standards are identified and filled.

1.5 To move this initiative forward, in December 1999 the CPSS and the Technical Committee of IOSCO created the Task Force on Securities Settlement Systems. The Task Force is comprised of 28 central bankers and securities regulators from 18 countries and regions and the European Union (Annex 1). The Task Force's mandate called for it to promote the implementation by SSSs of measures that can enhance international financial stability, reduce risks, increase efficiency and provide adequate safeguards for investors by developing recommendations for the design, operation and oversight of such systems. The recommendations were to identify minimum standards that systems should meet. They were to cover the settlement of both domestic and cross-border trades through individual settlement systems and links between those systems.

1.6 Based largely on input received at a consultative meeting at the Bank for International Settlements (BIS) in January 2000,³ the Task Force concluded that the recommendations should be

¹ Group of Thirty, *Clearance and Settlement Systems in the World's Securities Markets* (Group of Thirty, 1989).

² See International Securities Services Association, *Recommendations 2000* (ISSA, 2000) and Fédération Internationale des Bourses de Valeurs, *Clearing and Settlement Best Practices* (FIBV, 1996).

³ The consultative meeting was attended by 30 central bankers and 25 securities regulators (together representing about 30 countries) and by representatives of the International Monetary Fund and the World Bank.

designed to cover SSSs for all securities, including equities and corporate and government bonds and money market instruments, and securities issued in industrialised and developing countries.

1.7 The Task Force defined an SSS broadly to include the full set of institutional arrangements for confirmation, clearance and settlement of securities trades and safekeeping of securities. As described in Annex 2, quite a few institutions may be involved in this process. In recent years, most markets have established central securities depositories (CSDs) that immobilise physical securities or dematerialise them and transfer ownership by means of book entries to electronic accounting systems. Even when a market has a CSD, however, other institutions often perform functions that are critical to the settlement of securities trades. The confirmation of trade details is often performed by a stock exchange or trade association or by counterparties bilaterally, rather than by the CSD. In some markets, a central counterparty (CCP) interposes itself between buyers and sellers, becoming, in effect, the buyer to every seller and the seller to every buyer. Although funds may be transferred through internal accounts at the CSD, in many cases accounts at the central bank or at one or more private commercial banks are used. Finally, not all buyers and sellers of securities hold accounts at the CSD; instead, they may hold their securities and settle their trades through a custodian, and the custodian may, in turn, hold its customers' securities through a subcustodian. In some markets in which intermediaries and investors hold their securities at a very small number of custodians, those custodians may settle transactions between clients through book-entry transfers on their own books rather than on the books of the CSD.

1.8 Based on a review of existing standards and on discussions at the consultative meeting, the Task Force developed a list of specific topics and issues to be addressed by its recommendations. The list included the legal framework for securities settlements, risk management, access, governance, efficiency, transparency, and regulation and oversight. For those issues that the G30 addressed (primarily the risk management issues), the Task Force used the G30 recommendations as a starting point. For the other topics, the Task Force drew on prior work by the CPSS and IOSCO, especially the work on core principles for systemically important payment systems and for securities regulation, and by ISSA and the FIBV.⁴

1.9 As discussed in Annex 4, settlements of cross-border trades tend to increase the importance and complexity of certain issues, including legal issues, custody risks in tiered securities holding systems and the timing of finality in cross-system settlements. Cross-border settlement arrangements also pose special challenges for regulation and oversight. Nonetheless, the Task Force concluded that it could best address those issues in the discussions of the relevant recommendations for SSSs generally, rather than in separate recommendations. The one exception is a recommendation addressing the risks in cross-border links between CSDs.

1.10 Because of the diversity of institutional arrangements internationally, the recommendations must focus on the functions to be performed, not on the institutions that may perform them. While some of the recommendations are relevant primarily to CSDs, others are relevant to stock exchanges, trade associations and other operators of trade confirmation systems, CCPs, settlement banks or custodians. As noted above, the distinctions between the functions of CSDs and custodians have become blurred in some markets where custodians settle trades between clients on their own books. In such markets some of the recommendations addressed to CSDs may need to be applied to such custodians. Many are also relevant to the broker-dealers, banks, investment managers and investors who use the services provided by the above-mentioned institutions. Securities regulators, central banks and, in some cases, banking supervisors will need to work together to determine the appropriate scope of application of the recommendations and to develop an action plan for implementation. When key intermediaries are located in other jurisdictions, the cooperation of authorities in all of the relevant jurisdictions will be essential.

1.11 The recommendations are set out in Exhibit 1. The remainder of this paper provides the rationale for and elaborates on those recommendations. Section 2 briefly discusses the public policy objectives underlying the recommendations. Section 3 explains the reasoning behind and develops in greater detail each of the recommendations set out in Exhibit 1. Section 4 discusses implementation of the recommendations. Section 5 takes a first step towards development of a comprehensive

⁴ See CPSS, *Core Principles for Systemically Important Payment Systems* (BIS, 2001), IOSCO, *Objectives and Principles of Securities Regulation* (IOSCO, 1998), and the references cited in footnote 2.

methodology for assessing progress towards implementation by identifying key questions pertaining to each recommendation. As noted in the Foreword, the CPSS and the Technical Committee of IOSCO have directed the Task Force to complete work on a comprehensive assessment methodology in 2002.

Exhibit 1
CPSS-IOSCO Technical Committee
Recommendations for Securities Settlement Systems

Legal risk

1. *Legal framework*

Securities settlement systems should have a well founded, clear and transparent legal basis in the relevant jurisdictions.

Pre-settlement risk

2. *Trade confirmation*

Confirmation of trades between direct market participants should occur as soon as possible after trade execution, but no later than trade date (T+0). Where confirmation of trades by indirect market participants (such as institutional investors) is required, it should occur as soon as possible after trade execution, preferably on T+0, but no later than T+1.

3. *Settlement cycles*

Rolling settlement should be adopted in all securities markets. Final settlement should occur no later than T+3. The benefits and costs of a settlement cycle shorter than T+3 should be evaluated.

4. *Central counterparties (CCPs)*

The benefits and costs of a CCP should be evaluated. Where such a mechanism is introduced, the CCP should rigorously control the risks it assumes.

5. *Securities lending*

Securities lending and borrowing (or repurchase agreements and other economically equivalent transactions) should be encouraged as a method for expediting the settlement of securities transactions. Barriers that inhibit the practice of lending securities for this purpose should be removed.

Settlement risk

6. *Central securities depositories (CSDs)*

Securities should be immobilised or dematerialised and transferred by book entry in CSDs to the greatest extent possible.

7. *Delivery versus payment (DVP)*

CSDs should eliminate principal risk by linking securities transfers to funds transfers in a way that achieves delivery versus payment.

8. *Timing of settlement finality*

Final settlement should occur no later than the end of the settlement day. Intraday or real-time finality should be provided where necessary to reduce risks.

9. CSD risk controls to address participants' failures to settle

CSDs that extend intraday credit to participants, including CSDs that operate net settlement systems, should institute risk controls that, at a minimum, ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle. The most reliable set of controls is a combination of collateral requirements and limits.

10. Cash settlement assets

Assets used to settle the ultimate payment obligations arising from securities transactions should carry little or no credit or liquidity risk. If central bank money is not used, steps must be taken to protect CSD members from potential losses and liquidity pressures arising from the failure of the cash settlement agent whose assets are used for that purpose.

Operational risk

11. Operational reliability

Sources of operational risk arising in the clearing and settlement process should be identified and minimised through the development of appropriate systems, controls and procedures. Systems should be reliable and secure, and have adequate, scalable capacity. Contingency plans and backup facilities should be established to allow for timely recovery of operations and completion of the settlement process.

Custody risk

12. Protection of customers' securities

Entities holding securities in custody should employ accounting practices and safekeeping procedures that fully protect customers' securities. It is essential that customers' securities be protected against the claims of a custodian's creditors.

Other issues

13. Governance

Governance arrangements for CSDs and CCPs should be designed to fulfil public interest requirements and to promote the objectives of owners and users.

14. Access

CSDs and CCPs should have objective and publicly disclosed criteria for participation that permit fair and open access.

15. Efficiency

While maintaining safe and secure operations, securities settlement systems should be cost-effective in meeting the requirements of users.

16. Communication procedures and standards

Securities settlement systems should use or accommodate the relevant international communication procedures and standards in order to facilitate efficient settlement of cross-border transactions.

17. Transparency

CSDs and CCPs should provide market participants with sufficient information for them to identify and evaluate accurately the risks and costs associated with using the CSD or CCP services.

18. *Regulation and oversight*

Securities settlement systems should be subject to transparent and effective regulation and oversight. Central banks and securities regulators should cooperate with each other and with other relevant authorities.

19. *Risks in cross-border links*

CSDs that establish links to settle cross-border trades should design and operate such links to reduce effectively the risks associated with cross-border settlements.

2. Public policy objectives

2.1 The recommendations are intended to promote implementation of measures that enhance the safety and efficiency of SSSs and reduce systemic risk. Safe and reliable settlement systems are essential not only for the stability of the securities markets they serve, but often also to payment systems, which may be used by an SSS or may themselves use an SSS to transfer collateral. The safety of securities settlement arrangements and post-trade custody arrangements is also critical to the goal of protecting the assets of investors from claims by the creditors of intermediaries and other entities that perform the various functions in the operation of the SSS. The efficiency of SSS arrangements is another important concern. Inefficiencies will ultimately be reflected in higher costs to issuers of securities and lower returns to investors, which in turn will impede capital formation.

2.2 Ensuring safe and reliable settlement systems requires an understanding of the various steps involved, the types of risk that arise in completing those steps and the sources of that risk. These issues are discussed in detail in Annexes 2 and 3. In brief, a key source of risk is the possibility that a counterparty to a trade will fail to settle its obligations when due or at any time thereafter (credit risk) or will settle its obligations later than expected (liquidity risk). The nature of the credit risk differs, depending on whether a participant defaults before any transfer of securities or funds (pre-settlement risk) or once final transfer of securities or funds has begun but not been completed (settlement risk). Other important types of risk are the risk of a settlement bank's failure, operational risk, custody risk and legal risk. An SSS will be safe and reliable only if each of these types of risk is effectively controlled by the institutions that operate the system and their participants.

2.3 The implementation of safe and reliable SSSs unavoidably entails significant resource costs. In making choices about the design and operation of settlement systems, it is essential that unnecessary costs be avoided and that trade-offs between risk reduction (beyond certain minimum requirements for stability) and costs be weighed carefully. As noted above, efficient settlement systems contribute to well functioning financial markets, which is a public policy objective in its own right. Moreover, costly but relatively riskless settlement arrangements may encourage market participants to utilise comparatively cheaper but perhaps riskier (less safe and reliable) settlement mechanisms, resulting in higher overall systemic risks.

2.4 Competition can be an important mechanism for promoting efficiency. Where competition may be difficult to maintain because of economies of scale or scope in securities settlement, the recommendations emphasise other mechanisms for ensuring fairness and efficiency, such as appropriate governance arrangements and regulation and oversight.

3. Recommendations

Recommendation 1: Legal framework

Securities settlement systems should have a well founded, clear and transparent legal basis in the relevant jurisdictions.

3.1 The reliable and predictable operation of an SSS depends on (1) the laws, rules and procedures that support the holding, transfer, pledging and lending of securities and related payments; and (2) how these laws, rules and procedures work in practice, that is, whether system operators, participants and their customers can enforce their rights. If the legal framework is inadequate or its application uncertain, it can give rise to credit or liquidity risks for system participants and their customers or to systemic risks for financial markets as a whole.

3.2 The legal framework for securities settlements, SSSs and the holding of securities in SSSs varies from jurisdiction to jurisdiction and reflects the organisation of a jurisdiction's entire legal system. The legal framework for SSSs includes general laws, such as property and insolvency laws, and may include laws specifically related to the operation of the system. In some jurisdictions, the general laws governing property rights and insolvency may not apply to, or may contain special provisions related to, the settlement of securities transactions. Laws applicable to securities settlements may also be augmented by regulations or other administrative acts. Other important aspects of the legal framework are the rules and procedures of the various parts of the system, many of which represent contracts between the operators and the participants. This legal framework defines the relationships, rights and interests of the operators, the participants and their customers and the manner in which and time at which rights and obligations arise through the operation of the system.

3.3 As a general matter, the laws, regulations, rules and procedures, and contractual provisions governing the operation of SSSs should be clearly stated, understandable, internally coherent and unambiguous. They also should be public and accessible to system participants.

3.4 Key aspects of the settlement process that the legal framework should support include: enforceability of transactions, protection of customer assets (particularly against loss upon the insolvency of a custodian), immobilisation or dematerialisation of securities, netting arrangements, securities lending (including repurchase agreements and other economically equivalent transactions), finality of settlement, arrangements for achieving delivery versus payment, default rules, and liquidation of assets pledged or transferred as collateral.

3.5 The effective operation of an SSS requires that its internal rules and procedures be enforceable with a high degree of certainty. The rules and contracts related to the operation of the SSS should be enforceable in the event of the insolvency of a system participant, whether the participant is located in the jurisdiction whose laws govern the SSS or in another jurisdiction. The effective operation of an SSS also requires that the SSS have a high degree of certainty regarding its rights and interests in the securities and other assets held in the system, including its rights to use collateral, to transfer property interests, and to make and to receive payments, notwithstanding the bankruptcy or insolvency of an individual system participant or of one of its customers in another jurisdiction. The claims of the SSS or the system participants against collateral posted by a participant with the SSS should in all events have priority over the claims of such participant's non-system creditors. For example, non-system creditors should be able to enforce their claims against collateral posted in the system only after the satisfaction out of the collateral of all claims arising within the system. In some jurisdictions, this may cause collateral to be held by an SSS in the form of securities (eg government bonds) instead of in cash. Lastly, direct system participants, intervening intermediaries, and their respective customers should have a high degree of certainty regarding the rights and interests they hold through the system, notwithstanding the insolvency of a user, a participant or a component of an SSS such as a CSD, CCP or settlement bank.

3.6 The legal framework for an SSS must be evaluated in the relevant jurisdictions. These include the jurisdiction(s) in which the system and its direct participants are established, domiciled or have their principal office and any jurisdiction whose laws affect the operation of the system as a result of a contractual choice of law. Relevant jurisdictions may also include a jurisdiction in which a security handled by the SSS is issued, jurisdictions in which an intermediary, its customer or the customer's bank is established, domiciled or has its principal office, or a jurisdiction whose laws govern a contract between these parties.

3.7 Where a system crosses borders through linkages or remote participants, the rules governing the system should clearly indicate the law that is intended to apply to each aspect of the settlement process. The operators of cross-border systems must address conflict of laws issues when there is a difference in the substantive laws of the jurisdictions that have a potential interest in the system. In such circumstances, each jurisdiction's conflict of laws rules specify the criteria that determine the law applicable to the system. System operators and participants should be aware of conflict of laws issues when structuring the rules of a system and in choosing the law that governs the system. System operators and participants should also be aware of applicable constraints on their ability to choose the law that will govern the system. A relevant jurisdiction ordinarily does not permit system operators and participants to circumvent the fundamental public policy of that jurisdiction by contract. For example, jurisdictions that require that title to securities be recorded in a domestic registry generally do not permit parties to override that law through a contractual choice of law. Subject to such constraints, the legal framework should support appropriate contractual choices of law in the context of both domestic and cross-border operations. In many cases, the law chosen with respect to the operation of an SSS will be that of the location of a CCP or a CSD.

3.8 A harmonisation or convergence of laws would obviate conflict of laws issues that currently impede the cross-border operation of SSSs. Therefore, countries should voluntarily seek to harmonise or bring about a convergence of laws governing SSSs, the contracts between SSSs and direct system participants, and the contracts between direct system participants, other intervening intermediaries and their respective customers. In this connection, the deliberations of the Hague Conference on Private International Law relating to the promulgation of a Convention on the Law Applicable to Proprietary Rights in Indirectly Held Securities are encouraged.

3.9 The legal framework, including requirements relating to contractual choices of law, should give great weight to the public interest in the effective operation of SSSs and to the public necessity for legal certainty in the irreversibility of securities settlements. Each jurisdiction should seek to promote national laws and public policies that support the CPSS-IOSCO Technical Committee recommendations for SSSs and related arrangements. If the legal framework in a particular jurisdiction does not support the existing SSSs or the implementation of these recommendations, the appropriate regulatory and supervisory authorities should seek legislative reform.

Recommendation 2: Trade confirmation

Confirmation of trades between direct market participants should occur as soon as possible after trade execution, but no later than trade date (T+0). Where confirmation of trades by indirect market participants (such as institutional investors) is required, it should occur as soon as possible after trade execution, preferably on T+0, but no later than T+1.

3.10 The first step in settling a securities trade is to ensure that the buyer and the seller agree on the terms of the transaction, a process referred to as trade confirmation. Often a broker-dealer or member of an exchange (a direct market participant) acts as an intermediary in executing trades on behalf of others (indirect market participants). In such circumstances, trade confirmation often occurs on two separate tracks: confirmation of the terms of the trade between direct participants and confirmation (sometimes termed "affirmation") of the intended terms between each direct participant and the indirect participant for whom the direct participant is acting. (Generally, indirect market participants for whom confirmations are required include institutional investors and cross-border clients.) On both tracks, agreement of trade details should occur as soon as possible so that errors and discrepancies can be discovered early in the settlement process. Early detection should help to avoid errors in recording trades, which could result in inaccurate books and records, increased and mismanaged market risk and credit risk, and increased costs. While this process is occurring, the back offices of the direct market participants, indirect market participants and custodians that act as agents for the indirect market participants need to prepare settlement instructions, which should be matched prior to the settlement date. Speedy, accurate verification of trades and matching settlement instructions is an essential precondition for avoiding settlement failures, especially when the settlement cycle is relatively short. (See Recommendation 3 regarding the length of settlement cycles.)

3.11 Trade confirmation systems are increasingly becoming automated. Many markets already have in place systems for the automatic comparison of trades between direct market participants. (In many markets, the use of electronic trading systems obviates the need for direct market participants to match the terms of the trade.) Automated matching systems are also being proposed and implemented for trade confirmation between direct market participants and indirect market participants

and for the matching of settlement instructions. Automation improves processing times by eliminating the requirement to send information back and forth manually between parties and by avoiding the errors inherent in manual processing.

3.12 At its most sophisticated, automation allows manual intervention to be eliminated from post-trade processing through the implementation of straight through processing (STP), that is, procedures that require trade data to be entered only once and then use those same data for all post-trade requirements related to settlement. Many practitioners believe that market-wide achievement of STP is essential, both for maintaining high settlement rates as volumes increase and for ensuring timely settlement of cross-border trades, particularly if reductions in settlement cycles are to be achieved. STP systems may use a common message format or use a translation facility that either converts different message formats into a common format or translates between different formats. Several initiatives aim to achieve STP. These initiatives should be encouraged, and direct and indirect market participants should achieve the degree of internal automation necessary to take full advantage of whatever solutions emerge.

Recommendation 3: Settlement cycles

Rolling settlement should be adopted in all securities markets. Final settlement should occur no later than T+3. The benefits and costs of a settlement cycle shorter than T+3 should be evaluated.

3.13 Under a rolling settlement cycle, trades settle a given number of days after the trade date rather than at the end of an “account period”, thereby limiting the number of outstanding trades and reducing aggregate market exposure. The longer the period from trade execution to settlement, the greater the risk that one of the parties may become insolvent or default on the trade, the larger the number of unsettled trades, and the greater the opportunity for the prices of the securities to move away from the contract prices, thereby increasing the risk that non-defaulting parties will incur a loss when replacing the unsettled contracts. In 1989, the G30 recommended that final settlement of cash transactions should occur on T+3, that is, three business days after the trade date. However, the G30 recognised that “to minimise counterparty risk and market exposure associated with securities transactions, same day settlement is the final goal”.

3.14 This recommendation retains T+3 settlement as a minimum standard. Markets that have not yet achieved a T+3 settlement cycle should identify impediments to achieving T+3 and actively pursue the removal of those impediments. Many markets already are settling at a shorter interval than T+3. For example, many government securities already settle on T+1 or even T+0, and some equity markets are currently considering a T+1 settlement cycle. The standard judged appropriate for a type of security or market will depend upon factors such as transaction volume, price volatility and the extent of cross-border trading in the instrument. Each securities market should evaluate whether a cycle shorter than T+3 is appropriate, given the risk reduction benefits that could be achieved, the costs that would be incurred and the availability of alternative means of limiting pre-settlement risk, such as trade netting through a CCP (see Recommendation 4 below). Depending on these factors, some markets may conclude that different types of securities should have different settlement cycles.

3.15 Reducing the cycle is neither costless nor without certain risks. This is especially true for markets with significant cross-border activity because differences in time zones and national holidays, and the frequent involvement of multiple intermediaries, make timely trade confirmation more difficult. In most markets, a move to T+1 (perhaps even to T+2) would require a substantial reconfiguration of the trade settlement process and an upgrade of existing systems. For markets with a significant share of cross-border trades, substantial system improvements may be essential for shortening settlement cycles. Without such investments, a move to a shorter cycle could generate increased settlement fails, with a higher proportion of participants unable to agree and exchange settlement data or to acquire the necessary resources for settlement in the time available. Consequently, replacement cost risk would not be reduced as much as anticipated and operational risk and liquidity risk could increase.

3.16 Regardless of the settlement cycle, the frequency and duration of settlement failures should be monitored closely. In some markets, the benefits of T+3 settlement are not being fully realised because the rate of settlement on the contractual date falls significantly short of 100%. In such circumstances, the risk implications of the fail rates should be analysed and actions identified that could reduce the rates or mitigate the associated risks. For example, monetary penalties for failing to settle could be imposed contractually or by market authorities; alternatively, failed trades could be marked to market and, if not resolved within a specified timeframe, closed out at market prices.

Recommendation 4: Central counterparties (CCPs)

The benefits and costs of a CCP should be evaluated. Where such a mechanism is introduced, the CCP should rigorously control the risks it assumes.

3.17 A central counterparty (CCP) interposes itself between trade counterparties, becoming the buyer to every seller and the seller to every buyer. Thus, from the point of view of market participants the credit risk of the CCP is substituted for the credit risk of the other participants. (In some markets many of the benefits of a CCP are achieved by establishing an entity that indemnifies market participants against losses from counterparty defaults without actually acting as CCP.) If a CCP manages its risks effectively, its probability of default may be less than that of all or most of the market participants. Moreover, a CCP often bilaterally nets its obligations vis-à-vis its participants, which achieves multilateral netting of each participant's obligations vis-à-vis all of the other participants. This can reduce substantially the potential losses in the event of the default of a participant, both on trades that have not reached settlement (replacement cost exposures) and on trades in the process of settlement (principal exposures). In addition, netting reduces the number and value of deliveries and payments needed to settle a given set of trades, thereby reducing liquidity risks and transaction costs.

3.18 Introduction of a CCP is another tool, in addition to shortening settlement cycles, for reducing counterparty credit risks. It is especially effective for reducing risks vis-à-vis active market participants, who often buy and sell the same security for settlement on the same date. In addition to these risk reduction benefits, the growing demand for CCP arrangements in part reflects the increasing use of anonymous electronic trading systems, where orders are matched according to the rules of the system and participants cannot always manage their credit risks bilaterally through their choice of counterparty.

3.19 Nevertheless, a CCP will not be appropriate in all markets. Establishing a CCP is not without costs. In particular, establishing the kind of robust risk management system that a CCP must have (see discussion below) generally requires significant initial investments and ongoing expenses. Thus, individual markets should assess carefully the balance of the benefits and costs of a CCP. This balance will depend on factors such as the volume and value of transactions, trading patterns among counterparties, and the opportunity costs associated with settlement liquidity. A growing number of markets have determined that the benefits of implementing a CCP outweigh the costs.

3.20 If a CCP is established, it is important that it have sound risk management because the CCP assumes responsibility for risk management and reallocates risk among its participants through its policies and procedures. As a result, if a CCP does not perform risk management well, the CCP could increase risk to market participants. The ability of the system as a whole to withstand the default of individual participants depends crucially on the risk management procedures of the CCP and its access to resources to absorb financial losses. The failure of a CCP would almost certainly have serious systemic consequences, especially where multiple markets are served by one CCP. Consequently, a CCP's ability to monitor and control the credit, liquidity, legal and operational risks it incurs and to absorb losses is essential to the sound functioning of the markets it serves. A CCP must be able to withstand severe shocks, including defaults by one or more of its participants, and its financial support arrangements should be evaluated in this context. Furthermore, there must be a sound and transparent legal basis for the netting arrangements, whether by novation or otherwise. For example, netting must be enforceable against the participants in bankruptcy. Without such legal underpinnings, net obligations may be challenged in judicial or administrative insolvency proceedings. If these challenges are successful, the CCP or the original counterparty may face additional settlement exposure. The CCP must also be operationally sound and must ensure that its participants have the incentive and the ability to manage the risks they assume.

3.21 CCPs adopt a variety of means to control risk. The precise means reflects the market served and the nature of the risks incurred. Access criteria are essential (see Recommendation 14 on access). The CCP's exposures should be collateralised. Most CCPs require members to deposit collateral to cover potential market movements on open positions or unsettled transactions. Positions are also generally marked to market one or more times daily, with the CCP taking additional cash or collateral to cover any changes in the net value of the open positions of participants since the previous valuation and settlement. During volatile periods, CCPs may collect additional collateral to minimise further their exposure. CCPs should also have rules specifying clearly how defaults will be handled and how losses will be shared in the event that a defaulting firm's collateral fails to cover its exposure. For example, CCPs may require their members to contribute to default clearing funds, typically composed of cash or high-quality, liquid securities and calculated using a formula based on the

volume of the participant's settlement activity. Those funds are often augmented through insurance or other financial support. Liquidity demands are usually met by some combination of clearing fund assets and firmly committed bank credit lines. Rules and procedures for handling defaults should be transparent to enable members and other market participants to assess the risks they assume because of their membership in and use of a CCP.

3.22 CCPs are currently developing global risk management standards that draw on their common experience and expertise. In February 2001, senior executives of the European Association of Central Counterparty Clearing Houses (EACH) developed risk management standards for their organisations. Subsequently, CCP-12, a group that includes CCPs from Asia and the Americas as well as Europe, has been working to revise the EACH standards and broaden their acceptance among CCPs.⁵ Once CCP-12's work is finalised, national authorities should consider using it as a starting point when evaluating the risk management procedures of a CCP.

Recommendation 5: Securities lending

Securities lending and borrowing (or repurchase agreements and other economically equivalent transactions) should be encouraged as a method for expediting the settlement of securities transactions. Barriers that inhibit the practice of lending securities for this purpose should be removed.

3.23 Mature and liquid securities lending markets (including markets for repurchase agreements and other economically equivalent transactions) generally improve the functioning of securities markets by allowing sellers ready access to securities needed to settle transactions where those securities are not held in inventory, by offering an efficient means of financing securities portfolios, and by supporting participants' trading strategies.⁶ The existence of liquid markets for securities lending reduces the risks of failed settlements because market participants with an obligation to deliver securities that they have failed to receive and do not hold in inventory can borrow these securities and complete delivery. Securities lending markets also enable market participants to cover transactions that have already failed, thereby curing the failure sooner. In cross-border transactions, particularly back-to-back transactions, it is often more efficient and cost-effective for a market participant to borrow a security for the delivery than to deal with the risk and costs associated with a settlement failure.

3.24 Liquid securities lending markets are therefore to be encouraged, subject to appropriate limits on their use for purposes prohibited by regulation or law. For example, borrowing to support short sales is illegal in some circumstances in some markets. Even in jurisdictions that restrict securities lending because of other public policy concerns, authorities should consider permitting lending to reduce settlement failures. Impediments to the development and functioning of securities lending markets should, as far as possible, be removed. In many markets, the processing of securities lending transactions involves manually intensive procedures. In the absence of robust and automated procedures, errors and operational risks increase, and it may be difficult to achieve timely settlement of securities lending transactions, which often need to settle on a shorter cycle than regular trades. The scope for improvement in the processing of cross-border borrowing and lending transactions is particularly large. Some CSDs seek to overcome these impediments by providing centralised lending facilities; others offer services intended to support the bilateral lending market. The needs of individual markets will differ, and market participants and CSDs should evaluate the usefulness of the different types of facilities.

3.25 Other impediments might arise from tax or accounting policies, from legal restrictions on lending, from an inadequate legal underpinning for securities lending or from ambiguities about the treatment of such transactions in a bankruptcy. One of the most significant barriers to development

⁵ The CCP-12 is composed of the following entities: (1) the Australian Stock Exchange; (2) the Brazilian Clearing and Depository Corporation; (3) Eurex Clearing; (4) the Chicago Mercantile Exchange; (5) Clearnet; (6) Hong Kong Exchanges and Clearing Limited; (7) the London Clearing House; (8) S D Indeval, SA de CV; (9) Singapore Exchange Limited; (10) The Canadian Depository for Securities Limited; (11) The Depository Trust & Clearing Corporation; (12) The Options Clearing Corporation; and (13) the Tokyo Stock Exchange.

⁶ For a thorough discussion of securities lending and repurchase agreements, see Technical Committee of IOSCO and CPSS, *Securities Lending Transactions: Market Development and Implications* (BIS, 1999); Committee on the Global Financial System, *Implications of Repo Markets for Central Banks* (BIS, 1999).

may be related to taxation of securities lending transactions. A tax authority's granting of tax neutrality to the underlying transaction and the elimination of certain transaction taxes have served to increase activity in several jurisdictions. Accounting standards also have an influence on the securities lending market, particularly with respect to whether, and under what conditions, collateral must be reflected on the balance sheet. Authorities in some jurisdictions restrict the types or amounts of securities that may be loaned, the types of counterparties that may lend securities, or the permissible types of collateral. Uncertainty about the legal status of transactions, for example their treatment in insolvency situations, also inhibits development of a securities lending market. The legal and regulatory structure must be clear so that all parties involved understand their rights and obligations.

3.26 While securities lending may be a useful tool, it presents risk to both the borrower and the lender. The securities lent or the collateral may not be returned when needed, because of counterparty default, operational failure or legal challenge, for example. Those securities would then need to be acquired in the market, perhaps at a cost. Counterparties to securities loans should employ appropriate risk management policies, including conducting credit evaluations, collateralising exposures, marking exposures and collateral to market daily, and employing master legal agreements.

Recommendation 6: Central securities depositories (CSDs)

Securities should be immobilised or dematerialised and transferred by book entry in CSDs to the greatest extent possible.

3.27 There are several different ways for beneficial owners to hold securities. In some jurisdictions, physical securities circulate and beneficial owners may keep securities in their possession, although beneficial owners typically employ a custodian to hold them to reduce risks and safekeeping costs. The costs and risks associated with owning and trading securities may be reduced considerably through immobilisation of physical securities, which involves concentrating the location of physical securities in a depository (or CSD). To promote immobilisation of all certificates of a particular issue, a jurisdiction could encourage the issuance of a global note, which represents the whole issue. A further step away from circulating physical securities is full dematerialisation of a securities issue. In this approach, there is no global note issued, as the rights and obligations stem from book entries in an electronic register.

3.28 In addition to differences in physical arrangements for holding securities, there are important differences in the legal arrangements. Holding systems may be categorised generally as direct or indirect (see Annex 2). Each type of system has advantages and disadvantages and either type of system can be designed in a manner that complies with these Recommendations. In jurisdictions that operate a direct holding system but in which the CSD is not the official registrar of the issuer, a transfer of securities in the CSD should result automatically in the transfer of legal title to the securities in the official register of the issuer.

3.29 The immobilisation or dematerialisation of securities and their transfer by book entry within a CSD significantly reduces the total costs associated with securities settlements and custody. By centralising the operations associated with custody and transfer within a single entity, costs can be reduced through economies of scale. In addition, efficiency gains can be achieved through increased automation, which reduces the errors and delays inherent in manual processing. By reducing costs and improving the speed and efficiency of settlement, book entry settlement also supports the development of securities lending markets, including markets for repurchase agreements and other economically equivalent transactions. These activities, in turn, enhance the liquidity of securities markets and facilitate the use of securities collateral to manage counterparty risks, thereby increasing the efficiency of trading and settlement. Effective governance (see Recommendation 13) is necessary, however, to ensure that these benefits are not lost as a result of monopolistic behaviour by the CSD.

3.30 The immobilisation or dematerialisation of securities also reduces or eliminates certain risks, for example destruction or theft of certificates. The transfer of securities by book entry is a precondition for the shortening of the settlement cycle for securities trades, which reduces replacement cost risks. Book entry transfer also facilitates delivery versus payment, thereby eliminating principal risks.

3.31 Thus, for both safety and efficiency reasons, securities should be immobilised or dematerialised in CSDs to the greatest extent possible. In practice, retail investors may not be prepared to give up their certificates. However, it is not necessary to achieve complete immobilisation to realise the benefits of CSDs. It may be sufficient that the most active market participants immobilise

their holdings. Less active investors that insist on holding certificates should bear the costs of their decisions.

Recommendation 7: Delivery versus payment (DVP)

CSDs should eliminate principal risk by linking securities transfers to funds transfers in a way that achieves delivery versus payment.

3.32 The settlement of securities transactions on a DVP basis ensures that principal risk is eliminated, that is, there is no risk that securities could be delivered but payment not received, or vice versa. DVP procedures reduce, but do not eliminate, the risk that the failure of a CSD participant could result in systemic disruptions. Systemic disruptions are still possible because the failure of a participant could produce substantial liquidity pressures or high replacement costs. Achievement of DVP by the CSD also enables the CSD's participants to offer their customers DVP.

3.33 DVP can be achieved in several ways.⁷ Three different "models" can be differentiated. They vary according to whether the securities and/or funds transfers are settled on a gross (trade by trade) basis or on a net basis, and in terms of the timing of the finality of transfers. Finality may be in real time (ie throughout the day), intraday (ie at multiple times during the day), or only at the end of the day. Whichever approach is taken, what is essential is that the technical, legal and contractual framework ensures that each transfer of securities is final if and only if the corresponding transfer of funds is final. DVP can and should be achieved for issuance and redemption of securities as well as for transactions in secondary markets.

3.34 Strictly speaking, DVP does not require simultaneous final transfers of funds and securities. Often when a CSD does not itself provide cash accounts for settlements, it first blocks the underlying securities in the account of the seller or his custodian. It then requests transfer of funds from the buyer to the seller in the settlement bank. The securities are delivered to the buyer or his custodian if and only if the CSD receives confirmation of settlement of the cash leg from the settlement bank. In such arrangements blocked securities must not be subject to a claim by a third party (by other creditors, tax authorities or even the CSD itself), because this would give rise to principal risk.

3.35 If a CSD achieves DVP, it enables local agents to offer DVP to their customers in other jurisdictions. Cross-border links between CSDs (see Recommendation 19) can be designed to permit DVP settlement of cross-border trades between participants in the linked CSDs.

Recommendation 8: Timing of settlement finality

Final settlement should occur no later than the end of the settlement day. Intraday or real-time finality should be provided where necessary to reduce risks.

3.36 The timing of settlement finality should be defined clearly to all the participants for both free of payment transfers and delivery versus payment transfers. The completion of final transfers by the end of the day is essential. Deferral of settlement to the next business day can substantially increase the potential for participant failures to settle to create systemic disturbances, in part because the authorities tend to close insolvent institutions between business days. However, end-of-day net settlements may entail significant liquidity risks, unless risk controls to address participant defaults are highly robust. (See Recommendation 9.)

3.37 Even if the risks of participant failures to settle are controlled effectively, end-of-day net settlement may entail risks to participants that can and should be reduced by providing intraday (or even real-time) finality. For example, intraday or real-time finality is sometimes necessary for: monetary policy or payments operations; settlement of back-to-back transactions or intraday margin calls by CCPs; or safe and efficient cross-border links between CSDs.

3.38 Central banks' monetary policy operations must often be settled at a designated time within the day. Also, when a payment system requires credit extensions to be collateralised, it may be crucial

⁷ See CPSS, *Delivery Versus Payment in Securities Settlement Systems* (BIS, 1992).

for the smooth functioning of the payment system that this collateral be transferable with real-time or intraday finality.

3.39 Intraday or real-time finality may also be essential to active trading parties, for example those conducting back-to-back transactions in securities, including the financing of securities through repurchase agreements and similar transactions; for such active counterparties, end-of-day notification of fails would create significant liquidity risk. Intraday finality is also essential for CCPs that rely on intraday margin calls to mitigate risks vis-à-vis their members.

3.40 Finally, in the absence of intraday or real-time settlement, a CSD's links to other CSDs (for example, links to foreign CSDs to facilitate settlements of cross-border trades) may pose systemic risks unless additional risk controls are imposed that may impair the efficiency of the links. In particular, systemic risks could arise if one CSD allows provisional transfers of securities to the other CSDs. In such circumstances, an unwind of those provisional transfers could transmit any disturbances from a failure to settle at the CSD making the provisional transfer to the linked CSDs. To guard against this, either the CSD would need to prohibit such provisional transfers, or the linked CSDs would need to prohibit their retransfer prior to their becoming final. But such risk controls may impose significant opportunity costs on users of the link, especially on active trading parties who engage in back-to-back transactions.

3.41 For these purposes, intraday or real-time settlement of securities transactions is being demanded in a growing number of markets. However, these risks and the resulting demands for intraday finality are not equally pressing in all markets. Where such demands are not pressing, an end-of-day net settlement system with robust risk controls (Recommendation 9) may offer the best combination of safety and efficiency. Whatever approach is adopted, it is critical that the CSD make clear to its participants the timing of finality. Furthermore, the CSD should prohibit the unilateral revocation of unsettled transfer instructions late in the settlement day, so as to avoid the liquidity risks that such actions can create.

Recommendation 9: CSD risk controls to address participants' failures to settle

CSDs that extend intraday credit to participants, including CSDs that operate net settlement systems, should institute risk controls that, at a minimum, ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle. The most reliable set of controls is a combination of collateral requirements and limits.

3.42 Where they are permitted to do so, CSDs often extend intraday credit to participants (either as principal or as agent for other participants) to facilitate timely settlements and, in particular, to avoid gridlock. In a gross settlement system, where credit extensions occur, they are usually extended by the CSD as principal and take the form of intraday loans or repurchase agreements. In net settlement systems these credit extensions are usually in effect extended by the CSD as agent for other participants and take the form of net debit positions in funds, which are settled only at one or more discrete, prespecified times during the processing day. (See the discussion in 3.44 of the implication of unwinds of provisional transfers in net settlement systems.)

3.43 Whenever a CSD extends credit to participants, it creates the risk that participants will be unable to settle their obligations. Such failures to settle can impose credit losses and liquidity pressures on the CSD or on its other participants. If those losses and liquidity pressures exceed the financial resources of those expected to bear them, further failures to settle would result and the system as a whole may fail to achieve timely settlement. If so, both the securities markets the CSD serves and payment systems may be disrupted.

3.44 While the failure of a large participant to settle may create such disruptions in any settlement system, the potential is especially large in net settlement systems that attempt to address such settlement failures by unwinding transfers involving that participant, that is, by deleting some or all of the provisional securities and funds transfers involving that participant and then recalculating the settlement obligations of the other participants. An unwind has the effect of imposing liquidity pressures (and any replacement costs) on the participants that had delivered securities to, or received securities from, the participant that failed to settle. If all such transfers must be deleted and if the unwinding occurs at a time when money markets and securities lending markets are illiquid (for example, at or near the end of the day), the remaining participants could be confronted with shortfalls of funds or securities that would be extremely difficult to cover.

3.45 Consequently, CSDs that extend credit to participants must impose risk controls to limit the potential for failures to settle to generate systemic disruption. At a minimum, the controls should enable the system to complete settlement following a failure to settle by the participant with the single largest payment obligation. Such failures may not occur in isolation, however, and systems should, wherever possible, be able to survive additional failures. In determining the precise level of comfort to target, each system will need to balance carefully the additional costs to participants of greater certainty of settlement against the probability and potential impact of multiple settlement failures. To achieve the chosen comfort level the CSD can use a variety of risk controls. The appropriate choice of controls depends on several factors, including the systemic importance of the settlement system, the volume and value of settlements, and the effect of the controls on the efficiency of the system.

3.46 The most reliable approach to controlling potential losses and liquidity pressures from participants' failures to settle is a combination of collateral requirements and limits. To control potential credit exposures in this approach, any credit extensions on the funds or securities sides are fully collateralised. To ensure that credit exposures are, in fact, fully collateralised, the CSD applies haircuts to collateral values that reflect the price volatility of the collateral. Also as part of this approach, legally binding arrangements are in place to allow collateral to be sold or pledged promptly. In addition, to control potential liquidity pressures, limits are imposed on credit extensions. On the securities side, a CSD sometimes arranges securities loans to participants to facilitate timely settlement, but debit balances are prohibited. (No CSD should permit overdrafts or debit balances in securities.) On the funds side, the size of its credit extension to each participant (the participant's debit position in a net settlement system or the size of its intraday borrowing in a gross settlement system) is limited. The limits are then set at amounts that could be covered by the CSD or by other participants, taking into account their respective responsibilities under the system's default rules and their liquidity resources. If a central bank grants credit in its own currency to CSD participants, such credit extension need not be limited because its liquidity resources are unlimited. The central bank may nonetheless choose to contain its risks vis-à-vis participants by setting limits.

Recommendation 10: Cash settlement assets

Assets used to settle the ultimate payment obligations arising from securities transactions should carry little or no credit or liquidity risk. If central bank money is not used, steps must be taken to protect CSD members from potential losses and liquidity pressures arising from the failure of the cash settlement agent whose assets are used for that purpose.

3.47 Arrangements for the settlement of payment obligations associated with securities transactions vary across market participants and CSDs. In some cases a market participant has a direct relationship with the CSD and with the cash settlement agent where the ultimate cash settlement occurs. In other cases a market participant has a direct relationship with the CSD but has no direct relationship with the cash settlement agent.⁸ Instead the market participant uses one of several settlement banks to settle its payment obligations.⁹ The settlement banks ultimately settle the cash leg by transferring balances held with the cash settlement agent. These transfers are made through an interbank payment system, typically a central bank payment system. The use of a payment system for this purpose would generally make it systemically important. Therefore, the payment system used for such interbank transfers should adhere to the Core Principles for Systemically Important Payment Systems.¹⁰

3.48 Whatever the payments arrangement, the failure of the settlement agent whose assets are used to settle the ultimate payment obligations could disrupt settlement and result in significant losses and liquidity pressures to CSD members. Furthermore, these risks are involuntary and difficult for CSD members to control. Consequently, there is a strong public interest in containing the potential systemic risks by using a cash settlement asset that carries little or no credit or liquidity risk.

⁸ Some market participants may not have a direct relationship with the CSD or with the cash settlement agent.

⁹ In some instances, a settlement institution may not be organised as a bank. The term "bank" in this discussion refers broadly to any institution providing such services, regardless of whether or not it is organised as a bank.

¹⁰ See CPSS, *Core Principles for Systemically Important Payment Systems* (BIS, 2001).

3.49 In a single currency system, some CSDs use the central bank of issue as cash settlement agent, which eliminates the risk of its failure. Use of the central bank of issue as the single settlement agent may not, however, always be practicable. Even in a single currency system, some (in some cases many) CSD members, CCPs and linked CSDs may not have access to accounts with the central bank of issue.¹¹ In a multicurrency system, the use of central banks of issue can be especially difficult. Even if remote access to central bank accounts by CSD members is possible, the hours of operation of the relevant central banks' payment systems may not overlap with those of the CSD settling in their currencies.

3.50 When a private bank is used as the cash settlement agent, steps must be taken to protect CSD members from potential losses and liquidity pressures that would arise from its failure. One widely employed way of providing the necessary protection is for the CSD to organise itself as a limited purpose bank and become the settlement agent by offering cash accounts to its members. To limit the risk of default, the functions of the limited purpose bank must be clearly defined and the CSD should: institute reliable controls on its credit exposures to members (see Recommendation 9); be strongly capitalised or supported by effective loss-sharing mechanisms or reliable third-party credit support arrangements; and strictly limit any non-settlement activities and associated risks.

3.51 Even if the risk of failure of the cash settlement agent is eliminated or limited effectively, where some (perhaps many) CSD members do not have a direct relationship with the cash settlement agent and instead use one of several settlement banks, failure of one of these settlement banks may also give rise to systemic disturbances. In such circumstances, the fewer the settlement banks, the greater the proportion of payments that will be effected through transfers of balances at these banks rather than transfers of balances at the settlement agent. Thus, it is important that settlement banks are properly regulated institutions with the legal and technical capacity to provide an effective service. If use of only a few settlement banks produces a significant concentration of exposures, those exposures should be monitored and the financial condition of the settlement banks evaluated, either by the operator of the CSD or by regulators and overseers.

3.52 Finally, whatever the payments arrangements, market participants should be able to retransfer the proceeds of securities settlements as soon as possible, at a minimum on the same day, and ideally intraday, so as to limit their liquidity risk and any credit risks associated with the assets used.

Recommendation 11: Operational reliability

Sources of operational risk arising in the clearing and settlement process should be identified and minimised through the development of appropriate systems, controls and procedures. Systems should be reliable and secure, and have adequate, scalable capacity. Contingency plans and backup facilities should be established to allow for timely recovery of operations and completion of the settlement process.

3.53 Operational risk is the risk that deficiencies in information systems or internal controls, human errors or management failures will result in unexpected losses. As clearing and settlement systems become increasingly dependent on information systems, the reliability of these systems is a key element in operational risk. The importance of operational risk lies in its capacity to impede the effectiveness of measures adopted to address other risks in the settlement process and to cause participants to incur unforeseen losses, which, if sizeable, could have systemic risk implications.

3.54 Operational risk can arise from inadequate control of systems and processes; from inadequate management more generally (lack of expertise, poor supervision or training, inadequate resources); from inadequate identification or understanding of risks and the controls and procedures needed to limit and manage them; and from inadequate attention being paid to ensuring that procedures are understood and complied with.

¹¹ This Recommendation is not intended to imply that all such CSD members should have access to accounts at the central bank. The criteria governing access to settlement accounts vary between central banks, but access is generally limited to institutions whose role or size justifies access to a risk-free settlement asset. Not all CSD members need access to central bank money; tiered banking arrangements, in which some CSD members settle their payment obligations through other members that have access to central bank accounts, may achieve an appropriate balance between safety and efficiency.

3.55 Potential operational failures include errors or delays in message handling, transaction processing, system deficiencies or interruption, fraudulent activities by staff and disclosure of confidential information. Errors or delays in transaction processing may result from miscommunication, incomplete or inaccurate information or documentation, failure to follow instructions or errors in transmitting information. These problems are particularly common in manual processes. The existence of physical securities, which may be defective, lost or stolen, also increases the chance of error and delay. While automation has allowed improvements in the speed and efficiency of the clearing and settlement process, it brings its own risks of system deficiencies, interruptions and computer crime. These may arise from factors such as inadequate security, capacity or resilience of backup systems.

3.56 Operational failures may lead to a variety of problems: late or failed settlements that impair the financial condition of participants; customer claims; legal liability and related costs; reputational and business loss; and compromises in other risk control systems that increase credit or market risks. A severe operational failure at a CSD, CCP, cash settlement agent or major participant could have significant adverse effects throughout securities and other markets.

3.57 To minimise operational risk, system operators should identify sources of operational risk, whether arising from the arrangements of the operator itself or from those of its participants, and establish clear policies and procedures to address those risks. There should be adequate management controls and sufficient (and sufficiently well qualified) personnel to ensure that procedures are implemented accordingly. Risks, operational policies and procedures, and systems should be reviewed periodically and after modifications to the system. Information systems should be subject to periodic independent audit, and external audits should be seriously considered.

3.58 All key systems should be secure (that is, have access controls, be equipped with adequate safeguards to prevent external intrusions, and provide audit trails), reliable, scalable and able to handle stress volume and have appropriate contingency plans to account for system interruption. Contingency plans should be rehearsed and capacity stress-tested. Ideally, backup systems should be immediately available. While it may be possible to recommence operations following a system disruption with some data loss, contingency plans should ensure that, as a minimum, the status of all transactions at the time of the disruption can be identified with certainty in a timely manner. The system should be able to recover operations and data in a manner that does not disrupt settlement. Increasingly, SSSs are dependent on electronic communications and need to ensure the integrity of messages through using reliable networks and procedures (such as cryptographic techniques) to transmit data accurately, promptly and without material interruption. Markets should strive to keep up with improvements in technologies and procedures even though the ability to contain operational risks may be limited by the infrastructure in the relevant market (for example, telecommunications). Core Principle VII of the Core Principles for Systemically Important Payment Systems provides more details on operational issues.¹²

3.59 Some clearing and settlement operations may be outsourced to third parties. In these circumstances, operational risk will reside with the outside service provider. System operators who outsource operations should ensure that those operations meet the same standards as if they were provided directly by the system operator.

Recommendation 12: Protection of customers' securities

Entities holding securities in custody should employ accounting practices and safekeeping procedures that fully protect customers' securities. It is essential that customers' securities be protected against the claims of a custodian's creditors.

3.60 Custody risk is the risk of a loss on securities held in custody occasioned by a custodian's (or subcustodian's) insolvency, negligence, misuse of assets, fraud, poor administration, inadequate record keeping, or failure to protect a customer's interests in securities (including voting rights and entitlements).¹³ Although custodians are predominantly commercial banks, CSDs also hold and

¹² See CPSS, *Core Principles for Systemically Important Payment Systems* (BIS 2001).

¹³ For a thorough discussion of custody issues, see Technical Committee of IOSCO, *Client Asset Protection* (IOSCO, 1996).

administer securities on behalf of their direct participants, and thus present custody risk. (Direct participants in a CSD may hold securities both for their own account and on behalf of customers.)

3.61 A custodian should employ procedures ensuring that all customer assets are appropriately accounted for and kept safe whether it holds them directly or through a subcustodian. Because customer securities must also be protected against the claims of a custodian's creditors, a customer's claims against a custodian are typically given priority or are given preferential treatment under insolvency law. (Nonetheless, customer assets could be subject to liens in favour of the custodian if, for example, the customer has pledged them to secure an obligation to the custodian.) One way that a customer can be protected in the event of a custodian's insolvency is through segregation (identification) of customer securities on the books of the custodian (and of all subcustodians, and ultimately, the CSD). Even when customer securities are segregated from a custodian's own securities, customers may still be at risk of a loss if the custodian does not hold sufficient securities to satisfy all customer claims or if an individual customer's securities cannot be readily identified. Thus, entities that hold securities in custody (or maintain records of balances of securities) should reconcile their records regularly to keep them current and accurate. Other ways to safeguard or protect customers against misappropriation and theft include internal controls and insurance or other compensation schemes.

3.62 Ideally, a customer's securities are immune from claims made by third-party creditors of the custodian. Although the ideal is not realised in all circumstances, when the entities through which securities are held are performing their responsibilities effectively, the likelihood of a successful legal claim made on a customer's securities by a third-party creditor is minimised. In addition, in the event of a custodian's or subcustodian's insolvency, it should be highly improbable that a customer's securities could be frozen or made unavailable for an extended period of time. If that were to happen, the customer could come under liquidity pressures, suffer price losses or fail to meet its obligations. Segregation is a common device that facilitates the movement of a customer's positions by a receiver to a solvent custodian, thereby enabling customers to manage their positions and meet their settlement obligations. To bring these results about, it is essential that the legal framework support segregation of customer assets or other arrangements for prioritising claims in bankruptcy that serve to protect customers' holdings. It is also important for supervisory authorities to enforce effective segregation of customer assets by custodians.

3.63 Cross-border holdings of securities often involve several layers of intermediaries acting as custodians. For example, an institutional investor may hold its securities through a global custodian, which, in turn, holds securities in a subcustodian that is a member of the local CSD. Or a broker-dealer may hold its securities through its home country CSD or an international CSD, which, in turn, holds its securities through a cross-border link with the local CSD or through a local custodian. Mechanisms to protect customer assets may vary depending on the type of securities holding system instituted in a jurisdiction. Beneficial owners of securities should understand the extent of a custodian's responsibility for securities held through intermediate custodians.

3.64 To prevent unexpected losses, a global custodian should determine whether the legal framework in the jurisdiction of each of its local subcustodians has appropriate mechanisms to protect customer assets. Alternatively, a global custodian should keep its customers apprised of the custody risk arising from holding securities in a particular jurisdiction. Global custodians should also ascertain whether their local subcustodians employ appropriate accounting, safekeeping and segregation procedures for customer securities. Likewise, when home country CSDs and ICSDs establish links to other CSDs, they should ensure that those other CSDs protect customer securities adequately. With complex cross-border arrangements, it is imperative that sound practices and procedures be used by all entities in the chain of custodians so that the interests of beneficial owners are protected from legal actions relating to the insolvency of, or the commission of fraud by, any one of the custodians. Each jurisdiction should take the attributes of its securities holding system into account in judging whether its legal framework includes appropriate mechanisms to protect a custodian's customer against loss upon the insolvency of, or the commission of fraud by, a custodian.

Recommendation 13: Governance

Governance arrangements for CSDs and CCPs should be designed to fulfil public interest requirements and to promote the objectives of owners and users.

3.65 Governance arrangements encompass the relationships between management and owners and other interested parties, including users and authorities representing the public interest. The key components of governance include the ownership structure; the composition of the board; the reporting lines between management and board; and the processes that make management accountable for its performance, eg an audit committee or similar arrangement.

3.66 This recommendation focuses on CSDs and CCPs. These entities sit at the heart of the settlement process. Moreover, because their activities are subject to significant economies of scale, many are sole providers of services to the markets they serve. Therefore, their performance is a critical determinant of the safety and efficiency of those markets, which is a matter of public as well as private interest. Governance arrangements for these entities are extremely important because the economies of scale that characterise their activities impair the forces of competition that might otherwise be relied upon to ensure that they operate safely and efficiently. The same may be true of other providers of settlement services (for example trade comparison or messaging services), in which case their governance arrangements should also be consistent with this recommendation.

3.67 No single set of governance arrangements is appropriate for all institutions within the various securities markets and regulatory schemes. However, an effectively governed institution should meet certain basic requirements. Governance arrangements should be clearly specified, coherent, comprehensible and fully transparent. Objectives, those principally responsible for achieving them and the extent to which they have been met should be disclosed to owners, users and public authorities. Management should have the incentives and skills needed to achieve those objectives and should be fully accountable for its performance. Reporting lines between management and board should be clear and direct, and the board should contain suitable expertise and take account of all relevant interests. These basic requirements should be met regardless of the corporate structure of the institution, that is, whether it is a mutual or for-profit entity.

Recommendation 14: Access

CSDs and CCPs should have objective and publicly disclosed criteria for participation that permit fair and open access.

3.68 Broad access to CSDs, CCPs and other providers of services critical to the clearance and settlement process (for example trade comparison or messaging services) encourages competition among users and promotes efficient, low-cost clearing and settlement. But participants must have sufficient technical, business and risk management expertise, necessary legal powers and adequate financial resources so that their activities do not generate unacceptable risk for the operator or for other users and their customers.

3.69 CSDs and CCPs therefore need to establish criteria that balance fairly the benefits of openness against the need to limit participation to those with the necessary expertise, powers and financial resources. The precise criteria are likely to vary according to the role the participant plays in the system. CCPs, which incur direct credit exposure to their members, tend to emphasise financial resource requirements. CSDs, particularly those in which members incur little or no liquidity and credit exposure to one another, tend to emphasise technical expertise and legal powers. Some CSDs and CCPs may establish more stringent criteria for members that act as custodian or clear for other members or for customers. Each operator must consider carefully the risks to which it and its users are exposed in determining appropriate access criteria.

3.70 Unnecessarily restrictive criteria can reduce efficiency and generate risk by concentrating activity and exposure within a small group of users. The more restrictive the criteria, the greater the importance of the operator assuring itself that its members can control the risks generated by their customers. To avoid discriminating against classes of users and introducing competitive distortions, criteria should be fair and objective. They should be clearly stated and publicly disclosed, so as to promote certainty and transparency. It may be possible to use as criteria indirect indicators of risk, such as whether an institution is supervised, but these indicators should be related clearly to the relevant risks the operator is managing. Some jurisdictions may find it useful for the authorities with responsibility for competition issues to have a role in reviewing access rules or for there to be an appeals procedure that is independent of the CSD or CCP if access is denied. CSDs and CCPs should have procedures facilitating the orderly exit of participants that no longer meet membership criteria, and those procedures should also be publicly disclosed.

3.71 Criteria that limit access on grounds other than risks to the CSD or CCP should be avoided. So, for example, restrictions on access for non-resident users are unlikely to be acceptable except where material doubts exist over whether system rules are enforceable against residents of other jurisdictions or where remote access would expose the operator or other users to unacceptable risks which cannot reasonably be mitigated. Restrictions on access for competitors and others providing comparable services is acceptable only if clearly justifiable on the same risk grounds. For example, to facilitate cross-border settlement, CSDs should, where consistent with law and public policy, grant access to foreign CSDs or foreign CCPs, provided the legal and other risks associated with such links can be controlled effectively (see Recommendation 19 on risks in cross-border links).

Recommendation 15: Efficiency

While maintaining safe and secure operations, securities settlement systems should be cost-effective in meeting the requirements of users.

3.72 In assessing the efficiency of settlement systems, the needs of users and the costs imposed on them must be carefully balanced with the requirement that the system meet appropriate standards of safety and security. If systems are inefficient, financial activity may be distorted. However, the first priority of a securities settlement system is to assure domestic and foreign market participants that their trades will consistently settle on time, on the agreed terms of the transaction. If market participants view a settlement system as unsafe, they will not use it, regardless of the efficiency provided by the system.

3.73 Efficiency has several aspects, and it is difficult to assess the efficiency of a particular settlement system in any definitive manner. Accordingly, the focus of any assessment should largely be on whether the system operator or other relevant party has in place the mechanisms to review periodically the service levels, costs, pricing and operational reliability of the system.

3.74 Settlement systems should seek to meet the service requirements of system users in a cost-effective manner. This includes meeting the needs of its users, operating reliably and having adequate system capacity to handle both current and potential transaction volumes. When looking at the overall costs of settlement systems, it is important to include both the direct costs of operating any central facilities, such as costs to users, and indirect costs, such as liquidity costs.

3.75 The primary responsibility for promoting the efficiency and controlling the costs of a system lies with the designers, owners and operators. In some jurisdictions, regulatory authorities may have a responsibility to review the costs imposed on users, particularly where the system enjoys some form of monopoly over the service it provides. Antitrust and competition law principles may also be relevant. In the absence of a monopoly, market forces are likely to provide incentives to control costs.

3.76 Settlement systems may use a variety of mechanisms to improve efficiency. For example, immobilisation or dematerialisation of physical certificates enables securities transactions to be settled without the actual physical movement of securities. The book entry settlement of securities transactions increases the efficiency of the settlement system because it reduces manual errors, lowers costs and increases the speed of processing through automation.

3.77 Other examples of ways in which a cost-effective system may be achieved include: developing technical capabilities to meet operational service requirements of system users; where relevant, reducing the requirements for market participants to maintain multiple interfaces either by rationalisation of different securities systems or by the creation of consistent communication standards and system interface arrangements across different systems for market participants; and establishing communication procedures and standards that support straight through processing of transactions, wherever appropriate.

Recommendation 16: Communication procedures and standards

Securities settlement systems should use or accommodate the relevant international communication procedures and standards in order to facilitate efficient settlement of cross-border transactions.

3.78 The ability of all participants to communicate in a quick, reliable and accurate manner is central to achieving efficient domestic and cross-border securities transactions. Therefore, securities settlement systems should apply consistent communication procedures and standards relating to securities messages, securities identification processes and counterparty identification.

3.79 Increasingly, internationally recognised message and securities numbering procedures and standards are being utilised for cross-border transactions. These currently include the international numbering process (ISO 6166) and international message standard (ISO 15022). Not all securities settlement systems may wish to use these international procedures and standards for purely domestic securities transactions. However, securities settlement systems that want to play an active role in cross-border transactions will need to be able to process messages written according to these procedures and standards. This can be accomplished by developing systems for the efficient translation or conversion of these message procedures and standards into domestic equivalents and translating domestic acknowledgment and other messages and securities identification codes into the relevant international procedures and standards. Alternatively, SSSs may widen the scope of messages accepted and generated by the local system to include the generally accepted international procedures and standards.

3.80 Countries establishing or fundamentally reforming their securities settlement system should consider the benefits of adopting international procedures and standards from the outset in the design of their domestic systems.

Recommendation 17: Transparency

CSDs and CCPs should provide market participants with sufficient information for them to identify and evaluate accurately the risks and costs associated with using the CSD or CCP services.

3.81 During the past decade there has been a growing appreciation of the contribution transparency can make to the stability and smooth functioning of financial markets. In general, financial markets operate most efficiently when participants have access to relevant information concerning the risks to which they are exposed and, therefore, can take actions to manage those risks. As a result, there has been a concerted effort to improve the public disclosures of major participants in the financial markets.

3.82 The need for transparency applies to the entities that form the clearing, settlement and custodial infrastructure of the securities markets. Informed market participants are better able to evaluate the costs and risks to which they are exposed as a result of participation in the system. They can then impose strong and effective discipline on operators of that infrastructure, encouraging them to pursue objectives that are consistent with those of owners and users and with any public policy concerns. CSDs and CCPs should therefore provide market participants with a full and clear understanding of their rights and obligations, the rules, regulations and laws governing the system, their governance procedures, any risks arising either to participants or the operator, and any steps taken to mitigate those risks. Relevant information should be accessible to market participants, for example through the internet. Information should be current, accurate and available in formats (eg language) that meet the needs of users.

3.83 Completion of the CPSS/IOSCO Disclosure Framework or completion and disclosure of the answers to the key questions (see Section 5) would be ways to provide market participants with the information they need about the risks of CSD or CCP services. If a CSD or CCP publicly discloses the answers to the key questions, it need not complete the CPSS/IOSCO Disclosure Framework. The key questions address all of the major topics covered by the Disclosure Framework. Whatever approach is taken, it is critical that the disclosures are complete and accurate. Any assessment of implementation of this recommendation should include a review of the accuracy and completeness of any disclosures.

Recommendation 18: Regulation and oversight

Securities settlement systems should be subject to transparent and effective regulation and oversight. Central banks and securities regulators should cooperate with each other and with other relevant authorities.

3.84 Securities regulators (including, in this context, banking supervisors where they have similar responsibilities and regulatory authority with respect to CSDs and CCPs) and central banks share the common objective of promoting the implementation of measures that enhance the safety and efficiency of securities settlement systems. The division of responsibilities for regulation and oversight of securities settlement systems among public authorities varies from country to country depending on the legal and institutional framework.

3.85 While the primary responsibility for ensuring the system's observance of the recommendations lies with the designers, owners and operators of securities settlement systems, regulation, oversight or both are needed to ensure that designers, owners and operators fulfil their responsibilities. Where the central bank itself operates a CSD, it should ensure that its system implements the recommendations.

3.86 The objectives and responsibilities as well as roles and major policies of the securities regulator and the central bank should be clearly defined and publicly disclosed, so that designers, owners, operators and participants of securities settlement systems are able to operate in a predictable environment and to act in a manner that is consistent with those policies.

3.87 The securities regulator and the central bank should have the ability and the resources to carry out regulation and oversight responsibilities effectively. Regulatory and oversight activities should have a sound basis, which may or may not be based on statute, depending on a country's legal and institutional framework. The securities regulator and the central bank should have adequate resources to carry out their regulatory and oversight functions, such as gathering information on securities settlement systems, assessing the operation and design of the systems, and taking action to promote systems' observance of the recommendations.¹⁴

3.88 Cooperation between the securities regulator and the central bank as well as their cooperation with other relevant authorities is important in achieving their respective policy goals. Issues raised by the operation of cross-border systems should be addressed in a way that delivers regulation/oversight consistent with each relevant authority's responsibilities and avoids unnecessary cost. Regulators/overseers can consider a variety of approaches including 1) information-sharing arrangements; 2) coordination of regulatory/oversight responsibilities for specific matters; and 3) other cooperation arrangements.¹⁵ The approach selected may vary, depending on such issues as the law and regulatory approach in each jurisdiction. Option 2) might entail a cooperative agreement for the allocation of regulatory/oversight responsibility in line with the recommendation in the 1990 Lamfalussy Report.

Recommendation 19: Risks in cross-border links

CSDs that establish links to settle cross-border trades should design and operate such links to reduce effectively the risks associated with cross-border settlements.

3.89 The various channels through which cross-border securities transactions may be effected and the sources of related risks are described in Annex 4. Settlement of cross-border securities transactions typically is more complicated and potentially involves more risk than domestic transactions. Cross-border transactions are usually settled through a local agent, often acting as a subcustodian on behalf of a global custodian, but a CSD can make alternative arrangements available to its participants by establishing links with other CSDs.

3.90 CSDs may perform different sets of functions including the provision of depository, credit, securities lending, collateral management, custodian and settlement services. Links also may provide these functions, and the choice of functions determines the design of the link, as do the structure of the CSDs themselves and the legal framework applicable in the respective jurisdictions. For example, to settle cross-border trades between their participants, one or both of the linked CSDs become a participant in the other CSD. Such links permit participants in either CSD to settle trades in securities

¹⁴ Public disclosure of the roles and major policies of the securities regulator and the central bank would be consistent with the International Monetary Fund's Code of Good Practices on Transparency in Monetary and Financial Policies (IMF, September 1999).

¹⁵ Where a securities settlement system provides services in more than one jurisdiction, consultation and cooperation among relevant regulators/overseers will be essential to avoid duplicative (or conflicting) requirements, regulatory/oversight gaps and unnecessary costs. Within the context of the requirements of individual national laws and a firm foundation for the sharing of information, this process could include an allocation of regulatory/oversight roles to satisfy the responsibilities and objectives of each relevant authority. See the *Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries* (BIS, November 1990) (known as the Lamfalussy Report), pages 53-6. See also *Principles for the Oversight of Screen-based Trading Systems for Derivative Products – Review and Additions* (Technical Committee of IOSCO, October 2000).

from multiple jurisdictions through a single gateway operated by its domestic CSD or by an international CSD. Links also can facilitate data transmission and information exchange about securities holdings. Furthermore, by expanding the range of collateral that can be held in an account with a single CSD, links can reduce costs to participants of meeting various collateral requirements. Finally, links can reduce the number of intermediaries involved in cross-border settlements, which tends to reduce legal, operational and custody risks.

3.91 However, CSDs need to design links carefully to ensure that risks are, in fact, reduced. Because linked CSDs are located in different jurisdictions, they must address legal and operational complexities that are more challenging than those confronted in their domestic operations. If a link is not properly designed, settling transactions across the link could subject participants to new or exacerbated risks relative to the risks to which the participant would be subject if it settled its transactions through alternative channels, such as a global custodian or local agent. Links may present legal risks relating to a coordination of the rules of and the laws governing the linked systems, including laws and rules relating to netting and the finality of transfers, and potential conflicts of laws. Links may also present additional operational risks due to inefficiencies associated with the operation of the link. These inefficiencies may arise because of variations in the operating hours of the linked systems or out of the need to block securities that are earmarked for use in the consummation of transactions to be settled across a link. Lastly, settlement links may create significant credit and liquidity interdependencies between systems, particularly if one of the systems experiences an operational problem or if one of the systems permits provisional transfers of funds or securities that may be unwound. An operational failure or default in one system may precipitate settlement failures or defaults in the linked system and expose participants in the linked system (even participants who did not transact across the link) to losses.

3.92 A CSD should evaluate the financial integrity and operational reliability of any CSD with which it intends to establish a link. Any credit extensions between CSDs should be fully secured by securities, letters of credit or other high-quality collateral and should be subject to limits. Liquidity management arrangements should be implemented to address operational inefficiencies and potential defaults. Notwithstanding operational and legal difficulties, DVP should be achieved and, to eliminate the danger of unwinds, provisional transfers across the link should be prohibited or, at a minimum, their retransfer should be prohibited, until the first transfer is final. Links between CSDs should be designed so that the operation of the link in accordance with the rules of each CSD and the terms of any associated contracts between the CSDs and the CSDs and their participants will be supported by the legal framework in each jurisdiction in which the linked CSDs operate. Each jurisdiction should assess the extent to which its legal framework supports the proper operation of links between CSDs. To the extent jurisdictions permit CSDs operating there to establish a link, the legal frameworks of both jurisdictions should support the operation of the link in accordance with these recommendations. The laws applicable to the linked CSDs, their participants and the various steps and mechanisms in the operation of the link should be clear and transparent and should protect participants and their customers in case of the insolvency of one of the linked CSDs or one of their direct participants. Any choice of applicable law should be enforceable in the jurisdiction of each linked CSD and be documented and transparent to all participants. Issues associated with the protection of customer securities should also be addressed in the design and operation of cross-border links, particularly the need to reconcile holdings to determine that they are accurate and current (see Recommendation 12). Reconciliation is particularly important when more than two CSDs are involved (that is, the securities are kept by one CSD or custodian while the seller and the buyer participate in two other CSDs).

4. Implementation of recommendations

4.1 If these recommendations are to result in significant improvements in the safety and efficiency of SSSs, there needs to be a concerted effort to implement them. Primary responsibility for ensuring compliance with the recommendations lies with the designers, owners and operators of SSSs, which most often are private sector entities. Nonetheless, as part of their responsibility for regulation and oversight, central banks, securities regulators and, where relevant, banking supervisors should assess and promote implementation of the recommendations by SSSs.

4.2 Experience with efforts to implement other international standards highlights the importance of developing a clear and specific methodology for assessing whether the standards have been implemented, ideally in the form of a questionnaire.¹⁶ The CPSS and the Technical Committee of IOSCO have directed the Task Force to complete development of a comprehensive assessment methodology by the end of 2002. As an important first step towards such a methodology, the next section identifies key questions pertaining to each of the recommendations. The answers to these questions are intended to provide a basis for a narrative evaluation of whether the recommendations for SSSs have been implemented. Given the complexity of SSSs and the diversity of institutional arrangements, an assessment of observance should evaluate the substance or quality of observance rather than adopt a simple “ticks and crosses” approach.

4.3 As noted in Recommendation 18, as part of their responsibilities for oversight and regulation, the appropriate national authorities should assess whether markets in their jurisdiction have implemented the recommendations. On the basis of their initial assessment, they should develop an action plan for implementation that should identify what specific steps need to be taken, by whom, and according to what timetable. Subsequent assessments of observance should be undertaken to gauge what has been achieved on completion of the action plan.

4.4 Following completion of the initial self-assessment by the appropriate national authorities, the CPSS and the Technical Committee of IOSCO see value in an external assessment of implementation. The CPSS sees the international financial institutions (IFIs, ie the International Monetary Fund and the World Bank) as having primary responsibility for external assessment, as part of their Financial Sector Assessment Program (FSAP). The Technical Committee of IOSCO believes that the CPSS and IOSCO should bear primary responsibility for external assessments, by organising peer reviews or at least by having a CPSS or IOSCO representative participate in the IFI assessments. These issues will be revisited by the Task Force and the CPSS and the Technical Committee of IOSCO in the course of the work on a comprehensive assessment methodology.

¹⁶ See FSF, *Issues Paper of the Task Force on Implementation of Standards* (FSF, 2000).

5. Assessment of implementation: key questions

Recommendation 1: Legal framework

Securities settlement systems should have a well founded, clear and transparent legal basis in the relevant jurisdictions.

1. Are the laws, regulations, rules and contractual provisions of the jurisdiction and of the system governing securities settlement arrangements and related pre-settlement and securities lending arrangements (including repurchase agreements and other economically equivalent transactions) public and readily accessible to system participants?
2. Does the legal framework support:
 - (a) the enforceability of transactions?
 - (b) the protection of customer assets (particularly against insolvency of custodians and intermediaries)?
 - (c) the immobilisation or dematerialisation of securities and the transfer of securities by book entry?
 - (d) netting arrangements?
 - (e) securities lending?
 - (f) the finality of settlement?
 - (g) arrangements for achieving delivery versus payment?
 - (h) rules addressing the consequences of a participant's default?
 - (i) the liquidation of assets pledged or transferred as collateral to support participants' obligations?
3. Are the rules of the system enforceable notwithstanding the bankruptcy of a participant?
4. Does applicable law support appropriate choice of law provisions in contracts executed between the system operator(s), direct system participants and indirect system participants to permit operation of the securities settlement system (and related arrangements) in accordance with the system's rules?
5. Are jurisdictions other than the jurisdiction in which the system is established relevant for determining the adequacy of the legal framework? How has this been determined? Has the legal framework been evaluated for the other relevant jurisdictions?
6. Has a court in your jurisdiction ever failed to enforce a contract concluded through an SSS? If so, what contract and for what reasons?

Recommendation 2: Trade confirmation

Confirmation of trades between direct market participants should occur as soon as possible after trade execution, but no later than trade date (T+0). Where confirmation of trades by indirect market participants (such as institutional investors) is required, it should occur as soon as possible after trade execution, preferably on T+0, but no later than T+1.

1. Are trades between direct market participants confirmed through a system provided by a stock exchange, trade organisation, CCP or other central entity? What is the process for confirming such trades?
2. What percentage of trades between direct market participants is submitted to a trade confirmation system on trade date (T+0)? How soon after submission are problems communicated to the appropriate parties?
3. Is there a trade confirmation system in place that is capable of comparing trade information between direct and indirect market participants by T+1? Is use of the system mandatory? For what types of indirect market participants? Is the information flow between direct and indirect market

participants bilateral or do both parties submit their respective information to a central matching or comparison entity?

4. What percentage of trades between indirect market participants is confirmed on trade date? By the contractual settlement date? Of those trades involving indirect market participants for which confirmation is required, what percentage is confirmed by T+0, by T+1, by the contractual settlement date?
5. What are the primary reasons for trades between direct market participants and between direct and indirect market participants not confirming successfully? What percentage of unconfirmed trades is resolved prior to the settlement date? How are unconfirmed trades dealt with?
6. What is the process for matching settlement instructions? How is matching of settlement instructions linked with trade confirmation?
7. Do the systems for confirmation of trades (by both direct and indirect participants) and matching of settlement instructions support straight through processing? How broadly are the systems used, and for what types of participants?

Recommendation 3: Settlement cycles

Rolling settlement should be adopted in all securities markets. Final settlement should occur no later than T+3. The benefits and costs of a settlement cycle shorter than T+3 should be evaluated.

1. Do trades settle on a “rolling” basis or on an “account period” basis? If on a rolling basis, how many business days after the trade date? If on an account basis, what is the length of the account period?
2. If settlement is on an account period basis or on a rolling basis at T+3 or longer, have the benefits and costs of a shorter settlement cycle been evaluated? By whom? Has the evaluation been documented? What was the conclusion? Did the conclusion differ depending on the type of security?
3. What percentage of trades (by number and value) fails to settle on the contractual date? What is the average duration of fails (by number and value)? What are the primary sources of fails?
4. Do market practices, regulations or SSS rules provide incentives for counterparties to settle their obligations on the contractual date? What forms do these incentives take, for example are penalties assessed for failing to settle?
5. What steps, if any, are taken to mitigate the risks of fails? Are fails required to be marked to market? Are open positions required to be closed out at market prices if the duration of the fail exceeds a specified number of business days? What entity or entities establish, monitor and enforce these requirements?

Recommendation 4: Central counterparties (CCPs)

The benefits and costs of a CCP should be evaluated. Where such a mechanism is introduced, the CCP should rigorously control the risks it assumes.

1. Has a CCP mechanism (or an indemnification arrangement) been introduced? If so, what types of securities and market participants are covered? When does the CCP interpose itself between its participants to assume the role of guarantor to each trade?
2. If no such mechanism has been introduced, have the benefits and costs of such a mechanism been evaluated? By whom? Has the assessment been documented? What was the conclusion?
3. Does the CCP impose financial and operational standards for participation?
4. How does the CCP manage its credit risk vis-à-vis participants? Does it require participants to collateralise their exposures? How often are requirements recomputed and collateral collected?
5. What are the financial resources of the CCP? How does the CCP assess the adequacy of the size and liquidity of its financial resources? Does it require participants to contribute to a clearing or guarantee fund? Does the CCP have legally enforceable interests in or claims on the assets in the fund? Does the CCP have transparent and enforceable loss allocation rules?

6. How does the CCP manage its liquidity risk? Does the CCP have in place agreements permitting it to borrow against collateral?
7. Has a participant ever defaulted? If so, how did the CCP handle the default? In the past year, has the CCP experienced an operational failure that resulted in a delay in completing settlement?

Recommendation 5: Securities lending

Securities lending and borrowing (or repurchase agreements and other economically equivalent transactions) should be encouraged as a method for expediting the settlement of securities transactions. Barriers that inhibit the practice of lending securities for this purpose should be removed.

1. Are there markets for securities lending (or repurchase agreements and other economically equivalent transactions)? If any, how active are they? How wide is the range of securities and participants involved in the markets?
2. Are the markets for securities lending (or repurchase agreements and other economically equivalent transactions) clearly supported by law, regulation, tax and accounting systems?
3. How is the transfer of a loaned security executed? Does the transfer of the loaned security typically occur over accounts held at a central securities depository (CSD) or over accounts held with custodians?
4. What is the convention for the settlement of a securities lending transaction (T+0, T+1, etc)? Does the CSD or CCP facilitate securities lending? If so, do they perform any of the following services: (1) act as principal or agent in securities lending; (2) provide trade matching or comparison services for securities lending transactions; (3) provide guarantees or indemnification to counterparties in securities lending transactions?
5. What risk management procedures are used to monitor and/or limit risks stemming from securities lending activity (eg DVP, mark-to-market valuation of securities and collateral, daily margining, monitoring of counterparties)?

Recommendation 6: Central securities depositories (CSDs)

Securities should be immobilised or dematerialised and transferred by book entry in CSDs to the greatest extent possible.

1. Are securities issued on a dematerialised basis or as a physical certificate? If the latter, are they immobilised in a CSD to facilitate settlement? What percentage of securities issued domestically is either immobilised or dematerialised, and what is the trend? Is the transfer of securities carried out by book entry or does it require any form of physical delivery?
2. What laws govern the book entry issuance, custody and transfer of securities? Do beneficial owners of securities have a direct property interest in identifiable securities or a claim against a pool of fungible securities? What ownership rights does an entry in the CSD confer? Is there an underlying register, and if so what is the legal status of a register entry? Is there a lag between settlement and registration and what are the implications of the time lag for finality? If the CSD is not the official registrar, does the transfer of securities in the CSD result automatically in the transfer of securities in the official register?
3. Is the issuance of securities centralised in a single CSD? If there are several CSDs, what are the criteria followed to determine which securities are issued in which CSD? Might a security be issued into, or held in, more than one CSD?
4. How does the CSD ensure that the amount of securities recorded in the accounts of its participants on its book at any time equals the total amount of securities immobilised or dematerialised in its system?

Recommendation 7: Delivery versus payment (DVP)

CSDs should eliminate principal risk by linking securities transfers to funds transfers in a way that achieves delivery versus payment.

1. Does the technical, legal and contractual framework ensure that delivery of securities takes place if, and only if, payment is received? If so, how? What proportion of trades are settled on a DVP basis?
2. What “model” of DVP is followed? Are securities transfers settled on a gross or net basis? Are funds transfers settled on a gross or net basis?
3. Is the CSD linked to other CSDs within the jurisdiction? Do any of the links permit transfers of securities against payment? If so, how is DVP achieved? Are there any links to CSDs in other jurisdiction? Do the links permit transfers of securities against payment? If so, how is DVP achieved? If not, what alternative arrangements are in place?
4. How are principal risk exposures between direct participants in the SSS and their customers controlled?

Recommendation 8: Timing of settlement finality

Final settlement should occur no later than the end of the settlement day. Intraday or real-time finality should be provided where necessary to reduce risks.

1. Does the CSD permit final settlement of securities transfers on a DVP basis by the end of the settlement day? Is the timing of settlement finality clearly defined for transactions within the CSD and for transactions over a link to another CSD?
2. Does the CSD permit final settlement of DVP transfers on a continuous basis throughout the day or at certain designated times during the day? If the latter, at what times do transfers become final?
3. Is there a need for intraday or real-time finality to reduce risks? Do central banks use the SSS in monetary policy operations or to collateralise intraday credit extensions in a payment system? Do active trading parties or CCPs have a need for intraday or real-time finality to manage their risks effectively? Is there a need for intraday or real-time finality to facilitate settlement through links to other CSDs?
4. Does the CSD receive provisional transfers of securities from any other CSDs? If so, does it prohibit retransfer of these securities until they become final? If not, what would be the consequences of an unwind of such provisional transfers for the CSD’s participants?

Recommendation 9: CSD risk controls to address participants’ failures to settle

CSDs that extend intraday credit to participants, including CSDs that operate net settlement systems, should institute risk controls that, at a minimum, ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle. The most reliable set of controls is a combination of collateral requirements and limits.

1. Does the CSD extend intraday credit to participants? Are the credit extensions explicit (usually in a gross settlement system) or implicit (in a net settlement system)?
2. If the system is a net settlement system, would a failure of a participant to settle result in the reversal of transfers involving the defaulting participant and the recalculation of obligations of non-defaulting participants? Would all of the transfers involving the defaulting participant need to be reversed? When would the non-defaulting participants be informed of their recalculated obligations? When would they be required to meet the recalculated obligations?
3. What risk controls are in place to limit the likelihood of participants’ inability to settle and the losses and liquidity pressures in such settlement failures?
4. Does the CSD ensure that timely settlement can be completed in the event of an inability to settle by the participant with the single largest obligation? If so, how?

5. Are the credit exposures of the CSD fully collateralised? If not, to what extent and to which participants does the CSD extend uncollateralised credit? Does the CSD have the capacity to value (ie mark to market) the securities posted as collateral and apply haircuts? Are limits imposed on credit extensions by the CSD?
6. Does the CSD permit debit balances in securities?
7. Has any CSD participant been unable to settle any obligations to the CSD? How did the CSD handle the default?

Recommendation 10: Cash settlement assets

Assets used to settle the ultimate payment obligations arising from securities transactions should carry little or no credit or liquidity risk. If central bank money is not used, steps must be taken to protect CSD members from potential losses and liquidity pressures arising from the failure of the cash settlement agent whose assets are used for that purpose.

1. How is the settlement of the cash leg of securities transfers effected? Is the settlement effected through transfers on the books of a central bank, a CSD organised as a limited purpose bank, or one or more financial institutions?
2. If a single bank is used, is it the central bank that issues the currency? Is the CSD itself organised as a limited purpose bank? If the central bank is not used, what steps are taken to protect CSD members from failure of the settlement institution?
3. If multiple settlement institutions can be used in principle, how many are used in practice? Who determines which institutions can be used as settlement institutions? What are the criteria? How concentrated are payment flows? Which institution is used by the highest percentage of CSD members? On an average day, what percentage of total payments is credited to accounts at that institution? What is the financial condition of that institution (for example, its capital ratios and its credit ratings)?
4. How quickly can CSD members retransfer the proceeds of settlement?
5. If multiple settlement institutions are used, are the resulting obligations between settlement institutions settled through a payment system that adheres to the Core Principles for Systemically Important Payment Systems?
6. If the system is a multicurrency system, how are non-domestic funds transfers effected?

Recommendation 11: Operational reliability

Sources of operational risk arising in the clearing and settlement process should be identified and minimised through the development of appropriate systems, controls and procedures. Systems should be reliable and secure, and have adequate, scalable capacity. Contingency plans and backup facilities should be established to allow for timely recovery of operations and completion of the settlement process.

1. Does the system operator have a process to identify and manage its operational risks?
2. Does the system operator have internal control policies and procedures, including security measures, designed to limit operational risk? How are they enforced?
3. Does the system operator have contingency plans and backup facilities for the failure of key systems and are these rehearsed/tested? How long does it take to recover operations through backup systems? Do the procedures provide for preservation of all transaction data? How does the system operator ensure the integrity of messages?
4. How many times during the last year has a key system failed? How long did it take to resume processing? How much transaction data, if any, was lost?
5. Does the system operator have capacity plans for key systems and are key systems stress-tested periodically?
6. Are the matters above approved and reviewed regularly by senior management, including review by persons not responsible for the relevant operations? Are periodic external audits of the IT

(information technology) system conducted? Is there an independent internal audit function and does it review operational risk controls?

7. Does the system impose minimum operational or performance standards on third parties (for example, communications providers)? If the system operator has outsourced its operations to other entities, what measures are taken to ensure that outsourced operations meet the same standards as if they were provided directly by the system operator?

Recommendation 12: Protection of customers' securities

Entities holding securities in custody should employ accounting practices and safekeeping procedures that fully protect customers' securities. It is essential that customers' securities be protected against the claims of a custodian's creditors.

1. What arrangements are used to protect customers' securities from theft, loss or misuse and to ensure that they will not become subject to claims of the custodian's creditors (for example, is segregation used)? Are those arrangements based upon specific laws and regulations? In the event of the custodian's insolvency, do those arrangements enable a customer's positions to be moved by a receiver to a solvent intermediary?

2. Are the entities holding securities in custody subject to mandatory internal or external audit, or both, to determine if there are sufficient securities to satisfy customer claims? On how many occasions during the past year have investors suffered losses as a result of their custodian? How large were the losses? What were the causes of such losses?

3. How often do the entities holding securities in custody reconcile their records?

4. Are the entities holding securities in custody subject to prudential supervision or regulation? Do audits or regulatory reviews examine the procedures and internal controls used in the safekeeping of securities?

5. What responsibilities does national law or regulation place on a custodian to determine the adequacy of the accounting and safekeeping practices used by its subcustodians? What responsibilities does national law or regulation place on a CSD to determine the adequacy of the accounting and safekeeping practices used by CSDs or ICSDs to which it is linked?

Recommendation 13: Governance

Governance arrangements for CSDs and CCPs should be designed to fulfil public interest requirements and to promote the objectives of owners and users.

1. How is the composition of the board determined? What steps are taken to ensure that board members have the necessary skills, and represent or take into account in their deliberations the full range of shareholder and user interests as well as the public interest?

2. What steps are taken to ensure that management has the incentives and skills needed to achieve the system's objectives and is accountable for its performance?

3. Are the system's public interest, financial and other objectives clearly articulated? What are they? Do the objectives reflect the needs of users as well as owners? How is the public interest taken into account?

4. Are the system's public interest, financial and other objectives publicly stated? How are major decisions communicated to owners and users? What information is publicly available regarding the system, its ownership and its board and management structure, and the process by which board members are appointed, major decisions taken and management made accountable?

Recommendation 14: Access

CSDs and CCPs should have objective and publicly disclosed criteria for participation that permit fair and open access.

1. What rules determine who may access the system? Are they clearly disclosed to all potential applicants? Can restrictions on access to the system be justified in terms of the need to limit risks to the system operator or to other users?
2. Are the same rules applied regardless of the identity, type and location of the applicant? If not, what variations apply and why?
3. What steps are taken to confirm whether an applicant satisfies the relevant access rules? Initially? On an ongoing basis?
4. Under what conditions can participants terminate their membership? What arrangements does the system have in place to facilitate the exit of members who no longer meet the participation requirements? How quickly could any such exit take effect? How would the system ensure that any exit was as orderly as possible?
5. Are participants which do not satisfy access rules nevertheless able to access the system indirectly? What information does the system operator receive regarding their activities and the risk controls applied to them?

Recommendation 15: Efficiency

While maintaining safe and secure operations, securities settlement systems should be cost-effective in meeting the requirements of users.

1. Does the system have sufficient capacity to meet existing operating demands and anticipated peak volumes without maintaining unnecessary levels of excess capacity? Does the system operator have in place procedures to periodically review its capacity levels against projected demand?
2. Does the system operator have in place procedures to benchmark its costs and charges against other systems and, if so, does this show whether the costs are higher or lower than those of comparable systems? Does the system operator have in place procedures to periodically review its pricing levels against its costs of operation?
3. Does the system give participants the mechanisms and management information to enable them to manage their liquidity effectively?
4. Does the system operator have in place procedures to determine whether participants are satisfied with the service levels they receive (for example, by regularly surveying its users and/or benchmarking its service levels against those of similar systems)?
5. Does the system operator have in place procedures to review system and technical interface issues with users and assess the costs to users of different system configurations?

Recommendation 16: Communication procedures and standards

Securities settlement systems should use or accommodate the relevant international communication procedures and standards in order to facilitate efficient settlement of cross-border transactions.

1. Does the securities settlement system use international communication procedures or standards or is it able to easily convert domestic procedures and standards into the relevant international communication procedures and standards for cross-border securities transactions?

Recommendation 17: Transparency

CSDs and CCPs should provide market participants with sufficient information for them to identify and evaluate accurately the risks and costs associated with using the CSD or CCP services.

1. Do entities that provide the clearing, settlement and custodial infrastructure of securities markets make clear disclosures to market participants about their rules, regulations, relevant laws, governance procedures, risks, steps taken to mitigate risks, and the rights and obligations of participants?

2. How is this information made available? In what language or languages? In what form? Is it available on the internet? Has the system completed the questionnaire set out in the CPSS/IOSCO disclosure framework? Have the authorities responsible for regulation and oversight publicly disclosed their answers to the key questions regarding implementation of the recommendations?
3. What steps are taken to ensure that the disclosures are complete and accurate? Are there periodical reviews to ensure they remain current?

Recommendation 18: Regulation and oversight

Securities settlement systems should be subject to transparent and effective regulation and oversight. Central banks and securities regulators should cooperate with each other and with other relevant authorities.

1. How is the system regulated/overseen?
2. Are the objectives and responsibilities of the securities regulator, central bank and, where relevant, banking supervisor clearly defined with respect to securities settlement systems? Are their roles and major policies disclosed publicly? Are they written in plain language so that they can be fully understood by designers, operators and participants of securities settlement systems, and other relevant parties?
3. What is the regulatory and oversight framework based on? Is it a statute-based approach where specific tasks, responsibilities and powers are assigned to specific public authorities? Or a non-statute-based approach? If the latter, should consideration be given to establishing a new regulatory and oversight framework based on statute? Do the securities regulator and the central bank have experienced staff, proper resources and funding to carry out regulatory and oversight functions effectively?
4. Have the authorities assessed the extent to which securities settlement systems observe the recommendations? Has the assessment been documented? What were the conclusions?
5. Is there a framework for cooperation between the securities regulator and the central bank, such as for the exchange of information and views on securities settlement systems? Is there such a framework for cooperation with relevant authorities both within and outside the country?

Recommendation 19: Risks in cross-border links

CSDs that establish links to settle cross-border trades should design and operate such links to reduce effectively the risks associated with cross-border settlements.

1. Has a CSD in your jurisdiction established a link with one or more non-domestic CSDs? What functions are provided by the CSDs in connection with the operation of the link?
2. Was a risk analysis of the design of the link undertaken?
3. How does the design of the link address each of the recommendations? How are systems, capacity or other operational issues addressed by the design of the link?
4. Have the respective rules and procedures of the linked CSDs regarding the operation of the link been published and made available to system participants and the public generally?
5. Identify the design features or other mechanisms by which the operation of the link reduces or eliminates the credit and liquidity risks associated with cross-border settlements identified in these recommendations.
6. How have any credit and liquidity interdependencies between the linked CSDs been addressed?
7. Does the link permit provisional transfers of securities across the link? If so, is the retransfer of these securities prohibited until the first transfer is final?

8. Has each relevant local regulatory authority evaluated and assessed the legal framework governing the link? Is there a framework for cooperation among relevant local authorities? What steps were taken to assure enforceability of rules of the link and conclusion of linked transactions with finality in each linked jurisdiction?
9. Do the legal frameworks applicable in the jurisdictions of the linked CSDs support the design of the link?

Annex 1: Members of the CPSS-IOSCO Task Force on Securities Settlement Systems

Co-Chairmen

| | |
|--|------------------------------------|
| Board of Governors of the Federal Reserve System | Patrick Parkinson |
| Australian Securities and Investments Commission | Shane Tregillis |
| Commissione Nazionale per le Società e la Borsa, Italy | Giovanni Sabatini (until May 2001) |

Members

| | |
|--|--|
| National Bank of Belgium | Johan Pissens |
| Comissão de Valores Mobiliários, Brazil | Fabio Menkes Elizabeth Garbayo (until January 2001) |
| The People's Bank of China | Li Yongqing |
| Czech National Bank | Tomáš Hládek |
| European Central Bank | Daniela Russo |
| Commission des Opérations de Bourse, France | Bénédicte Doumayrou |
| Bank of France | Yvon Lucas |
| Deutsche Bundesbank | Roland Neuschwander |
| Securities and Futures Commission, Hong Kong | Gerald Greiner |
| Reserve Bank of India | Usha Thorat |
| Securities and Exchange Board of India | Pratip Kar |
| Commissione Nazionale per le Società e la Borsa, Italy | Salvatore Lo Giudice |
| Bank of Japan | Shuhei Aoki |
| Financial Services Agency, Japan | Kotaro Nagasaki |
| Securities Commission, Malaysia | Ranjit Ajit Singh |
| Comisión Nacional Bancaria y de Valores, Mexico | Paola Bortoluz |
| Bank of Mexico | Francisco Solis |
| Securities Board of the Netherlands | Henk Bruggeman Hans Wolters (until May 2001) |
| Saudi Arabian Monetary Agency | Abdullah Al Suweilmy |
| Comisión Nacional del Mercado de Valores, Spain | José Manuel Portero Bujalance |
| Bank of England | John Trundle Alastair Wilson (until January 2001) |
| United States Securities and Exchange Commission | Larry Bergmann |
| US Commodity Futures Trading Commission | Andrea Corcoran |

Board of Governors of the Federal Reserve
System

Patricia White

Federal Reserve Bank of New York

Lawrence Radecki

Secretariat

Bank for International Settlements

Tomoyuki Shimoda

Masayuki Mizuno (until January 2001)

Benoît Bourtembourg (National Bank of Belgium), Stella Leung (Securities and Futures Commission, Hong Kong), Shri Venkatappa (Reserve Bank of India), Tetsuya Sakamoto (Bank of Japan), Shareena Mohd Sheriff (Securities Commission, Malaysia), Jeffrey Mooney, Jennifer Lucier (US Securities and Exchange Commission) and Terry Hart (US Commodity Futures Trading Commission) also made significant contributions to the Task Force's work.

Annex 2: The process of clearance and settlement

1. The process of clearing and settling a securities trade includes several key steps: the **confirmation** of the terms of the trade by the direct market participants; the calculation of the obligations of the counterparties resulting from the confirmation process, known as **clearance**; and the final transfer of securities (**delivery**) in exchange for final transfer of funds (**payment**) in order to **settle** the obligations. Each of these steps can typically be accomplished in one or more ways. In addition, other important activities may take place within or ancillary to each of these steps. Such activities include the confirmation of trade details between direct market participants and indirect market participants (institutional investors and foreign investors or their agents), the communication of settlement instructions to central securities depositories and to **custodians** that many investors employ to **safekeep** their securities, and the **registration** of the ownership of shares.

Confirmation of trade and settlement instructions

2. Once a trade is executed, the first step in the clearing and settlement process is to ensure that the counterparties to the trade (the buyer and the seller) agree on the terms, that is, the security involved, the price, the amount to be exchanged, the settlement date and the counterparty. This process of trade confirmation can take place in a variety of ways, and the trading mechanism itself often determines how it occurs. Thus, for example, an electronic trading system automatically produces a confirmed trade between the two counterparties. Other trades are confirmed by exchanges, clearing corporations, trade associations, etc, based on data submitted to them by the counterparties. In over-the-counter markets, counterparties must submit the terms of the trade to each other for verification by some mechanism, be it fax, SWIFT message, or perhaps some specialised electronic messaging and matching service. While this process is occurring, the back offices of the direct counterparties to the trade also issue settlement instructions, which central securities depositories typically require to match before they effect any settlements.

3. Because the counterparties to trades are often acting on behalf of others, an important ancillary part of the trade confirmation process is the transmission of trade information to these ultimate investors. In order for settlement to be completed, investors must confirm trade details and issue instructions for the proper positioning of funds and securities. It is true that the counterparties to the trade will typically be responsible for performance of the transaction, regardless of whether the investors they are acting for agree that they have correctly executed instructions. However, the process by which indirect market participants confirm the details of transactions (sometimes termed affirmation) and issue settlement instructions to their custodians is important because it provides an early indication of trades for which delivery may be problematic. Currently, the process by which indirect market participants **confirm** trades and issue settlement instructions can be complex, in part because information may need to be transmitted to the direct market participant about the allocation of trades among various accounts of the indirect participant. Additional complexity often arises in cross-border trades because multiple intermediaries and custodians may be involved. Efforts are under way to simplify and automate this process to reduce costs and improve the efficiency of the clearing and settlement process. Automation efforts, sometimes referred to as straight through processing, focus on developing systems that require data to be entered only once in the clearing and settlement process.

Clearance

4. After trades have been confirmed, the next step in the process is clearance, the computation of the obligations of the counterparties to make deliveries or to make payments on the settlement date. Clearance typically occurs in one of two ways. Many systems compute the obligations for every trade individually. That is, clearance occurs on a **gross** or trade for trade basis. In other systems, the obligations are subject to **netting**. In some markets, a central counterparty (CCP) interposes itself between the counterparties to a securities trade, taking on each party's obligation in relation to the other. By achieving netting of the underlying trade obligations, the use of a CCP reduces credit risk (both replacement cost and principal risk) and liquidity risk for the trade counterparties. Netting arrangements are increasingly common in securities markets with high volumes of trades because properly designed netting produces very significant reductions in gross exposures in such markets.

Trade or obligation netting arrangements should be distinguished from settlement or payment netting arrangements, in which underlying obligations are not extinguished but funds or securities transfer instructions are settled on a net basis.

Settlement

5. Settlement of a securities trade involves the final transfer of the securities from the seller to the buyer and the final transfer of funds from the buyer to the seller. Historically, securities transfers involved the physical movement of certificates. However, in recent years, securities have increasingly been immobilised in a **central securities depository** (CSD), or the CSD has held the securities in dematerialised form. Immobilisation or dematerialisation enables securities transfers to occur through accounting entries on the books of the CSD. A CSD may also offer funds accounts and permit funds transfers on its own books as a means of payment for securities. Alternatively, these funds transfers may occur on the books of another institution, such as a central bank or commercial bank.

6. While many CSDs handle the securities for a single domestic market, others serve multiple markets. In some cases, this has been accomplished by links between domestic CSDs (achieved by each depository opening an account with the other and acting as custodian for their respective members); in some cases, CSDs have merged. **International central securities depositories** (ICSDs) have also been set up to provide custodial, clearing and settlement services for a wide range of debt and equity securities from multiple markets. ICSDs provide their services by linking directly or indirectly (through a local custodian) to domestic CSDs.

7. The processing of transfer instructions by a securities transfer system and a funds transfer system often involves several stages during which the rights and obligations of the buyer and the seller are significantly different. For example, often books may have been debited or credited, but the transfer is provisional, and one or more parties retain the right by law or agreement to rescind the transfer. If the transfer can be rescinded by the sender of the instruction, the transfer is said to be revocable. Even if the instruction is irrevocable, if a party such as the system operator or a liquidator can rescind the transfer, it is considered provisional. At the stage at which the transfer becomes final, that is, an irrevocable and unconditional transfer, the obligation is discharged. Final transfer of a security by the seller to the buyer constitutes **delivery**, and final transfer of funds from the buyer to the seller constitutes **payment**. When delivery and payment have occurred, the settlement process is complete.

8. Many settlement systems have associated **registries** in which ownership of securities is listed in the records of the issuer. Registrars typically assist issuers in communicating with securities owners about corporate actions, dividends, and so forth. In some markets, securities may be registered in the name of a broker-dealer or custodian rather than that of the ultimate investor. These types of arrangements are sometimes referred to as indirect holding systems. In other markets, the beneficial or ultimate owner is represented on the issuer's official records, which may be the records of the CSD, a transfer agent or the issuer itself. This is sometimes known as a direct holding system. The efficiency of the registration system has implications for the clearing and settlement process because it determines the ease and speed with which full legal title to securities can be transferred. Full legal title may not be obtained until ownership is listed in a registry, and thus finality in the settlement process may not be achieved until registration is complete.

Safekeeping or custody

9. An ongoing part of the securities settlement process after the final settlement of a trade is the **safekeeping** of securities. While securities are typically held in a CSD, many of the ultimate holders of securities are not direct members of these depositories. Rather, investors establish **custody** relationships with depository members, who provide safekeeping and administrative services related to the holding and transfer of the securities. Custodians keep records of securities holdings on behalf of investors, for example, and monitor the receipt of dividends and interest payments and corporate actions (for example share repurchases, mergers and acquisitions). As cross-border investment activities have grown, many investors have centralised the safekeeping of their securities at a single global custodian. This custodian is generally a member of numerous depositories around the world; in instances where it is not a direct member, it establishes a subcustodial relationship with such a member.

Annex 3:

Risks in securities clearing and settlement

1. Participants in securities settlement systems are confronted with a variety of risks that must be identified and understood if they are to be controlled effectively. There is the risk that participants will not settle obligations either when due or at any time thereafter (credit risk) or that participants will settle obligations late (liquidity risk). If a commercial bank is used for money settlements, its failure could create credit and liquidity risks for the system. Other risks potentially arise from the safekeeping and administration of securities on behalf of others (custody risk), from deficiencies in information systems or internal controls (operational risk), or from the failure of the legal system to support the rules and procedures of the settlement system (legal risk). If the failure of one participant renders other participants unable to meet their obligations, the settlement system might be a source of instability for financial markets more generally (systemic risk).

Credit risk

2. Credit risk is the risk of loss from default by a participant, typically as a consequence of its insolvency. Two types of credit risk are usefully distinguished: pre-settlement risk and settlement risk. Pre-settlement risk is also called replacement cost risk, that is, the risk of loss of unrealised gains on unsettled contracts with the defaulting participant. Settlement risk is sometimes termed principal risk, the risk of the loss of securities delivered or payments made to the defaulting participant prior to detection of the default. Settlement risk also involves liquidity risk that arises on the settlement date, as discussed below.

3. The risk of loss of unrealised gains is termed the replacement cost component of credit risk. A failure to perform on the part of one party to the transaction will leave the solvent counterparty with the need to replace, at current market prices, the original transaction. When the solvent counterparty replaces the original transaction at current prices, however, it will lose the gains that had occurred on the transaction in the interval between the time of the trade and the default. The unrealised gain, if any, on a transaction is determined by comparing the market price of the security at the time of default with the contract price; the seller of a security is exposed to a replacement cost loss if the market price is below the contract price, while the buyer of the security is exposed to such a loss if the market price is above the contract price. Because future securities price movements are uncertain at the time of the trade, both counterparties face replacement cost risk. The magnitude of replacement cost risk depends on the volatility of the security price and the amount of time that elapses between the trade date and the settlement date. The replacement cost component of credit risk can be reduced by compressing the time between trade execution and settlement. It may also be reduced by implementing legally binding trade netting systems.

4. Another form of credit risk arises in connection with contracts scheduled to settle on the date on which a counterparty default may occur. On such contracts, the non-defaulting counterparty may be exposed to principal risk, that is, the risk that the seller of a security could deliver but not receive payment or that the buyer could make payment but not receive delivery. If either of these events occurred, the entire principal value of the transaction would be at risk, hence the term principal risk. Both the buyer and the seller of a security may be exposed to principal risk. The buyer is at risk if it is possible to complete payment but not receive delivery, and the seller is at risk if it is possible to complete delivery but not receive payment. Principal risk can be eliminated through use of a delivery versus payment (DVP) mechanism. A DVP mechanism links a funds transfer (payment) system and a securities transfer (delivery) system to ensure delivery occurs if and only if payment occurs. Central counterparties (CCPs) are sometimes used to mitigate principal risk. Principal risk in securities settlements is analogous to what is termed cross-currency settlement risk (Herstatt risk) in foreign exchange settlements. Principal risk is of particular importance because it involves the full value of securities transferred, and in the event of default it may entail credit losses so sizeable as to create systemic problems.

Liquidity risk

5. Liquidity risk includes the risk that the seller of a security who does not receive payment when due may have to borrow or liquidate assets to complete other payments. It also includes the risk that the buyer of the security does not receive delivery when due and may have to borrow the security in order to complete its own delivery obligation. Thus, both parties to a securities trade are exposed to liquidity risk on the settlement date. The costs associated with liquidity risk depend on the liquidity of the markets in which the affected party must make its adjustments; the more liquid the markets, the less costly the adjustment.

6. Liquidity problems have the potential to create systemic problems, particularly if they occur at a time when securities prices are changing rapidly and failures to meet obligations when due are more likely to create concerns about solvency. In the absence of a strong linkage between delivery and payment, the emergence of systemic liquidity problems at such times is especially likely, as the fear of a loss of the full principal value of securities or funds could induce some participants to withhold deliveries and payments, which, in turn, may prevent other participants from meeting their obligations.

Risk of settlement bank failure

7. In addition to the risks associated with counterparties, participants in a securities settlement system may face the risk of a settlement bank failure. The failure of any bank that provides cash accounts to settle payment obligations for CSD members could disrupt settlement and result in significant losses and liquidity pressures for those members. The impact on CSD members would be particularly severe if all CSD members were required to use the same settlement bank. Thus, when use of a single settlement bank is required, it is usually the central bank of issue or a limited purpose bank with strong risk controls and access to sizeable financial resources. Alternatively, the risk of settlement bank failure may be controlled and diversified by allowing CSD members to choose among multiple private settlement banks. In this case, the settlement banks ultimately settle among themselves through a cash settlement agent, which typically is a central bank or limited purpose bank.

Custody risk

8. Risk may arise from the safekeeping and administration of securities and financial instruments on behalf of others. Users of custodial services face risk from the potential loss of securities in the event that the holder of the securities becomes insolvent, acts negligently or commits fraud. Even if there is no loss of the value of the securities held by the custodian or subcustodian, the ability of participants to transfer the securities might temporarily be impaired. Custody risk is particularly important for indirect participants in securities settlement systems whose securities are held in custody by direct participants, but CSDs also pose custody risk.

Operational risk

9. Operational risk is the risk of unexpected losses as a result of deficiencies in systems and controls, human error or management failure. It can reduce the effectiveness of other measures the settlement system takes to manage risk, for example by impairing the system's ability to complete settlement, perhaps creating liquidity pressures for itself or its participants, or by hampering the system's ability to monitor and manage its credit exposures. Possible operational failures include errors or delays in processing, system outages, insufficient capacity or fraud by staff.

Legal risk

10. Legal risk is the risk that a party will suffer a loss because laws or regulations do not support the rules of the securities settlement system, the performance of related settlement arrangements, or the property rights and other interests held through the settlement system. Loss and legal risk can also arise if the application of these laws and regulations is uncertain. For example, legal risk encompasses the risk a counterparty faces from an unexpected application of a law that renders contracts illegal or unenforceable. It also includes the risk of loss resulting from a delay in the recovery of funds or securities or a freezing of positions. In a cross-border context, the laws of more than one jurisdiction apply or can potentially apply to a transaction, conduct or relationship. Counterparties may face loss

resulting from the application of a different law than they had expected, or had specified in a contract, by a court in a relevant jurisdiction. Legal risk thus exacerbates other risks, such as market, credit or liquidity risk, relating to the integrity of transactions.

Systemic risk

11. Systemic risk is the risk that the inability of one institution to meet its obligations when due will cause other institutions to fail to meet their obligations when due. The possibility that the liquidity and credit problems precipitated by these failures to perform will disrupt financial markets and impair the functioning of payment and settlement systems is of particular concern. Securities settlement systems can create significant credit, liquidity and other risks for their participants. Payment systems and clearing systems for other financial instruments often depend critically on securities settlement systems because of their use of securities as collateral in their own risk management procedures. Market liquidity in securities markets is dependent on confidence in the safety and reliability of settlement systems because traders will be reluctant to deal if they doubt that the trade will settle. Thus it is important that the risks in securities settlement systems be appropriately managed in order that securities settlement systems are not a source of systemic disturbances to securities markets and other payment and settlement systems.

Annex 4:

Settlement of cross-border trades: channels and sources of risk

1. The settlement of a cross-border trade takes place in a country other than the country in which one or both trade counterparties are located. Often, settlement takes place in the country where the security is issued, but there are exceptions to this general pattern. For example, large volumes of trades of eurobonds and European government securities are currently settled in either Belgium or Luxembourg through the international central securities depositories (ICSDs), Euroclear and Clearstream. Cross-border consolidation of securities settlement systems could make settlements outside the country of issue increasingly common.

Settlement channels

2. There are five common channels through which the settlement of a cross-border trade could be effected, depending upon how the non-resident counterparty to the trade accesses the settlement system where the security is issued.¹⁷ Use of these channels for cross-border settlements is not mutually exclusive. Active market participants may use one channel for certain types of securities or counterparties and another channel for other securities and counterparties.

3. *Direct membership.* In this channel, the non-resident counterparty establishes direct access to the settlement system in the country where the security is issued through membership in the relevant CSD. This channel may not be available to all non-resident counterparties, however, because some systems prohibit non-resident firms from becoming direct participants. Alternatively, local branches or subsidiaries of non-resident firms may be allowed to participate.

4. *Local agent.* A common method of settling cross-border trades is to employ a local agent or custodian in the country of issue. This agent is a direct member of the CSD and can perform settlement and settlement-related services. For example, the agent may provide banking services such as funds transfers, overdraft facilities, foreign exchange transactions, and securities borrowing and lending. Custody services that would typically be offered include securities safekeeping, collection of interest and dividends, and processing of corporate actions. The precise mix of services that the non-resident counterparty obtains from the local agent is determined contractually.

5. *Global custodian.* A global custodian provides its customers with access to settlement and custody services in multiple markets through a network of subcustodians, both the global custodian's own branches and other local agents. The non-resident counterparty is thus able to employ a single communication link for providing settlement instructions and for receiving reports from local markets. The global custodian also typically offers accounting and credit services, including multicurrency banking and cash management services. Some global custodians provide their customers with daily conversion of all foreign currency denominated receipts and payments into the investor's home currency.

6. *International central securities depository.* The ICSDs, Euroclear and Clearstream, were originally created to provide settlement and custody services for eurobonds. The services offered have expanded, however, and the ICSDs now offer settlements in a wide range of securities and currencies. Settlements can occur in more than one way. The ICSDs have developed links to dozens of local CSDs that enable them to settle trades between their participants and counterparties in the local markets. In some cases, the ICSDs have agents in the local market that settle trades on behalf of the ICSDs' participants. When two participants in the ICSDs trade with each other, the ICSDs can settle these trades on their own books or via a "bridge" that links their two systems. Because the ICSDs have a critical mass of actively trading participants, a substantial portion of activity can be settled on their books.

¹⁷ These channels for settling cross-border trades are described more extensively in CPSS, *Cross-Border Securities Settlements* (BIS, 1995).

7. *Links between CSDs.* Links between CSDs offer another channel for settling cross-border trades between members of different CSDs. Links can take several different forms. Some are reciprocal, that is, participants in either system can settle trades in the other system. Other links permit settlements only in one direction. In some links, the respective CSDs become full participants in the other system. Other links allow only free-of-payment transfers.

Risks in cross-border settlements

8. Cross-border settlements may involve foreign exchange transactions that entail replacement cost and liquidity risks, but in many other respects the types of risks associated with cross-border settlements are the same as those that arise in domestic settlements. Nonetheless, the channels through which cross-border settlements are effected may alter the character of some of these risks. The greater use of custodians (local agents, global custodians, CSDs and ICSDs) in cross-border settlements and the multiple legal jurisdictions involved heighten custody and legal risk. Cross-border settlements more frequently occur outside the CSD in the country of issue, and thus are more often subject to rules other than those of the local CSD, entailing different risks for counterparties. Finally, cross-border settlements are sometimes effected through links between systems, which may expose participants in one system to weaknesses in the risk management procedures of another.

9. *Custody risk.* Whenever market participants hold securities indirectly they face custody risk. Custody risk is a part of domestic settlements, but the extent of use of custodians is much greater in cross-border settlements, and thus the custody risk tends to be greater. Several of the channels for settling cross-border trades - local agents, global custodians, ICSDs and CSD links - involve a custodian or a custodian and subcustodians. The tiering of holdings such as occurs with subcustodians not only exacerbates custody risk but also makes the magnitude of such risk more difficult to assess.

10. *Legal risk.* The most important legal issues that arise in cross-border settlements, but not in domestic settlements, relate to choice of law and conflict of laws. These concepts address the basic question of the law that governs the relationship between the parties to a securities transaction. By definition, cross-border settlements involve multiple legal jurisdictions. This complicates the analysis of legal risk. It may introduce new risks as system operators choose the law that will govern the system and the relationships between system participants, and it may introduce risks if such choices are not honoured by the courts in relevant jurisdictions.

11. *Settlements outside the local CSD.* When multiple counterparties use a single custodian, it is possible to settle trades on the books of the custodian rather than on the books of the CSD of issue. This can occur in the settlement of domestic trades where a local bank acts as custodian for many active market participants, but it is perhaps more common in the settlement of cross-border trades. The ICSDs settle large volumes of trades between their participants internally through debits and credits to accounts. Likewise, a purpose of CSD-to-CSD links is to allow the non-local CSD to settle trades between its participants in the non-local securities internally. When trades are settled in an intermediary other than the CSD of issue, those trades settle according to the rules of the intermediary, which may differ from the rules of the local CSD. As a result, risks may differ.

12. *Cross-system settlements.* Cross-system settlements are effected through links between securities settlement systems, both between pairs of CSDs and between CSDs and ICSDs. Such cross-system settlements often involve inefficiencies that derive from the need for the systems to exchange information on whether the two counterparties have the securities and funds (or access to credit) necessary to complete settlement. Operational difficulties may arise from variations in operating hours and time zones. Often, counterparties must pre-position or borrow securities and funds to ensure their ability to settle in a timely fashion, thereby increasing the liquidity needs of counterparties.

13. Special problems may arise if one or both of the securities settlement systems make provisional transfers of securities that are not final until money settlement is completed later in the day. If a system receiving a provisional transfer allows that security to be redelivered before money settlement is complete, an unwind of the provisional transfer could lead to unwinds and losses within its own system. The implications for those participating through a link will depend upon how the losses are allocated by the system receiving the provisional transfer.

14. Even if they are not vulnerable to unwinds from provisional transfers, links create operational dependencies between the systems. An operational problem in one system can result in failures to complete deliveries which, in turn, could affect the completion of settlement in a linked system. Credit

and liquidity dependencies are also created when one system provides another with a cash account. The system using the account is exposed to credit and liquidity risk on balances held in the account; the system providing the account is exposed to credit and liquidity risk if it permits overdrafts or debit balances in the account.

Annex 5: Glossary

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| back-to-back transaction | A pair of transactions that requires a counterparty to receive and redeliver the same securities on the same day. The transactions involved may be outright purchases and sales or collateral transactions (repurchase agreements or securities loans). For example, a securities dealer might buy and sell the same securities for the same settlement date in the course of making markets for customers or it might buy securities for inventory and finance the position through a repurchase agreement. |
| beneficial ownership/interest | Entitlement to receive some or all of the rights deriving from ownership of a security or financial instrument (eg income, voting rights, power to transfer). Beneficial ownership is usually distinguished from legal ownership of a security or financial instrument. |
| book entry system | An accounting system that permits the electronic transfer of securities without the movement of certificates. |
| cash settlement agent | The entity whose assets are used to settle the ultimate payment obligations arising from securities transfers within the CSD. Accounts with the cash settlement agent are held by settlement banks which act on their own behalf and may also offer payment services to participants that do not have accounts with the settlement agent. |
| central counterparty (CCP) | An entity that interposes itself between the counterparties to trades, acting as the buyer to every seller and the seller to every buyer. |
| central securities depository (CSD) | An institution for holding securities that enables securities transactions to be processed by means of book entries. Physical securities may be immobilised by the depository or securities may be dematerialised (so that they exist only as electronic records). |
| certificate | A document that evidences the ownership of, and the undertakings of the issuer of, a security or financial instrument. |
| choice of law | A contractual provision by which parties choose the law that will govern their contract or relationship. Choice of law may also refer to the question of what law should govern in the case of a conflict of laws. See conflict of laws. |
| clearance | The term “clearance” has two meanings in the securities markets. It may mean the process of calculating the mutual obligations of market participants, usually on a net basis, for the exchange of securities and money. It may also signify the process of transferring securities on the settlement date, and in this sense the term “clearing system” is sometimes used to refer to securities settlement systems. |
| collateral | An asset or third-party commitment that is accepted by the collateral taker to secure an obligation of the collateral provider vis-à-vis the collateral taker. |
| confirmation | The process in which the terms of a trade are verified either by market participants directly or by some central entity (typically the marketplace). When direct market participants execute trades on behalf of indirect market participants, trade confirmation often occurs on two separate tracks: verification (generally termed confirmation) of the terms of the trade between direct participants and verification (sometimes termed affirmation) of the intended terms between each direct participant and the indirect participant for whom the direct participant is acting. |

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| conflict of laws | An inconsistency or difference in the laws of jurisdictions that have a potential interest in a transaction. Each jurisdiction's conflict of laws rules specify the criteria that determine the law applicable in such a case. |
| counterparty | A party to a trade. |
| credit risk | The risk that a counterparty will not settle an obligation for full value, either when due or at any time thereafter. Credit risk includes replacement cost risk and principal risk. It also includes the risk of settlement bank failure. |
| cross-border settlement | A settlement that takes place in a country other than the country in which one trade counterparty or both are located. |
| cross-border trade | A trade that requires cross-border settlement. |
| cross-margining agreement | An agreement between CCPs to consider positions and supporting collateral at their respective organisations as a portfolio for participants that are members of both organisations. Positions held in cross-margined accounts are subject to lower collateral requirements because the positions held at one CCP collateralise part of the exposure of related positions at the other CCP. In the event of default by a participant whose account is cross-margined, one CCP can use the positions and collateral in the cross-margined account at the other CCP to cover losses. |
| cross-system settlement | A settlement of a trade that is effected through a link between two separate securities settlement systems. |
| custodian | An entity, often a bank, that safekeeps securities for its customers and may provide various other services, including clearance and settlement, cash management, foreign exchange and securities lending. |
| custody | The safekeeping and administration of securities and other financial instruments on behalf of others. |
| custody risk | The risk of loss on securities in safekeeping (custody) as a result of the custodian's insolvency, negligence, misuse of assets, fraud, poor administration or inadequate record keeping. |
| delivery | Final transfer of a security or financial instrument. |
| delivery versus payment | A link between securities transfers and funds transfers that ensures that delivery occurs if, and only if, payment occurs. |
| dematerialisation | The elimination of physical certificates or documents of title that represent ownership of securities so that securities exist only as accounting records. |
| direct holding system | A holding system for securities in which the beneficial owner of securities (i) is reflected as the legal owner on the issuer's official register(s) (and, if the securities are required to be certificated, the securities are issued in the name of the owner) or (ii) is in possession of securities issued to bearer. The issuer, CSD, participants in the CSD, and third-party claimants are required to recognise the owner's rights and interests in the securities based on the record of the register or the owner's possession of the security. |
| direct market participant | A broker-dealer or member of an exchange that directly executes an order. |

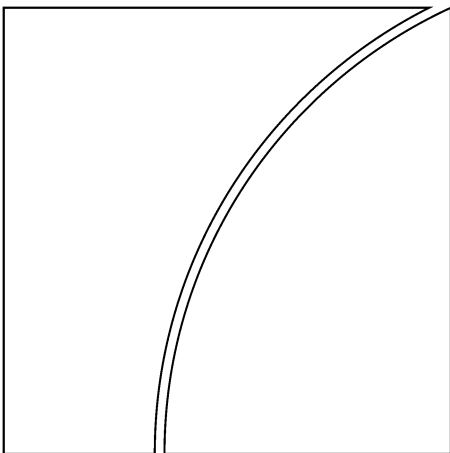
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| failed transaction | A securities transaction that does not settle on the contractual settlement date. |
| final settlement | The discharge of an obligation by a transfer of funds and a transfer of securities that have become irrevocable and unconditional. |
| global custodian | A custodian that provides its customers with custody services in respect of securities traded and settled not only in the country in which the custodian is located but also in numerous other countries throughout the world. |
| gross settlement system | A transfer system in which the settlement of funds or securities transfer instructions occurs individually (on an instruction by instruction basis). |
| immobilisation | Placement of physical certificates for securities and financial instruments in a central securities depository so that subsequent transfers can be made by book entry, that is, by debits from and credits to holders' accounts at the depository. |
| indirect holding system | A holding system for securities in which (i) a nominee is reflected as the legal owner of securities on the official register of the issuer and the beneficial owner (or the intermediary through which the latter holds the security) is reflected as the owner of the securities on the books of the nominee or (ii) bearer securities are deposited with an intermediary and the intermediary maintains an account reflecting the beneficial owner's rights and interests in the security. The beneficial owner's rights and interests in securities in an indirect holding system are transferred by accounting entries on the nominee's or relevant intermediary's books. |
| indirect market participant | A market participant that uses an intermediary for the execution of trades on its behalf. Generally, institutional investors and cross-border clients are indirect market participants. |
| international central securities depository (ICSD) | A central securities depository that settles trades in international securities and in various domestic securities, usually through direct or indirect (through local agents) links to local CSDs. |
| issuer | The entity that is obligated on a security or financial instrument. |
| legal risk | The risk that a party will suffer a loss because laws or regulations do not support the rules of the securities settlement system, the performance of related settlement arrangements, or the property rights and other interests held through the settlement system. Legal risk also arises if the application of laws and regulations is unclear. |
| liquidity risk | The risk that a counterparty will not settle an obligation for full value when due, but on some unspecified date thereafter. |
| local agent | A custodian that provides custody services for securities traded and settled in the country in which it is located to trade counterparties and settlement intermediaries located in other countries (non-residents). |
| margin | Generally, the term for collateral used to secure an obligation, either realised or potential. In securities markets, the collateral deposited by a customer to secure a loan from a broker to purchase shares. In organisations with a CCP, the deposit of collateral to guarantee performance on an obligation or cover potential market movements on unsettled transactions is sometimes referred to as margin. |
| marking to market | The practice of revaluing securities and financial instruments using current market prices and requiring the counterparty with an as yet unrealised loss on the contract to transfer funds or securities equal to the value of the loss to the other counterparty. |

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| master agreement | An agreement that sets forth the standard terms and conditions applicable to all or a defined subset of transactions that the parties may enter into from time to time, including the terms and conditions of closeout netting. |
| net settlement system | A settlement system in which final settlement of transfer instructions occurs on a net basis at one or more discrete, prespecified times during the processing day. |
| netting | An agreed offsetting of mutual obligations by trading partners or participants in a system, including the netting of trade obligations, for example through a CCP, and also agreements to settle securities or funds transfer instructions on a net basis. |
| nominee | A person or entity named by another to act on its behalf. A nominee is commonly used in a securities transaction to obtain registration and legal ownership of a security. |
| operational risk | The risk that deficiencies in information systems or internal controls, human errors or management failures will result in unexpected losses. |
| oversight | A public policy activity principally intended to promote the safety and efficiency of payment and securities settlement systems and in particular to reduce systemic risk. |
| pre-settlement risk | The risk that a counterparty to a transaction for completion at a future date will default before final settlement. The resulting exposure is the cost of replacing the original transaction at current market prices and is also known as replacement cost risk. |
| principal risk | The risk that the seller of a security delivers a security but does not receive payment or that the buyer of a security makes payment but does not receive delivery. In such an event, the full principal value of the securities or funds transferred is at risk. |
| provisional transfer | A conditional transfer in which one or more parties retain the right by law or agreement to rescind the transfer. |
| real-time gross settlement | The continuous settlement of funds or securities transfers individually on an order by order basis as they are received. |
| registration | The listing of ownership of securities in the records of the issuer. This task is often performed by an official registrar/transfer agent. |
| repurchase agreement | A contract to sell and subsequently repurchase securities at a specified date and price. |
| revocable transfer | A transfer that a system operator or a system participant can rescind. |
| rolling settlement | A procedure in which settlement takes place a given number of business days after the date of the trade. This is in contrast to account period procedures in which the settlement of trades takes place only on a certain day, for example a certain day of the week or month, for all trades that occurred within the account period. |
| same day funds | Money balances that the recipient has the right to transfer or withdraw from an account on the day of receipt. |
| securities settlement system | The full set of institutional arrangements for confirmation, clearance and settlement of securities trades and safekeeping of securities. |
| segregation | A method of protecting client assets and positions by holding and designating them separately from those of the carrying firm or broker. |
| settlement | The completion of a transaction through final transfer of securities and funds between the buyer and the seller. |
| settlement agent | See cash settlement agent. |

| | |
|------------------------------------|---|
| settlement bank | The entity that maintains accounts with the settlement agent in order to settle payment obligations arising from securities transfers, both on its own behalf and for other market participants. |
| settlement date | The date on which parties to a securities transaction agree that settlement is to take place. This intended settlement date is sometimes referred to as the contractual settlement date. |
| settlement interval | The amount of time that elapses between the trade date (T) and the settlement date. The settlement interval is typically measured relative to the trade date; for example, if settlement is to occur on the third business day following the date of the trade, the settlement interval is referred to as T+3. |
| settlement risk | A general term used to designate the risk that settlement in a transfer system will not take place as expected. This risk may comprise both credit and liquidity risk. |
| straight through processing | The completion of pre-settlement and settlement processes based on trade data that is manually entered only once into an automated system. |
| subcustodian | A custodian that holds securities on behalf of another custodian. A global custodian, for example, may hold securities through another custodian in a local market. The latter custodian is known as a subcustodian. |
| SWIFT | SWIFT, the Society for Worldwide Interbank Financial Telecommunications, provides a secure messaging service for interbank communication. Its services are extensively used in the foreign exchange, money and securities markets for confirmation and payment messages. |
| systemic risk | The risk that the inability of one institution to meet its obligations when due will cause other institutions to be unable to meet their obligations when due. Such a failure may cause significant liquidity or credit problems and, as a result, might threaten the stability of or confidence in markets. |
| unwind | A procedure followed in some clearing and settlement systems in which transfers of securities or funds are settled on a net basis, with the transfers provisional until all participants have discharged their settlement obligations. If a participant fails to settle, some or all of the provisional transfers involving that participant are deleted from the system, and the settlement obligations from the remaining participants are recalculated. This process of recalculating obligations is known as an unwind. |

Committee on Payment and
Settlement Systems

Technical Committee of the
International Organization of
Securities Commissions



Assessment methodology for “Recommendations for Securities Settlement Systems”

November 2002



BANK FOR INTERNATIONAL SETTLEMENTS



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Foreword

Securities settlement systems (SSSs) are an increasingly important component of the domestic and global financial infrastructure. It is for this reason that the Committee on Payment and Settlement Systems (CPSS) of the central banks of the Group of Ten countries and the Technical Committee of the International Organisation of Securities Commissions (IOSCO) established the Task Force on Securities Settlement Systems in December 1999 to develop recommendations for the safety and soundness of SSSs.

In November 2001 the CPSS-IOSCO Recommendations for Securities Settlement Systems were published. The November 2001 report sets out and discusses 19 recommendations for SSSs that identify minimum standards that SSSs should meet. The recommendations are designed to cover systems for all types of securities, for securities issued in both industrialised and developing countries, and for domestic as well as cross-border trades. These recommendations have been included in the Key Standards for Sound Financial Systems highlighted by the Financial Stability Forum. The CPSS and the Technical Committee of IOSCO encourage national authorities responsible for the regulation and oversight of SSSs to assess whether markets in their jurisdiction have implemented the recommendations and to develop action plans for implementation where necessary.

This report aims to set out a clear and comprehensive methodology for use in these assessments. The methodology is primarily intended for use in self-assessments by national authorities or in peer reviews of such self-assessments. It is also intended to serve as guidance for the international financial institutions (IFIs, ie the International Monetary Fund and the World Bank) undertaking their Financial Sector Assessment Program (FSAP) assessments and for other forms of technical assistance, possibly including financing of reform efforts by the World Bank. In this regard, IFIs took part in developing this assessment methodology. Further, we hope that the methodology may also prove useful to private market participants who may be conducting their own assessments of the safety and efficiency of SSSs on the basis of the SSSs' observance of the recommendations.

The CPSS and the Technical Committee of IOSCO are grateful to the members of the Task Force and its Co-Chairmen, Patrick Parkinson of the Board of Governors of the Federal Reserve System and Shane Tregillis of the Monetary Authority of Singapore, for their work in completing this report in a timely manner.

Tommaso Padoa-Schioppa, Chairman
Committee on Payment and Settlement Systems

David Knott, Chairman
Technical Committee, IOSCO

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1. Introduction

1.1 In November 2001 the Bank for International Settlements published a report entitled *Recommendations for Securities Settlement Systems (RSSS)*. This report was prepared by the Task Force on Securities Settlement Systems, which was created for that purpose in December 1999 by the Committee on Payment and Settlement Systems (CPSS) of the central banks of the Group of Ten countries and the Technical Committee of the International Organisation of Securities Commissions (IOSCO). It sets out and discusses 19 recommendations for securities settlement systems (SSSs), implementation of which is intended to enhance the safety and efficiency of those systems. Subsequently, the Financial Stability Forum included the recommendations in its list of Key Standards for Sound Financial Systems. Among the Key Standards, the recommendations for SSSs have been grouped with the CPSS's *Core Principles for Systemically Important Payment Systems (CPSIPS)* under the common subject of Payment and Settlement Systems. The Key Standards also include IOSCO's *Objectives and Principles of Securities Regulation*.

1.2 The November 2001 report emphasises the need for a concerted effort to implement the recommendations. While primary responsibility for implementation lies with the designers, owners, and operators of SSSs, which most often are private sector entities, the report stresses the need for central banks, securities regulators, and other relevant national authorities to promote implementation by undertaking self-assessments of whether systems in their jurisdiction have implemented the recommendations and by identifying steps necessary for completing implementation where initially the recommendations are not fully observed. The CPSS and the Technical Committee of IOSCO indicated that they also saw value in external assessments of implementation, including assessments by the international financial institutions (IFIs, ie the International Monetary Fund and the World Bank), in particular as part of their Financial Sector Assessment Program (FSAP).

1.3 The purpose of this report is to develop a clear and comprehensive methodology for assessing whether the recommendations have been implemented. The methodology is intended primarily for use in self-assessments by national authorities or in peer reviews of such self-assessments. It also is intended to serve as guidance for FSAP assessments and for other forms of technical assistance, possibly including financing of reform efforts by the World Bank. The methodology may also prove useful to private market participants who may be conducting their own assessments of the safety and efficiency of SSSs on the basis of the SSSs' observance of the recommendations. For example, a CSD or CCP may wish to perform its own self-assessment of those recommendations that are directly applicable to its operations. Or, broker-dealers or custodians may wish to use the recommendations to assess the risks to which they are exposed through participation in an SSS.

1.4 This report must be read in conjunction with the November 2001 report. It avoids repetition of the discussions of the recommendations that were contained in the earlier report and is not intended to amend or expand upon those discussions. The earlier report included key questions pertaining to the recommendations, as a first step towards development of an assessment methodology and as a potential framework for meeting the transparency recommendation (Recommendation 17). In this report, the key questions have been amended fairly extensively to align them more closely with the key issues that must be evaluated in order to determine the extent to which the recommendations have been implemented.

1.5 The next section of this report discusses the determination of the appropriate scope of an assessment. The core of the report is Section 3, which discusses how to assess implementation. For each recommendation, it (1) identifies the key issues that need to be evaluated to determine the extent to which the recommendation has been implemented, (2) identifies the key questions that must be asked to evaluate the key issues, and (3) discusses the relationship between the answers to the key questions and the assignment of an assessment category that summarises the extent of implementation. Where appropriate, explanatory notes addressing specific assessment issues are included. Section 4 provides guidance on development of a formal action plan for implementation where that is appropriate, including a discussion of how to set priorities and advice on how to engage the private sector in implementation efforts. Annex 1 provides a template for an Assessment Report and Annex 2 provides a template for public disclosure of information relevant to the assessment of the safety and efficiency of an SSS based on answers to the key questions.

2. Determination of the scope of an assessment

2.1 Before beginning an assessment, careful consideration needs to be given to its appropriate scope. Securities regulators, central banks, and other relevant authorities must work together to determine the range of securities to be covered and to identify the institutions that perform critical functions in the SSS. If any of those institutions are located in other jurisdictions or if the domestic central securities depositories (CSDs) involved have established links to settle cross-border trades, they will need to consider how best to cooperate with authorities in those relevant jurisdictions to obtain essential information without imposing unnecessary costs on the institutions involved.

2.2 In some countries trades in all securities are settled through the same settlement system. Consequently, in those countries an assessment of that system would cover all securities. However, in other countries different types of securities may be settled through different SSSs. For example, government securities may be cleared and settled through a CSD and a central counterparty (CCP) that are different from the CSD and CCP used to clear and settle equity securities. Or different stock exchanges within a country may operate their own distinct settlement systems. Authorities must clearly specify the range of securities covered by an assessment. Also, where there is more than one SSS, it may not be possible initially to assess all the SSSs at the same time and the authorities will need to set priorities. In general, priority should be given to the SSS that processes the highest average daily value of trades, because weaknesses in the largest systems are most likely to pose the greatest threat to financial stability and to entail the most significant opportunity costs from inefficiencies. However, if authorities are aware of significant weaknesses in a smaller SSS (for example, a failure to achieve delivery versus payment (DVP) or a lengthy settlement cycle), they may wish to assess that smaller system first. Other considerations, such as whether the system is used for monetary policy operations, may influence the order in which multiple SSSs are assessed, so that the order will not necessarily be indicative of the authorities' views of the relative weakness of the various systems. Where there are multiple markets and SSSs within a jurisdiction, no assessment may be necessary for very small markets with a separate SSS and a volume and value of trades that are very small relative to the aggregate activity in the jurisdiction.

2.3 Even if all securities traded in a country are settled through the same SSS, derivatives may be settled through a separate system. Exchange-traded derivatives are nearly always cleared and settled through a CCP, which may be organised as a department of the exchange or as a separate legal entity. Where it is a separate legal entity, that entity may act as CCP for multiple derivatives exchanges and possibly also for securities trades. The RSSS were not designed to be applied to derivatives and do not address comprehensively the risks they face or the risk management procedures they typically employ. Nonetheless, many of the recommendations, notably those on CCPs, legal framework, operational reliability, governance, access, transparency, and regulation and oversight, are relevant to clearance and settlement of exchange-traded derivatives. Where derivatives are settled through a CCP that also acts as counterparty to securities trades, the assessment of the SSS for those securities may need to address the CCP's management of risks with respect to those derivatives transactions. This is especially the case if collateral requirements and financial support arrangements apply to portfolios that include both securities and derivatives. But the recommendations need not be applied to exchange-traded derivatives that are cleared and settled by a separate CCP. In the future, international standards that would be applicable to CCPs for both securities and derivatives may need to be developed.

2.4 Because institutional arrangements for securities settlements are quite diverse internationally, the RSSS focus on the functions to be performed rather than the institutions that perform them. While several of the recommendations are addressed explicitly to CSDs, CCPs, or both, other recommendations are relevant to stock exchanges (as operators of trade confirmation systems or issuers of settlement guarantees), settlement banks, or custodians. In systems in which securities are held in an indirect holding system and in which custody services are highly concentrated, the distinction between the functions of a CSD and those of custodians has become blurred. If the trade counterparties (or the intermediaries through which they settle their trades) use the same custodian and the custodian holds the counterparties' securities in the same omnibus account at the CSD, those trades may be settled on the books of the custodian and not on the books of the CSD. If a significant share of settlements takes place on the books of any custodian, authorities should consider whether that custodian's policies and procedures are consistent with some of the recommendations, notably those addressing delivery versus payment, timing of settlement finality, CSD risk controls, cash settlement assets, custody risk, securities lending, and operational reliability.

2.5 Some institutions that perform critical functions in an SSS may be located in other jurisdictions. As noted earlier, some CCPs act as counterparties to trades in multiple markets, sometimes including markets in two or more countries. Also, if an SSS offers multicurrency settlement, it may conduct cash settlements using banks in other jurisdictions. In some cases, securities issued and traded in one country are settled solely through a CSD in another country. Finally, many CSDs have established cross-border links with other CSDs. When such links are used to settle cross-border trades, implementation of the recommendation on risks in cross-border links should be assessed. Even when such links are used solely to settle domestic trades in foreign securities, assessments of the recommendations on the legal framework and the protection of customers' securities may require the authorities to include the linked foreign CSDs (or CCPs) within the scope of the assessment. However, as noted earlier, whenever a foreign institution is included within the scope of the assessment, the authorities should cooperate with authorities in that country to obtain the necessary information about the institution.

2.6 An assessment report (see the template in Annex 1) should begin by identifying precisely the securities that are covered. It should then provide a description of the architecture of the settlement system for those securities (and any covered derivatives) that identifies the institutions that perform critical functions in the system. The description should include sufficient data to understand clearly the scale and scope of the system's operations, including data on the value of the securities held in the system and the average and peak values of securities settled within the system. The introductory section of the assessment report should also describe the process followed in conducting the assessment and identify the main sources of information that were utilised. The report should then provide a recommendation by recommendation assessment of implementation. An assessment report should conclude with steps for achieving full observance of any recommendations that are not fully observed, identifying specific actions to be taken and the parties that are best positioned to implement the recommended steps.

3. Assessment of implementation

3.1 The degree of implementation of each recommendation should be summarised by the assignment of one of five assessment categories: Observed, Broadly observed, Partly observed, Non-observed, or Not applicable. (Only a few of the recommendations may not be applicable in certain circumstances and an assessor should make clear why the recommendation is not applicable.) The remainder of this section provides guidance on how to assign a rating category for each of the recommendations. For each recommendation the guidance identifies the key issues relevant to implementation. These include the issues identified in the recommendations themselves as well as certain important issues that were identified in the discussions of the recommendations in the November 2001 report. For each key issue, the guidance identifies a key question, the answer to which should clearly demonstrate whether and how the key issue has been addressed by an SSS.

3.2 The guidance then indicates how the answers to the key questions should be translated into an assessment category. This guidance on the assignment of rating categories is not intended to be applied in a purely mechanical fashion. In some instances, an SSS may not strictly meet the assessment criteria for observance of a recommendation but may successfully address the safety or efficiency objectives that underlie the recommendation and the key issues and key questions. Nonetheless, the guidance is intended to establish a presumption as to what the appropriate rating should be, given the circumstances indicated by the answers to the key questions. Moreover, assessors should take a conservative approach to the assignment of ratings - when in doubt about observance, assign the lower category of observance. Whenever an assessor chooses to assign a different rating than is indicated by the guidance, the assessment report should explain clearly why a different rating category was deemed more appropriate. This approach is intended to foster discipline in the ratings process while allowing some flexibility to deal with special circumstances. The guidance also includes explanatory notes to clarify certain issues that seem likely to arise in the course of an assessment.

3.3 In some cases an SSS may be in the midst of significant transition at the time it is being assessed. An assessment should focus on the system as it is, not on how system operators plan or hope it to be. Plans to improve the system should be reflected in the section of the assessment report that presents the assessor's comments on necessary future actions to achieve observance of the

recommendations. In these comments the assessor should set out whether once in place the planned improvements would be sufficient to justify a higher rating category.

Recommendation 1: Legal framework

Securities settlement systems should have a well founded, clear and transparent legal basis in the relevant jurisdictions.

Key issues

1. As a general matter, the laws, regulations, rules and procedures, and contractual provisions governing the operation of SSSs should be clearly stated, understandable, public and accessible to system participants.
2. The legal framework should demonstrate a high degree of legal assurance for each aspect of the settlement process.
3. The rules and contracts related to the operation of the SSS should be enforceable in the event of the insolvency of a system participant.
4. The operators should identify the relevant jurisdictions and address any conflict of laws issues for cross-border systems.

Key questions

1. Are the laws, regulations, rules and procedures, and contractual provisions governing securities settlement arrangements public and readily accessible to system participants?
2.
 - (i) Does the legal framework demonstrate a high degree of legal assurance that:
 - (a) transactions are enforceable?
 - (b) customers' assets are adequately protected (particularly against the insolvency of custodians and intermediaries)?
 - (ii) Does the legal framework demonstrate a high degree of assurance that there is a clear and effective legal basis for:
 - (a) arrangements for the immobilisation or dematerialisation of securities and the transfer of securities by book entry?
 - (b) netting arrangements?
 - (c) securities lending arrangements (particularly the ability to obtain a security interest in assets)?
 - (d) finality of settlement?
 - (e) arrangements for achieving delivery versus payment?
 - (iii) Has a court in the jurisdiction ever failed to uphold the legal basis of these activities/arrangements? And if so, for what reasons?
3. Are the rules of the system and contracts between system participants enforceable notwithstanding the insolvency of a participant?
4.
 - (i) Is there a significant level of cross-border participation in the SSS? If so, please describe and answer Question 4(ii).
 - (ii) Are other jurisdictions relevant for determining the adequacy of the legal framework? How has this been determined? Has the legal framework been evaluated for the other relevant jurisdictions? Are there conflict of laws issues and, if so, have they been addressed?

Assignment of an assessment category

1. Observed
 - (a) The laws, regulations, rules and procedures, and contractual provisions governing the operation of SSSs are public and accessible to system participants. (Q1)
 - (b) The legal framework demonstrates a clear legal basis and a high degree of legal assurance for each aspect of the settlement process. (Q2)
 - (c) The rules and contracts are enforceable in the event of the insolvency of a system participant. (Q3)
 - (d) The operators of cross-border systems have identified the relevant jurisdictions and taken steps to address conflict of laws issues; or it is not necessary to address conflict of laws issues in assessing risk because cross-border participation in the system (such as non-domestic participants or assets) is at an insignificant level. (Q4)
2. Broadly observed
 - (a) 1a, 1b and 1c are satisfied with only very minor exceptions that do not risk undermining the safety and soundness of the system. (Q1, 2, 3)
 - (b) 1d is not satisfied. (Q4)
3. Partly observed
 - (a) The legal framework does not demonstrate a high degree of legal assurance for some aspects of the settlement process that, while important and posing some risks, do not jeopardise the overall safety and soundness of the system. (Q2)
 - (b) Or: there are some limited cases where rules and contracts may not be fully enforceable in the event of the insolvency of a system participant. (Q3)
4. Non-observed
 - (a) Aspects of the settlement process are not supported by the legal framework and this poses risks to the overall safety and soundness of the system. (Q2)
 - (b) Or: there is no demonstrated assurance that the rules and contracts are enforceable in the event of the insolvency of a system participant. (Q3)

Explanatory note

1. In the case of cross-border transactions the relevant jurisdictions for the legal assessment are set out in paragraph 3.6 of the report.
2. The general emphasis of an assessment should be for the assessor to be reasonably confident that there are no obvious gaps or problems with the legal basis for the SSS. The various components of the legal framework (eg securities law, contract law, commercial law, bankruptcy law, etc) should not be inconsistent with or override the rules or procedures of the SSS or its ability to meet these recommendations.
3. The assessor should obtain supporting evidence in the form of relevant statutory provisions, rules of the CSD and CCP, relevant legal opinions, regulations and policy statements and any inconsistent judgments from courts, if applicable.
4. A weakness in the legal framework that poses some risk but does not jeopardise the safety and soundness of the system would be one that the system operator or regulator can demonstrate can be appropriately mitigated by other means.
5. The legal framework is clearly insufficient if the courts of the jurisdiction do not function adequately, property rights are not respected, contracts are not enforceable, or there is no procedural due process. A system would also be non-observed if its domestic law is seriously inadequate and does not support the operation of the system upon the insolvency of a participant (eg by allowing the unwinding of settlements post-insolvency as a result of preference or zero hour rules).

Recommendation 2: Trade confirmation

Confirmation of trades between direct market participants should occur as soon as possible after trade execution, but no later than trade date (T+0). Where confirmation of trades by indirect market participants (such as institutional investors) is required, it should occur as soon as possible after trade execution, preferably on T+0, but no later than T+1.

Key issues

1. Confirmation of trades between direct market participants should occur no later than T+0.
2. Settlement instructions should be matched prior to settlement.
3. Where confirmation of trades by indirect market participants is required by regulators, clearing systems, or market operators, it should occur as soon as possible after trade execution, preferably on T+0, but no later than T+1.

Key questions

1. What percentage of trades between direct market participants is submitted to a trade confirmation system on the trade date (T+0)? How soon after submission are problems communicated to the appropriate parties?
2. Does the CSD require settlement instructions to be matched prior to settlement?
3. Are there trade confirmation procedures that are capable of comparing trade information between direct and indirect market participants by T+1? Is use of the system mandatory? For what types of indirect market participants? Of those trades involving indirect market participants for which confirmation is required, what percentage is confirmed by T+0, by T+1, by the contractual settlement date?

Assignment of an assessment category

1. Observed
 - (a) A high percentage of trades between direct market participants is confirmed on T+0. (Q1)
 - (b) Settlement instructions are matched prior to settlement. (Q2)
 - (c) Where confirmation of trades by indirect market participants is required, a high percentage is confirmed no later than T+1. (Q3)
2. Broadly observed
 - (a) 1a and 1b are satisfied. (Q1, 2)
 - (b) But: 1c is not satisfied. (Q3)
3. Partly observed
 - (a) 1a is satisfied. (Q1)
 - (b) But: 1b is not satisfied. (Q2)
4. Non-observed
 - (a) 1a is not satisfied. (Q1)

Explanatory note

1. In many markets, the use of electronic trading systems obviates the need for direct market participants to confirm the terms of the trade.
2. This recommendation does not require confirmation by indirect market participants, but in some markets such confirmation is required by regulators, clearing systems or market operators. Generally, indirect market participants for whom confirmations are required include institutional investors and cross-border customers.

3. It is sometimes difficult for all the trades to be confirmed by the deadlines. However, a high percentage of trades should be confirmed by the deadlines to meet the recommendation. For confirmation of trades between direct market participants, "a high percentage" means 98% or more. For confirmation of trades between direct and indirect market participants, "a high percentage" means 90% or more. If centralised systems are in place, assessors should obtain data about the performance of the systems. If trades are matched or compared bilaterally rather than through a centralised system, it may be difficult to determine the degree of observance of the recommendation based only on such data. Qualitative information about performance should be obtained, however, and used to assess observance.
4. Where 24-hour trading is conducted, confirmation within 24 hours after each trade is regarded as compliant with T+0. Where trading is conducted during a limited time window, confirmation before resumption of the next day's trading is regarded as compliant with T+0 trade confirmation.
5. The CSD need not require that settlement instructions be matched prior to free-of-payment transfers.

Recommendation 3: Settlement cycles

Rolling settlement should be adopted in all securities markets. Final settlement should occur no later than T+3. The benefits and costs of a settlement cycle shorter than T+3 should be evaluated.

Key issues

1. Rolling settlement should occur no later than T+3.
2. Frequency and duration of settlement failures should be monitored.
3. Risk implications of fail rates should be analysed and actions taken that reduce the rates or mitigate the associated risks.
4. The benefits and costs of a settlement cycle shorter than T+3 should be evaluated.

Key questions

1. Are trades settled on a rolling basis of T+3 or shorter?
2. What percentage of trades (by number and value) fails to settle on the contractual date? What is the average duration of fails (by number and value)?
3. Do market practices, regulations or SSS rules provide incentives for counterparties to settle their obligations on the contractual date? What forms do these incentives take, for example are penalties assessed for failing to settle? What steps, if any, are taken to mitigate the risks of fails? Are fails required to be marked to market? Are open positions required to be closed out at market prices if the duration of the fail exceeds a specified number of business days? What entity or entities establish, monitor and enforce these requirements?
4. If settlement is on an account period basis or on a rolling basis at T+3 or longer, have the benefits and costs of a rolling cycle or a shorter settlement cycle been evaluated? If so, by whom? Has the evaluation been documented? What was the conclusion? Did the conclusion differ depending on the type of security?

Assignment of an assessment category

1. Observed
 - (a) Rolling settlement occurs no later than T+3. (Q1)
 - (b) Fails are not a significant source of added risk or risks from fails are effectively mitigated. (Q2, 3)
 - (c) If T+3, a cost-benefit analysis of a shorter settlement cycle has been performed. (Q4)

2. Broadly observed
 - (a) 1a and 1b are satisfied. (Q1, 2, 3)
3. Partly observed
 - (a) 1a is satisfied. (Q1)
 - (b) 1b is not satisfied. (Q2, 3)
4. Non-observed
 - (a) Settlement on an account period basis or settlement on a rolling basis longer than T+3. (Q1)

Explanatory note

1. The amount of risk posed by fails will be a function of the volatility of the security being settled, the length of time before the fail is resolved and the size of the transaction. This risk can be mitigated by marking failed positions to market and collateralising exposures that arise. Some systems also place limits on the time that a failure can remain outstanding before the system itself buys and delivers the security.
2. The cost-benefit analysis should, at minimum, include assessment of the risks involved under T+3, the potential benefit of reducing risks under the shorter settlement cycle, the steps to compress the settlement cycle, and any preconditions necessary for a shorter cycle. The cost-benefit analysis preferably should take into account the risks of an increase in the settlement fail rate if a shortening of the settlement cycle is implemented. Alternatively, the study could demonstrate that the risks of T+3 do not pose a danger to the settlement system (for example, if the risks are small relative to the capital of participants). In some instances, the risks associated with T+3 settlement may be large but the costs of a shorter settlement may also be large. A solution in such cases may be to mitigate the risks of T+3 settlement rather than to shorten the settlement cycle.
3. In assessing whether fails are a significant source of risk, fails should not exceed 5% by value.

Recommendation 4: Central counterparties (CCPs)

The benefits and costs of a CCP should be evaluated. Where such a mechanism is introduced, the CCP should rigorously control the risks it assumes.

Key issues

1. The balance of the benefits and costs of a CCP should be carefully assessed.
2. The legal basis for any netting arrangements should be sound and transparent.
3. A CCP should institute risk controls sufficient to withstand severe shocks, including defaults by one or more of its participants.
4. Adequacy of resources to absorb financial losses should be monitored; resources should be accessible and rules should specify clearly how defaults will be handled and how losses will be shared.

Key questions

1. Has a CCP mechanism (or an indemnification arrangement) been introduced? If so, what types of securities and market participants are covered? If no such mechanism has been introduced, have the benefits and costs of such a mechanism been evaluated? If so, by whom? Has the assessment been documented? What was the conclusion?
2. What are the netting arrangements for a CCP (by novation or otherwise)? Do the netting arrangements have a sound and transparent legal basis? Is netting enforceable against the participants in insolvency?

3. Does the CCP impose financial and operational standards for participation? How does the CCP manage its credit risk vis-à-vis participants? Does it require participants to collateralise their exposures? How often are collateral requirements recomputed and collateral collected? How does the CCP manage its liquidity risk? Does the CCP have in place agreements permitting it to borrow against collateral? In assessing its credit and liquidity risk, does the CCP evaluate its ability to withstand the default of more than one of its participants?
4. Has a participant ever defaulted? If so, how did the CCP handle the default? What are the financial resources of the CCP? How does the CCP assess the adequacy of the size and liquidity of its financial resources? Does it require participants to contribute to a clearing or guarantee fund? Does the CCP have legally enforceable interests in or claims on the assets in the fund? Does the CCP have transparent and enforceable loss allocation rules?

Assignment of an assessment category

1. Observed
 - (a) If there is no CCP, the balance of the benefits and costs of a CCP has been assessed carefully and benefits do not exceed costs. (Q1)
 - (b) If a CCP is in place, the legal basis for any netting arrangements is sound and transparent (Q2) and rigorous risk control is achieved. (Q3, 4)
2. Broadly observed
 - (a) If a CCP has been introduced, netting arrangements are sound and transparent. (Q1, 2)
 - (b) While the CCP is able to withstand severe shocks, including defaults by one or more of its participants, some risk control measures should be strengthened. (Q3, 4)
3. Partly observed
 - (a) If a CCP has been introduced, netting arrangements are sound and transparent. (Q1, 2)
 - (b) But: some risk control measures could be strengthened, particularly those related to the ability to handle multiple defaults. (Q3, 4)
4. Non-observed
 - (a) There is no CCP and the balance of the benefits and costs of a CCP has not been assessed. (Q1)
 - (b) If a CCP is in place, netting arrangements do not have a sound and transparent legal basis or risk control measures are insufficient to withstand a default by its largest participant. (Q2, 3, 4)

Explanatory note

1. The evaluation of whether a CCP could withstand severe shocks should consider its ability to cope with defaults by its very largest participants.
2. For securities markets where volume and value are relatively small, the cost and benefit analysis does not need to be extensive.
3. In some markets many of the benefits of a CCP are achieved by establishing an entity that indemnifies market participants against losses from counterparty defaults without actually acting as CCP (see 3.17 in the report). The recommendation applies to such an indemnification arrangement.
4. If there is no CCP, the recommendation will be observed or not observed depending upon whether a cost benefit analysis has been done. If the assessor was concerned about the quality of this analysis, however, the assessor might consider use of the broadly or partly observed categories.

Recommendation 5: Securities lending

Securities lending and borrowing (or repurchase agreements and other economically equivalent transactions) should be encouraged as a method for expediting the settlement of securities transactions. Barriers that inhibit the practice of lending securities for this purpose should be removed.

Key issues

1. Impediments (legal and tax, for example) to the development and functioning of securities lending should be removed.
2. Securities lending and borrowing should be encouraged as a method for expediting securities settlement (such as reducing settlement failures).
3. Supervisors and overseers should have policies and procedures to ensure that risks stemming from securities lending activities are appropriately managed by entities subject to their oversight.

Key questions

1. Are markets or facilities for securities lending (or repurchase agreements and other economically equivalent transactions) clearly supported by legal, regulatory, accounting and tax systems?
2. Are there markets or facilities for securities lending (or repurchase agreements and other economically equivalent transactions)? If any, are they used as a method to expedite securities settlement? How wide is the range of securities and participants involved in the markets?
3. Do supervisors and overseers review risk management procedures for securities lending? Do they have policies with respect to these activities?

Assignment of an assessment category

1. Observed
 - (a) There are no impediments to the development and functioning of securities lending. (Q1)
 - (b) Securities lending activities are available as a method for expediting securities settlement (such as reducing settlement failures). (Q2)
 - (c) Supervisors have policies and procedures related to securities lending arrangements and review these arrangements to ensure that risks are appropriately monitored and controlled. (Q3)
2. Broadly observed
 - (a) 1a and 1b are satisfied. (Q1, 2)
 - (b) But: 1c is not satisfied. (Q3)
3. Partly observed
 - (a) 1b is satisfied. (Q2)
 - (b) 1a is not satisfied, but authorities are making efforts to remove the impediments. (Q1)
4. Non-observed
 - (a) 1a is not satisfied or 1b is not satisfied. (Q1, 2)
5. Not applicable

Explanatory note

1. An assessor should take into account that securities lending may be available but is not used to expedite settlement owing to low fail rates or other mechanisms available to market

participants to deal with settlement issues. In such cases, the appropriate assessment category may be “Not applicable”.

2. The lending of securities by a CSD to its participants is not necessarily inconsistent with the requirement that debit balances in securities be prohibited (Recommendation 9). If a CSD acts as principal in securities lending transactions, however, it must have appropriate risk controls.

Recommendation 6: Central securities depositories (CSDs)

Securities should be immobilised or dematerialised and transferred by book entry in CSDs to the greatest extent possible.

Key issues

1. Immobilisation or dematerialisation and transfer by book entry in CSDs should be implemented to the greatest extent possible.
2. In jurisdictions that operate a direct holding system but in which the CSD is not the official registrar of the issuer, a transfer of securities in the CSD should result automatically in the transfer of legal title to the securities in the official register of the issuer.

Key questions

1. Are securities issued on a dematerialised basis or as a physical certificate? If the latter, are they immobilised in a CSD to facilitate settlement? What percentage of securities issued domestically is either immobilised or dematerialised, and what is the trend? Is the transfer of securities carried out by book entry or does it require any form of physical delivery?
2. Is there a lag between settlement and registration and what are the implications of the time lag for finality? If the CSD is not the official registrar, does the transfer of securities in the CSD result in the transfer of securities in the official register?

Assignment of an assessment category

1. Observed
 - (a) Immobilisation or dematerialisation is achieved (at least for the securities held by the most active market participants) and securities are transferred by book entry in CSDs. (Q1)
 - (b) If the system is a direct holding system in which the CSD is not the official registrar, a transfer of securities in the CSD results in transfer of legal title. (Q2)
2. Broadly observed
 - (a) A CSD exists that allows securities to be transferred by book entry. (Q1)
 - (b) But: some of the most active market participants do not have their securities immobilised or dematerialised. (Q1)
 - (c) 1b is satisfied. (Q2)
3. Partly observed
 - (a) Immobilisation or dematerialisation and book entry transfer in CSDs is not achieved for significant numbers of the most active market participants. (Q1)
 - (b) 1b is not satisfied. (Q2)
4. Non-observed
 - (a) 1a is not satisfied. (Q1)

Explanatory note

1. The “most active market participants” are those that account for the highest daily average value of trades.

Recommendation 7: Delivery versus payment (DVP)

CSDs should eliminate principal risk by linking securities transfers to funds transfers in a way that achieves delivery versus payment.

Key issues

1. The technical, legal and contractual framework should ensure DVP.
2. The great majority of securities transactions between direct participants of the CSD by value should actually be settled on a DVP basis.

Key questions

1. Does the technical, legal and contractual framework ensure that delivery of securities takes place if, and only if, payment is received? If so, how?
2. What proportion of trades between direct participants of the CSD (by value) is settled on a DVP basis?

Assignment of an assessment category

1. Observed
 - (a) The technical, legal and contractual framework ensures DVP. (Q1)
 - (b) Ninety-five per cent or more of the trades between direct participants of the CSD (by value) are actually settled on a DVP basis. (Q2)
2. Broadly observed
 - (a) 1a is satisfied. (Q1)
 - (b) Ninety per cent or more of the trades between direct participants of the CSD (by value) are actually settled on a DVP basis. (Q2)
3. Partly observed
 - (a) 1a is satisfied. (Q1)
 - (b) Fifty per cent or more of the trades between direct participants of the CSD (by value) are actually settled on a DVP basis. (Q2)
4. Non-observed
 - (a) 1a is not satisfied or less than 50% of trades between direct participants of the CSD (by value) are actually settled on a DVP basis. (Q1, 2)

Explanatory note

1. In some instances there is a CSD that achieves DVP but the majority of trades by value are settled by free transfers rather than by use of the DVP mechanism. Such a situation would not meet the standard for observed or broadly observed.
2. This recommendation relates to the settlement of purchases and sales of securities: free transfers of securities may occur for other reasons, for example satisfaction of collateral requirements. Free transfers for these purposes are not inconsistent with the recommendation.
3. DVP can be achieved through various models (three can be differentiated) providing different timing of settlement finality. Whatever model is used, it is essential that the technical, legal

and contractual frameworks ensure that such transfer of securities is final if and only if the corresponding transfer of funds is final.

Recommendation 8: Timing of settlement finality

Final settlement should occur no later than the end of the settlement day. Intraday or real-time finality should be provided where necessary to reduce risks.

Key issues

1. The timing of settlement finality should be defined clearly and final settlement should occur no later than the end of the settlement day.
2. Intraday or real-time finality should be provided where necessary to reduce risks (monetary policy, payment system operations, settlement of back-to-back transactions, intraday margin call by CCPs, safe and efficient cross-border links between CSDs).
3. The unilateral revocation of unsettled transfer instructions late in the settlement day should be prohibited.

Key questions

1. Does the CSD permit final settlement of securities transfers by the end of the settlement day? Is the timing of settlement finality clearly defined for transactions within the CSD and for transactions over a link to another CSD?
2. Does the CSD permit final settlement of DVP transfers on a continuous basis throughout the day or at certain designated times during the day? If the latter, at what times do transfers become final? Is there a need for intraday or real-time finality to reduce risks? Do central banks use the SSS in monetary policy operations or to collateralise intraday credit extensions in a payment system? Do active trading parties or CCPs have a need for intraday or real-time finality to manage their risks effectively? Is there a need for intraday or real-time finality to facilitate settlement through links to other CSDs? Is there a need for intraday finality to facilitate the smooth functioning of some markets (for example, repurchase agreement markets)?
3. Does the CSD prohibit the unilateral revocation of unsettled transfer instructions late in the settlement day? Does the CSD receive provisional transfers of securities from any other CSDs? If so, does it prohibit retransfer of these securities until they become final? If not, what would be the consequences of an unwind of such provisional transfers for the CSD's participants?

Assignment of an assessment category

1. Observed
 - (a) The timing of settlement finality is clearly defined and final settlement occurs no later than the end of the settlement day. (Q1)
 - (b) Intraday or real-time finality is provided where necessary or there is no need for intraday finality to reduce risks. (Q2)
 - (c) The unilateral revocation of unsettled transfer instructions late in the settlement day is prohibited. (Q3)
2. Broadly observed
 - (a) 1a and 1b are satisfied. (Q1, 2)
 - (b) But: 1c is not satisfied. (Q3)
3. Partly observed
 - (a) 1a is satisfied. (Q1)
 - (b) But: 1b and 1c are not satisfied. (Q2, 3)

4. Non-observed
 - (a) 1a is not satisfied. (Q1)

Explanatory note

1. Intraday or real-time settlement of securities transactions is being demanded in a growing number of markets. However, the risks and the resulting demands for intraday finality are not equally pressing in all markets. Where intraday finality is unnecessary to reduce risks, an end-of-day net settlement system with robust risk controls (Recommendation 9) may offer the best combination of safety and efficiency, and therefore may be assessed as having satisfied criterion 1b.
2. In assessing the observance of the recommendation, it is essential to know the time when the transaction is settled, not the time when the transaction is entered into the system.

Recommendation 9: CSD risk controls to address participants' failures to settle

CSDs that extend intraday credit to participants, including CSDs that operate net settlement systems, should institute risk controls that, at a minimum, ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle. The most reliable set of controls is a combination of collateral requirements and limits.

Key issues

1. A CSD that extends intraday credit to participants should, at a minimum, ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle. Risk controls should be imposed to control potential losses and liquidity pressures from participants' failures to settle.
2. Overdrafts or debit balances in securities should not be permitted.
3. The probability and potential impact of multiple settlement failures should be evaluated relative to the costs to ensure settlement in such an event.

Key questions

1. Does the CSD ensure that timely settlement can be completed in the event of an inability to settle by the participant with the largest obligation? If so, how? Are the credit exposures of the CSD fully collateralised? If not, what measures are in place to address risks stemming from granting uncollateralised credit? Are limits imposed on credit extensions by the CSD? Does the CSD have sufficient liquidity resources to ensure timely settlement?
2. Does the CSD permit overdraft or debit balances in securities?
3. Does the CSD evaluate the probability of multiple failures? Can settlement be completed in that event? If not, has the CSD evaluated the cost of ensuring settlement in the event of multiple failures?

Assignment of an assessment category

1. Observed
 - (a) The CSD, at a minimum, ensures timely settlement in the event that the participant with the largest payment obligation is unable to settle. Rigorous risk controls, in particular collateral requirements and limits, are imposed to control potential losses and liquidity pressures from participants' failures to settle. (Q1)
 - (b) Overdrafts or debit balances in securities are not permitted. (Q2)
 - (c) The CSD has evaluated the additional costs to participants of greater certainty of settlement against the probability and potential impact of multiple settlement failures. (Q3)

2. Broadly observed
 - (a) 1a and 1b are satisfied. (Q1, 2)
 - (b) The CSD cannot ensure timely settlement in the event of multiple defaults and it has not evaluated the costs of ensuring settlement in such events. (Q3)
3. Partly observed
 - (a) 1a is partially satisfied but there are some weaknesses in risk controls such as inadequate measures to address risks from uncollateralised credit. (Q1)
 - (b) 1b is satisfied. (Q2)
4. Non-observed
 - (a) Numerous weaknesses in risk controls imply that the CSD does not satisfy 1a. (Q1)
 - (b) Or: 1b is not satisfied. (Q2)
5. Not applicable if the CSD does not extend intraday credit and the CSD does not operate a net settlement system.

Explanatory note

1. If a central bank grants credit in its own currency to CSD participants, such credit extension need not be limited because its liquidity resources are unlimited. The central bank may nonetheless choose to contain its risks vis-à-vis participants by setting limits and fully collateralising its credit exposures.
2. For exposures to be fully collateralised, the CSD must have the capacity to value (mark to market) the securities posted as collateral and apply haircuts to the collateral values.
3. If a CSD extends credit to issuers for corporate actions (for example, advances to issuers to fund dividend or interest payments), the CSD should institute risk controls for these exposures.
4. If a CSD acts as principal in securities lending activities, it must have appropriate risk controls for that activity.
5. The risk control measures referred to in Recommendation 9 also apply to the implicit intraday credit extended to the participants of a net settlement system (DVP models 2 and 3) operated by a CSD, even though the CSD does not itself extend intraday credit to participants.

Recommendation 10: Cash settlement assets

Assets used to settle the ultimate payment obligations arising from securities transactions should carry little or no credit or liquidity risk. If central bank money is not used, steps must be taken to protect CSD members from potential losses and liquidity pressures arising from the failure of the cash settlement agent whose assets are used for that purpose.

Key issues

1. The settlement agent should be a central bank, or if it is a private bank, steps should be taken to protect CSD members from potential losses and liquidity pressures that would arise from its failure.
2. The operator of the CSD or regulators or overseers of the CSD should monitor the concentration of exposures and evaluate the financial condition of the settlement banks.
3. The proceeds of securities settlements should be available for recipients to use, at a minimum on the same day, and ideally intraday.
4. The payment system used for interbank transfers among settlement banks should observe the Core Principles for Systemically Important Payment Systems (CPSIPS).

Key questions

1. Is the settlement agent the central bank that issues the currency? If the central bank is settling in a foreign currency, what steps has it taken as settlement agent to ensure that the settlement assets pose little or no credit or liquidity risk? If the central bank is not used, what steps have been taken to protect CSD members from failure of the cash settlement agent? Is the CSD itself organised as a limited purpose bank? Does it strictly limit any risks associated with non-settlement activities?
2. Are settlement banks subject to prudential supervision by government authorities? Who determines which institutions can be used as settlement institutions? What are the criteria? If multiple settlement institutions can be used in principle, how many are used in practice? How concentrated are payment flows? On an average day, what percentage of total payments is credited to accounts at the institution that accounts for the largest share of payment flows? What is the financial condition of that institution (for example, its capital ratios and its credit ratings)? Are the concentration of exposures and the financial condition of the settlement banks monitored and evaluated? If so, by whom?
3. How quickly can recipients use the proceeds of securities settlements? On the same day? Intraday?
4. Does the payment system used for interbank transfers among settlement banks observe CPSIPS?

Assignment of an assessment category

1. Observed
 - (a) If a private bank is used as the settlement agent for any currency, steps are taken to protect CSD members from potential losses and liquidity pressures that would arise from its failure. The settlement agent is the central bank of issue, or if the central bank acting as settlement agent is not the central bank of issue, steps are taken to ensure that the settlement asset poses little or no credit or liquidity risk to CSD members. (Q1)
 - (b) Exposures to settlement banks are not concentrated or the financial condition of settlement banks is monitored and evaluated by regulators and overseers in liaison with banking supervisors. (Q2)
 - (c) The proceeds of securities settlements are available for recipients to use, at a minimum on the same day, and ideally intraday. (Q3)
 - (d) The payment system used for interbank transfers among settlement banks substantially observes the CPSIPS. Any deviations from full observance of those principles do not cause any material credit or liquidity risks for CSD participants. (Q4)
2. Broadly observed
 - (a) 1a, 1b and 1c are satisfied. (Q1, 2, 3)
 - (b) The payment system used for interbank transfers among settlement banks observes most of the CPSIPS. The deviations from full observance of those principles may cause a limited, but not significant, amount of credit or liquidity risk for CSD participants. (Q4)
3. Partly observed
 - (a) 1a and 1b are satisfied. (Q1, 2)
 - (b) 1c is not satisfied. (Q3)
 - (c) Or: the payment system used for interbank transfers among settlement banks does not observe some of the CPSIPS, with the result that there could be potentially significant credit or liquidity risks for CSD participants. (Q4)

4. Non-observed
 - (a) 1a is not satisfied. (Q1)
 - (b) Or: 1b is not satisfied. (Q2)

Explanatory note

1. If the settlement asset is a claim of a central bank other than the central bank of issue, procedures should be in place to strictly limit the risk that a participant's holdings of the foreign currency might not be readily convertible into claims on the central bank of issue.
2. 1b and 1d should be satisfied when there is a tiered settlement system with multiple settlement banks. Assessors should identify which Core Principles are not observed. If not observed, assessors should be convinced that the deviations do not expose market participants to significant credit or liquidity risk.
3. In assessing whether the settlement agent addresses Key Issue 1, the restrictions on the activities of a private entity serving as settlement agent are more important than whether the entity meets the legal definition of a bank. One widely employed method of addressing the issue is for the CSD to organise itself as a limited purpose bank and become the settlement agent by offering cash accounts to its members.

Recommendation 11: Operational reliability

Sources of operational risk arising in the clearing and settlement process should be identified and minimised through the development of appropriate systems, controls and procedures. Systems should be reliable and secure, and have adequate, scalable capacity. Contingency plans and backup facilities should be established to allow for timely recovery of operations and completion of the settlement process.

Key issues

1. System operators should identify sources of operational risk and should establish clear policies and procedures to address those risks.
2. There should be appropriate contingency plans for key systems. Contingency plans and systems should be reviewed and tested regularly and after modifications to the system.
3. There should be adequate management controls and sufficient (and sufficiently well qualified) personnel to ensure that procedures are implemented accordingly. Information systems should be subject to periodic independent audit.
4. All key systems should be reliable, secure, and able to handle stress volume.

Key questions

1. Does the system operator have a process for identifying and managing its operational risks?
2. Does the system operator have contingency plans and backup facilities for the failure of key systems, and are these tested and reviewed regularly with participants taking part? Do contingency plans ensure at a minimum that the status of all transactions at the time of the disruption can be identified with certainty in a timely manner? How long does it take to recover operations through backup systems? Do the procedures provide for preservation of all transaction data? How does the system operator ensure the integrity of messages?
3. Are operational reliability issues reviewed regularly by senior management, including review by persons not responsible for the relevant operations? Are periodic external audits of the IT (information technology) system conducted? Is there an independent internal audit function and does it review operational risk controls?

4. How many times during the last year has a key system failed? What is the most common cause of failures? How long did it take to resume processing? How much transaction data, if any, was lost? Does the system operator have capacity plans for key systems and are key systems tested periodically to determine if they can handle stress volume?

Assignment of an assessment category

1. Observed
 - (a) System operators identify sources of operational risk and establish policies related to it. (Q1)
 - (b) All key systems have appropriate contingency plans and backup facilities, and key systems are reviewed regularly. (Q2)
 - (c) There are adequate management controls and sufficient personnel to ensure that procedures are implemented accordingly and information systems are subject to periodic independent audit. (Q3)
 - (d) There are few system failures, and all key systems are able to handle stress volume. (Q4)
2. Broadly observed
 - (a) 1a, 1b and 1c are satisfied. (Q1, 2, 3)
 - (b) But: more than a few system failures occur, though recovery of operations is adequate. (Q4)
3. Partly observed
 - (a) 1a is satisfied. (Q1)
 - (b) But: occasional system failures occur and difficulties in recovery of operations indicate that contingency plans or backup facilities need to be upgraded. (Q2, 4)
 - (c) Or: 1c is not satisfied. (Q3)
4. Non-observed
 - (a) 1a is not satisfied. (Q1)
 - (b) Or: there are frequent system failures, and contingency plans and backup facilities are not appropriate. (Q2, 4)

Explanatory note

1. Principle VII of the *Core Principles for Systemically Important Payment Systems* (pages 10 and 39-43 of the CPSIPS report) provides additional details on operational issues, many of which are relevant to SSSs.
2. System operators who outsource operations should ensure that those operations meet the same standards as if they were provided directly.

Recommendation 12: Protection of customers' securities

Entities holding securities in custody should employ accounting practices and safekeeping procedures that fully protect customers' securities. It is essential that customers' securities be protected against the claims of a custodian's creditors.

Key issues

1. Entities holding securities in custody should employ procedures to ensure customer securities are protected, particularly against claims of their creditors.
2. Entities holding securities in custody should regularly reconcile their records to ensure that customer claims can be satisfied and should be subject to mandatory audits.

3. Entities holding securities in custody should be supervised or regulated.

Key questions

1. What arrangements are used to protect customers' securities from theft, loss or misuse and to ensure that they will not become subject to claims of the custodian's creditors (for example, are segregation, insurance, or compensation schemes used)? Are those arrangements based upon specific laws and regulations? In the event of the custodian's insolvency, do those arrangements enable a customer's positions to be moved by a receiver to a solvent intermediary?
2. How often do the entities holding securities in custody reconcile their records? Are the entities holding securities in custody subject to mandatory internal or external audit, or both, to determine if there are sufficient securities to satisfy customer claims?
3. Are the entities holding securities in custody subject to prudential supervision or regulation? Do regulatory reviews examine the procedures and internal controls used in the safekeeping of securities?

Assignment of an assessment category

1. Observed
 - (a) Segregation or other arrangements protect customers' securities; these arrangements are supported by the legal framework. (Q1)
 - (b) The entities holding securities in custody reconcile their records regularly and are subject to mandatory audits. (Q2)
 - (c) All the entities holding securities in custody are supervised or regulated. (Q3)
2. Broadly observed
 - (a) 1a and 1b are satisfied. (Q1, 2)
 - (b) Entities holding 95% or more of securities (by value) in custody are supervised or regulated. (Q3)
3. Partly observed
 - (a) 1a is satisfied. (Q1)
 - (b) Entities holding securities in custody reconcile their records, but not as frequently as trading volume demands. (Q2)
 - (c) Or: entities holding 90% or more of securities (by value) in custody are supervised or regulated. (Q3)
4. Non-observed
 - (a) 1a is not satisfied. (Q1)
 - (b) Or: entities holding securities in custody do not reconcile their records. (Q2)
 - (c) Or: entities holding more than 10% of securities (by value) are not supervised or regulated. (Q3)

Recommendation 13: Governance

Governance arrangements for CSDs and CCPs should be designed to fulfil public interest requirements and to promote the objectives of owners and users.

Key issues

1. Governance arrangements should be clearly specified and transparent.
2. Objectives and major decisions should be disclosed to owners, users and public authorities.

3. Management should have the incentives and skills needed to achieve objectives and is fully accountable for its performance.
4. The board should contain suitable expertise and take account of all relevant interests.

Key questions

1. What are the governance arrangements of the CSD or CCP? What information is publicly available regarding the system, its ownership and its board and management structure, and the process by which major decisions are taken and management made accountable?
2. Are the system's public interest, financial and other objectives clearly articulated and public? What are they? Do the system's objectives reflect the needs of users as well as owners? How is the public interest taken into account? Can the system's participants or the public influence the system's decision-making process? How are major decisions communicated to owners and users?
3. What steps are taken to ensure that management has the incentives and skills needed to achieve the system's objectives and is accountable for its performance?
4. How is the composition of the board determined? What steps are taken to ensure that board members have the necessary skills, and represent or take into account in their deliberations the full range of shareholder and user interests as well as the public interest?

Assignment of an assessment category

1. Observed
 - (a) Governance arrangements are clearly specified and information about them is publicly available. (Q1)
 - (b) Objectives and major decisions are disclosed to owners, users and public authorities. (Q2)
 - (c) Management has the incentives and skills needed to achieve objectives and is fully accountable for its performance. (Q3)
 - (d) The board contains suitable expertise and takes account of all relevant interests. (Q4)
2. Broadly observed
 - (a) 1a and 1b are satisfied. (Q1, 2)
 - (b) But: either 1c or 1d is not satisfied. (Q3, 4)
3. Partly observed
 - (a) 1a and 1b are satisfied. (Q1, 2)
 - (b) But: neither 1c nor 1d is satisfied. (Q3, 4)
4. Non-observed
 - (a) 1a is not satisfied or 1b is not satisfied. (Q1, 2)

Explanatory note

1. If the CSD or CCP is wholly owned by another entity, the governance arrangements of that entity should also be examined to see that it does not have adverse effects on the CSD's or CCP's observance of this recommendation.
2. Governance arrangements are likely to be effective when decision-takers have the skills, information and incentives to take decisions which promote the objectives of owners and users and fulfil public interest requirements, but these aspects are difficult to observe directly. The assessment categories are therefore based on indirect, but more measurable, aspects of governance such as whether the decision-making processes are transparent. If, however, there was clear evidence of the lack of effectiveness of the governance

arrangements, an assessor could take that into account in assigning an assessment category provided that the evidence was set out in the explanation of the assessment.

Recommendation 14: Access

CSDs and CCPs should have objective and publicly disclosed criteria for participation that permit fair and open access.

Key issues

1. Criteria should be objective, clearly stated and publicly disclosed.
2. Criteria that limit access on grounds other than risks to the CSD or CCP should be avoided.
3. Procedures facilitating the orderly exit of participants that no longer meet membership criteria should be clearly stated and publicly disclosed.

Key questions

1. Are access rules/criteria objective and clearly disclosed to all potential applicants?
2. Are the same rules applied regardless of the identity, type and location of the applicant? If not, what variations apply and why? Can differential restrictions on access to the system be justified in terms of the need to limit risks to the system operator or to other users?
3. Under what conditions can participants terminate their membership? What arrangements does the system have in place to facilitate the exit of members who no longer meet the participation requirements? Are these arrangements publicly disclosed?

Assignment of an assessment category

1. Observed
 - (a) Criteria are objective, clearly stated and publicly disclosed. (Q1)
 - (b) Criteria that limit access on grounds other than risks to the CSD or CCP are avoided. (Q2)
 - (c) Procedures facilitating the orderly exit of participants are clearly stated and publicly disclosed. (Q3)
2. Broadly observed
 - (a) 1a and 1b are satisfied. (Q1, 2)
 - (b) But: 1c is not satisfied. (Q3)
3. Partly observed
 - (a) 1a is satisfied. (Q1)
 - (b) But: some non-risk-related criteria are employed. (Q2)
4. Non-observed
 - (a) 1a is not satisfied. (Q1)
 - (b) Or: non-risk-related criteria are employed that affect a broad set of potential applicants. (Q2)

Recommendation 15: Efficiency

While maintaining safe and secure operations, securities settlement systems should be cost-effective in meeting the requirements of users.

Key issues

1. The system operator or other relevant party should have in place the mechanisms to review regularly costs and pricing of the securities settlement system.
2. The system operator or other relevant party should have in place the mechanisms to review regularly the service levels and operational reliability of the securities settlement system.

Key questions

1. Does the system operator have in place procedures to control costs (for example, by benchmarking its costs and charges against other systems that provide a similar service and to analyse the reasons for significant differences)? Does the system operator have in place procedures to regularly review its pricing levels against its costs of operation?
2. Does the system operator regularly review its service levels, including by regularly surveying its users? Does the system operator have in place procedures to regularly review operational reliability, including its capacity levels against projected demand?

Assignment of an assessment category

1. Observed
 - (a) The system operator or other relevant party has in place various procedures to review pricing and costs, and do so regularly. (Q1)
 - (b) And the system operator regularly reviews its operational reliability and service levels, including by regularly surveying its users. (Q2)
2. Broadly observed
 - (a) Either 1a or 1b is satisfied. (Q1, 2)
3. Partly observed
 - (a) The system operators have procedures to review capacity, pricing, costs and services but do not *regularly* review them. (Q1, 2)
4. Non-observed
 - (a) The system operators do not have in place procedures to review capacity, pricing and costs, nor do they have procedures to review service levels. (Q1, 2)

Explanatory note

1. In assessing the efficiency of settlement systems, the needs of users and costs imposed on them must be carefully balanced with the requirement that the system meets appropriate standards of safety and security.
2. Efficiency in systems is very difficult to assess. Assessors should talk to as many market participants as possible about their views on the system's efficiency and on whether the system meets the needs of its users. It is also important to determine whether the pricing structure allows the system to cover fixed and variable costs.

Recommendation 16: Communication procedures and standards

Securities settlement systems should use or accommodate the relevant international communication procedures and standards in order to facilitate efficient settlement of cross-border transactions.

Key issues

1. International communication procedures and standards relating to securities messages, securities identification processes and counterparty identification should be applied for cross-border transactions.

Key questions

1. Does the securities settlement system use international communication procedures or standards or is it able to easily convert domestic procedures and standards into the relevant international communication procedures and standards for cross-border securities transactions?

Assignment of an assessment category

1. Observed
 - (a) The system uses international communication procedures or domestic ones that can be easily converted into the relevant international communication procedures and standards for cross-border transactions. (Q1)
2. Broadly observed
 - (a) The system uses communication procedures that can be converted into the relevant international communication procedures and standards with some difficulty. (Q1)
3. Partly observed
 - (a) The system uses communication procedures that can be converted into the relevant international communication procedures and standards with considerable difficulty. (Q1)
4. Non-observed
 - (a) The system uses communication procedures that cannot be converted into the relevant international communication procedures and standards. (Q1)

Explanatory note

1. Countries establishing or fundamentally reforming their securities settlement system should consider the benefits of adopting international procedures and standards from the outset in the design of their domestic systems.

Recommendation 17: Transparency

CSDs and CCPs should provide market participants with sufficient information for them to identify and evaluate accurately the risks and costs associated with using the CSD or CCP services.

Key issues

1. Market participants should have the information necessary to evaluate the risks and costs of participating in the system.
2. The CPSS/IOSCO Disclosure Framework or the answers to the key questions should be completed and disclosed.
3. Information should be accessible, for example through the internet. Information should be available in a language commonly used in financial markets as well as the domestic language.
4. The accuracy and completeness of disclosures should be reviewed periodically by the CSD or CCP.

Key questions

1. Does the CSD or CCP make clear disclosures to market participants about its rules, regulations, relevant laws, governance procedures, risks, steps taken to mitigate risks, the rights and obligations of participants and the cost of participating in the system?
2. Has the system completed and disclosed the questionnaire set out in the CPSS/IOSCO disclosure framework or the answers to the key questions set out in this assessment methodology? Have the authorities responsible for regulation and oversight publicly

disclosed their answers to the key questions regarding implementation of the recommendations?

3. How is this information made available? In what language or languages? In what form?
4. What steps are taken by the CSD or CCP to ensure that the disclosures are complete and accurate? Are there regular reviews to ensure they remain current?

Assignment of an assessment category

1. Observed
 - (a) Market participants are provided with a full and clear description of their rights and obligations, the cost of participating in the system, the rules, regulations and laws governing the system, its governance procedures, any risks arising either to participants or to the operator, and any steps taken to mitigate those risks. (Q1)
 - (b) The CPSS/IOSCO Disclosure Framework or the answers to the key questions have been completed and disclosed. (Q2)
 - (c) Information is easily accessible, for example through the internet. Information is available in a language commonly used in financial markets as well as the domestic language. (Q3)
 - (d) The accuracy and completeness of disclosures are regularly reviewed by the CSD or CCP. (Q4)
2. Broadly observed
 - (a) 1a and 1b are satisfied. (Q1, 2)
 - (b) But: 1c or 1d is not satisfied. (Q3, 4)
3. Partly observed
 - (a) 1a is satisfied. (Q1)
 - (b) But: 1b is not satisfied. (Q2)
4. Non-observed
 - (a) 1a is not satisfied. (Q1)

Recommendation 18: Regulation and oversight

Securities settlement systems should be subject to transparent and effective regulation and oversight. Central banks and securities regulators should cooperate with each other and with other relevant authorities.

Key issues

1. The system should be subject to effective regulation and oversight.
2. The responsibilities as well as roles and major policies of the securities regulator and the central bank should be clearly defined and publicly disclosed.
3. The securities regulator and the central bank should have the ability and the resources to carry out regulation and oversight policies effectively.
4. Securities regulators and central banks should cooperate with each other and with other relevant authorities both within and outside the country.

Key questions

1. How is the system regulated/overseen? Describe the laws that authorise and govern the system's operation, the applicable regulatory bodies and their respective authority concerning the system's operation.

2. Are the responsibilities of the securities regulator, central bank and, where relevant, banking supervisor clearly defined with respect to securities settlement systems? Are their roles and major policies disclosed publicly? Are they written in plain language so that they can be fully understood by designers, operators and participants of securities settlement systems, and other relevant parties?
3. What is the regulatory and oversight framework based on? Is it a statute-based approach where specific tasks, responsibilities and powers are assigned to specific public authorities? Or a non-statute-based approach? Do the securities regulator and the central bank have experienced staff, proper resources and funding to carry out regulatory and oversight functions effectively?
4. Is there a framework for cooperation between the securities regulator and the central bank, such as for the exchange of information and views on securities settlement systems? Is there such a framework for cooperation with relevant authorities both within and outside the country?

Assignment of an assessment category

1. Observed
 - (a) The system is subject to effective regulation and oversight. (Q1)
 - (b) The responsibilities as well as roles and major policies of the securities regulator and the central bank are clearly defined and publicly disclosed. (Q2)
 - (c) The securities regulator and the central bank have the ability and the resources to carry out regulation and oversight policies effectively. (Q3)
 - (d) Securities regulators and central banks cooperate with each other and with other relevant authorities. (Q4)
2. Broadly observed
 - (a) 1a, 1b and 1c satisfied. (Q1, 2, 3)
 - (b) But: the framework for cooperation between the securities regulator and the central bank and with other relevant authorities is not in place or does not work well. (Q4)
3. Partly observed
 - (a) 1a is satisfied. (Q1)
 - (b) 1b or 1c is satisfied. (Q2, 3)
4. Non-observed
 - (a) 1a is not satisfied. (Q1)
 - (b) Or: 1b and 1c are not satisfied. (Q2, 3)

Explanatory note

1. Although the discussion of key issues and key questions makes reference to central banks and securities regulators, where relevant, banking supervisors would also be within the scope of this recommendation.
2. Regulators or overseers can consider a variety of approaches to achieve cooperation such as information sharing arrangements, coordination of regulatory and oversight responsibilities for specific matters, and other cooperation arrangements.
3. The central bank should ensure that the systems it operates observe the recommendations. (See Responsibility B in the CPSIPS report.)

Recommendation 19: Risks in cross-border links

CSDs that establish links to settle cross-border trades should design and operate such links to reduce effectively the risks associated with cross-border settlements.

Key issues

1. CSDs should design links to ensure that settlement risks are minimised or contained. A CSD should evaluate the financial integrity and operational reliability of any CSD with which it intends to establish a link.
2. DVP should be achieved and provisional transfers across the link should be prohibited, or, at a minimum, their retransfer prohibited, until the first transfer is final.
3. Any credit extensions between CSDs should be fully secured and subject to limits. Liquidity management arrangements should be implemented to address operational inefficiencies and potential defaults.

Key questions

1. What kinds of links are in operation (see explanatory note)? Has the CSD done a risk analysis of the design of the link and the financial and operational integrity of the linked CSD?
2. How is DVP achieved? Does the link permit provisional transfers of securities across the link? If so, is the retransfer of these securities prohibited until the first transfer is final?
3. If the CSD extends credit to a linked CSD, are credit extensions to the linked CSD fully secured and subject to limits? Are risk controls and liquidity resources adequate to address liquidity risks posed by the link?

Assignment of an assessment category

1. Observed
 - (a) A risk analysis of the design of the link is undertaken. (Q1)
 - (b) The link achieves DVP and provisional transfers across the link are prohibited, or, at a minimum, their retransfer is prohibited, until the first transfer is final. (Q2)
 - (c) Credit extensions between CSDs are fully secured and adequate liquidity management arrangements are implemented. (Q3)
2. Broadly observed
 - (a) 1a and 1b are satisfied. (Q1, 2)
 - (b) Credit extensions to the linked CSD are fully secured but liquidity management arrangements are not adequate. (Q3)
3. Partly observed
 - (a) 1a and 1b are satisfied. (Q1, 2)
 - (b) 1c is not satisfied. (Q3)
4. Non-observed
 - (a) 1a is not satisfied or 1b is not satisfied. (Q1, 2)
5. Not applicable

Explanatory note

1. Legal risk and custody risk of cross-border links are covered in Recommendation 1 and Recommendation 12, respectively. The rules of each CSD and the terms of any associated contracts should be supported by the legal framework, including insolvency law, in each jurisdiction in which the linked CSDs operate. Issues associated with the protection of customer securities should be addressed in the design and operation of links to settle cross-border links, particularly the need to reconcile holdings to determine that they are accurate and current.
2. CSDs may perform different sets of functions, including the provision of depository, credit, securities lending, collateral management, custodian and settlement services. Links may

also provide these functions, and the choice of functions determines the design of the link, as does the structure of the CSDs themselves and the legal framework applicable in the respective jurisdictions.

3. Issues raised in cross-border links may also be relevant for some linked systems within a jurisdiction.
4. One can distinguish among different types of links:
 - (a) Direct links - Direct links occur where a CSD opens an account with another CSD. The report distinguishes links that are reciprocal (permit participants in either system to settle in the other system) from links that permit settlement only in one direction.
 - (b) Indirect links - Indirect links are established when a CSD uses the securities held in another CSD via an intermediary (a custodian bank, for example) that has an account in that CSD. This intermediary acts as depository on behalf of the first CSD.
 - (c) Relayed links - Relayed links are agreements for the transfer of securities involving three CSDs - the investor CSD, the issuer CSD and the middle CSD. Transactions take place between participants in the issuer CSD and in the investor CSD. Although the issuer and the investor CSD are not directly linked (that is, they do not hold accounts with each other), a third CSD, the middle CSD, acts as an intermediary for the transaction between them.

All those links may allow for both DVP and free-of-payment settlement. Links are further distinguished on a basis of settlement of the cash side of transactions.

5. This recommendation does not apply to links that are used solely to settle trades between participants in the same CSD, because risks of such trades are covered in other recommendations.

4. Guidance on the development of an action plan¹

4.1 *Self-assessment.* As part of their responsibility for regulation and oversight, central banks, securities regulators and, where relevant, banking supervisors should promote implementation of the recommendations for SSSs by conducting self-assessments. Following completion of a self-assessment, authorities and SSS operators will need to develop plans to remedy deficiencies that have been identified. Whether to develop a formal action plan will depend upon the severity of the deficiencies and the extent to which remedial actions are already under way.

4.2 *Scope of reform.* As the RSSS make clear, many of the recommendations are directed at the private sector operators of the system, and these entities have primary responsibility to ensure that the recommendations relevant to their operations are implemented. In many cases, the roles of the authorities will be limited to monitoring progress, helping establish goals and time lines, and facilitating progress through changes in their own policies. In some cases, however, national authorities may need to play a more active role, working with operators and participants of the SSS to set priorities and to effect improvements. This may be particularly important when major components of the system are being reassessed, for example when establishment of a CCP is being considered, or when significant changes in the legal structure are needed.

4.3 In such circumstances, authorities may need to develop a more formal action plan to enable all of the relevant parties to coordinate their actions, to ensure that implementation of various changes is staged appropriately, and to ensure that competitive concerns among private sector participants do not slow progress. A formal action plan may be especially necessary when changes to the payment system are needed to enable or facilitate implementation of recommendations related to the SSS. The

¹ This section draws on the assessment experience of the IFIs and of Task Force members involved in assessment programmes. It also draws on Section 10 of the CPSIPS report.

plan may also involve coordination with authorities in other jurisdictions when cross-border issues are addressed.

4.4 The type of the action plan prepared will depend on the scope of reform needed. In some instances, changes to the system will be incremental, and the scope of the plan will be more focused and limited. In others, fundamental changes will be deemed desirable, perhaps involving building an entirely new SSS. Where fundamental changes are being implemented, the action plan will of necessity be more extensive and formal to build the case for desired actions, to present the actions to be taken, and to ensure proper coordination of actions. Some jurisdictions undertaking fundamental changes may find it helpful to establish a coordinating body composed of the relevant regulatory and oversight bodies as well as system operators and market participants to prepare the action plan and to monitor subsequent progress.

4.5 *Implementation plan: priorities.* There is no simple recipe for developing an action plan, but some basic steps may be useful to consider. Authorities should identify the areas in which less-than-full observance of recommendations leads to major risks within the SSS. The CPSS and IOSCO Technical Committee have not assigned degrees of importance to the recommendations because the recommendations as a group contribute to the creation of a safe and efficient SSS. However, in devising an action plan, authorities, system operators and market participants will inevitably be forced to come to an understanding on priorities based upon their judgments as to the deficiencies that pose the greatest risks or opportunity costs for the system. In most instances, the priorities are likely to be the risk controls for the CSDs and CCPs that are central to many SSSs, achievement of DVP, and a sound legal foundation.

4.6 *Implementation plan: actions needed.* Having identified priority areas, authorities should then determine the types of actions needed in each area. Many of these actions will fall into the categories of legislation, regulatory change, process or contract changes by private sector entities, or shifts in supervisory policies. In each case, the party best positioned to initiate that action should be identified. Generally, public sector entities will need to take the lead on legislation, regulatory and supervisory changes. Throughout this process, the authorities will need to consult closely with SSS operators and market participants.

4.7 *Implementation plan: timing.* A reasonable time frame in which an action could be accomplished should also be specified. Some steps to remedy deficiencies in SSSs can be taken more quickly than others. Legislative change is often a lengthy and difficult process. When changes to the legal framework are required, the process of initiating legislation should begin as soon as possible. Other changes to the SSS, for example decisions about the purchase of new technology and its installation and testing, can also be a lengthy process. Authorities may see value in intermediate steps that move a system part of the way towards the goal of observance by mitigating risks that have been identified in the system until full observance can be accomplished. For instance, while legislative changes are pending, progress towards the desired objectives may be achieved through agreements under contract law if contract law would support such agreements. Because some actions may take years to implement, the action plan should distinguish between final and intermediate objectives in terms of observance of the recommendations. The experience of other countries that have made similar types of reforms may also be useful in helping determine reasonable time frames and how to sequence projects.

4.8 *Implementation plan: cost considerations.* Major reforms of SSSs, including changes in the infrastructure, may require significant funding. The RSSS report notes in several recommendations the need to evaluate costs and benefits, and it explicitly recognises that benefits may not exceed costs for implementing some features in the SSS. In that event, the RSSS suggest other risk mitigation techniques be explored. It is important that the authorities, system operators, and market participants work together to credibly estimate the range for the total cost of the reform. The experiences of other jurisdictions may be informative in this process. Costs are inevitably uncertain and estimates will need to be revised as the action plan is implemented. The estimates should include at least the explicit and implicit costs of implementation (equipment purchase, software, etc), staffing (including training), monitoring of the reform, and hiring of consultants.

4.9 *Implementation plan: infrastructure decisions.* If the action plan relates to the creation or complete restructuring of the SSS, it will need to include plans for the infrastructure of the SSS. Decisions about the choice of infrastructure will probably depend on factors such as: the size and role of the financial markets; the types of technology available and their costs; the infrastructure of the

payment system and the safety of the banking system; and the country's infrastructure for basic services such as electric power and telecommunications.

4.10 The size and role of the financial markets is one of the main factors determining the type of infrastructure best suited for a country. SSS reforms can be helped by new technology, but there should be no presumption that the most sophisticated and expensive technology is necessarily the most appropriate solution. Technology should always support business needs of the potential users of the system and broader public policy needs such as the conduct of monetary policy.

4.11 An early decision will probably be whether to develop the infrastructure from the ground up, for instance by means of cooperation between the SSS operators and an IT service provider, or to purchase a turnkey infrastructure. This decision will depend upon the relevant expertise in a country, and the appropriateness of the alternatives. While developing a completely new infrastructure could prove to be costly, a turnkey infrastructure may not include some features that participants feel to be very important in their particular environment. However, if one opts for a turnkey infrastructure, customising portions could also complicate future upgrading of the system. In any case, because most parts of the SSS are interdependent, SSS operators and market participants will need to coordinate their efforts.

4.12 The action plan for the SSS should also take into consideration the infrastructure of the payment and banking systems. Factors external to the SSS such as the type of payment systems available to settle the cash side of securities transactions will affect decisions on how to achieve DVP, for example. Similarly, the banking system presents its own set of risks for the SSS that must be taken into account in planning decisions related to the cash settlement asset. In some instances, jurisdictions may opt to reform both the securities settlement system and the payment system jointly in order to limit the instances in which features of one system constrain choices in the other.

4.13 The country's infrastructure must also be compatible with and support the choice of SSS infrastructure. If basic services such as telecommunications and electrical power are not reliable, for example, the SSS may be little used or embody large operational risk.

4.14 *Implementation plan: expertise.* Countries that are undertaking major revisions in their SSS may also have limited expertise in some of the areas needing change. Part of the action plan may thus entail developing or acquiring expertise in SSSs. The knowledge base can be increased through review of the various reports that have been published by the CPSS and IOSCO, as well as other public and private institutions and organisations. Participation in international seminars and workshops and contacts with foreign authorities that have experience in developing SSSs may also be part of the action plan.²

² In several cases, countries reforming their securities settlement system have received technical assistance from the CPSS, IOSCO or the IFIs.

Annex 1

Template for the self-assessment report on the observance of the recommendations for securities settlement systems

(Securities covered by the assessment)

I. Introduction

General

1. Identify the systems being assessed, the entity or entities conducting the self-assessment, and the objective and context of the assessment.

Scope of the assessment

2. Identify the securities that are covered by the assessment and the institutions that perform the critical functions in the system for these securities.

3. Identify any significant entity or entities in the jurisdiction that provide clearance and settlement services associated with these securities that are not covered by the assessment. State why that entity or those entities was/were excluded from the scope of the assessment.

Institutional and market structure

4. Provide a general description of the securities markets and the structure of trade execution, clearing and settlement of securities transactions. The description should include sufficient data to understand clearly the scale and scope of the system's operations, including data on the value of the securities held in the system and the average and peak values of securities settled within the system.

Description of regulatory structure and practices

5. Provide a description of the regulatory framework relating to SSSs in the jurisdiction and a brief description of the oversight, regulatory and supervisory bodies with competence over SSSs.

Information and methodology used for assessment

6. Identify the main sources of information used in making the assessment, eg written documentation (other self-assessments, third-party assessments, surveys, questionnaires, reports, studies, and other public or non-public documents, including relevant laws, regulations, or regulatory or industry guidance) or oral discussions with oversight, regulatory or supervisory bodies (eg the central bank, securities regulator, banking supervisor or other domestic authorities) and relevant industry associations (eg central securities depository, central counterparty, stock exchange, custodian, securities broker, or end user associations).

7. Discuss the process followed in conducting the assessment. Mention any practical difficulties in applying the assessment methodology such as lack of information or cooperation and any factors limiting the assessment process or its scope.

II. Assessment of observance

Executive summary of the recommendation by recommendation assessment

8. Provide an executive summary of the detailed assessment report reflected in Tables 2-3 below. In this executive summary:

- summarise the principal conclusions of the assessment regarding the major topics covered by the recommendations, ie legal risk, pre-settlement risk, settlement risk, operational risk, custody risk, and other issues;
- summarise any actions proposed or ongoing in the assessed jurisdiction to achieve full observance of the recommendations and the manner in which the level of observance would be improved if those actions were completed; and
- summarise the steps recommended by the assessor to achieve full observance of the recommendations and the manner in which the level of observance would be improved if those steps were completed.

9. Conclude the executive summary with a table collating the results of the recommendation by recommendation assessment of observance by reference to the assessment categories:

Table 1

Collation of assessment results by assessment category

| Assessment category | Recommendations |
|---------------------|-------------------------------|
| Observed | eg Recommendations 1, 3, 6, 8 |
| Broadly observed | |
| Partly observed | |
| Non-observed | |
| Not applicable | |

Recommendation by recommendation assessment of observance

10. Provide a table with a detailed recommendation by recommendation assessment of the observance of each of the recommendations. The detailed assessment of each recommendation should include three parts:

- *Key questions.* In this part, provide answers to the key questions relating to the recommendation as set out in Section 3. Include other factual information relevant to the assignment of assessment categories for that recommendation. Responses should reflect the actual practices followed by SSS system operators and participants and the competent domestic authorities in their oversight, regulation, or supervision of SSSs or their participants. The answers to the key questions should indicate how the assessor arrived at the response to the question. Accordingly, “yes” or “no” responses to the key questions will rarely (if ever) be sufficient. Additionally, the information or material used to support the answer should be described in reasonable detail so that a party not involved in the assessment could understand the response.
- *Assessment.* In this part, assign each recommendation to one of five assessment categories: *Observed*, *Broadly observed*, *Partly observed*, *Non-observed* or *Not applicable*. All explanations relating to the assignment of the assessment category should appear in this part. Guidance on the assignment of these assessment categories has been provided in

Section 3, where assessment categories have been linked to the answers to the key questions. The guidance also includes explanatory notes to clarify certain issues that seem likely to arise in the course of an assessment. The assignment of an assessment category with respect to a recommendation should be based on the current situation existing in the jurisdiction without regard to any proposed or ongoing actions.

- **Comments.** In this part, describe the actions that system operators, participants, or domestic authorities have proposed or that are ongoing in the jurisdiction to improve observance of the recommendations and the proposed timetable for their completion. Explain how the proposed action would lead to an improvement in the observance of the recommendation and whether completion of the proposed action would prompt the assignment of a higher assessment category relating to the recommendation.

Table 2

Recommendation by recommendation assessment of observance

| Legal risk | |
|---|--|
| Recommendation 1 | |
| <i>Securities settlement systems should have a well founded, clear and transparent legal basis in the relevant jurisdictions.</i> | |
| Answers to key questions | |
| Assessment | |
| Comments | |
| Pre-settlement risk | |
| Recommendation 2 | |
| <i>Confirmation of trades between direct market participants should occur as soon as possible after trade execution, but no later than trade date (T+0). Where confirmation of trades by indirect market participants (such as institutional investors) is required, it should occur as soon as possible after trade execution, preferably on T+0, but no later than T+1.</i> | |
| Answers to key questions | |
| Assessment | |
| Comments | |
| Recommendation 3 | |
| <i>Rolling settlement should be adopted in all securities markets. Final settlement should occur no later than T+3. The benefits and costs of a settlement cycle shorter than T+3 should be evaluated.</i> | |
| Answers to key questions | |
| Assessment | |
| Comments | |

Table 2 (continued)

Recommendation by recommendation assessment of observance**Recommendation 4**

The benefits and costs of a CCP should be evaluated. Where such a mechanism is introduced, the CCP should rigorously control the risks it assumes.

| | |
|--------------------------|--|
| Answers to key questions | |
| Assessment | |
| Comments | |

Recommendation 5

Securities lending and borrowing (or repurchase agreements and other economically equivalent transactions) should be encouraged as a method for expediting the settlement of securities transactions. Barriers that inhibit the practice of lending securities for this purpose should be removed.

| | |
|--------------------------|--|
| Answers to key questions | |
| Assessment | |
| Comments | |

Settlement risk**Recommendation 6**

Securities should be immobilised or dematerialised and transferred by book entry in CSDs to the greatest extent possible.

| | |
|--------------------------|--|
| Answers to key questions | |
| Assessment | |
| Comments | |

Recommendation 7

CSDs should eliminate principal risk by linking securities transfers to funds transfers in a way that achieves delivery versus payment.

| | |
|--------------------------|--|
| Answers to key questions | |
| Assessment | |
| Comments | |

Recommendation 8

Final settlement should occur no later than the end of the settlement day. Intraday or real-time finality should be provided where necessary to reduce risks.

| | |
|--------------------------|--|
| Answers to key questions | |
| Assessment | |
| Comments | |

Table 2 (continued)

Recommendation by recommendation assessment of observance**Recommendation 9**

CSDs that extend intraday credit to participants, including CSDs that operate net settlement systems, should institute risk controls that, at a minimum, ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle. The most reliable set of controls is a combination of collateral requirements and limits.

| | |
|--------------------------|--|
| Answers to key questions | |
| Assessment | |
| Comments | |

Recommendation 10

Assets used to settle the ultimate payment obligations arising from securities transactions should carry little or no credit or liquidity risk. If central bank money is not used, steps must be taken to protect CSD members from potential losses and liquidity pressures arising from the failure of the cash settlement agent whose assets are used for that purpose.

| | |
|--------------------------|--|
| Answers to key questions | |
| Assessment | |
| Comments | |

Operational risk**Recommendation 11**

Sources of operational risk arising in the clearing and settlement process should be identified and minimised through the development of appropriate systems, controls and procedures. Systems should be reliable and secure, and have adequate, scalable capacity. Contingency plans and backup facilities should be established to allow for timely recovery of operations and completion of the settlement process.

| | |
|--------------------------|--|
| Answers to key questions | |
| Assessment | |
| Comments | |

Custody risk**Recommendation 12**

Entities holding securities in custody should employ accounting practices and safekeeping procedures that fully protect customers' securities. It is essential that customers' securities be protected against the claims of a custodian's creditors.

| | |
|--------------------------|--|
| Answers to key questions | |
| Assessment | |
| Comments | |

Table 2 (continued)

Recommendation by recommendation assessment of observance**Recommendation 13**

Governance arrangements for CSDs and CCPs should be designed to fulfil public interest requirements and to promote the objectives of owners and users.

| | |
|--------------------------|--|
| Answers to key questions | |
| Assessment | |
| Comments | |

Other issues**Recommendation 14**

CSDs and CCPs should have objective and publicly disclosed criteria for participation that permit fair and open access.

| | |
|--------------------------|--|
| Answers to key questions | |
| Assessment | |
| Comments | |

Recommendation 15

While maintaining safe and secure operations, securities settlement systems should be cost-effective in meeting the requirements of users.

| | |
|--------------------------|--|
| Answers to key questions | |
| Assessment | |
| Comments | |

Recommendation 16

Securities settlement systems should use or accommodate the relevant international communication procedures and standards in order to facilitate efficient settlement of cross-border transactions.

| | |
|--------------------------|--|
| Answers to key questions | |
| Assessment | |
| Comments | |

Recommendation 17

CSDs and CCPs should provide market participants with sufficient information for them to identify and evaluate accurately the risks and costs associated with using the CSD or CCP services.

| | |
|--------------------------|--|
| Answers to key questions | |
| Assessment | |
| Comments | |

Table 2 (continued)

Recommendation by recommendation assessment of observance**Recommendation 18**

Securities settlement systems should be subject to transparent and effective regulation and oversight. Central banks and securities regulators should cooperate with each other and with other relevant authorities.

| | |
|--------------------------|--|
| Answers to key questions | |
| Assessment | |
| Comments | |

Recommendation 19

CSDs that establish links to settle cross-border trades should design and operate such links to reduce effectively the risks associated with cross-border settlements.

| | |
|--------------------------|--|
| Answers to key questions | |
| Assessment | |
| Comments | |

Actions to achieve observance

11. List in Table 3 actions the assessor recommends to achieve full observance of the recommendations. If a system has plans for improvements under way and implementation of those plans would be sufficient to achieve observance, that should be noted (although those plans will not be reflected in the current assignment of ratings). Any specific obstacles to observance should be noted. Explain the manner in which the recommended action would lead to an improvement in the level of observance of the recommendation. Identify the domestic institution competent to take each recommended action. Only list recommendations for which specific steps are being recommended.

12. In some instances, the self-assessment may reveal that major changes to systems are necessary, and preparation of a formal action plan that goes beyond the discussion in this part of the self-assessment may be desirable. Such a plan can more formally lay out the priorities for changes to the system and the ways in which steps to remedy deficiencies should be sequenced. A more detailed discussion of preparation of a formal action plan can be found in Section 4.

Table 3

Actions to achieve observance

| Reference recommendation | Actions to achieve observance |
|--------------------------|-------------------------------|
| eg Recommendation 1 | |
| | |
| | |
| | |
| | |

Annex 2

Template for disclosure based on Key Questions

1. Market participants should be provided with sufficient information to identify and evaluate the risks and costs to which they are exposed as a result of participation in the clearing, settlement and custodial infrastructure of the securities markets (see Recommendation 17). Completion of the answers to the key questions in Section 3 will serve not only as a basis for assessment of implementation of the recommendations but as a basis for public disclosure to provide them with the complete and accurate information they need.
2. In 1997, the CPSS and IOSCO published *Disclosure Framework for Securities Settlement Systems*. Around 70 systems in more than 40 countries have responded to the Disclosure Framework and the BIS website has served as the clearing house for the public disclosure of the responses (www.bis.org/publ/cpss20resp.htm). The key questions in Section 3³ address all of the important issues covered by the Disclosure Framework. If operators of the clearing, settlement and custodian infrastructure, such as CSDs and CCPs, publicly disclose the answers to the key questions, they need not complete the Disclosure Framework.
3. In addition to operators of that infrastructure, national authorities which conduct a self-assessment and complete an assessment report as set out in Annex1 may choose to publicly disclose their answers to the key questions. While authorities might feel reluctant to publish the results of their self-assessment of the extent to which the recommendations have been implemented, they could have good reason to publish their answers to the key questions. For example, authorities might think it appropriate to disclose their answers if they believe the answers to the key questions by system operators (or the information in the Disclosure Framework) are not totally accurate, complete or correct. It is useful to provide market participants with fair and objective information that would build confidence in the safety and efficiency of the system. It can also impose effective discipline on operators of the infrastructure, encouraging them to improve transparency.
4. Whoever completes and discloses the answers to the key questions, information should be complete, accurate and regularly reviewed. It should be readily accessible to market participants, in particular through the internet. It is strongly encouraged that the answers be posted on the respective websites of responding institutions in order that information can be updated easily and in a timely manner. The BIS is prepared to be the clearing house for such disclosures by providing links to these websites.
5. Below is a template for disclosure based on the key questions. In preparing the answers, the following should be noted.
 - (a) Identify the scope of the assessment (the range of securities that are covered in the answers). If prepared by an operator of the system, identify the functions in the settlement process performed by the operator.
 - (b) Indicate the date when the answers are completed and make sure that the information provided in the answers is current when completed.
 - (c) Answer all the questions in the order presented and restate the questions themselves when providing the answers. If a question is not applicable, indicate that this is the case and explain why it is not applicable. If necessary, cross-reference information given elsewhere if this is helpful in avoiding duplication.
 - (d) The glossary included in the November 2001 report defines the meaning of terms as used in the questions. Make sure that the use of terminology in the answers is consistent with these definitions. If a term used in the answers is system-specific or used in a way that could be misunderstood, provide a clear explanation of how the term is used.

³ The November 2001 report included key questions pertaining to each of the recommendations (Section 5) as a first step towards development of an assessment methodology. In this regard, the key questions have been amended fairly extensively (see 1.4 in this report). The amended key questions should be used as a basis for public disclosure.

- (e) Include charts and diagrams wherever they would be helpful. All charts and diagrams should be accompanied by a description that enables them to be understood.
- (f) In cases where multiple responses to a question are possible, for example if the SSS offers multiple approaches to settlement processing, provide a response covering each of the alternatives and indicate the extent to which each alternative response is relevant.
- (g) Do not simply refer to or quote rules or regulations as a response to the questions. As a supplement to a response, however, feel free to indicate where relevant rules or regulations may be found.
- (h) Where questions ask about the timing of events, provide responses relative to the local time zone(s) where the system is located.
- (i) Update the answers as soon as possible after significant changes occur so that the information provided continues to be complete and accurate. Review the answers periodically (at least annually) so that they do not fail to be updated.
- (j) Indicate contact details in case market participants or other relevant parties have enquiries concerning the answers.
- (k) When the answers are posted on the website of the responding institution, inform the BIS of the website address by sending an email to cpss@bis.org. The BIS will provide a link to the website. If the website address changes, the BIS should be notified.

**Answers to the Key Questions
for CPSS-IOSCO Recommendations for Securities Settlement Systems**

[Jurisdiction]

[Securities]

Responding institution: [name] as [national authority / operator of infrastructure]

Function(s): [regulator / central bank / CSD / CCP / confirmation service provider / ...]

The information provided in the answers is accurate as of [date].

This response can be found at [website address].

Any enquiries should be sent to [contact details].

Recommendation 1: Legal framework

Securities settlement systems should have a well founded, clear and transparent legal basis in the relevant jurisdictions.

Key Questions

- 1 Are the laws, regulations, rules and procedures, and contractual provisions governing securities settlement arrangements public and readily accessible to system participants?

[Provide answers here]

- 2 (i) Does the legal framework demonstrate a high degree of legal assurance that:
- (a) transactions are enforceable?
 - (b) customers' assets are adequately protected (particularly against the insolvency of custodians and intermediaries)?

(a) ...

[Provide answers here]

:
:
:

Members of the CPSS-IOSCO Task Force on Securities Settlement Systems

Co-Chairmen

| | |
|--|-------------------|
| Board of Governors of the Federal Reserve System | Patrick Parkinson |
| Monetary Authority of Singapore | Shane Tregillis |

Members

| | |
|--|-------------------------------|
| Australian Securities and Investments Commission | Mark Adams |
| National Bank of Belgium | Benoît Bourtembourg |
| Comissão de Valores Mobiliários, Brazil | Fabio Menkes |
| The People's Bank of China | Li Yongqing |
| Czech National Bank | Tomáš Hládek |
| European Central Bank | Daniela Russo |
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| Bank of France | Yvon Lucas |
| Deutsche Bundesbank | Bianca Schönfelder |
| Securities and Futures Commission, Hong Kong | Stella Leung |
| Reserve Bank of India | Usha Thorat |
| Securities and Exchange Board of India | Pratip Kar |
| Commissione Nazionale per le Società e la Borsa, Italy | Salvatore Lo Giudice |
| Bank of Japan | Tetsuya Sakamoto |
| Financial Services Agency, Japan | Hironobu Naka |
| Securities Commission, Malaysia | Ranjit Ajit Singh |
| Comisión Nacional Bancaria y de Valores, Mexico | Paola Bortoluz |
| Bank of Mexico | Francisco Solis |
| Netherlands Authority for the Financial Markets | Henk Bruggeman |
| Saudi Arabian Monetary Agency | Abdullah Al Suweilmy |
| Comisión Nacional del Mercado de Valores, Spain | José Manuel Portero Bujalance |
| Bank of England | John Trundle |
| US Securities and Exchange Commission | Larry Bergmann |
| US Commodity Futures Trading Commission | Andrea Corcoran |
| Board of Governors of the Federal Reserve System | Patricia White |
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Participating observers

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Annexure 3: CDS Risk Matrix

| CDS - RISK MATRIX | |
|---|----------------|
| NOTE: BIS/CPSS use the term CSD rather than CDS as in Palestine | |
| Recommendation 1: Legal framework | Answers |
| Key questions | |
| 1. Are the laws, regulations, rules and procedures, and contractual provisions governing securities settlement arrangements public and readily accessible to system participants? | |
| 2. (i) Does the legal framework demonstrate a high degree of legal assurance that: | |
| (a) transactions are enforceable? | |
| (b) customers' assets are adequately protected (particularly against the insolvency of custodians and intermediaries)? | |
| (ii) Does the legal framework demonstrate a high degree of assurance that there is a clear and effective legal basis for: | |
| (a) arrangements for the immobilisation or dematerialisation of securities and the transfer of securities by book entry? | |
| (b) netting arrangements? | |
| (c) securities lending arrangements (particularly the ability to obtain a security interest in assets)? | |
| (d) finality of settlement? | |
| (e) arrangements for achieving delivery versus payment? | |
| (iii) Has a court in the jurisdiction ever failed to uphold the legal basis of these activities/arrangements? And if so, for what reasons? | |
| 3. Are the rules of the system and contracts between system participants enforceable notwithstanding the insolvency of a participant? | |
| 4. (i) Is there a significant level of cross-border participation in the SSS? If so, please describe and answer Question (ii) Are other jurisdictions relevant for determining the adequacy of the legal framework? How has this been determined? Has the legal framework been evaluated for the other relevant | |
| Recommendation 2: Trade confirmation | |
| Key questions | |
| 1. What percentage of trades between direct | |

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| market participants is submitted to a trade confirmation system on the trade date (T+0)? How soon after submission are problems communicated to the appropriate parties? | |
| 2. Does the CSD require settlement instructions to be matched prior to settlement? | |
| 3. Are there trade confirmation procedures that are capable of comparing trade information between direct and indirect market participants by T+1? Is use of the system mandatory? For what types of indirect market participants? Of those trades involving indirect market participants for which confirmation is required, what percentage is confirmed by T+0, by T+1, by the contractual settlement date? | |
| Recommendation 3: Settlement cycles | |
| Key questions | |
| 1. Are trades settled on a rolling basis of T+3 or shorter? | |
| 2. What percentage of trades (by number and value) fails to settle on the contractual date? | |
| What is the average duration of fails (by number and value)? | |
| 3. Do market practices, regulations or SSS rules provide incentives for counterparties to settle their obligations on the contractual date? What forms do these incentives take, for example are penalties assessed for failing to settle? What steps, if any, are taken to mitigate the risks of fails? Are fails required to be marked to market? Are open positions required to be closed out at market prices if the duration of the fail exceeds a specified number of business days? What entity or entities establish, monitor and enforce these requirements? | |
| 4. If settlement is on an account period basis or on a rolling basis at T+3 or longer, have the benefits and costs of a rolling cycle or a shorter settlement cycle been evaluated? If so, by whom? Has the evaluation been documented? What was the conclusion? Did the conclusion differ depending on the type of security? | |
| Recommendation 4: Central counterparties (CCPs) | |
| Key issues | |
| 1. The balance of the benefits and costs of a CCP should be carefully assessed. | |
| 2. The legal basis for any netting arrangements should be sound and transparent. | |

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| 3. | A CCP should institute risk controls sufficient to withstand severe shocks, including defaults by one or more of its participants. | |
| 4. | Adequacy of resources to absorb financial losses should be monitored; resources should be accessible and rules should specify clearly how defaults will be handled and how losses will be shared. | |
| Recommendation 5: Securities lending | | |
| Key questions | | |
| 1. | Are markets or facilities for securities lending (or repurchase agreements and other economically equivalent transactions) clearly supported by legal, regulatory, accounting and tax systems? | |
| 2. | Are there markets or facilities for securities lending (or repurchase agreements and other economically equivalent transactions)? If any, are they used as a method to expedite securities settlement? How wide is the range of securities and participants involved in the markets? | |
| 3. | Do supervisors and overseers review risk management procedures for securities lending? Do they have policies with respect to these activities? | |
| Recommendation 6: Central securities depositories (CSDs) | | |
| Key questions | | |
| 1. | Are securities issued on a dematerialised basis or as a physical certificate? If the latter, are they immobilised in a CSD to facilitate settlement? What percentage of securities issued domestically is either immobilised or dematerialised, and what is the trend? Is the transfer of securities carried out by book entry or does it require any form of physical delivery? | |
| 2. | Is there a lag between settlement and registration and what are the implications of the time lag for finality? If the CSD is not the official registrar, does the transfer of securities in the CSD result in the transfer of securities in the official register? | |
| Recommendation 7: Delivery versus payment (DVP) | | |
| Key questions | | |
| 1. | Does the technical, legal and contractual | |

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| framework ensure that delivery of securities takes place if, and only if, payment is received? If so, how? | |
| 2. What proportion of trades between direct participants of the CSD (by value) is settled on a | |
| DVP basis? | |
| Recommendation 8: Timing of settlement finality | |
| Key questions | |
| 1. Does the CSD permit final settlement of securities transfers by the end of the settlement day? Is the timing of settlement finality clearly defined for transactions within the CSD and for transactions over a link to another CSD? | |
| 2. Does the CSD permit final settlement of DVP transfers on a continuous basis throughout the day or at certain designated times during the day? If the latter, at what times do transfers become final? Is there a need for intraday or real-time finality to reduce risks? Do central banks use the SSS in monetary policy operations or to collateralise intraday credit extensions in a payment system? Do active trading parties or CCPs have a need for intraday or real-time finality to manage their risks effectively? Is there a need for intraday or real-time finality to facilitate settlement through links to other CSDs? Is there a need for intraday finality to facilitate the smooth functioning of some markets (for example, repurchase agreement markets)? | |
| 3. Does the CSD prohibit the unilateral revocation of unsettled transfer instructions late in the settlement day? Does the CSD receive provisional transfers of securities from any other CSDs? If so, does it prohibit retransfer of these securities until they become final? If not, what would be the consequences of an unwind of such provisional transfers for the CSD's participants? | |
| Recommendation 7: Delivery versus payment (DVP) | |
| Key questions | |
| 1. Does the technical, legal and contractual framework ensure that delivery of securities takes place if, and only if, payment is received? If so, how? | |
| 2. What proportion of trades between direct participants of the CSD (by value) is settled on | |

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| a | |
| DVP basis? | |
| Recommendation 8: Timing of settlement finality | |
| Key questions | |
| 1. Does the CSD permit final settlement of securities transfers by the end of the settlement day? Is the timing of settlement finality clearly defined for transactions within the CSD and for transactions over a link to another CSD? | |
| 2. Does the CSD permit final settlement of DVP transfers on a continuous basis throughout the day or at certain designated times during the day? If the latter, at what times do transfers become final? Is there a need for intraday or real-time finality to reduce risks? Do central banks use the SSS in monetary policy operations or to collateralise intraday credit extensions in a payment system? Do active trading parties or CCPs have a need for intraday or real-time finality to manage their risks effectively? Is there a need for intraday or real-time finality to facilitate settlement through links to other CSDs? Is there a need for intraday finality to facilitate the smooth functioning of some markets (for example, repurchase agreement markets)? | |
| 3. Does the CSD prohibit the unilateral revocation of unsettled transfer instructions late in the settlement day? Does the CSD receive provisional transfers of securities from any other CSDs? If so, does it prohibit retransfer of these securities until they become final? If not, what would be the consequences of an unwind of such provisional transfers for the CSD's participants? | |
| Recommendation 9: CSD risk controls to address participants' failures to settle | |
| Key questions | |
| 1. Does the CSD ensure that timely settlement can be completed in the event of an inability to settle by the participant with the largest obligation? If so, how? Are the credit exposures of the CSD fully collateralised? If not, what measures are in place to address risks stemming from granting uncollateralised credit? Are limits imposed on credit extensions by the CSD? Does the CSD have sufficient liquidity resources to ensure timely settlement? | |
| 2. Does the CSD permit overdraft or debit balances in securities? | |

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| 3. | Does the CSD evaluate the probability of multiple failures? Can settlement be completed in that event? If not, has the CSD evaluated the cost of ensuring settlement in the event of multiple failures? | |
| Recommendation 10: Cash settlement assets | | |
| Key questions | | |
| 1. | Is the settlement agent the central bank that issues the currency? If the central bank is settling in a foreign currency, what steps has it taken as settlement agent to ensure that the settlement assets pose little or no credit or liquidity risk? If the central bank is not used, what steps have been taken to protect CSD members from failure of the cash settlement agent? Is the CSD itself organised as a limited purpose bank? Does it strictly limit any risks associated with non-settlement activities? | |
| 2. | Are settlement banks subject to prudential supervision by government authorities? Who determines which institutions can be used as settlement institutions? What are the criteria? If multiple settlement institutions can be used in principle, how many are used in practice? How concentrated are payment flows? On an average day, what percentage of total payments is credited to accounts at the institution that accounts for the largest share of payment flows? What is the financial condition of that institution (for example, its capital ratios and its credit ratings)? Are the concentration of exposures and the financial condition of the settlement banks monitored and evaluated? If so, by whom? | |
| 3. | How quickly can recipients use the proceeds of securities settlements? | |
| | On the same day? | |
| | Intraday? | |
| 4. | Does the payment system used for interbank transfers among settlement banks observe | |
| | CPSIPS? | |
| Recommendation 11: Operational reliability | | |
| Key questions | | |
| 1. | Does the system operator have a process for identifying and managing its operational risks? | |
| 2. | Does the system operator have contingency plans and backup facilities for the failure of key systems, and are these tested and reviewed regularly with participants taking part? Do contingency plans ensure at a minimum that the | |

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| status of all transactions at the time of the disruption can be identified with certainty in a timely manner? How long does it take to recover operations through backup systems? Do the procedures provide for preservation of all transaction data? How does the system operator ensure the integrity of messages? | |
| 3. Are operational reliability issues reviewed regularly by senior management, including review by persons not responsible for the relevant operations? Are periodic external audits of the IT (information technology) system conducted? Is there an independent internal audit function and does it review operational risk controls? | |
| 4. How many times during the last year has a key system failed? What is the most common cause of failures? How long did it take to resume processing? How much transaction data, if any, was lost? Does the system operator have capacity plans for key systems and are key systems tested periodically to determine if they can handle stress volume? | |
| Recommendation 12: Protection of customers' securities | |
| Key questions | |
| 1. What arrangements are used to protect customers' securities from theft, loss or misuse and to ensure that they will not become subject to claims of the custodian's creditors (for example, are segregation, insurance, or compensation schemes used)? Are those arrangements based upon specific laws and regulations? In the event of the custodian's insolvency, do those arrangements enable a customer's positions to be moved by a receiver to a solvent intermediary? | |
| 2. How often do the entities holding securities in custody reconcile their records? Are the entities holding securities in custody subject to mandatory internal or external audit, or both, to determine if there are sufficient securities to satisfy customer claims? | |
| 3. Are the entities holding securities in custody subject to prudential supervision or regulation? | |
| Do regulatory reviews examine the procedures and internal controls used in the safekeeping of securities? | |
| Recommendation 13: Governance | |
| Key questions | |

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| 1. | What are the governance arrangements of the CSD or CCP? What information is publicly available regarding the system, its ownership and its board and management structure, and the process by which major decisions are taken and management made accountable? | |
| 2. | Are the system's public interest, financial and other objectives clearly articulated and public? | |
| | What are they? Do the system's objectives reflect the needs of users as well as owners? How is the public interest taken into account? Can the system's participants or the public influence the system's decision-making process? How are major decisions communicated to owners and users? | |
| 3. | What steps are taken to ensure that management has the incentives and skills needed to achieve the system's objectives and is accountable for its performance? | |
| 4. | How is the composition of the board determined? What steps are taken to ensure that board members have the necessary skills, and represent or take into account in their deliberations the full range of shareholder and user interests as well as the public interest? | |
| Recommendation 14: Access | | |
| Key questions | | |
| 1. | Are access rules/criteria objective and clearly disclosed to all potential applicants? | |
| 2. | Are the same rules applied regardless of the identity, type and location of the applicant? If not, what variations apply and why? Can differential restrictions on access to the system be justified in terms of the need to limit risks to the system operator or to other users? | |
| 3. | Under what conditions can participants terminate their membership? What arrangements does the system have in place to facilitate the exit of members who no longer meet the participation requirements? Are these arrangements publicly disclosed? | |
| Recommendation 15: Efficiency | | |
| Key questions | | |
| 1. | Does the system operator have in place procedures to control costs (for example, by benchmarking its costs and charges against other systems that provide a similar service and to analyse the reasons for significant | |

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| differences)? Does the system operator have in place procedures to regularly review its pricing levels against its costs of operation? | |
| 2. Does the system operator regularly review its service levels, including by regularly surveying its users? Does the system operator have in place procedures to regularly review operational reliability, including its capacity levels against projected demand? | |
| Recommendation 16: Communication procedures and standards | |
| Key questions | |
| 1. Does the securities settlement system use international communication procedures or standards or is it able to easily convert domestic procedures and standards into the relevant international communication procedures and standards for cross-border securities transactions? | |
| Recommendation 17: Transparency | |
| Key questions | |
| 1. Does the CSD or CCP make clear disclosures to market participants about its rules, regulations, relevant laws, governance procedures, risks, steps taken to mitigate risks, the rights and obligations of participants and the cost of participating in the system? | |
| 2. Has the system completed and disclosed the questionnaire set out in the CPSS/IOSCO disclosure framework or the answers to the key questions set out in this assessment methodology? Have the authorities responsible for regulation and oversight publicly disclosed their answers to the key questions regarding implementation of the recommendations? | |
| 3. How is this information made available? In what language or languages? In what form? | |
| 4. What steps are taken by the CSD or CCP to ensure that the disclosures are complete and accurate? Are there regular reviews to ensure they remain current? | |
| Recommendation 18: Regulation and oversight | |
| Key questions | |
| 1. How is the system regulated/overseen? Describe the laws that authorise and govern the system's operation, the applicable | |

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| regulatory bodies and their respective authority concerning the system's operation. | |
| | |
| 2. Are the responsibilities of the securities regulator, central bank and, where relevant, banking supervisor clearly defined with respect to securities settlement systems? Are their roles and major policies disclosed publicly? Are they written in plain language so that they can be fully understood by designers, operators and participants of securities settlement systems, and other relevant parties? | |
| 3. What is the regulatory and oversight framework based on? Is it a statute-based approach where specific tasks, responsibilities and powers are assigned to specific public authorities? Or a non-statute-based approach? Do the securities regulator and the central bank have experienced staff, proper resources and funding to carry out regulatory and oversight functions effectively? | |
| 4. Is there a framework for cooperation between the securities regulator and the central bank, such as for the exchange of information and views on securities settlement systems? Is there such a framework for cooperation with relevant authorities both within and outside the country? | |
| Recommendation 19: Risks in cross-border links | |
| Key questions | |
| 1. What kinds of links are in operation (see explanatory note)? Has the CSD done a risk analysis of the design of the link and the financial and operational integrity of the linked CSD? | |
| 2. How is DVP achieved? Does the link permit provisional transfers of securities across the link? If so, is the retransfer of these securities prohibited until the first transfer is final? | |
| 3. If the CSD extends credit to a linked CSD, are credit extensions to the linked CSD fully secured and subject to limits? Are risk controls and liquidity resources adequate to address liquidity risks posed by the link? | |

Appendix 1.7: Review of Market Surveillance (November 2014)



বাংলাদেশ সিকিউরিটিজ অ্যান্ড এক্সচেঞ্জ কমিশন
Bangladesh Securities and Exchange Commission

ADB TA-8228 BAN: Enhancing Efficiency of the Capital Market

REVIEW OF MARKET SURVEILLANCE

November 2014



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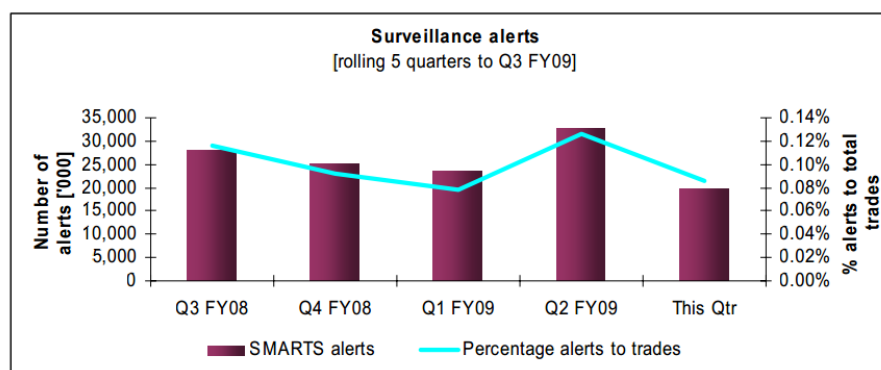
Review of Market Surveillance

Review of surveillance function

1. These notes have been prepared by the consultant at the request of Commissioner, Arif Khan.
2. The request was to make some comments on the surveillance process, particularly with regard to the current alert handling and the consultant spent some time in discussion with management and staff of the surveillance department. This was particularly to better understand the current processes and level of alerts being generated, those attended to and the level of alerts unhandled as at November 2014.
3. The Instant Watch market Alert System was bought in December 2012 and really establish after intensive training in March 2013.
4. The familiarise himself the consultant looked at the level of alerts in the period 1st January 2014 to 31st October 2014 (10 months of trading on the DSE and CSE).
5. During this period there were 24.5 million trades on the two exchanges (21.5 million on DSE and 3 million on CSE).
6. 27,760 alerts generated by the system, including 8,700 short selling alerts, the overall alerts to trades ratio was 0.11%. This compares to some known ratios for the Australian Stock Exchange which in 2009 had a similar ratio. This is depicted as follows:

Market surveillance

Real-time



- There were 19,907 alerts⁴ in the quarter. This represents a fall back to more normal levels and is well below the high numbers seen in the December quarter which was a period of extreme market volatility.

Review of Market surveillance

7. The current statistics available from the Surveillance system could be better presented and currently the department staff has to recast the statistics to make them understandable. They also spend considerable valuable time undertaking the reporting of general market statistics and this work should be located elsewhere (BSEC research unit?).
8. In fact in discussion with staff there are a number of functions that are creating back logs and administrative reporting of market statistics is one issue and the lack of a defined investigations unit, together with the absence of a adequately staffed enforcement unit, means that surveillance have induced backlogs as they are doing work that should be located elsewhere. The consult estimates that this could be over 50% of the time of surveillance analysts which really belongs elsewhere. This means a lack of attention to alerts which end up unattended to.
9. Annexure one sets out the available statistics generated by an internal instant watch system routine and exported to excel. A cursory review establishes that this report is confusing and needs to be re-casted to be understandable, these statistics the staff have to do daily.
10. Statistics has been re-casted in the Table below.

| Alert Type | Handled | Not handled | Under Investigation | Total | Handled | Not handled | Under Investigation |
|-----------------------------|---------|-------------|---------------------|-------|---------|-------------|---------------------|
| AUTO_CLIENT_REF | 1393 | 0 | 375 | 1768 | 79% | 0% | 21% |
| CIRCULAR_MOVEMENT | 930 | 3 | 396 | 1329 | 70% | 0% | 30% |
| CLOSING_PRICE | 3828 | 90 | 128 | 4046 | 95% | 2% | 3% |
| FRONTRUNNING_CLIENT | 7 | 4 | 2 | 13 | 54% | 31% | 15% |
| INSIDER_TURNOVER_NET_BROKER | 31 | 68 | 0 | 99 | 31% | 69% | 0% |
| INSIDER_TURNOVER_NET_CLIENT | 32 | 135 | 0 | 167 | 19% | 81% | 0% |
| INTRA_DAY | 1134 | 15 | 26 | 1175 | 97% | 1% | 2% |
| MARKING_THE_CLOSE | 347 | 15 | 3 | 365 | 95% | 4% | 1% |
| ORDER_SPREAD | 620 | 7 | 7 | 634 | 98% | 1% | 1% |
| POSITION_LIMIT | 207 | 5 | 0 | 212 | 98% | 2% | 0% |
| PRESSRELEASE_WARNING_NOTICE | 2087 | 148 | 4 | 2239 | 93% | 7% | 0% |
| QUOTE_STUFFING | 330 | 4 | 4 | 338 | 98% | 1% | 1% |
| SHORT_SELLING | 2549 | 0 | 6147 | 8696 | 29% | 0% | 71% |
| SPOOFING | 504 | 44 | 26 | 574 | 88% | 8% | 5% |
| STDDEV_DAY_PRICE | 1469 | 140 | 29 | 1638 | 90% | 9% | 2% |
| TRADE_CONCENTRATION | 58 | 0 | 0 | 58 | 100% | 0% | 0% |
| TURNOVER_AMOUNT | 0 | 6 | 0 | 6 | 0% | 100% | 0% |
| TURNOVER_DAY_STDDEV | 3386 | 483 | 30 | 3899 | 87% | 12% | 1% |
| | 18912 | 1167 | 7177 | 27256 | 69% | 4% | 26% |

11. A second view of these statistics should be available and that is by counter (ie. stock code).
12. Presently no standardised report is available to provide a view by company counter but the consultant has identified a list of about 50 stocks which exhibit high volatility compared to the market. The consultant has requested the surveillance staff manually extract the cross view of the alert generated these 50 counters on this list plus any they know outside this list, that they are aware generate numerous alerts. The list of high volatility stocks is shown in Annexure B. The following report displays the overall data for these 50 more volatile stocks which had 6726 alerts. Ideally a report for all counters should be available and it should be able to display this information three ways; as per the Table below, the alerts not handled and the alerts under investigation.

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| Counter | Total Of ID | AUTO_CLIENT_REF | CIRCULAR_MOVEMENT | CLOSING_PRICE | FRONTTRADING_CLIENT | INSIDER_TURNOVER_NET_BROKER | INSIDER_TURNOVER_NET_CLIENT | INTRA_DAY | MARKING_THE_CLOSE | ORDER_SPREAD | PRESSRELEASE_WARNING_NOTICE | QUOTE_SUFFING | SHORT_SELLING | SPOOFING | STDDEV_DAY_PRICE | TURNOVER_AMOUNT | TURNOVER_DAY_STDDEV |
|------------|-------------|-----------------|-------------------|---------------|---------------------|-----------------------------|-----------------------------|-----------|-------------------|--------------|-----------------------------|---------------|---------------|----------|------------------|-----------------|---------------------|
| AAMRATCH | 117 | 12 | 6 | 8 | | | | 1 | | 1 | 5 | | 60 | 3 | 4 | | 17 |
| ACI | 109 | 3 | 8 | 15 | | | | | | 1 | 12 | | 46 | | 6 | | 18 |
| ACTIVEFINE | 104 | 5 | 2 | 6 | | | | 1 | | 1 | 16 | | 39 | 9 | 3 | | 22 |
| AFCAGRO | 56 | 4 | 3 | 7 | | | | 1 | | 6 | | 2 | 31 | 1 | 1 | | |
| AL-HAJTEX | 125 | 4 | 35 | 24 | | 10 | 5 | | 1 | 1 | 6 | | 19 | 1 | 1 | | 18 |
| APOLOISPAT | 252 | 3 | 15 | 6 | | | | | | 2 | | 102 | 99 | 22 | 3 | | |
| BATBC | 104 | 19 | | 1 | 1 | | | 1 | 2 | 1 | 10 | | 49 | | 2 | 4 | 14 |
| BDAUTOCA | 37 | | | 11 | | | | 8 | 3 | 1 | 2 | | 1 | | 4 | | 7 |
| BDBUILDING | 99 | 15 | 8 | 10 | | | | 3 | | 1 | | | 56 | 4 | 2 | | |
| BENGALWTL | 77 | 6 | 4 | 15 | | | | 3 | | 2 | | | 40 | 4 | 3 | | |
| BEXIMCO | 353 | 12 | 89 | 15 | | | | | | 6 | 11 | 4 | 160 | 20 | 2 | 11 | 23 |
| BSC | 247 | 7 | 67 | 3 | | | | | | 2 | 13 | 8 | 119 | 11 | 3 | | 14 |
| BSCCL | 193 | 18 | 36 | 5 | | | | | | 2 | 10 | | 97 | 3 | 4 | | 18 |
| BSRMSTEEL | 109 | 4 | 4 | 5 | | | | | | 1 | 11 | | 50 | 3 | 1 | 4 | 26 |
| BXPHERMA | 142 | 1 | 5 | 8 | | | | 1 | 1 | 3 | 8 | | 91 | 2 | 5 | 2 | 15 |
| CENTRALPHI | 92 | 25 | 3 | 13 | | | | | 2 | 2 | | | 43 | 1 | 3 | | |
| DELTALIFE | 160 | 8 | 18 | 15 | | | | 1 | | 2 | 23 | | 72 | 2 | 3 | | 16 |
| DESCO | 100 | 1 | | 15 | | | | 10 | | 1 | 10 | | 24 | | 15 | | 24 |
| EBL | 49 | 2 | | 2 | | | | 2 | 2 | 2 | 9 | | 8 | | 5 | | 17 |
| EHL | 107 | 2 | 14 | 6 | | | | 3 | | 1 | 9 | | 47 | 7 | 4 | | 14 |
| ENVOYTEX | 60 | 2 | | 5 | | | | 3 | | | | | 43 | 2 | 5 | | |
| FARCHEM | 61 | 10 | 6 | 12 | | | | 2 | | 6 | | | 17 | 7 | 1 | | |
| GENNEXT | 103 | 2 | 4 | 12 | | | | 4 | | 3 | | | 64 | 10 | 4 | | |
| GP | 590 | 185 | 20 | | | 53 | 122 | | | 2 | 15 | | 149 | 8 | | 13 | 23 |
| GPHISPAT | 91 | 3 | 2 | 10 | | | | 4 | | 1 | 11 | | 33 | 2 | 3 | | 22 |
| HWAWELLTE | 43 | 2 | 8 | 8 | | | | | | 5 | | | 16 | 3 | 1 | | |
| ICBISLAMIC | 42 | | | 16 | | | | 8 | 7 | 4 | | | 2 | | 5 | | |
| IDLC | 98 | 4 | | 14 | | | | 2 | | 1 | 17 | | 32 | | 5 | | 23 |
| ISLAMIBANK | 194 | 26 | | 3 | | | | | | 1 | 35 | | 99 | | 12 | | 18 |
| JAMUNAOIL | 89 | 10 | | | | | | | | | 3 | | 50 | 1 | 4 | | 21 |
| LAFSURCEM | 201 | 7 | | 25 | | | | 1 | | 3 | 18 | | 118 | 5 | 2 | 5 | 17 |
| LANKABAFIN | 181 | 9 | 6 | 8 | | 23 | 27 | | | 1 | 16 | | 66 | 3 | 3 | | 19 |
| MAKSONSPI | 117 | 7 | 1 | 4 | | | | 2 | | 1 | 8 | | 72 | 8 | 2 | | 12 |
| MATINSPINN | 88 | 4 | 7 | 4 | | | | 2 | | 7 | | 12 | 48 | 2 | 2 | | |
| MJLBD | 215 | 2 | 15 | 13 | 1 | | | 1 | | | 22 | | 85 | 37 | 4 | 12 | 23 |
| NATLIFEINS | 57 | | | 4 | | | | 6 | 3 | 1 | 12 | | 9 | | 9 | | 13 |
| NBL | 198 | 4 | 13 | 6 | 1 | | | | | 1 | 14 | 14 | 109 | 4 | 9 | | 23 |
| OLYMPIC | 132 | 25 | 5 | 1 | | | | 1 | | | 7 | | 63 | 3 | 3 | 2 | 22 |
| ORIONINFU | 75 | | 11 | 12 | | | | | 1 | | 3 | | 26 | 1 | 4 | | 17 |
| ORIONPHAR | 94 | 5 | 5 | 6 | | | | 1 | | 1 | | 6 | 68 | | 2 | | |
| PADMAOIL | 101 | 6 | 6 | 1 | | | | | | | 3 | | 62 | 3 | | | 20 |
| PENINSULA | 87 | 2 | 3 | | | | | 1 | | 5 | | 26 | 48 | | 2 | | |
| POWERGRID | 64 | 1 | | 6 | | | | 1 | 1 | | 6 | | 24 | | 6 | | 19 |
| PRIMEBANK | 167 | 61 | | 12 | | | | 4 | 2 | 1 | 15 | | 52 | 1 | 5 | | 14 |
| PTL | 90 | 3 | 23 | 7 | | | | 1 | | 1 | | | 49 | 5 | 1 | | |
| RENATA | 60 | 9 | | 2 | 1 | | | | | 1 | 6 | | 20 | | 4 | | 17 |
| SQURPHARM | 353 | 142 | 26 | 5 | | | | | | 1 | 10 | | 130 | 14 | 5 | 5 | 15 |
| SUMITPOWER | 130 | 4 | 4 | 6 | | | | | | 2 | 7 | | 71 | 13 | 3 | | 20 |
| UCBL | 210 | 26 | 6 | 3 | | | | 1 | | 2 | 23 | | 118 | 9 | 4 | | 18 |
| UNIQUEHRL | 103 | 13 | | 1 | | | | | | 1 | 12 | | 57 | 1 | 5 | | 13 |
| | 6726 | 725 | 488 | 396 | 4 | 86 | 154 | 80 | 25 | 91 | 418 | 174 | 2951 | 235 | 189 | 58 | 652 |

13. As noted above the table represents alerts received; similar tables could be available showing alerts under investigation or not handled which would be a good management aid.

14. The consultant believes such analysis will also help establish a better way to organise the surveillance department work. This will involve having sets of companies (market sectors) that are assigned to an analyst, analysts should understand the dynamics of their assigned list of counters, investigations should be

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followed up by staff who are not front line analysts, thus making more use of scarce resources.

15. It would certainly help the department to receive some training in advanced excel and Microsoft Access or be trained to extract data from the Trapets database. This is done in other jurisdictions.
16. Currently as is evidenced by the statistics too many alerts pass through without assessment and leaving aside 6,000 short selling alerts under investigation there are 1000 other types of alerts outside short selling that have not been handled and 1000 under investigation and it is within these categories that the most likely manipulation offences are likely to be discovered.
17. Many regulators organise their surveillance staff by concentrating on counters rather than alert types and these staff members develop intimate knowledge of the counters. Surveillance “sets” are rotated each 12 to 18 months and one staff member is restricted by the system to seeing only their data set.
18. It is recommended the BSEC look at this approach. It is also necessary to designate personnel to handle different functions separate to initial alert examination elevating the live analysts from very detailed and consuming investigation work. By freeing the analysts from general market statistics, improving the system to generate required reports and shift functions will give more time to handle the very important manipulation matters currently not receiving attention.
19. Another issue is that the staff needs further training particularly on the fundamental issues of the rationale for the alert type and examples of the types of abuse identified by such alerts.
20. It is 18 months since Trapets did their formal training; the department meanwhile has new staff members.
21. Another issue is that the parameters set for setting off alerts have not been addressed since the system was installed; this needs urgent review, particularly an analysis of the false positives that have been generated to see if parameters need adjusting.
22. The situation with the level of short sale alerts needs particular attention so that these are handled by the exchanges rather than BSEC. In fact at the moment there is double and even triple handling of short sale cases, with the surveillance people having to review exchange responses and also enquiry reports, all this should be handled between the exchanges and enforcement. Without this being removed from Surveillance department functions the department will not be able to handle day to responses.

23. A number of alerts have been provided for as follows:

| Instant Watch Manual Reference | Name of Alert |
|--------------------------------|------------------------|
| 2.1.8 | COMBINATION_CLIENT_REF |
| 2.1.11 | INTRA_DAY_MOVEMENT |
| 2.1.12 | LATE_WITHDRAWAL |
| 2.1.14 | MOMENTUM_IGNITION |
| 2.1.16 | ORDER_SHORT_TIME |
| 2.1.17 | PINPOINT_ORDER |
| 2.1.18 | PINPOINT_TRADE |
| 2.1.22 | RELATION_COMBINATION |
| 2.1.27 | TRADE_OUTSIDE_SPREAD |
| 2.1.29 | TURNOVER_DAY_AVERAGE |
| 2.1.31 | VOLUME_DAY_AVERAGE |

24. However, whilst these alerts are programmed into the system they have been switched off, and here should be a review of their appropriateness and whether the time is right to utilise these alerts. There may be new alerts the staff, based on experience to date can suggest.

25. The consultant found the staff eager to improve the situation, quite knowledgeable of the issues to be addressed and keen to see more attention given to the surveillance department.

26. Key issues:

- Free the staff to do surveillance work not enforcement work
- Remove the daily market statistics report work to R&D
- Have Trapets improve the availability of statistics from the system
- More training to the staff on alert types and case studies, have Trapets do some reinforcement training
- Consider reviewing the parameters for alerts to remove false positives
- Give excel and ACCESS training to key staff and see if Trapets can make available ability of staff to do SQL queries against database
- Organise the department by counters not alert types
- Coal face analysts should not do in depth investigations
- Consider triggering the unused alerts as part of system
- Management should review overall alerts say every three months to see where patterns are developing
- The table of alert types should be reviewed in light of actual cases progressed, are there counters that have had significant alerts and no actions have been evident to date.

Annexure A: Alerts Jan –Oct 2014

| Monitor | Action | Not handled | Handled | Under investigation | Total |
|-----------------------------|--------------|-------------|---------|---------------------|-------|
| AUTO_CLIENT_REF | | 0 | 0 | 375 | 375 |
| | Action taken | 0 | 320 | 0 | 320 |
| | Dismissed | 0 | 1073 | 0 | 1073 |
| CIRCULAR_MOVEMENT | | 3 | 0 | 396 | 399 |
| | Action taken | 0 | 13 | 0 | 13 |
| | Dismissed | 0 | 917 | 0 | 917 |
| CLOSING_PRICE | | 90 | 0 | 128 | 218 |
| | Action taken | 0 | 5 | 0 | 5 |
| | Dismissed | 0 | 3823 | 0 | 3823 |
| FRONTRUNNING_CLIENT | | 4 | 0 | 2 | 6 |
| | Dismissed | 0 | 7 | 0 | 7 |
| INSIDER_TURNOVER_NET_BROKER | | 68 | 0 | 0 | 68 |
| | Dismissed | 0 | 31 | 0 | 31 |
| INSIDER_TURNOVER_NET_CLIENT | | 135 | 0 | 0 | 135 |
| | Dismissed | 0 | 32 | 0 | 32 |
| INTRA_DAY | | 15 | 0 | 26 | 41 |
| | Action taken | 0 | 1 | 0 | 1 |
| | Dismissed | 0 | 1133 | 0 | 1133 |
| MARKING_THE_CLOSE | | 15 | 0 | 3 | 18 |
| | Dismissed | 0 | 347 | 0 | 347 |
| ORDER_SPREAD | | 7 | 0 | 7 | 14 |
| | Action taken | 0 | 2 | 0 | 2 |
| | Dismissed | 0 | 618 | 0 | 618 |
| POSITION_LIMIT | | 5 | 0 | 0 | 5 |
| | Dismissed | 0 | 207 | 0 | 207 |
| PRESSRELEASE_WARNING_NOTICE | | 148 | 0 | 4 | 152 |
| | Action taken | 0 | 1 | 0 | 1 |
| | Dismissed | 0 | 2086 | 0 | 2086 |

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| Monitor | Action | Not handled | Handled | Under investigation | Total |
|---------------------|--------------|-------------|--------------|---------------------|--------------|
| QUOTE_STUFFING | | 4 | 0 | 4 | 8 |
| | Dismissed | 0 | 330 | 0 | 330 |
| SHORT_SELLING | | 0 | 0 | 6147 | 6147 |
| | Action taken | 0 | 1 | 0 | 1 |
| | Dismissed | 0 | 2548 | 0 | 2548 |
| SPOOFING | | 44 | 0 | 26 | 70 |
| | Action taken | 0 | 13 | 0 | 13 |
| | Dismissed | 0 | 491 | 0 | 491 |
| STDDEV_DAY_PRICE | | 140 | 0 | 29 | 169 |
| | Action taken | 0 | 1 | 0 | 1 |
| | Dismissed | 0 | 1468 | 0 | 1468 |
| TRADE_CONCENTRATION | Dismissed | 0 | 2 | 0 | 2 |
| TURNOVER_AMOUNT | | 6 | 0 | 0 | 6 |
| | Dismissed | 0 | 56 | 0 | 56 |
| TURNOVER_DAY_STDDEV | | 483 | 0 | 30 | 513 |
| | Action taken | 0 | 1 | 0 | 1 |
| | Dismissed | 0 | 3385 | 0 | 3385 |
| | | 1167 | 18912 | 7177 | 27256 |

Annexure B: High Volatility Counters

| Stock | Volatility |
|------------|------------|
| NATLIFEINS | 74% |
| BEXIMCO | 73% |
| FARCHEM | 66% |
| MJLBD | 48% |
| HWAWELLTEX | 46% |
| AL-HAJTEX | 44% |
| MATINSPINN | 40% |
| APOLOISPAT | 38% |
| DELTALIFE | 37% |
| BXPHARMA | 37% |
| LAFSURCEML | 37% |
| SQURPHARMA | 37% |
| AAMRATECH | 37% |
| PENINSULA | 37% |
| CENTRALPHL | 36% |
| ACTIVEFINE | 36% |
| AFCAGRO | 35% |
| BSRMSTEEL | 35% |
| IDLC | 34% |
| ACI | 34% |
| SUMITPOWER | 33% |
| BDBUILDING | 31% |
| PRIMEBANK | 30% |
| BSC | 30% |
| LANKABAFIN | 30% |
| GPHISPAT | 30% |
| GENNEXT | 29% |
| PTL | 29% |
| BENGALWTL | 29% |
| GP | 29% |
| ICBISLAMIC | 28% |
| ORIONINFU | 26% |
| BATBC | 26% |

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| Stock | Volatility |
|------------|------------|
| OLYMPIC | 25% |
| PADMAOIL | 25% |
| NBL | 24% |
| EHL | 23% |
| ORIONPHARM | 23% |
| RENATA | 23% |
| POWERGRID | 22% |
| ENVOYTEX | 21% |
| UCBL | 21% |
| JAMUNAOIL | 20% |
| MAKSONSPIN | 20% |
| EBL | 20% |
| UNIQUEHRL | 19% |
| ISLAMIBANK | 19% |
| BDAUTOCA | 18% |
| BSCCL | 18% |
| DESCO | 18% |
| PUBALIBANK | 17% |
| TITASGAS | 17% |
| AFTABAUTO | 17% |
| MPETROLEUM | 16% |
| HEIDELBCEM | 16% |
| CITYBANK | 14% |

Appendix 1.8: Outline of a Draft Consultation Paper on New Risk Based Capital Adequacy (RBCA) Regime for Licensed Persons (November 2014)



বাংলাদেশ সিকিউরিটিজ অ্যান্ড এক্সচেঞ্জ কমিশন
Bangladesh Securities and Exchange Commission

ADB TA-8228 BAN: Enhancing Efficiency of the Capital Market

**OUTLINE OF A DRAFT CONSULTATION PAPER WHICH
COULD BE ISSUED BY BSEC ON NEW RISK BASED
CAPITAL ADEQUACY (RBCA) REGIME FOR LICENSED
PERSONS**

November 2014



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Outline of a Draft Consultation Paper which could be issued by BSEC on New Risk Based Capital Adequacy (RBCA) Regime for Licensed Persons

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Outline of a Draft Consultation Paper which could be issued by BSEC on New Risk Based Capital Adequacy (RBCA) Regime for Licensed Persons

**Outline of a Draft Consultation Paper which could be issued by
BSEC on New Risk Based Capital Adequacy (RBCA) Regime for
Licensed Persons**

1. Introduction

- 1.1 Current capital requirement is not based on any estimation of the true worth of assets held on the balance sheet. An entity is required to have Tk XX million of paid in capital, ongoing shareholder's funds greater than Tk YY million and a working capital equal to or greater than Tk Z million.
- 1.2 All assets are included at book value including intangible assets and long term assets for which there may not be a current realisable value of the assets known. There is no measurement of the liquid value of assets and no set parameters to guide licensees as to the computation of such values.
- 1.3 Currently no assessment is made of off balance sheet liabilities or contingent liabilities.
- 1.4 No assessment is made of the risks associated with concentrated positions held in equities or other securities and no concentrated lending is recognised as an additional risk.
- 1.5 Collateral held against Margin Financing is not subject to mark to market valuation.
- 1.6 Working capital is currently measured using unadjusted current assets minus current liabilities. No gearing limitations are set and shareholder's funds which may include valuations placed on intangible assets like the DSE & CSE TRECS.
- 1.7 There are several inherent weaknesses in this methodology that does not allow the true liquidity or collectability of current assets and does not allow for the impact of overall liabilities or the potential impact of off balance sheet or contingent liabilities on a firms overall financial capacity.
- 1.8 In addition to issues related to the measurement of liquid capital the DSE & CSE are developing a joint clearinghouse and this behoves only allowing well capitalised TREC holders and others being allowed to be clearing members of the new entity.
- 1.9 Whilst stockbrokers are required to have a minimum "paid in capital" to commence and remain in business but there is no measure as to how liquid are the funds utilised in the business and which may be required to be convertible to cash for the benefit of unpaid clients in the event of forced liquidation.

Outline of a Draft Consultation Paper which could be issued by BSEC on New Risk Based Capital Adequacy (RBCA) Regime for Licensed Persons

- 1.10 The BSEC desires to introduce a Risk Based Capital Adequacy (RBCA) regime where licensed persons have not only to maintain a minimum amount of Paid in Capital but that the calculation of a minimum liquid capital should be the higher of a prudential minimum or a variable amount calculated by reference to the total liabilities of the firm, the amount of which includes adjustments for off balance sheet liabilities and contingencies as well as amounts representing concentrated assets. For example exposure to single security or client above a certain percentage of that assets class.
- 1.11 The liquid capital calculation methodology will be compiled to better reflect the true risks in principal positions, the collectability of debtors and other credit risks, the impact of derivative positions, and the possible risk in off balance sheet liabilities and contingencies. The methodology will severely discount long term non trading or securities business assets.
- 1.12 At this time the exchanges only facilitate multilateral netting and do not “guarantee” final settlement by acting as a central counterparty and novating the trades into its own name thus guaranteeing both sides to the trade. Thus there is a lack of certainty in trade clearing and settlement.
- 1.13 The current situation is unacceptable for a modern capital market, and is contrary to IOSCO principles. The present clearing system and liquid capital requirements are both considered below world best practise.
- 1.14 BSEC is introducing new risk based capital adequacy standards (RBCA) together with RBCA returns and enhanced capital calculations from xxxxx 2015. This is being done to improve the capital adequacy standards for brokers, broker dealers, investment banks and other licensed entities such as asset managers. Attached as Annexure 1 is a copy of the proposed new RBCA format. In addition BSEC will require firms from yyyyyyyyyyyy to supply back up detail to the RBCA returns at each month end.
- 1.15 RBCA standards aim to foster confidence in the financial markets by achieving an environment in which securities firms and other market intermediaries can wind down their business when they are in financial distress and still allow them to fulfil their financial obligations without harm to the investor or other market intermediaries. In short, capital requirements should allow an intermediary to absorb its losses.
- 1.16 Minimum capital requirements also help protect the securities community as a whole by reducing the possibility of systemic risk. For instance the insolvency of one broker or some other market intermediary may call into question the financial solvency of other intermediaries and thereby lead to serious market disruption and loss of investor confidence. In turn, banks or other financial institutions may become unwilling to continue providing financing for firms to carry or clear securities transactions. Any significant interruptions in the availability of bank financing, or any other source of financing, could significantly affect the securities community and the operation of the markets. In this regard minimum capital standards are a vital tool to reducing systemic risk.
- 1.17 This consultation paper seeks comments on a number of the proposals to strengthen the equities capital market.
-

Outline of a Draft Consultation Paper which could be issued by BSEC on New Risk Based Capital Adequacy (RBCA) Regime for Licensed Persons

2. Financial Responsibility Framework

- 2.1 Capital adequacy standards in securities markets should be one element in a financial responsibility framework and that larger framework should consider:
- (a) A liquidity and solvency standard that ensures market intermediaries have sufficient liquid assets to meet their obligations;
 - (b) Risks different intermediaries face including market or position risk, settlement/counterparty risk, operational risk, and systemic risk;
 - (c) Mark- to- market system for securities positions to provide a true picture of an intermediary's positions thereby avoiding accumulated losses at a particular firm;
 - (d) Segregation of customer monies and securities,
 - (e) Recordkeeping, reporting and examination programs to reinforce capital adequacy requirements, and
 - (f) Standards of internal control and risk management practise expected of licensed intermediaries.
- 2.2 It is proposed that concurrent with these RBCA principles that Internal Control and Risk Management Guidelines will be issued to all licensed firms in late 2010

3. A liquidity and solvency standard

- 3.1 A capital adequacy structure for securities firms should cover both securities and non-securities activities and should address liquidity and solvency.
- 3.2 Lack of liquidity can cause difficulties for a firm because the firm may not be able to meet its liabilities as they fall due. Furthermore given the risks in the activities of securities firms, significant losses can materialise very quickly causing difficulties for a firm.

4. Minimum Requirements

- 4.1 It is appropriate to require firms wishing to enter the industry to demonstrate a level of commitment by requiring them to meet certain minimum capital requirements. These minimum requirements should not be uniform for all firms. While substantial minimum capital requirements are necessary to enhance confidence in the financial safety of the markets, a principal effect of a minimum requirement is that it also acts as a barrier to entry, too high a requirement could adversely effect competition in the marketplace. To address this concern, differential minimum capital requirements should be based on the type of business the firm will conduct. In general, higher minimum capital requirements should be imposed on firms that hold customer funds and securities.
- 4.2 Currently a one size fits all approach is taken as regards clearinghouse membership. However it has been deemed that the capital markets would best be served by only allowing appropriately capitalised firms access to the clearing company's clearing

Outline of a Draft Consultation Paper which could be issued by BSEC on New Risk Based Capital Adequacy (RBCA) Regime for Licensed Persons

guarantee. Risks in settlement should be supplemented by assessing required collateral deposits and eventually such a collateral process should be phased out and replaced by general guarantee fund deposits calculated in accordance with a clearinghouse member's recent clearing volumes.

- 4.3 Additionally it is proposed eventually to have in place a continuous net settlement process, with the buy-in of securities, which will be supported by the availability of a central stock lending and borrowing facility, as well as the development of an isolated trades system to ensure a safer clearing system.

5. Types of risks faced by securities firms

- 5.1 Capital adequacy should address the risks faced by securities firms. Some of these risks and how they can be measured for capital purposes are set forth below.

6. Position Risk (Market Risk)

- 6.1 Securities firms that trade as principal usually hold securities with a view to selling them in the near future at a profit. In others words, they are not in the business of holding securities as long term investments; their objective is to run a "trading book." Consequently, they must be in a position to withstand losses that could result from their trading activities. Position risk or market risk has various forms. There is the basic risk that the price of securities that the firm holds might fall or that the price of securities that comprise a short securities position of the firm might arise. Also, the risk of non-payment of principal and interest in debt issues must be considered.
- 6.2 There is also the risk associated with a position in a security that is large in relation to the total market for that security. In attempting to liquidate the position, the firm might experience a significant decline in the price of the security (or a significant increase if it is buying to cover a short position). Furthermore, the risk (concentration risk) relative to its capital that a firm experiences when it holds a large position in one issue or a number of different issues of a single issuer must be taken into account. Risk stemming from other activities, such as foreign currency forward and interest rate swap transactions and other off-balance sheet transactions, also must be addressed.
- 6.3 In order to measure the potential market risk one needs to gauge how much the price of a security might rise or fall in value. This requires a review of a number of factors:
- (a) the historical fluctuations in the market price of each type of issue;
 - (b) the nature of the issuer,
 - (c) the liquidity of the market for a security, and
 - (d) the ratings of recognised rating services which categorise debt securities as investment or non-investment grade.
- 6.4 The assessment of potential market risk should also take account of concentrated positions in one issue or in a number of issues of a single issuer, as well as risk reducing strategies firms may adopt to diminish concentration risk. Risk reducing

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strategies include offsetting long and short securities positions, hedged options and futures positions, as well as diversified equities portfolios.

- 6.5 The identification, assessment of risk and the risk reducing strategies adopted should be considered in determining the level of capital necessary to accommodate a given level of market or position risk.

7. Settlement/Counterparty Risk

- 7.1 The settlement risks faced by a firm depend in large part on the nature of the clearance and settlement systems in the various markets. In every system, firms will be exposed to the risk that their clients will renege on a transaction and also, in some systems to the risk that other market participants will renege. Some systems remove a large part of the risk between market participants through, for example, the simultaneous exchange of money and securities via book-entry transfer and/or the guarantee of settlement by the clearing house. However, if there is a clearing house guarantee, firms would still be collectively exposed where the risk of a member's default to the clearing house is, to some degree, shared by all clearing house members.
- 7.2 Another factor that varies from market to market is the extent to which settlement risks accumulate (i.e., the build-up of delivery obligations resulting from the failure of a securities firm to deliver securities on an agreed settlement date to the counterparty). In some markets contracts remain valid until settled, but settlement of outstanding contracts can be accelerated. A firm can buy-in securities that another firm has failed to deliver by the settlement date, in order to enable settlement to take place. On the other hand in other markets unilateral cancellation of a contract is permitted against the non-delivering firm after the settlement due date.
- 7.3 Clearly, requirements to cover settlement risks must reflect the nature of the risks in a particular market. Some of the risks that could be involved follows:

8. Price Movements

- 8.1 If a firm purchased securities and then sold them (with neither transaction having settled) and the price increased, the firm would be exposed to the risk that the original seller could default. Assume, for example that securities firm A sells to securities firm B, who in turn sells to securities firm C. If the price of the security rises and firm A fails to deliver the security and becomes insolvent, firm B must purchase the securities in the market at the higher price, without the ability to recover from insolvent firm A, because firm B is still liable to firm C. The risk in such a transaction, and indeed any transaction, is that a firm would have to meet the money difference between the contract price of a securities transaction and the subsequent market price if the counterparty did not settle. The price difference is measurable at any time.

9. Unsecured Claims and Free Deliveries

- 9.1 If a firm purchased securities from counterparty and paid for the securities prior to the counterparty's delivery of the securities, it would have an unsecured claim. The firm would be exposed to the risk of loss if the counterparty failed to deliver the securities. Likewise, if the firm delivers securities and has not been paid it would be exposed to

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risk of loss. The risk is clearly increased if the total unsecured claims or those with respect to one of the counterparties are large relative to a firm's capital.

10. Funding Costs

- 10.1 Even if the counterparty does not renege, the firm might incur additional funding or borrowing costs when delivery is delayed. A firm that bought and then sold securities could feel obliged because of business considerations to make delivery on the sale even though the firm from whom it purchased had not made delivery. To do so the firm might have to purchase or borrow securities in the market a day or two before it makes delivery on the sale. The firm would have to absorb the funding costs for carrying those positions.
- 10.2 Timing differences in settlement create other funding costs and risks. For example, where a firm has paid a counterparty upon receipt of securities, the firm may be unable to settle with the client until the next day or the following day. The firm would have to fund the transaction either by borrowing funds or using other funds in its possession. In either case, the firm will incur a cost either in terms of interest expense or the opportunity cost of uninvested funds. These costs, again depending on the system, can be large.
- 10.3 Cross border exposures are also a very important consideration. A firm might have to settle in the market in country A today, but either stock or money might not be available in country B for two to three days. Major differences in settlement cycles increase the problems caused by cross border trading. A move towards standard settlement cycles would be a helpful development in reducing these types of risks.
- 10.4 The exposure attributable to settlement related problems can be identified. In systems where contracts remain unsettled over long periods, time can be used as a rough proxy for the likelihood of default (i.e., the older outstanding contracts are likely to be at greater risk).
- 10.5 Effective requirements for reducing settlement risks include encouraging firms to settle promptly and facilitating more efficient clearance and settlement systems. More efficient clearance and settlement systems would reduce the risks to the financial system as a whole.

11. Other Risks

- 11.1 Firms face a myriad of other risks in the securities business. One such risk is execution errors that result from misunderstandings or negligence. For example, errors may result from misinterpretation (1) of instructions received from a client, (2) between the front office and the back office, or (3) in communicating instructions to third parties. Other common errors include the purchase or sale of an incorrect amount of securities, a sale intended as a purchase (or vice versa), and delays in executing a client order.
- 11.2 Some of the costs created are of an administrative nature, but there are also the costs of having to make good any transaction by buying or selling securities at the current market price and absorbing any loss incurred as a result of adverse price movements (i.e., the price difference). Trying to examine the prevalence of these

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mistakes can help assess the risk. This risk generally tends to increase in periods of heavy volume.

- 11.3 Other basic risks faced by securities firms are reduced revenues, increased expenses, increases in back office paperwork, and fraud. For example, an unexpected decrease in a firm's transaction volume may result in reduced income to the firm while expenses remain constant or increase. On the other hand, an unexpected growth in the firm's business may result in increased back office paperwork. This could strain a securities firm's capabilities causing recordkeeping and settlement problems. These are generally unmeasurable risks that need to be captured in a cushion of capital that is based on a firm's scale of activities.

12. Marking to Market

- 12.1 Marking to market is the process of adjusting the value of a security to reflect its fair value. For example, if a firm buys one share of common stock for 500 taka on day 1, and on day 2 the price drops to 450 taka/share, the firm must re-value the security for financial reporting purposes as a 450 taka asset. If on day 3, the price increases to taka 550/share, the firm must again re-value it, now as a 550 taka asset. This process will continue until the firm sells the security. Securities firms mark to market their proprietary securities, the securities they hold as collateral and the securities they have pledged as collateral. If the mark to market process indicates that the value of collateral held is less than the asset it is securing, they will request more collateral. Conversely, if it indicates that the value of collateral pledged is greater than the obligation it is securing, they will request a return of some of the collateral.

13. Recordkeeping and Reporting

- 13.1 Rules designed to establish capital adequacy standards are effective only to the extent that the securities firms records are adequate accurate, and current. Recordkeeping requirements should be designed to ensure that securities firms in their business records maintain standardised categories of information in a readily accessible format. This facilitates examination by supervisory authorities to assure that the securities firms are conducting their activities in compliance with the regulations and through which unlawful activities are detected.
- 13.2 Some of the records that should be required are records reflecting:
- (a) all purchases and sales of securities;
 - (b) customer and firm account information;
 - (c) all receipts and disbursements of cash and other debits and credits;
 - (d) all receipts and deliveries of securities;
 - (e) all assets, liabilities, income, expenses, and capital accounts;
 - (f) location and ownership of customer and firm securities;
 - (g) trial balances and net capital computations; and

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(h) Reporting and Examination Structure.

- 13.3 An effective capital adequacy structure should also include reporting requirements, which should be designed to provide supervisory authorities with information regarding the financial and operational health of securities firms and financial and operational problems being experienced by firms.
- 13.4 Securities firms should be required to file periodic reports with their supervisory authority so that the supervisory authority is aware of the firms' financial and operational condition. For example, monthly or more frequent reports could be required to be filed by a firm indicating its compliance with net capital requirements, profit or loss for the period, and firm positions. Detailed financial statements and capital adequacy computations should be filed on a reasonably frequent basis. The frequency and detail of the reports should depend on the type of business the firm conducts. Additionally, many countries require securities firms to obtain on an annual basis an audited financial report.
- 13.5 Securities firms should also be required to give supervisory authorities warning of financial or operational problems. For example, if a securities firm's capital falls below a "warning level" set by the supervisory authority, if it fails to have the required level of capital, or if it has books and records which are not current or accurate, prompt notice should be required to be given to a supervisory authority.
- 13.6 Finally, firms should be examined routinely and when possible problems exist by the supervisory authority for compliance with financial responsibility and recordkeeping requirements.

14. Approaches to Capital Adequacy

- 14.1 There are two major capital frameworks in place in the securities sector.

15. Capital Adequacy Directive

- 15.1 Within the EU countries, the Capital Adequacy Directive applies to both banks and investment firms and is essentially equivalent to the Basel Accord, although some jurisdictions apply additional requirements. The other primary approach to capital regulation in the securities sector is the net capital approach. Malaysia and the Philippines use a modified version of this approach.

16. Net Capital Approach

- 16.1 In the US, Canada, Australia, Hong Kong, Singapore, Japan, and other non-EU countries, capital requirements are based on liquidity or net capital.
- 16.2 This approach requires securities firms to maintain minimum levels of highly liquid assets sufficient to satisfy all obligations to customers and other market participants promptly. Such requirements also ensure the existence of a cushion against potential losses arising from market, credit and operational risks. Generally, these requirements apply only to the securities firm (i.e., not to the consolidated entity that includes the securities firm).

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- 16.3 Under the US net capital rule, securities firms determine their minimum liquid asset (or net capital) requirement by first calculating their net worth according to US generally accepted accounting principles. This includes valuing securities and other financial instruments at their market prices. The next step is to add certain subordinated liabilities to net worth and subtract illiquid assets, such as furniture, equipment, buildings, and the value of exchange seats. Generally, unsecured receivables are also deducted from net worth. The remaining assets consisting of cash, securities, foreign currencies, and other financial instruments comprise what is referred to as the firm's "tentative net capital." The final step is to deduct from the tentative net capital specified percentages of the market values of these financial assets, taking into account certain hedged positions. The amounts of these deductions known as "haircuts" are based on the liquidity of the given asset. The haircut-adjusted value of the tentative net capital constitutes a broker-dealer's actual net capital for purposes of the rule.
- 16.4 Once a firm has determined the amount of its actual net capital, it must compare that figure with its required minimum to determine whether it is in compliance with the rule. A firm's required minimum is the greater of two amounts. The first amount is specified in the rule based on the type of business a firm engages in. Generally, the second amount is a percentage of total liabilities including assessment of off balance sheet and "ranking liabilities". The percentage varies across jurisdictions with most developed markets at 5% and emerging markets, like China at 8%.

17. Liquidity

17.1 Net Liquid Assets

- 17.2 There are two different methods of addressing liquidity. In the larger markets, the standard, after the proposals announced by Japan, will be a net liquid assets test for securities firms. The objective of this test is that a firm should be able to wind down quickly its activities and repay all of its liabilities including the claims of other securities houses and customers. Under this requirement, which is a combined test of liquidity and solvency, a firm at all times must have liquid assets which exceed its total liabilities by a sufficient margin to cover the risks to the firm's net worth. Securities and commodities positions are marked to market daily, which prevents the securities firm from storing up losses that could lead ultimately to its failure or bankruptcy.
- 17.3 A key feature of the net liquid assets approach is that all intangible, non-marketable, and illiquid assets, such as goodwill and property, are deducted from capital. Most unsecured receivables are treated as illiquid assets; and therefore, are also deducted from capital.

18. Liquidity Risk

- 18.1 An alternative approach to the net liquid assets test is to treat liquidity as an additional risk faced by the firm. This has led some countries to set a ratio of liquid assets to short-term liabilities as part of a number of ratios linking the capital of the firm to the risks faced. For example, a firm could be required to hold liquid assets that exceeded the total of all liabilities with a maturity of less than one year. This would ensure that the firm had adequate day-to-day liquidity while it remained in business but it would not provide that the firm could meet all claims by customers and market

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counterparties. Countries that use this approach have separate solvency requirements. These solvency requirements are designed to provide that a firm has sufficient capital to cover the risks to its net worth. It is also important in this approach that securities and commodities positions are marked to market daily so that losses are not stored up.

19. Risk Based Approach

- 19.1 A risk based approach to capital adequacy involves developing a risk profile of a firm by identifying its financial activities and the risks to which these activities expose the firm. Once the risks are identified a risk assessment methodology is employed to measure that specific risk. In the securities industry these risks are generally, market risk, credit risk, liquidity risk. There are also operational and systems risks, as well as front and back office operational risk (which includes clearing and settlement risk) and legal risk.
- 19.2 Through the use of additional methodology and specific parameters that indicate the level of exposure the firm is willing to accept, capital adequacy requirements can be calculated.
- 19.3 The advantage of a risk based approach is that it provides firms with a level of capital appropriate to the amount of risk. Thus, the capital requirements are neither too severe which would increase costs for the firms and affect their efficiency, nor too slack, which would enable firms to run excessive risks relative to their capital and leave the markets vulnerable to participant default.

20. Definition of Capital

- 20.1 The definition of capital is crucial since it directly affects the efficiency of the capital standard. Some regulatory regimes with capital requirements closely tied to the risks associated with a securities firm's business allow firms to use both short-term and long-term subordinated loans in addition to owners' equity as capital to cover these risks. Some countries also make some allowances for bank guarantees as a substitute for capital. This enables a firm to meet its fluctuating risks; and if a firm were to fail, the subordinated loans or funds, which provide guarantees, would be used to meet the claims on the firm by customers or counterparties.
- 20.2 Subordinated loans are permanent capital in the sense that repayment to the lender is not allowed if it would result in a firm's capital falling below a threshold higher than its required capital. In all regulatory systems, though, the degree to which these forms of capital or substitutes for capital can be used is limited relative to owner's equity. Some systems however do not make allowances for subordinated loans or guarantees.
- 20.3 For securities firms subject to net capital rules, the list of eligible capital elements is generally much shorter than for banks and insurance firms. For example, under the net capital framework for US securities firms, capital consists of net worth (i.e., ownership equity and preferred stock that is not maturing within a year) plus certain subordinated liabilities. The balance sheets of these firms do not contain any hidden or undisclosed reserves that must be taken into consideration. Subordinated loans are added back to net worth only if certain conditions are met, including that the term

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of the loan exceeds one year and that the loan documentation clearly provides that the lender's claim against the firm is legally subordinated to those of other creditors.

21. Definitions of Capital in the Bangladesh capital market Context

Fund Managers, Brokers and Broker Dealers

21.1 Net Capital = Assets-Liabilities or Share capital + Reserves + Approved Subordinated debt

21.2 Net capital is defined in accordance with generally accepted accounting principals and is the assets of the firm less its on balance sheet liabilities. This is represented by the share capital and reserves of the firm. Approved subordinated debt will also rank as share capital.

21.3 RBCA = Liquid Assets [discounted by haircuts] – {On Balance Sheet Liabilities + Risk associated with Off Balance Sheet Ranking Liabilities}

21.4 RBCA is defined as liquid assets which have been adjusted by an appropriate haircut (note: fixed assets, related party amounts due to the firm, long term assets, deferred expenditure and intangibles are not counted as liquid assets) less, all liabilities, including off balance sheet liabilities and contingencies.

21.5 RBCA shall be maintained at a minimum required level or to a level defined for each category of intermediary. For example, stockbrokers will have to maintain an RBCA of 30 million taka or **8% of on balance sheet** and off balance sheet (**ranking liabilities**) whichever is the higher.

Investment Banks

$$\text{Capital Adequacy Ratio (CAR)} = \frac{\text{Liquid Capital (LC)}}{\text{Total Risk Requirement (TRR)}}$$

The ratio linking the merchant Bank's Liquid Capital to Total Risk Requirement

Minimum capital Requirement: Capital Adequacy Ratio > 1.20 times

Components of Capital:

21.6 The Components of capital shall be divided into two parts as follows:

A) Core Capital

B) Supplementary Capital

Whereas Total Capital = Core Capital + Supplementary Capital

Total Risk Requirement (TRR) = Operation Risk Requirement (ORR) + Position Risk Requirement (PRR) + Counterparty Risk Requirement (CRR) + Underwriting Risk Requirement (URR) + Large Exposure Risk Requirement (LERR)

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To ensure proper Risk Management of Merchant Bank the following will be mandated:

1. **Credit Risk Management:** For effective credit risk management Introduction of exposure limit is required as following:
 - (i) Clients' Portfolio should be diversified minimum across three scrips and two sectors. Single stock holding should not be allowed.
 - (ii) Single borrower exposure limit may be set at maximum 10% of total equity of the Merchant Bank or Tk. 5.0 crore, whichever is lower.
 - (iii) Exposure to a single scrip under any client portfolio should not be higher than 15% of the Equity of the Merchant Bank or 10% of the paid up capital of the issuer.
 - (iv) Market value of a single industry holding should not be higher than 33% of the assets under discretionary account and own portfolio of the Merchant Bank.
2. **Proprietary desk limit:** The amount injected for proprietary fund management plus maximum 25% of the balance equity of the Merchant Bank.
3. **Margin facility for highly volatile securities:** Margin facility would not be given to highly volatile securities, measures like standard deviation of close price may be used for calculating volatility.
4. **Management of Non-performing loan (NPL):** Merchant Bank may set gearing ratio for the counterparty which will be calculated on MTM basis
5. **Ineffective Collateral System:** No collateral security should be required for accounts availing margin loan facility. Rather it should be ensured that Portfolio Managers will strictly maintain margin ratio by collecting additional margin deposit or by ensuring forced sell, it is to be made mandatory. However, for single client large exposure limit, the merchant bank may introduce financial collateral under its own jurisdictions.
6. **Introduction of Unique Identification Number (UIN):** The Commission may introduce UIN for all BO account holder under the supervision of CDBL to open any account.
7. **Introduction of client Assessment Process:** Merchant Bank should conduct a client assessment before lending Tk. 1.0 crore and above. Clients having taka 5 lac or below should not be allowed to open margin trading account in Merchant Bank.
8. **Fixed Sanctioned Limit vs. Ratio based loan:** There should be a fixed sanctioned limit for margin loan. Ratio based loan creates market bubble.
9. **Conditions in the Margin Agreement:** Length of contract – There can be a one year tenor for margin agreement. However, Merchant Bank must confirm

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the client about the renewal or continuation of financing or termination of contact. There should have a clause regarding set off/write off during shortfall in the margin account: (Mentionable here that If MTM is implemented this clause may not be required).

Market Risk Management

10. **Mark to Market Valuation (MTM):** Mark-to-Market should start when equity/debt (E/D) ratio of a client falls below 50%. If in a given day, clients' E/D ratio falls to 48%, he/she will have to deposit fund or sell a portion of the portfolio to raise the E/D ratio to 50%. In this regard a notice period of at least 3 days required to adjust.
11. **Approach towards Trigger Sell:** If MTM is implemented, Trigger Sell won't be required. The prevailing concept of Trigger Sell means liquidating the entire portfolio of a client. Contrary to that, MTM asks for daily basis gradual adjustment.

Liquidity Risk - Investment in illiquid scrip using margin:

Operational Risk Management

12. **Effect of Double Limit (both cash and share limit) due to lack of API:** Currently all the stock exchanges are not providing Application Protocol Interfaces (APIs). As such, it is required to upload cash limit and share limit separately in both the exchanges as panel brokers have seat in both the bourses. This opens the gate for operational risk like double execution or execution beyond limit.
13. **Separation of back office and front office:** In any trading environment, separation of back office (who provides support service) and front office (staffs who has business target to achieve) is an ideal setup.
14. **Disaster recovery plan:** This is another standard process enforced globally. Client data should be protected against risks of earthquake, fire, war and other acts of God. Client service should be seamless irrespective of any disaster. Remote distance is preferable to save the documents.
15. **Obtaining Client Order in case of electronic transactions including Internet Trading:** The market expectation is to preserve order book for all clients. It's originated from the practices of the brokerage houses.
16. **Reconciliation of DP shareholding vs. back office software of the merchant banks** is to be performed at least once in a month to avoid operational risk.

Legal Risk Management

17. **No Access to Artha Rin Adalat:** Merchant Banks do not have access to Artha Rin Adalat. They do not have any other recourse other than the shares under lien. However, if MTM is introduced, access to Artha Rin Adalat will not be required.

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18. Mandatory maintenance margin: Maintenance Margin is an “optional” action item as per Securities and Exchange Commission (Merchant Bankers and Portfolio Manager) Rules, 1996 though it is mandatory for brokers in Bangladesh. In India and Sri Lanka, maintaining adequate margin is a responsibility of the lender. Indian laws even ask for fine if the lender is unable to collect margin or maintain appropriate margin.

Governance Risk

19. Inadequate Internal Control System: Introduction of Internal Audit Department is vital in each Merchant Bank.

20. Introduction of Audit/Risk Committee: Each Merchant Bank should have a Audit/Risk Committee with a TOR to look after the risk management and compliance issues.

Recommendation for Investment Banks

Proposed Regulatory Capital Requirement (RCR)

| Existing Framework | Proposed Entry Capital | Rationale |
|-------------------------------|---|--|
| Tk. 5 crore (Base Capital) | As AMC : Tk. 10 crore (Base Capital) | Considering the present initial set-up cost, financial soundness and other contingency requirement to support the operation smoothly |
| | As Sponsor : Additional Capital required to be injected over the Base Capital or net worth must be above Tk. 10.00 crore to support the Sponsorship requirement | To be a Sponsor of a Fund, minimum 10% of the Fund size is required to subscribe by the Sponsor |
| | As Portfolio Manager (Institutional Fund Management): Minimum additional Tk.2 crore required to inject above the Base Capital requirement Note : AMC should not be a margin loan provider albeit it act as Portfolio Manager | A Merchant Bank has to inject Tk. 12.5 crore to be a Portfolio Manager. |

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Proposed Capital Adequacy Regime under Continuous Assessment Process

- 21.7 The Components of capital shall be divided into two parts which are as follows:

A) Core Capital and

B) Supplementary Capital

Each AMC shall ensure that –

Its Total Capital is at all times 1.25 times greater than its Total Risk Requirement

Its Core Capital is at all times greater than its Operational Risk Requirement

Supplementary capital will get capital treatment upto 2 times of Core capital

Whereas Total Capital = Core Capital + Supplementary Capital

And Total Risk Requirement = Operation Risk Requirement + Proprietary Position Risk Requirement + Institutional Fund Management Risk Requirement + Commitment Risk Requirement

- 21.8 Control over fund account in case of Fund Management: Settlement obligation and control over fund account may be fully on a custodian bank.

Approved Subordinated Debt

- 21.9 BSEC will allow the inclusion of appropriately approved subordinated debt and/or redeemable preference shares as capital. BSEC believes this form of capital will assist coverage for exposures to short term underwriting commitments or large on market transactions being undertaken on behalf of clients.

Ranking Liabilities

- 21.10 Off balance sheet risks and contingent liabilities are known as **ranking liabilities**.
- 21.11 Risks associated with concentrated positions are also deemed ranking liabilities.
- 21.12 **Ranking liabilities** will count as liabilities according to a formula to be agreed to by the BSEC and published to licensed persons on a regular basis. Proposed inclusions, together with calculations are set out in Annexure 3.

Marketability of Assets and Haircuts

- 21.13 Assets such as utility deposits, prepaid expenses and deferred tax assets as well as intangible assets such as goodwill or the value of operating licences will not be counted in the value of liquid assets.

House Positions

- 21.14 House positions (debt and equity), as well as deposits, in the form of government securities, placed to cover broker exposure will also be subject to haircuts. Haircuts will vary by security type and maturity.

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Customer amounts due greater than T+15 and T+30

- 21.15 Where customer funds are past 15 days due the receivable will be reduced to the market value of scrip held less an appropriate the haircut percentage. Debtors >30 days will have no value attributable to them.

Proposed Haircuts by Asset type

- 21.16 The following table sets out the proposed “haircut to be applied to asset types:

| Asset | RBCA |
|--|-------------|
| Cash in Hand | 0.0% |
| Cash at Bank in Company's account | 0.0% |
| Cash at Bank accounts for clients (segregated) | 0.0% |
| Cash deposits with Nairobi Stock Exchange | 25.0% |
| Cash deposits with CDSC | 100.0% |
| Cash deposits with BSEC | 100.0% |
| Cash at Bank other accounts | 0.0% |
| Amounts receivable from exchange and clearing houses | 0.0% |
| NSE | 25.0% |
| CDSC deposit | 100.0% |
| Amounts Receivable Securities Trading | 0.0% |
| Amount receivable from clients <T+4 | 0.0% |
| Amount receivable from clients >T+4<T+15 | 15.0% |
| Amount receivable from clients >T+30 | 50.0% |
| Amount receivable from agents | 100.0% |
| Securities purchased for clients | 75.0% |
| Amounts paid in advance for subs of securities - IPOs | 100.0% |
| Amounts receivable from securities dealers arising from dealing in securities | 0.0% |
| Amounts receivable arising from dealing in futures or options contracts (Spare - not used) | 0.0% |
| Amounts receivable from margin clients (Note 5) | 0.0% |
| Amounts receivable from licensed corporations licensed for securities margin financing | 0.0% |
| Proprietary positions in securities and specified investments | 100.0% |
| Proprietary positions in Derivatives | 100.0% |
| Spare Account | 100.0% |
| Current Portion Lending Products (after DD reserves) | |
| Property and Other finance provided | 25.0% |

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| Asset | RBCA |
|---|-------------|
| Long Term Finance | 25.0% |
| <u>Other assets arising from</u> | |
| Advisory Fees | 5.0% |
| Prepaid expenses and security deposits | 100.0% |
| Other investments | 50.0% |
| Investments in Associated undertakings | 100.0% |
| Subsidiaries | 100.0% |
| Associated Companies | 100.0% |
| Directors & Staff | 100.0% |
| Other | 100.0% |
| <u>HOUSE POSITIONS</u> | |
| Treasury Securities | 5.00% |
| Government Bonds | 10.00% |
| Listed TFC | 15.00% |
| Unlisted TFC | 30.00% |
| Other Fixed Interest Securities | 30.00% |
| Unlisted Securities | 50.00% |
| Listed Securities (Not included in NSE index) | 30.00% |
| Listed Securities (included in NSE index) | 15.00% |
| Listed Mutual Funds | 40.00% |

22. Quantitative Impact Study

- 22.1 The BSEC based on the xxxx financial statements of DSE & CSE members has undertaken a quantitative study of the impact on firms of the new RBCA requirements. 25 firms were included in the study. As at xxx the major assets of the consolidated position of the industry was as follows:

| Asset Class | Tk |
|--|-----------|
| Bank balances | |
| Amounts receivable from exchange and clearing houses | |
| Amounts Receivable Securities Trading | |
| Other assets arising from non-trading activities | |
| Long Term Lending | |
| Intangible Assets | |
| Long Term Assets | |
| Total assets | |

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- 22.2 Less than x% of assets were held in short term cash or debtors and securities arising from dealing and applying the above haircut table resulted in a Liquid asset calculation of Tk xxx billion. The resultant deficiency of capital based on the higher of xx million liquid capital or 8% of liabilities applied on a firm by firm basis, resulted in yy of zz firms exhibiting sufficient capital and the overall deficiency being 632 million.

23. Proposed Capital requirements

- 23.1 It is proposed that in January 201X the paid in capital for licensed entities is to be increased as follows:

- (i) Stockbrokers from Tk x million to Tk yy million
- (ii) Investment Banks from Tk x million to Tk yyy million

- 23.2 Shareholders' funds will have to be maintained above paid in capital levels.

- 23.3 As from xxxx it is proposed that the minimum net liquid capital requirement both stockbrokers and investment banks will be the higher of Tk xx million or 8% of on and off balance sheet ranking liabilities. It is noted that the variable required liquid capital will be equal to 8% of total all on balance sheet and off balance sheet liabilities. This will mean that recognition is being given to the overall level of both customer liabilities and other liabilities payable by the firm. The higher the level of liabilities the greater the required liquid capital.

- 23.4 The liquid capital requirement at the higher of Tk xx million or 8% of liabilities is independent of the new paid in capital requirement commencing 201x.

- 23.5 The proposed capital requirements can be summarised as follows:

| Category | Existing Capital | DSE | CSE | Both | Rationale |
|---|-------------------------------|---|--|--|--|
| General Stock Broker (RT)/ Stock Dealer | Tk. 25.00 lac for all segment | Tk.40.00 ml (Single) or 50.00 ml (Dual) | Tk.40.00 ml(Single) or 50.00 ml (Dual) | Tk.60.00 ml Single) or 70.00 ml (Dual) | Only For the First Year of operation |
| +/- General Broker (either as WT and FT) | | + 40.00 ml | + 40.00 ml | + 60.00 ml | Requires to bear high risk of settlement |
| + Stock Dealer | | + 20.00 ml | + 20.00 ml | +20.00 ml | Should support through own capital |
| +/- Margin Provider (MP) | | + 50.00 ml | + 50.00 ml | +60.00 ml | To reduce dependency on bank financing |
| Full Fledged | | 100.00 ml | 100.00 ml | 150.00 ml | In lieu of 190 ml it |

Outline of a Draft Consultation Paper which could be issued by BSEC on New Risk Based Capital Adequacy (RBCA) Regime for Licensed Persons

| | | | | | |
|-----------------------------------|--|---------------------------------------|---------------|---------------|---|
| Stock Broker (SB+MP+D) | | (single slot) | (single slot) | (single slot) | requires 150 ml for both |
| DP with Full Fledged Stock Broker | | For DP Role not suggested any capital | | | After setting-up clearing corporation DP may be cancelled |

24. RBCA Reporting timeframe

- 24.1 It is proposed that proforma returns will be completed for xxxx yyyy and that from zzzz proforma monthly returns will be required.
- 24.2 The aim will be to achieve the introduction of new monthly RBCA reporting as the BSEC develops its internal computer systems and databases to accommodate the shift to full monthly reporting.
- 24.3 The BSEC has commenced this process and will have the requisite systems by late zzzz.
- 24.4 Full formal implementation will occur by qqqqq.

25. Supporting Financial resources Rules

- 25.1 The BSEC will issue and promulgate a set of “**FINANCIAL RESOURCES RULES**” that provide the definitions, treatment of asset classes, the haircuts applicable, treatment of off balance sheet items and the formal reporting and monitoring regulations. These are envisaged to be formally issued by the commencement of full RBCA reporting in 201x.
- 25.2 The BSEC will also develop proposals and rules for the introduction of approved subordinated debt.
- 25.3 Until the new rules are put in place pro-forma returns mentioned above will be based on the draft proposed rules that BSEC will issue after consideration of industry feedback from this consultation process.

26. RBCA Monitoring by BSEC

- 26.1 In order to gain confidence in the new capital requirements and reporting regime, BSEC will require that a licensed person reports any breach of RBCA requirements immediately and where the RBCA comes within 120% of its requirement by the next day. Accountants will be required to undertake random checks (Dates determined by BSEC) that RBCA continues to be calculated on an ongoing basis and that no breaches have occurred for the random dates selected in the RBCA calculations.

27. Comments on this Consultation Paper

- 27.1 Interested parties are invited to comment on this paper. BSEC would like answers to the following:

Outline of a Draft Consultation Paper which could be issued by BSEC on New Risk Based Capital Adequacy (RBCA) Regime for Licensed Persons

- (a) Is the move to a RBCA regime welcomed?
- (b) Do you agree that the risk inherent in off balance sheet liabilities needs to be included in RBCA calculations as ranking Liabilities?
- (c) Comment on the split being made between Net Capital and required liquid capital?
- (d) Do you think the base Paid in Capital requirement is set at the right level?
- (e) Do you think the base liquid capital requirements are set at the right levels?
- (f) Is 8% of liabilities too much or a sufficient level of liquid capital?
- (g) Are the proposed asset haircuts set at the right level?
- (h) Should Fixed Assets, Long term investments, utility deposits, amounts due from associated companies, prepaid expenses, deferred and recoverable taxes and intangibles be excluded from liquid assets? If not why?
- (i) Ranking Liabilities -Should a percentage of guarantees, liabilities arising from repos and other off balance sheet liabilities be added to liabilities for the purpose of liquid asset calculations?
- (j) Is the concept of approved subordinated debt being included in capital likely to be used by your firm?
- (k) Is monthly reporting appropriate for the new RBCA regime?
- (l) Do you have any other comments on the proposals outlined in this paper?

Outline of a Draft Consultation Paper which could be issued by BSEC on New Risk Based Capital Adequacy (RBCA) Regime for Licensed Persons

Annexure 1: Proposed RBCA return

| Balance Sheet Input | Value | | |
|---|-------|--------------------|--|
| Assets | | | |
| Bank balances | | | |
| Cash in Hand | | | |
| Cash at Bank in Company's account | | | |
| Cash at Bank accounts for clients (segregated) | | | |
| Cash deposits with Nairobi Stock Exchange | | | |
| Cash deposits with CDSC | | | |
| Cash deposits with BSEC | | | |
| Cash at Bank other accounts and short term deposits | | | |
| Amounts receivable from exchange and clearing houses | | | |
| NSE | | | |
| CDSC non clearing | | | |
| Spare Account | | | |
| Amounts Receivable Securities Trading | | | |
| Amount receivable from clients T-15 days | | | |
| Amount receivable from clients >15 <30 days | | | |
| Amount receivable from clients >30 | | Mkt Val Scrip Held | |
| Amount receivable from agents | | | |
| Securities purchased for clients | | Mkt Val Scrip Held | |
| Amounts paid in advance for subs of securities - IPOs | | | |
| Amounts receivable from securities dealers arising from dealing in securities | | | |
| Amounts receivable arising from dealing in futures or options contracts (Spare - not used) | | | |
| Amounts receivable from margin clients (Note 5) | 0 | | |
| Amounts receivable from licensed corporations licensed for securities margin financing | | | |
| Proprietary positions in securities and specified investments | 0 | | |
| Proprietary positions in Derivatives | 0 | | |
| Spare Account | | | |
| Current Portion Lending Products (after DD reserves) | | | |
| Hire purchase | | | |
| Leasing | | | |
| Property and Other finance provided | | | |

Outline of a Draft Consultation Paper which could be issued by BSEC on New Risk Based Capital Adequacy (RBCA) Regime for Licensed Persons

| Balance Sheet Input | Value | | |
|---|--------------|--|--|
| Long Term Finance | | | |
| Other assets arising from | | | |
| Advisory Fees | | | |
| Prepaid expenses and security deposits | | | |
| Other investments-current income tax recoverable | | | |
| Investments in Associated undertakings | 0 | | |
| Subsidiaries | | | |
| Associated Companies | | | |
| Directors & Staff | | | |
| Other associated persons or entities | | | |
| Other Spare Account | | | |
| Other Spare Account | | | |
| Total liquid assets | | | |
| Fixed assets (after Deprec.) | | | |
| Long Term Portion Lending Products (after DD reserves) | | | |
| Hire purchase | | | |
| Leasing | | | |
| Property and Other finance provided | | | |
| Intangible Assets | | | |
| NSE Seat | | | |
| Goodwill, Patents and other Intangible Assets | | | |
| Deferred Cost expenditure | | | |
| Deferred Tax and current tax recoverable | | | |
| Long Term Finance Provided | | | |
| Long Term Assets | | | |
| Long term asset- unquoted equity investment | | | |
| Long Term Investments | | | |
| Long Term Prepayments & Deposits | | | |
| Other | | | |
| Total assets | 0 | | |
| | | | |
| Liabilities | | | |
| Short positions in securities and specified investments held for own account | | | |
| Short Term Brokerage Business Liabilities: | | | |
| Payments to CDSC (non clearing) | | | |
| Payments due to NSE | | | |

Outline of a Draft Consultation Paper which could be issued by BSEC on New Risk Based Capital Adequacy (RBCA) Regime for Licensed Persons

| Balance Sheet Input | Value | | |
|---|--------------|---|---------------------------|
| Payable to Agents | | | |
| Payable to Clients | | | |
| Bank Overdrafts | | | |
| Running Finance from NBFCs | | | |
| Margin Financing from Banks | | | |
| Amounts payable to securities dealers arising from provision of securities margin financing to clients | | | |
| Associated Companies and Persons | | | |
| Amounts payable to clearing houses | | | |
| CDSC | | | |
| NSE | | | |
| Spare Account- preference shares | | | |
| Other Current Liabilities | | | |
| Accruals, amounts payable and other liabilities other than approved subordinated loan | | | |
| Deferred tax and other differ liabilities | | | |
| Amounts payable to licensed corporations licensed for securities margin financing and other securities dealers in respect of dealing in securities | | | |
| Provisions for contingent liabilities and floating losses | | | |
| Ranking liabilities relating to | | | Ranking percentage |
| gearing adjustment in respect of securities margin financing | | | 10% |
| concentration of margin clients | | | 10% |
| short selling of Securities on behalf of clients | | | 20% |
| increase in amounts in respect of short positions for own account | | | 20% |
| concentrated proprietary positions | | | 30% |
| securities borrowing and lending | | | 15% |
| net underwriting commitments | | | 50% |
| off-exchange traded derivative contracts and interest rate swap agreements | | | 5% |
| guarantees and other financial commitments | | | 15% |
| foreign exchange agreements and foreign currency positions | | | 5% |
| Repos | | 0 | 30% |
| miscellaneous ranking liabilities | | | 30% |
| Total liabilities (aggregate of amounts in items 26 to 32) | 0 | | |
| Redeemable shares (other than approved redeemable shares) | | | |

Outline of a Draft Consultation Paper which could be issued by BSEC on New Risk Based Capital Adequacy (RBCA) Regime for Licensed Persons

| Balance Sheet Input | Value | | |
|---|--------------|--|--|
| Total incl. ranking liabilities | | | |
| Liquid capital | | | |
| Required liquid capital - Max of: | | | |
| 8% of Liabilities | | | |
| Minimum | | | |
| Excess liquid capital/(Required liquid capital deficit) | | | |
| Shareholders' funds | 0 | | |
| Analysis of shareholders' funds | | | |
| Paid-up share capital | | | |
| Retained profits/(accumulated losses) | | | |
| Other reserves | | | |
| Amounts included in B/Sheet | 0 | | |
| Cross check Balance Sheet | 0 | | |
| Cross check P&L | 0 | | |

| House Positions | Held | Repo'd | Total | Haircut | | |
|--|-------------|---------------|--------------|----------------|-------|---|
| Treasury Securities | | | 0 | 5.0% | 95.0% | 0 |
| Government Bonds | | | 0 | 10.0% | 90.0% | 0 |
| Listed TFC | | | 0 | 15.0% | 85.0% | 0 |
| Unlisted TFC | | | 0 | 30.0% | 70.0% | 0 |
| Other Fixed Interest Securities | | | 0 | 30.0% | 70.0% | 0 |
| Unlisted Securities | | | 0 | 50.0% | 50.0% | 0 |
| Listed Securities (Not included in NSE 20 index) | | | 0 | 30.0% | 70.0% | 0 |
| Listed Securities (included in NSE 20 index) | | | 0 | 15.0% | 85.0% | 0 |
| Mutual Funds or CIS Investment Trusts | | | 0 | 40.0% | 60.0% | 0 |

Outline of a Draft Consultation Paper which could be issued by BSEC on New Risk Based Capital Adequacy (RBCA) Regime for Licensed Persons

| PROFIT AND LOSS ACCOUNT FOR PERIOD ENDED | | |
|---|---------------|--------------|
| | Current month | Year-to-date |
| TURNOVER | | |
| Total value of transactions in securities dealing | | |
| - own account | | |
| - client account | | |
| | 0 | 0 |
| Total number of contracts of dealing in futures and options contracts | | |
| - own account | | |
| - client account | | |
| | 0 | 0 |
| Other dealing | | |
| Securities dealing: | | |
| Commission income | | |
| Less: Commission paid (Note 3) | | |
| Sub-total (A) | 0 | 0 |
| Futures and options dealing: | | |
| Commission income | | |
| Less: Commission paid (Note 3) | | |
| Sub-total (B) | 0 | 0 |
| Other dealing | | |
| Commission income | | |
| Less: Commission paid (Note 3) | | |
| Sub-total (C) | 0 | 0 |
| Trading profit and loss: | | |
| - in securities | | |
| - in futures and options contracts | | |
| - in other trading | | |
| - in other foreign exchange trading | | |
| - in OTC derivatives trading | | |
| - others (please specify) (Note 4) | | |
| | | |
| Sub-total (D) | 0 | 0 |
| Income arising from: | | |
| - underwriting | | |
| - advising on securities and/or futures contracts | | |

Outline of a Draft Consultation Paper which could be issued by BSEC on New Risk Based Capital Adequacy (RBCA) Regime for Licensed Persons

| | | |
|--|----------|----------|
| - advising on corporate finance | | |
| - provision of automated trading services | | |
| - asset management | | |
| - management fees charged on group companies | | |
| - others (please specify if material) (Note 4) | | |
| <input type="text"/> | | |
| Sub-total (E) | 0 | 0 |
| Total income (F) = (A) + (B) + (C) + (D) + (E) | 0 | 0 |
| Interest income/expense | | |
| Interest income received (Note 5) | | |
| Less: Interest expense paid (Note 5) | | |
| Sub-total (G) | 0 | 0 |
| Overheads | | |
| - salary and staff benefits | | |
| - office rental and utilities | | |
| - depreciation | | |
| - legal and professional expenses | | |
| - provision for bad & doubtful debts | | |
| - management fees charged by group companies or other related parties | | |
| - others (please specify if material) (Note 4) | | |
| <input type="text"/> | | |
| Sub-total (H) | 0 | 0 |
| Net profit/(loss) before tax (I) = (F) + (G) - (H) | 0 | 0 |
| Less: Taxation (J) | | |
| Net profit/(loss) after tax (K) = (I) - (J) | 0 | 0 |
| Retained profits/(accumulated losses) at the beginning of the period (L) | | |
| Less: Dividend declared during the period (M) | | |
| Retained profits/(accumulated losses) at the end of the period (N) = (K) + (L) - (M) (Note 6) | 0 | 0 |

Outline of a Draft Consultation Paper which could be issued by BSEC on New Risk Based Capital Adequacy (RBCA) Regime for Licensed Persons

Annexure 2: Guide to Ranking Liabilities

Concept is to increase the liabilities and make such an increase subject to the 8% liquid capital calculation.

For example if a bank guarantee has been provided to a commercial bank to cover a client's off balance sheet dealing, say, for Tk 20 million then a percentage of that commitment is added back to the on Balance Sheet liabilities. This percentage is determined at the BSEC's discretion. The RBCA input form sets this at 15% currently. So in this example 3 million is added to liabilities and 8% liquid capital increased by 8% times 15% or Tk 240,000

Similar calculations are provided as follows:

| <u>Off Balance Sheet or other Activity</u> | <u>% included as Liabilities</u> | <u>comments</u> |
|--|---|--|
| 1. Operational Risk | 20% of amount | Annual revenues |
| 2. gearing adjustment in respect of securities margin financing | 30% of amount | If borrowings from finance sources >80% then add 30% of amount in excess of 80% |
| 3. concentration of margin clients | 10% of amount | Add 10% of >10% of portfolio held by any client |
| 4. short selling of securities on behalf of clients | 20% of amount | |
| 5. increase in amounts in respect of short positions for own account | 20% of amount | |
| 6. concentrated proprietary positions | 30% of amount | If the net market value (NMV) of any single item of securities or investments equals 30% or more of required liquid capital (RLC), shall include in ranking liabilities 30% of the NMV |
| 7. securities borrowing and lending and repurchase transactions | 15% | Add back 15% of repo'd amounts outstanding |

Outline of a Draft Consultation Paper which could be issued by BSEC on New Risk Based Capital Adequacy (RBCA) Regime for Licensed Persons

| <u>Off Balance Sheet or other Activity</u> | <u>% included as Liabilities</u> | <u>comments</u> |
|---|---|--|
| 8. net underwriting commitments | 50% | Add back 50% of outstanding IPO commitments |
| 9. off-exchange traded derivative contracts and interest rate swap agreements | 5% | Add back 5% of notional value of swaps |
| 10. guarantees and other financial commitments | 15% | 15% of gross amounts guaranteed |
| 11. foreign exchange agreements and foreign currency positions | 5% | Add back 5% of gross foreign currency exposure |
| 12. miscellaneous ranking liabilities | Variable % depending on nature | % estimated as required |

**Appendix 1.9: Draft Submission for BSEC to pass to ADB: Risk Based
Regulatory System and Enterprise Resource Planning
System for Bangladesh Securities and Exchange
Commission (November 2014)**



বাংলাদেশ সিকিউরিটিজ অ্যান্ড এক্সচেঞ্জ কমিশন
Bangladesh Securities and Exchange Commission

ADB TA-8228 BAN: Enhancing Efficiency of the Capital Market

**DRAFT SUBMISSION FOR BSEC TO PASS TO ADB
RISK BASED REGULATORY SYSTEM AND ENTERPRISE
RESOURCE PLANNING SYSTEM FOR BANGLADESH
SECURITIES AND EXCHANGE COMMISSION (BSEC)**

November 2014



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Risk Based Regulatory System and Enterprise Resource Planning System for Bangladesh Securities and Exchange Commission (BSEC)

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Risk Based Regulatory System and Enterprise Resource Planning System for Bangladesh Securities and Exchange Commission (BSEC)

DRAFT SUBMISSION FOR BSEC TO PASS TO ADB

**Risk Based Regulatory System and Enterprise Resource Planning
System for the Bangladesh Securities and Exchange Commission**

Background

1. Regulatory agencies in emerging markets require a computer system development strategy that supports its basic approach to regulation.
2. The BSEC is at present largely a paper based system with some Microsoft PC utilization. Plans are to expand the BSEC rapidly over the next 10 years, with new premises and a four to fivefold increase in staff.
3. There is seen a very large potential for productivity gains from the use of appropriate technology and the development of simple incremental regulatory support systems might enable a sizable reduction in the planned human resources proposed if a proper system solution is implemented from an early date.
4. BSEC is developing and implementing a supervisory framework based on Risk Based Supervision (RBS).
5. BSEC needs a system solution to support its RBS objectives that is straight forward, provides an efficient system solution and provides the necessary tools to support RBS, as well as, a solution that can be implemented at least cost.
6. Such a system in order to minimise its cost should utilize where possible already proven risk based regulatory systems that have been implemented in emerging market jurisdictions in recent years. Utilisation of “open” source solutions should be sought to further reduce on-going maintenance costs.
7. BSEC does not have sufficient internal resources to undertake the specification development and rollout of the required systems.
8. BSEC has already announced its new premises are under construction and ambitious plans to expand and attract new staff a staffing plan and new organization is before government. The new premises, which will require extensive computerisation is planned for early 2016.

Risk Based Regulatory System and Enterprise Resource Planning System for Bangladesh Securities and Exchange Commission (BSEC)

9. These plans will be very difficult to implement unless new hardware and software supporting the BSEC's RBS ambitions are available.
10. To solve the dilemma facing BSEC it is seeking support from ADB to assist it develop the appropriate systems to support its risk based supervisory objectives.

The basic systems requirements

11. The basis systems requirements that BSEC needs are:
 - a. A core database of entities, people and instruments all of which can be related to each other;
 - b. A Licensing system to manage and cross connect the entities, people and instruments;
 - c. A Document collection and management system to link each document to the relevant entity, person or instrument;
 - d. A risk based regulatory assessment and monitoring system related to licensing, inspections and capital adequacy monitoring;
 - e. A case management system to record and track complaints, inspections and inquires involving entities, people and instruments;
 - f. An automated process of sending notices and reminders to the relevant regulator staff and/or regulated entities and people;
 - g. A data collection, storage, analysis and reporting system for financial data for licensed entities including data on collective investment schemes;
 - h. Regulatory reporting and MIS system incorporating market data from securities and derivative exchange activities;
 - i. Data Exchange Portal on BSEC Website (which need modernisation);
 - j. Efficient and modern email system (current BSEC email is not of adequate quality); and
 - k. Linkages to exchange systems, Trapets Surveillance System, and CDBL.

Key systems objectives

12. The key systems of objectives are:
 - a. Combine the benefits of an enterprise resource planning system with a risk based regulatory system;
 - b. Reduce time taken to prepare data outputs and analysis;
 - c. Enable registration for individuals and corporate entities, and license renewal
 - d. Facilitate corporate notifications;

Risk Based Regulatory System and Enterprise Resource Planning System for Bangladesh Securities and Exchange Commission (BSEC)

- e. Improve off-site and on-site supervision and the oversight of exchanges, clearing and settlement as well as the depository;
- f. Introduce risk profiling and risk based capital requirements with appropriate financial monitoring;
- g. Improve enforcement case management process;
- h. Ease enquiry and complaint handling;
- i. Accelerate enforcement and penalty handling; and
- j. Enhance BSEC's own financial processes, HR and support function needs.

System development philosophy

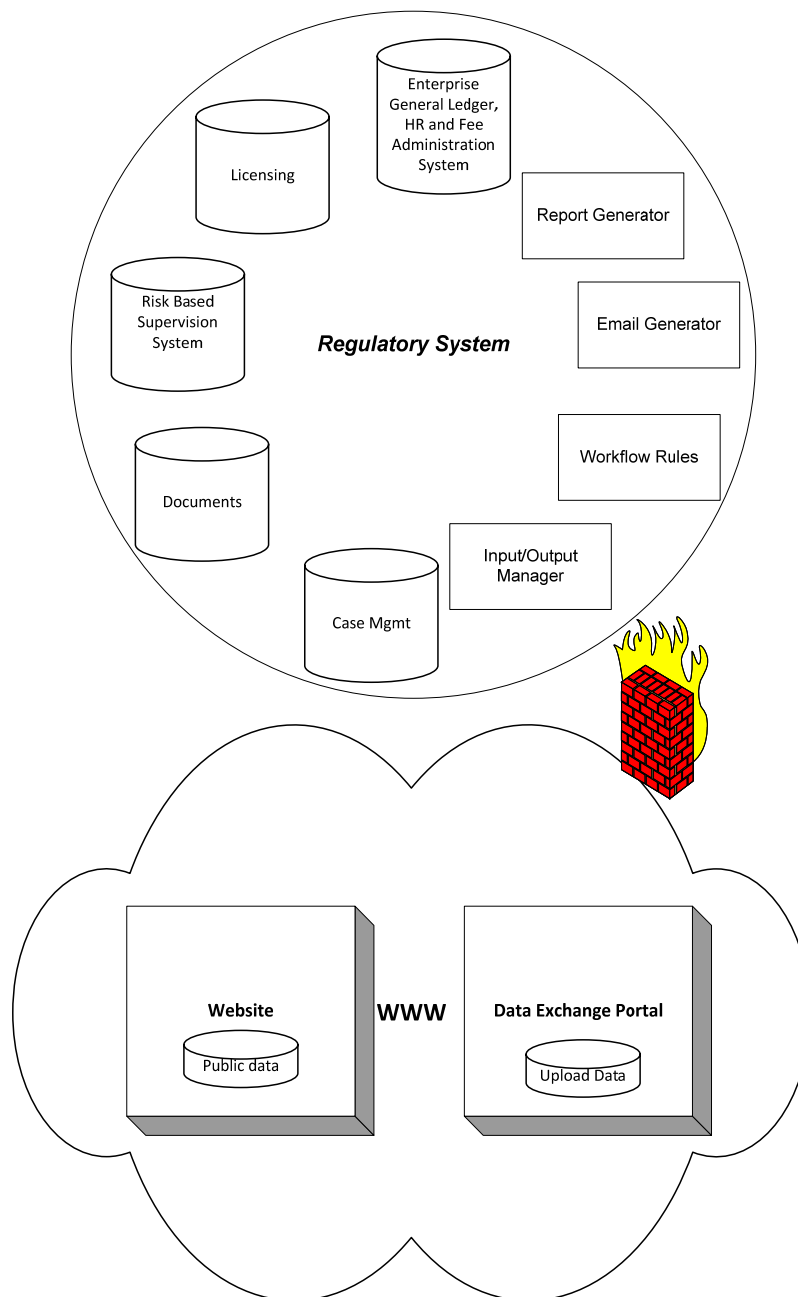
- 13. Given the staffing and financial resource limitations of both the BSEC and the Regulated Entities there is a need to keep the system and processes as simple and user friendly as possible.
- 14. "Keep It Simple Software" is an overarching principle for the design and architecture of the required system(s) proposed by this paper.
- 15. The more complex the system the less likely it is to be used and updated. Systems expensive to maintain with ongoing software licensing that are out of scale and beyond the BSEC's budget resources to maintain are not likely to be used beyond the startup period.
- 16. The Regulated entities do not have technical resources to utilize sophisticated processes like XBRL that require significant effort and cost justification to implement them.
- 17. The processes and tools need to be simple enough and within the capacity of a middle level employee in both the BSEC and the Regulated Entity to use without extensive specialized training.
- 18. The design team needs to look to construct a product that works reliably and can be easily grasped by the users and is consistent with their current environment.
- 19. Utilization of more dynamic tools like XBRL can be adapted later in the systems development cycle.
- 20. Some specialist risk based supervisory systems developed by other regulators are also available to be utilized.

Risk Based Regulatory System and Enterprise Resource Planning System for Bangladesh Securities and Exchange Commission (BSEC)

Appropriate Technology

21. Emerging markets all now have reasonable internet access which is available to the business community and to working professionals.
22. They have a well-developed and fairly extensive mobile telephone network. Most regulated entities (with the exception of small operators) have some computerization with experience in word processing and spreadsheets as well as industry specific software applications. Internet access and therefore experience with web browsers is growing and prevalent with business professionals.
23. Internet users are familiar with unstructured data such as annual reports, regulations and similar data in PDF or Word Document formats which are common and familiar.
24. Businesses both large and small often use spreadsheets for record keeping and analysis. Almost anyone who uses the internet has used login screens and setup and managed their own accounts. These experiences appear to be to be common to most of the people involved in regulated entities in almost all emerging markets.
25. Whilst some local firms are providing sophisticated database systems and programs this is an area of limited expertise and cannot be assumed to be available to many of the regulated entities.
26. Data will be both structured (financial reports and filings with specific data fields) and unstructured (annual reports, board minutes, industry analysis, etc in text and prose form)

Risk Based Regulatory System and Enterprise Resource Planning System for Bangladesh Securities and Exchange Commission (BSEC)



Risk Based Regulatory System and Enterprise Resource Planning System for Bangladesh Securities and Exchange Commission (BSEC)

Simple Approaches

27. The essence of the approach is to use technology readily available and in use by the Regulators and Regulated entities.
28. A system based on a modified customer relationship management (CRM) approach can have simple browser based forms for staff use and extend data input for simple forms to clients using appropriate SSL security and encryption techniques
29. Spreadsheets (eg: MS Excel, Open Office, Libre office, Star Office, Numbers, etc) can be provided to reporting entities and uploaded to the BSEC where the needed data is extracted and stored in a database
30. A document management system with approval workflow can be used to upload, store and index the relevant documents and link them to the appropriate entities and cases.

Development of a basic software approach

31. Regulators can use existing tools the users are familiar with and create a useful while not exhaustive system based on common sense and user friendly approaches without reinventing or designing a whole new system from scratch.

How can ADB help BSEC?

32. BSEC seeks support from Asian Development Bank (ADB) to assist it develop a systems solution. Specifically it would like assistance as follows:
 - a. Technical Assistance (TA) to develop the necessary systems specification based on the keep it simple philosophy outline in this paper;
 - b. It is believed that a three month consultancy undertaken by a consultant familiar with RBS and regulatory system needs would enable an RFP to be prepared for the development of an appropriate system for BSEC's needs;
 - c. Once the system specification has been agreed and signed off by both BSEC and ADB which includes a cost estimate for the systems development and deployment funding would be sought from ADB to assist in its development

Risk Based Regulatory System and Enterprise Resource Planning System for Bangladesh Securities and Exchange Commission (BSEC)

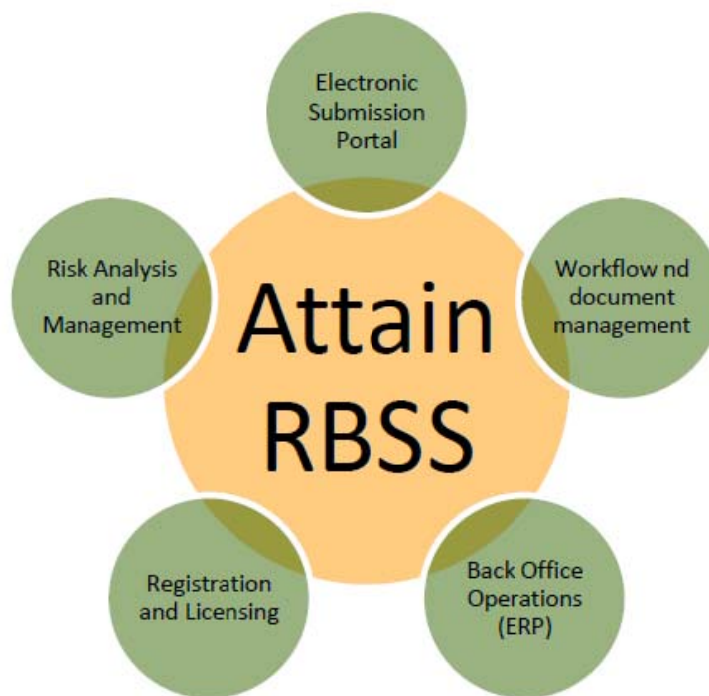
- d. The ball-park cost of development based on two recent known regulatory systems development and deployment is between \$US 1.5 million and \$US 2 million¹.

¹ Kenyan CMA utilising Attain Systems and funded by World Bank FLSTAP and Botswana's NBFIRA utilising Vizor Systems funded by AfDB

Risk Based Regulatory System and Enterprise Resource Planning System for Bangladesh Securities and Exchange Commission (BSEC)

Annexure A: Attain and Vizor Systems

ATTAIN RBSS RISK BASED SUPERVISORY SYSTEM FOR REGULATORY AUTHORITIES



Attains Offering.....



The complete Risk Based Supervisory Solution

Our solution collects all your regulatory functions into one integrated system. Experience a comprehensive solution that identifies measures and controls risks through the risk management framework put in by regulators. Attain RBSS also offers breakthrough user experience that simplifies access to information, improves regulatory agility, streamlines integration, and enhances reporting and efficient help desk automation.

Risk Based Regulatory System and Enterprise Resource Planning System for Bangladesh Securities and Exchange Commission (BSEC)

Key Benefits

Effective compliance to regulatory rules and regulations

Fast secure online and mobile payments, effective collection of levies, notifications, automated calculation of risks, notifications for renewals, supervision, and submission of reports ensures the industry players are constantly informed.

Improved customer satisfaction and service

Personalized quality service, easy accessibility both online and mobile access, Complaints handling ensuring all your issues are handled by the correct persons while receiving progress. Registration, licensing and collection of certificates are done online.

Helps people work faster and better

Faster approval processes, improved workflows and document management, enhanced collaboration and centralized feedback within the authority. Employees can also access the system on smart phones, tablets and IPads.

Bird's view of industry operations

Intelligent dashboards enable the Authority to gain greater control of its performance therefore assisting in decision making.

NBFIRA, Botswana Chooses Vizor Software

Vizor Canada Inc. is delighted to announce that Botswana's Non-Bank Financial Institutions Regulatory Authority (NBFIRA) has chosen Vizor Software. Mandated to regulate and enforce compliance within the NBFI sector in order to safeguard the stability, fairness and efficiency of the non-bank financial sector, the Authority's regulatory portfolio encompasses a wide variety of industries including Insurance, Pension, Capital Markets, Non-Bank Lenders, Collective Investment Undertakings (CIUs), Asset Managers, Investment Advisors, and Custodians (among others).

Built using Vizor Software the Non-Bank Financial Institutions Regulatory Authority Risk Based Supervision System (NBFIRA RBSS) is set to go live in November, 2014 and will deliver the following objectives:

- Reduce time taken to prepare data outputs and analysis
- Enable registration for individuals and corporate entities, and license renewal
- Facilitate corporate notifications
- Improve off-site and on-site supervision
- Introduce risk profile management
- Implement market data production
- Ease enquiry and complaint handling
- Accelerate enforcement and penalty handling
- Provide levy analysis capabilities

APPENDICES

COMPONENT 2:

**EXPEDITED ADJUDICATION OF ENFORCEMENT
ACTIONS**

Appendix 2.1: Draft Securities Markets Administrative Tribunal Rules (14 May 2014)



বাংলাদেশ সিকিউরিটিজ অ্যান্ড এক্সচেঞ্জ কমিশন
Bangladesh Securities and Exchange Commission

ADB TA-8228 BAN: Enhancing Efficiency of the Capital Market

COMPONENT 2: EXPEDITED ADJUDICATION OF ENFORCEMENT ACTIONS

DRAFT CASE MANAGEMENT RULES FOR THE SPECIAL TRIBUNAL (CRIMINAL JURISDICTION)

25 February 2014



The International Securities Consultancy Limited

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COMPONENT 2: EXPEDITED ADJUDICATION OF ENFORCEMENT ACTIONS
DRAFT CASE MANAGEMENT RULES FOR THE SPECIAL TRIBUNAL (CRIMINAL JURISDICTION)

DRAFT
CASE MANAGEMENT RULES FOR THE SPECIAL TRIBUNAL
(CRIMINAL JURISDICTION)

CONTENTS OF RULES

1. PURPOSE AND SCOPE

- 1.1 Just disposal of cases
- 1.2 The duty of the participants in a criminal case

2. CASE MANAGEMENT

- 2.1 The duty of the court
- 2.2 The duty of the parties
- 2.3 Case progression officers and their duties
- 2.4 The court's case management powers
- 2.5 Application to vary a direction
- 2.6 Agreement to vary a time limit fixed by a direction
- 2.7 Plea and Case Management Hearings
- 2.8 Conduct of a trial
- 2.9 Readiness for trial
- 2.10 Conduct of a trial

3. CASE MANAGEMENT FORMS AND RECORDS

COMPONENT 2: EXPEDITED ADJUDICATION OF ENFORCEMENT ACTIONS
DRAFT CASE MANAGEMENT RULES FOR THE SPECIAL TRIBUNAL (CRIMINAL JURISDICTION)

SUGGESTED DRAFT CASE MANAGEMENT RULES FOR THE SPECIAL TRIBUNAL (CRIMINAL JURISDICTION)¹

1. PURPOSE AND SCOPE

1.1 Just disposal of cases

- (1) Dealing with a criminal case justly includes –
- (a) dealing with the case efficiently and expeditiously;
 - (b) ensuring that appropriate information is available to the court when bail and sentence are considered; and
 - (c) dealing with the case in ways that take into account –
 - (i) the gravity of the offence alleged;
 - (ii) the complexity of what is in issue;
 - (iii) the severity of the consequences for the defendant and others affected; and
 - (iv) the needs of other cases.

1.2 The duty of the participants in a criminal case

- (1) Each participant, in the conduct of each case, must –
- (a) comply with these Rules; and
 - (b) at once inform the court and all parties of any significant failure (whether or not that participant is responsible for that failure) to take any procedural step required by these Rules. A failure is significant if it might hinder the court in justly disposing of a case.
- (2) Anyone involved in any way with a criminal case is a participant in its conduct for the purposes of this rule.

¹ As I understand the position there is already an initiative underway to create a set of fast track case management rules for the criminal and civil jurisdictions of the Courts. The Special Tribunal operates under the current Criminal Procedure Act. The BSEC have no jurisdiction to make any changes to this legislation. However the purpose of these rules is to enable the BSEC to present these draft rules as a suggested proposal as to how the Special Tribunal may dispose of its cases justly and expeditiously. In practice an amendment to the Criminal Procedure Act would have to be made in order for these rules to become enforceable.

These suggested draft rules are modelled on the most recent criminal case management rules in the UK. It has taken more than 20 years for case management to become an integral part of the procedural rules in the UK but the effects of the rules on the speed of disposal of cases and the time to trial have been significant.

COMPONENT 2: EXPEDITED ADJUDICATION OF ENFORCEMENT ACTIONS
DRAFT CASE MANAGEMENT RULES FOR THE SPECIAL TRIBUNAL (CRIMINAL JURISDICTION)

2. CASE MANAGEMENT

2.1 The duty of the court

- (1) The court must actively manage the cases before it.
- (2) Active case management includes –
 - (a) the early identification of the real issues;
 - (b) the early identification of the needs of witnesses;
 - (c) achieving certainty as to what must be done, by whom, and when, in particular by the early setting of a timetable for the progress of the case;
 - (d) monitoring the progress of the case and compliance with directions;
 - (e) ensuring that evidence, whether disputed or not, is presented in the shortest and clearest way;
 - (f) discouraging delay, dealing with as many aspects of the case as possible on the same occasion, and avoiding unnecessary hearings;
 - (g) encouraging the participants to co-operate in the progression of the case; and
 - (h) making use of technology.
- (3) The court must actively manage the case by giving any direction appropriate to the needs of that case as early as possible.

2.2 The duty of the parties

Each party must –

- (a) actively assist the court in fulfilling its duty under rule 2.1, without or if necessary with a direction; and
- (b) apply for a direction if needed to further progress active case management.

2.3 Case progression officers and their duties ²

- (1) At the beginning of the case each party must, unless the court otherwise directs –
 - (a) nominate an individual responsible for progressing that case; and
 - (b) tell other parties and the court who he is and how to contact him.
- (2) In fulfilling its duty under rule 2.1, the court must where appropriate –
 - (a) nominate a court officer responsible for progressing the case; and
 - (b) make sure the parties know who he is and how to contact him.
- (3) In this Part a person nominated under this rule is called a case progression officer.
- (4) A case progression officer must –

² These case progression officers are usually the lawyer with day to day responsibility for the conduct of the case. From a practical point of view difficulties only arise where no lawyer is appointed and one of the parties is unrepresented. This is a rare occurrence in criminal cases in the UK. Where a party is unrepresented the Judiciary and the prosecution are under a greater obligation to ensure the unrepresented party is fully aware of the nature and effect of a case management direction and the consequences of failure to comply with such a direction.

COMPONENT 2: EXPEDITED ADJUDICATION OF ENFORCEMENT ACTIONS
DRAFT CASE MANAGEMENT RULES FOR THE SPECIAL TRIBUNAL (CRIMINAL JURISDICTION)

- (a) monitor compliance with directions;
- (b) make sure that the court is kept informed of events that may affect the progress of that case;
- (c) make sure that he can be contacted promptly about the case during ordinary business hours;
- (d) act promptly and reasonably in response to communications about the case; and
- (e) if he will be unavailable, appoint a substitute to fulfil his duties and inform the other case progression officers.

2.4 The court's case management powers

- (1) In fulfilling its duty under rule 2.1 the court may give any direction and take any step actively to manage a case unless that direction or step would be inconsistent with legislation or these Rules.
- (2) In particular, the court may –
 - (a) nominate a judge³ to manage the case;
 - (b) give a direction on its own initiative or on application by a party;
 - (c) ask or allow a party to propose a direction;
 - (d) for the purpose of giving directions, receive applications and representations by letter or by any other means of electronic communication⁴;
 - (e) give a direction –
 - (i) at a hearing, in public or in private, or
 - (ii) without a hearing;
 - (f) fix, postpone, bring forward, extend, cancel or adjourn a hearing;
 - (g) shorten or extend (even after it has expired) a time limit fixed by a direction;
 - (h) require that issues in the case should be –
 - (i) identified in writing,
 - (ii) determined separately, and decide in what order they will be determined; and
 - (iii) specify the consequences of failing to comply with a direction.
- (3) Any power to give a direction under this Part includes a power to vary or revoke that direction.
- (4) If a party fails to comply with a rule or direction, the court may –
 - (a) fix, postpone, bring forward, extend, cancel or adjourn a hearing;
 - (b) exercise its powers to make a costs order; and
 - (c) impose such other sanction as may be appropriate⁵.

³ Most Judges retain their own case load or the case load of the particular “Division” of the Court. Thus the Judges of the Special Tribunal would be expected to manage their case load and their knowledge of those cases would enable them to make effective case management directions without the need for much “reading into” the papers.

⁴ This would need to elide with the overall IT systems operating in the Courts. Email requests for directions are accepted practice in the UK and are directed in the first instance to the Listing Office who then pass on the requests to the Judge. There is also a judicial intranet facility available for all members of the judiciary with dedicated email addresses for all judges. These email addresses are not made available to the public even for the purposes of case management.

⁵ Sanctions are integral in making case management work. Costs orders may be made directly against the lawyers for delay however in criminal trials evidence put forward by the defence is rarely excluded due to a breach of a case management direction as it may prejudice the defendant. However the prosecution may be penalised by way of exclusion of material for breach of a case management direction.

COMPONENT 2: EXPEDITED ADJUDICATION OF ENFORCEMENT ACTIONS
DRAFT CASE MANAGEMENT RULES FOR THE SPECIAL TRIBUNAL (CRIMINAL JURISDICTION)

Note: if a party fails to comply with a rule or a direction then in some circumstances –

- (a) the court may refuse to allow that party to introduce evidence;*
- (b) evidence that that party wants to introduce may not be admissible; and*
- (c) the court may draw adverse inferences from the late introduction of an issue or evidence.*

2.5 Application to vary a direction

(1) A party may apply to vary a direction if –

- (a) the court gave it without a hearing;
- (b) the court gave it at a hearing in his absence; or
- (c) circumstances have changed.

(2) A party who applies to vary a direction must –

- (a) apply as soon as practicable after he becomes aware of the grounds for doing so; and
- (b) give as much notice to the other parties as the nature and urgency of his application permits.

2.6 Agreement to vary a time limit fixed by a direction

(1) The parties may agree to vary a time limit fixed by a direction, but only if –

- (a) the variation will not –
 - (i) affect the date of any hearing that has been fixed; or
 - (ii) significantly affect the progress of the case in any other way;
- (b) the court has not prohibited variation by agreement; and
- (c) the court's case progression officer is promptly informed.

(2) The court's case progression officer must refer the agreement to the court if he doubts the condition in paragraph (1)(a) is satisfied.

2.7 Plea and Case Management Hearings⁶

(1) At every hearing, if a case cannot be concluded there and then the court must give directions so that it can be concluded at the next hearing or as soon as possible after that.

(2) At every hearing the court must, where relevant –

- (a) if the defendant is absent, decide whether to proceed nonetheless;
- (b) take the defendant's plea (unless already done) or if no plea can be taken then find out whether the defendant is likely to plead guilty or not guilty;
- (c) set, follow or revise a timetable for the progress of the case, which may include a timetable for any hearing including the trial or appeal;
- (d) in giving directions, ensure continuity in relation to the court and to the parties' representatives where that is appropriate and practicable; and

⁶ These hearings take place on a running basis to continually guide the case to a hearing. They narrow down the issues often by producing a list of agreed facts; disposing of all but the essential issues and enabling "skeleton" arguments on the law to be submitted and served in advance of the hearing so that the Judge has time to properly consider the legal issues raised.

COMPONENT 2: EXPEDITED ADJUDICATION OF ENFORCEMENT ACTIONS
DRAFT CASE MANAGEMENT RULES FOR THE SPECIAL TRIBUNAL (CRIMINAL JURISDICTION)

- (e) where a direction has not been complied with, find out why, identify who was responsible, and take appropriate action.
- (3) In order to prepare for the trial, the court must take every reasonable step –
 - (a) to encourage and to facilitate the attendance of witnesses when they are needed; and
 - (b) to facilitate the participation of any person, including the defendant.

2.8 Conduct of a trial

- (1) In order to manage a trial the court –
 - (a) must establish, with the active assistance of the parties, what are the disputed issues;
 - (b) must consider setting a timetable that –
 - (i) takes account of those issues and of any timetable proposed by a party, and
 - (ii) may limit the duration of any stage of the hearing;
 - (c) may require a party to identify –
 - (i) which witnesses that party wants to give evidence in person;
 - (ii) the order in which that party wants those witnesses to give their evidence;
 - (iii) whether that party requires an order compelling the attendance of a witness;
 - (iv) what arrangements are desirable to facilitate the giving of evidence by a witness;
 - (v) what arrangements are desirable to facilitate the participation of any other person, including the defendant;
 - (vi) what written evidence that party intends to introduce;
 - (vii) what other material, if any, that person intends to make available to the court in the presentation of the case; and
 - (viii) whether that party intends to raise any point of law that could affect the conduct of the trial or appeal;
 - (d) may limit –
 - (i) the examination, cross-examination or re-examination of a witness; and
 - (ii) the duration of any stage of the hearing.
- (2) At every hearing the court must, where relevant –
 - (a) if the defendant is absent, decide whether to proceed nonetheless;
 - (b) take the defendant's plea (unless already done) or if no plea can be taken then find out whether the defendant is likely to plead guilty or not guilty;
 - (c) set, follow or revise a timetable for the progress of the case, which may include a timetable for any hearing;
 - (d) in giving directions, ensure continuity in relation to the court and to the parties' representatives where that is appropriate and practicable; and
 - (e) where a direction has not been complied with, find out why, identify who was responsible, and take appropriate action.
- (3) In order to prepare for a trial –

COMPONENT 2: EXPEDITED ADJUDICATION OF ENFORCEMENT ACTIONS
DRAFT CASE MANAGEMENT RULES FOR THE SPECIAL TRIBUNAL (CRIMINAL JURISDICTION)

- (a) the court must conduct a plea and case management hearing unless the circumstances make that unnecessary;
 - (b) the defendant must notify the court officer of the identity of the intended defence trial advocate –
 - (i) as soon as practicable, and in any event no later than the day of the plea and case management hearing (if there is one);
 - (ii) in writing, or orally at the plea and case management hearing (if there is one);
 - (c) the defendant must notify the court officer in writing of any change in the identity of the intended defence trial advocate as soon as practicable, and in any event not more than 5 business days after that change.
- (4) In order to prepare for the trial, the court must take every reasonable step –
- (a) to encourage and to facilitate the attendance of witnesses when they are needed; and
 - (b) to facilitate the participation of any person, including the defendant.

2.9 Readiness for trial

- (1) This rule applies to a party's preparation for trial and trial includes any hearing at which evidence will be introduced.
- (2) Each party must –
- (a) comply with directions given by the court;
 - (b) take every reasonable step to make sure his witnesses will attend when they are needed;
 - (c) make appropriate arrangements to present any written or other material; and
 - (d) promptly inform the court and the other parties of anything that may –
 - (i) affect the date or duration of the trial or appeal, or
 - (ii) significantly affect the progress of the case in any other way.
- (3) The court may require a party to give a certificate of readiness⁷.

2.10 Conduct of a trial ⁸

In order to manage a trial the court –

- (a) must establish, with the active assistance of the parties, what are the disputed issues;
- (b) must consider setting a timetable that –
 - (i) takes account of those issues and of any timetable proposed by a party; and
 - (ii) may limit the duration of any stage of the hearing;
- (c) may require a party to identify –
 - (i) which witnesses that party wants to give evidence in person;
 - (ii) the order in which that party wants those witnesses to give their evidence;
 - (iii) whether that party requires an order compelling the attendance of a witness;
 - (iv) what arrangements are desirable to facilitate the giving of evidence by a witness;
 - (v) what arrangements are desirable to facilitate the participation of any other person including the defendant;

⁷ Where a certificate of readiness is supplied and in fact the case is not ready the Judge can make directions which include a personal costs order against the lawyers who signed the certificate of readiness.

⁸ Where a trial has been listed and the case “goes short” (finishes early) or “collapses” (due to a plea) Judges are required to use the available Judicial time by doing case management work for their Division.

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- (vi) what written evidence that party intends to introduce;
- (vii) what other material, if any, that person intends to make available to the court in the presentation of the case; and
- (viii) whether that party intends to raise any point of law that could affect the conduct of the trial or appeal;
- (d) may limit –
 - (i) the examination, cross-examination or re-examination of a witness; and
 - (ii) the duration of any stage of the hearing.

3. CASE MANAGEMENT FORMS AND RECORDS

- (1) The case management forms ⁹ should be used where available and where there is no particular form then no specific formality is required.
- (2) The court must make available to the parties a record of directions given.
- (3) Where a person is entitled or required to attend a hearing, the court officer must give as much notice as reasonably practicable to that person¹⁰.

⁹ Standard case management forms have been developed for completion by the Judges which are a useful “snapshot” of how the case is progressing. A manual or electronic system is used to check for compliance (compliance dates are BF or brought forward on a rolling basis by the List Office) with case management directions. Where a direction has not been complied with the Court of its own motion restores the matter to the Judge for a further direction.

¹⁰ Where the person is represented the notice is sent via email to the representatives. Where a person is unrepresented and supplied an email contact address notice is sent to that email address. When the List Office first receives contact details under case management arrangements they check that the email and mobile numbers supplied are active and monitored. If they suspect that is not the case then notices are sent by hard copy ordinary post. The List Office has many departments and each department will be allocated a case load of a division of the Courts.

Appendix 2.3: Judicial Workshop Handout (31 May 2014)

This workshop is accredited by the General Council of Bar of England and Wales

Judicial Workshop

Pan Pacific Sonargaon Hotel
Dhaka, Bangladesh
31 May 2014

Prepared by: **Michele Parnell**
ISC consultant
(& International Capital Markets Tribunal Expert)

ADB TA-8228 BAN: Enhancing Efficiency of the Capital Market
Component 2: Expedite adjudication of enforcement actions

ISC
The International Securities Consultancy Limited

Introduction and Welcome

Michele Parnell:

- Practising Barrister: commercial law;
- Part Time Judge of the Supreme Court in the UK;
- Former General Counsel at the Financial Services Authority in the UK;
- Former General Counsel to the Bank of England; and
- Fellow of the Chartered Institute of Arbitrators in the UK;

Enhancing the Efficiency of Capital Markets

ADB project to enhance efficiency in capital/securities markets:

Components on:

- Enforcement actions (investigations, sanctions and penalties) that Bangladesh Securities and Exchange Commission (BSEC) as the statutory regulator may impose on capital markets licence holders' for breaches of the law and regulations; and
- An alternative means of challenging BSEC enforcement actions for licence holders;

International Bench Marks

- International Organisation of Securities Commissions (IOSCO) set the standards for securities markets worldwide;
- BSEC is a full member of IOSCO and committed to follow its standards;
- IOSCO Principles of Securities Regulation (not a law but akin to equitable maxims) require that a regulator (BSEC) is accountable in the exercise of its functions and powers (particularly enforcement) – withdrawal of a licence means the end of a securities business

International Bench Marks

3 IOSCO core objectives of securities regulation are:

- Protection of investors;
- Ensuring that markets are fair, efficient and transparent; and
- Reduction of systemic risk.

Regulators have a tough balancing act between the need to protect investors and the need to take swift and proportionate enforcement action;

International Bench Marks

Accountability in IOSCO terms requires that the Regulator is subject to appropriate scrutiny and review, including:

- transparency in the regulator's process and conduct;
- A system permitting licence holders to challenge regulatory decisions; (and receive reasons for those decisions) and
- a ultimately a system permitting judicial review of the exercise of the decisions of the regulator;

International Bench Marks

IOSCO envisages:

- a “staged / layered” means of challenging decision making;
- decision making that is in accordance with the principles of natural justice;
- that provides reasons for the decision;
- an opportunity to make representations to a body other than the original decision maker; and
- an ultimate recourse to the Courts as the final arbiters of justice

Enhancing the Efficiency of Capital Markets

- Currently challenges to BSEC decisions are made to the Courts;
- Cases can be complex; time consuming for the parties; expensive and subject to long delays before ultimate determination;
- Purpose of ADB project is to create a forum for fast track adjudication (the proposed Tribunal) as a alternative to going to the Courts; and
- The Tribunal would be in line with the IOSCO principles

Rationale for Tribunals in capital markets

- Courts are under increasing pressure from ever larger case loads;
- International recognition that alleviating the burden on the Courts by introducing alternative mechanisms of resolution is desirable, speedy and cost effective for the parties;
- Seen a steady increase in use of arbitration, ADR in all types of commercial claims; and
- An increase in the development of Tribunals for specialist areas of law

Tribunals: Important Cogs in the Machinery of Justice

- In UK until mid 1950's Tribunals were the “Cinderella's” of administrative justice, receiving little professional or academic attention;
- Perceived as poor persons’ courts operating relatively informally and inexpensively in welfare cases;
- Perceived as too close to government departments to be truly independent, and
- Too informal in their procedures to bear comparison with real courts of law.

Tribunals: Important Cogs in the Machinery of Justice

In the UK two significant incremental changes:

- Report of the Franks Committee on Tribunals and Enquiries 1957: status of Tribunals changed to become part of Judicial System (governed by a Committee on Tribunals) rather than as creatures of the government administration; and
- Report of Sir Andrew Leggatt (Court of Appeal) new legislation: the Tribunals, Courts and Enforcement Act 2007 Tribunal system fully integrated and on a firm statutory footing in the Judicial System

Case Management: the fundamental building blocks

- In the UK parallel to the development of the “specialist” Tribunal was the then “radical” and strongly opposed (initially) Woolf recommendations on case management in the 1980/90's;
- Driven by:
 - criticism of the arcane procedural requirements in the High Court;
 - The ability of Counsel to take advantage of the Supreme Court Rules on technical points and adjournments; and
 - Criticism of the delay and cost of getting to Trial

Case Management: the fundamental building block

- Case management now an integral part of the Judicial role;
- Phenomenal success in improving access to justice;
- Reduced lead time to trial significantly;
- Reduced case back log so virtually non-existent;
- Now combined case management with use of new technology:
 - E filing;
 - Cloud disclosure;

Enforcement; Tribunals and Case Management

- Judges are now required to satisfy themselves as an integral part of case management procedure that ADR/settlement has been tried by the parties and failed BEFORE they will give case management directions;
- Counsel must give undertakings ADR/settlement has failed;
- Judges have powers to order ADR/settlement negotiations where they feel there is room for compromise

Enforcement; Tribunals and Case Management

- Previously counsel and parties dictated the timetable of cases;
- Now the Judiciary drives the timetable of cases;
- Increased specialisation by Division of the Judiciary
 - The Commercial Court
 - The Admiralty Courts
 - The Mercantile Court, and
 - The Technology and Construction Court

The Role of the Judiciary in Capital Markets

- Capital markets are fast moving;
- Encompass many areas of law not just those dedicated securities and banking laws but also:
 - Contract;
 - Company and partnership;
 - Take overs and Mergers and competition;
 - Trust;
 - Insolvency (bankruptcy and winding up);
 - Intellectual property;
 - IT and data protection; and the list goes on

The Role of the Judiciary in Capital Markets

- Knowledge of the laws and of market practices;
- Knowledge of regulatory framework;
- Understanding of the role of the regulator: a balance between investor protection and allowing a innovative market to develop; but to punish miscreants

Enforcement: where the regulators rely on the Courts

- Injunctions (asset freezing orders and restitution);
- Winding up licensed firms;
- Oversight of regulators (by way of Judicial Review);
- Oversight of Tribunals (by way of Judicial Review) and
- Criminal Offences

Enforcement: where the regulators rely on the Courts

- Regulatory sanctions must be swift and proportionate;
- Follow the money; seize, freeze, and restore;
- Injunctive relief is the most effective and most regulatory remedy in the UK (and the USA);
- Criminal prosecutions are the least effective and least used remedy (in the UK: but the USA has a better criminal track record!)

The Role of the Tribunal

- Fills the middle ground between freeze and seize and/or prosecute;
- Majority of regulatory cases relate to day to day conduct of licensed firms;
- Decisions that are challenged are regulatory;
 - Grant; suspension or withdrawal of licence;
 - Disciplinary matters; (e.g. breach of client money rules);
 - Penalties; and
 - official listing

Financial Services Tribunal UK

- UK Financial Conduct Authority 2012/2013:
 - 5 civil actions in the High Court; and
 - 4 criminal actions; and
 - 150 regulatory decision notices

40% of the UK's regulatory decisions are challenged in the Tribunals and those mainly relate to the amount fines imposed (unlimited power of fines)

Financial Services Tribunal UK

- £160m: UBS - Libor rigging;
- £87.5m: Royal Bank of Scotland - Libor rigging;
- £59.5m: Barclays - Libor rigging;
- £33.32m: JP Morgan - failing to protect client money;
- £30m: Prudential - failing to inform FSA of acquisition plans;
- £29.7m: UBS - failing to prevent unauthorised trading;
- £17.5m: Goldman Sachs - weaknesses in controls;
- £17m: Shell - market abuse;
- £13.96m: Citigroup - failing to conduct its business properly; and
- £10.5m: Card Protection Plan - mis-selling insurance

Financial Services Tribunal UK

Forthcoming Hearings and Register
(Updated 23/05/2014)

| Reference No. | Applicant | Respondent | Date of receipt | Hearing Date | Type of Hearing | Outcome and reasons |
|---------------|-----------------------|------------|-----------------|--|------------------------------|---------------------|
| FS20140001 | John Smith-Jones | FCA | 19/05/2014 | 10 June 2014 @ 10.30am @ 40 Bedford Square London WC1R 4EJ | Application | |
| FS20140002 | John Garry Williams | FSM | 20/05/2014 | To Be Fixed | | |
| FS20140003 | Robert Lynn Huxley | FSM | 20/05/2014 | 10 February 2014 @ 10.30am @ 40 Bedford Square London WC1R 4EJ | Priority Application Hearing | Dismissed |
| FS20140004 | Priority application | FCA | 19/05/2014 | 17-18 March 2014 @ 10.30am @ 40 Bedford Square London WC1R 4EJ | Substantive | Withdrawn |
| FS20140005 | Haroldson Capital Ltd | FCA | 21/05/2014 | Not Reported | | Withdrawn |
| FS20140006 | Priority Application | FCA | 1/6/2014 | To Be Fixed | | |
| FS20140007 | Patric Thomas-Carson | FCA | 16/12/2013 | 23 March 2014 @ 10.30am @ 40 Bedford Square | Application | |

The Proposed Tribunal

- Impartial and perceived to be impartial;
- Speed of decision making;
- Practical Industry expertise of Tribunal members;
- Lesser cost to industry than litigation;

The Proposed Tribunal

- Proposed rules - consultation;
- Industry must have confidence in the Tribunal;
- Primarily confidence will come from the reputation, gravitas and experience of the panel members;
- Legal chairman and two industry experts provides balance and day to day expertise;
- Pool of legal chairman;
- Pool of industry experts;
- All called on an as and when basis: not full time appointments

The Proposed Tribunal

- Not bound by strict evidential rules;
- Parties pay their own legal costs but they need NOT use lawyers;
- But case management best practices and procedures are built into the rules;
- Panel drives the case and not the parties; and
- Appeal only on a point of law to the Supreme Court so the Panel are the arbiters of fact (save where the decision was so unreasonable as to trigger judicial review)

Case Management

- Applies to ALL cases: criminal, civil and Tribunals;
- Case management protocols developed for crime; pre hearing directions – majority of criminal matters take 6 months from charge to trial save in complex serious fraud – dedicated part of Crown Prosecution Service deals with serious fraud;
- Case management protocol for personal injury dictates only one expert shared by both parties

Case Management: Basic Requirements

- the early identification of the real issues;
- the early identification of the needs of witnesses;
- achieving certainty as to what must be done, by whom, and when, in particular by the early setting of a timetable for the progress of the case;
- monitoring the progress of the case and compliance with directions;
- ensuring that evidence, whether disputed or not, is presented in the shortest and clearest way;

Case Management: Basic Requirements

- discouraging delay, dealing with as many aspects of the case as possible on the same occasion, and avoiding unnecessary hearings;
- encouraging the participants to co-operate in the progression of the case; and
- making use of technology.

Judges Explicit Powers

- Cases are usually allocated to a particular Judge (by field of expertise);
- Judges have power to:
 - give a direction on its own initiative or on application by a party;
 - ask or allow a party to propose a direction;
 - for the purpose of giving directions, receive applications and representations by letter or by any other means of electronic communication;
 - give a direction:
 - at a hearing, in public or in private, or
 - without a hearing;

Judges Explicit Powers

- fix, postpone, bring forward, extend, cancel or adjourn a hearing;
- shorten or extend (even after it has expired) a time limit fixed by a direction;
- require that issues in the case should be:
 - identified in writing,
 - determined separately, and decide in what order they will be determined; and
 - specify the consequences of failing to comply with a direction.



Failure to Comply with Directions

If a party fails to comply with a rule or direction, the court may:

- fix, postpone, bring forward, extend, cancel or adjourn a hearing;
- exercise its powers to make a costs order; and
- impose such other sanction as may be appropriate

Costs orders are very effective means to secure compliance with directions in case management



Questions



Appendix 2.4: BSEC Training Workshop Handout (2 June 2014)

This workshop is accredited by the General Council of Bar of England and Wales

BSEC Training Workshop

Hotel Purbani International Limited
Dhaka, Bangladesh
2 June 2014

Prepared by: Michele Parnell
ISC consultant
(& International Capital Markets Tribunal Expert)

ADB TA-8228 BAN: Enhancing Efficiency of the Capital Market
Component 2: Expedite adjudication of enforcement actions

ISC
The International Securities Consultancy Limited

Introduction and Welcome

Michele Parnell:

- Practising Barrister: commercial law;
- Part Time Judge of the Supreme Court in the UK;
- Former General Counsel at the Financial Services Authority in the UK;
- Former Head of Enforcement FSA;
- Former General Counsel to the Bank of England; and
- Fellow of the Chartered Institute of Arbitrators in the UK;

ISC **বাংলাদেশ সিকিউরিটিজ অ্যান্ড এক্সচেঞ্জ কমিশন**
Bangladesh Securities and Exchange Commission

**Enhancing the Efficiency of Capital Markets
Some background.....**

ADB project to enhance efficiency in capital/securities markets:

Components on:

- Enforcement actions (investigations, sanctions and penalties) that Bangladesh Securities and Exchange Commission (BSEC) as the statutory regulator may impose on capital markets licence holders' for breaches of the law and regulations; and
- How to improve the mechanisms by which challenges to BSEC decisions are dealt with;

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International Bench Marks

- International Organisation of Securities Commissions (IOSCO) set the standards for securities markets worldwide;
- BSEC is a full member of IOSCO and committed to follow its standards;
- IOSCO Principles of Securities Regulation require that a regulator (BSEC) is **accountable** in the exercise of its functions and powers (particularly enforcement) – withdrawal of a licence means the end of a securities business

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International Bench Marks

3 IOSCO core objectives of securities regulation are:

- Protection of investors;
- Ensuring that markets are fair, efficient and transparent; and
- Reduction of systemic risk.

So regulators have a tough balancing act between the need to protect investors and the need to take swift and proportionate enforcement action;

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International Bench Marks

Accountability in IOSCO terms requires that the Regulator is subject to appropriate scrutiny and review, including:

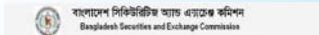
- Transparency in the regulator's process and conduct;
- A system permitting licence holders to challenge regulatory decisions; (and receive reasons for those decisions) and
- a ultimately a system permitting judicial review of the decisions of the regulator;

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International Bench Marks

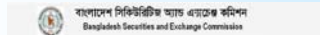
IOSCO envisages:

- a “staged / layered” means of challenging decision making;
- decision making that is in accordance with the principles of natural justice;
- that provides reasons for the decision;
- an opportunity to make representations to a body **other** (ie not BSEC) than the original decision maker; and
- an ultimate recourse to the Courts as the final arbiters of justice



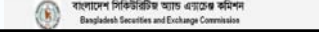
Enhancing the Efficiency of Capital Markets

- Currently challenges to BSEC decisions are made to the Courts;
- Cases can be complex; time consuming for the parties; expensive and subject to long delays before ultimate determination;
- Purpose of ADB project is to **consider** how to create a forum for fast track adjudication (the proposed Tribunal) as a alternative to going to the Courts; and
- Tribunal arrangements would be in line with the IOSCO principles



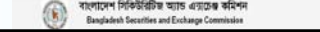
Rationale for Tribunals in capital markets

- Courts are under increasing pressure from ever larger case loads;
- International recognition that alleviating the burden on the Courts by introducing alternative mechanisms of resolution is desirable, speedy and cost effective for the parties;
- Seen a steady increase in use of arbitration, ADR in all types of commercial claims; and
- An increase in the development of Tribunals for specialist areas of law



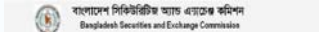
Case Management: the fundamental building blocks

- In the UK parallel to the development of the “specialist” Tribunal was the then “radical” and strongly opposed (initially) Woolf recommendations on case management in the 1980/90’s;
- Driven by:
 - criticism of the arcane procedural requirements in the High Court;
 - The ability of Counsel to take advantage of the Supreme Court Rules on technical points and adjournments; and
 - Criticism of the delay and cost of getting to Trial



Case Management: the fundamental building block

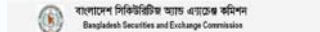
- Case management now an integral part of the Judicial role;
- Phenomenal success in improving access to justice;
- Reduced lead time to trial significantly;
- Reduced case back log so virtually non existent;
- Now combined case management with use of new technology:
 - E filing;
 - Cloud disclosure;



Best Practise for Tribunals

Includes case management provisions:

- The Tribunal drives the timetable;
- Overall timescale for start to finish is 6 months;
- Case Management powers are built into the rules;
- e filing and new technology.
- Tribunal can:
 - Uphold a regulatory decision;
 - Impose any other decision that would have been available to the regulator including penalties; or
 - Dismiss the case (regulator cannot appeal a dismissal)



The Need for Specialist Expertise

- Capital markets are fast moving;
- Encompass many areas of law not just those dedicated securities and banking laws but also:
 - Contract;
 - Company and partnership;
 - Take overs and Mergers and competition;
 - Trust;
 - Insolvency (bankruptcy and winding up);
 - Intellectual property;
 - IT and data protection; and the list goes on

The Need for Specialist Expertise

- Knowledge of the laws and of market practices;
- Knowledge of regulatory framework;
- Understanding of the role of the regulator: a balance between investor protection and allowing a innovative market to develop; but to punish miscreants;
- Judiciary may not be familiar with all of the above but Tribunal provides for experts from the market will understand the market and regulatory role

Enforcement: where the regulators rely on the Courts

- Injunctions (asset freezing orders and restitution);
- Winding up licensed firms;
- Oversight of regulators (by way of Judicial Review);
- Oversight of Tribunals (by way of Judicial Review) and
- Criminal Offences

Enforcement: where the regulators rely on the Courts

- Regulatory sanctions must be swift and proportionate;
- Follow the money; seize, freeze, and restore;
- Injunctive relief is the most effective and most regulatory remedy in the UK (and the USA);
- Criminal prosecutions are the least effective and least used remedy (in the UK: but the USA has a better criminal track record!)

The Role of the Tribunal

- Fills the middle ground between freeze and seize and/or prosecute;
- Majority of regulatory cases relate to day to day conduct of licensed firms;
- Decisions that are challenged are regulatory;
 - Grant; suspension or withdrawal of licence;
 - Disciplinary matters; (e.g. breach of client money rules);
 - Penalties; and
 - official listing

Financial Services Tribunal UK

- UK Financial Conduct Authority 2012/2013:
 - 5 civil actions in the High Court; and
 - 4 criminal actions; and
 - 150 regulatory decision notices

40% of the UK's regulatory decisions are challenged in the Tribunals and those mainly relate to the amount fines imposed (unlimited power of fines)

Financial Services Tribunal UK

- £160m: UBS - Libor rigging;
- £87.5m: Royal Bank of Scotland - Libor rigging;
- £59.5m: Barclays - Libor rigging;
- £33.32m: JP Morgan - failing to protect client money;
- £30m: Prudential - failing to inform FSA of acquisition plans;
- £29.7m: UBS - failing to prevent unauthorised trading;
- £17.5m: Goldman Sachs - weaknesses in controls;
- £17m: Shell - market abuse;
- £13.96m: Citigroup - failing to conduct its business properly; and
- £10.5m: Card Protection Plan - mis-selling insurance



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The Need for Expedited Enforcement: Case Studies



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Enforcement is only one method of securing compliance

- Objective of surveillance/inspection is to ensure continuing compliance and rectification of breaches;
- Enforcement must be proportionate, swift and effective;
- Enforcement is a deterrent as well a punishment and the choice of sanction will depend on the gravity of the breach and the particular circumstances of the case



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Overview of Fundamental Enforcement Considerations

Key fundamentals:

- **Integrity:** acting honestly, forthrightly and impartially in every aspect of the work;
- **Fairness:** assuring that everyone receives fair and respectful treatment, without regard to wealth, social standing, publicity, politics, or personal characteristics; and
- **Teamwork:** supporting and cooperating with colleagues and other Departments at BSEC and fellow law enforcement professionals.



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Overview of Fundamental Enforcement Considerations

Remember: Once lost or tainted reputation and integrity are rarely regained and only the largest most developed regulators can bounce back from reputational damage:

- SEC and Madoff;
- FSA and SEC in the banking crisis;
- FSA and Client Money "loophole"; and
- FSA and Libor price fixing;



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Conflicts of Interest

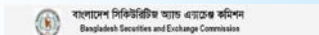


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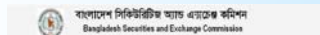
Ethics, Conflicts and Integrity: A Practical example

- USA: Federal conflict of interest law requires government employees to be disqualified from participating in a matter *"if it would have a direct and predictable effect on the employee's own financial interests."*
- After Madoff case SEC went to great lengths to make sure that none of its employees working on the case posed a conflict of interest e.g. an employee who had attended the wedding of member of Madoff family was told they were "conflicted out".



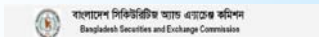
Ethics, Conflicts and Integrity

- 2008 Madoff scheme comes to light
- The SEC chairman, Mary L. Schapiro says Madoff victims should receive only the money they put into their accounts and not the fictitious profits;
- In 2009 SEC hired David M. Becker as their Counsel;
- His role was advise and recommended how the Madoff scheme's victims would be compensated;



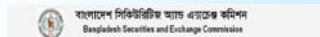
Ethics, Conflicts and Integrity

- Before joining the SEC Becker and other family members received an inheritance from their mother;
- That inheritance included \$2 million from a Bernard L. Madoff account; and
- About \$1.5 million of the \$2 million were "profits" generated by Madoff



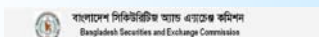
Ethics, Conflicts and Integrity

- When he joins the SEC to head up their approach to restitution to victims namely "you get back what you actually invested" Becker informs Ms. Schapiro of his mother's Madoff account and his inheritance; and
- This disclosure was made only to Ms Schapiro and no other SEC Commissioners;
- He is still hired



Ethics, Conflicts and Integrity

- By May 2009 S.E.C. receives numerous requests from lawyers representing Madoff victims asking that compensation approach is more generous; and
- That victims receive the amounts stated in their final Madoff statements
- Becker takes the lead in the matter, becoming Ms. Schapiro's "point person" and says no to this approach



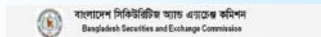
Ethics, Conflicts and Integrity

- But by 9th November 2009 on advice from MR Becker SEC recommends victims receive more than they invested to reflect what they might have earned in an interest-bearing account;
- This could benefit the Becker family by potentially reducing the amount that they might have to return to the Madoff estate.



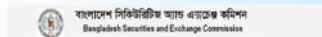
Ethics, Conflicts and Integrity

- Congress takes an interest in the SEC's method of quantifying the restitution
- Becker is scheduled to give evidence to Congress on 10th November 2009;
- but S.E.C. decides he should not do so after officials realise he would disclose the existence of his late mother's account.



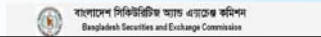
Ethics, Conflicts and Integrity

- 1st December 2010 Madoff trustee sues Becker and his two brothers to recover \$1.5 million in what is called "fictitious profits."; and
- The lawsuit is not disclosed until 22nd February 2011
- Mr Becker's "interest" was referred by inspector general of the S.E.C., to the Justice Department, on the advice of the Office of Government Ethics, which oversees the ethics of the executive branch of US government

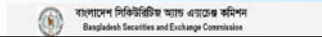


Ethics, Conflicts and Integrity

- Ethics committee said Becker "participated personally and substantially in particular matters in which he had a personal financial interest," and
- Becker said he notified 7 individuals at the SEC but criticism that 'none of these individuals (at the SEC) recognized a conflict or took any action to suggest that Becker consider recusing himself from the Madoff liquidation,'



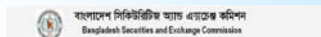
**Tea Break
11.15 to 11.30**



Inspection vs Investigation

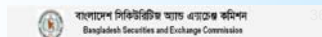
Many similarities in procedures but the fundamental difference is the purpose:

- Inspection is routine part of surveillance and monitoring to ensure compliance by way of remedial action;
- Investigation is undertaken a result of cumulative or very grave compliance concerns and will result in proportionate enforcement action;
- Misappropriation of client money is the most serious enforcement matter



Ranking and Prioritisation

- How to rank and prioritise investigations?
- No regulator has unlimited resources?
- What should be the decision making process for which case to select? and
- No regulator can select all the cases



Client Money

Client Money: A Case Study

- Client money is sacrosanct;
- Segregation is an internationally required best practice;
- Regulators should apply zero tolerance to client money breaches;
- But they didn't bank on the ingenuity of the legal profession!

The "alternative approach" to client money segregation

- Lehman's put client money in to their general bank accounts;
- The money was then invested and Lehman's made a profit;
- Client money was then reconciled and transferred into segregated accounts;
- Client money rules required segregation as soon as reasonably possible and not forthwith – supported by legal advice

The Lehman's Collapse

- Client money was transferred to a bank that was a wholly owned subsidiary of Lehman's;
- That bank held \$1 billion of what was undisputed client money; but
- Lehman's then went into administration before a further reconciliation and segregation could occur;
- So client funds were in the general account and in theory available to all creditors of the bank

The "alternative approach" to client money segregation

- Strong criticism of FSA's rules that allowed this "temporary mixing" of client money and the firms money;
- FSA reviewed and quickly changed the client money regulations; and
- There was a "crack down" on firms for breaches of the principles (high level statements of conduct as there was no breach of law or regulations) as it was discovered the practice was widespread in the City of London;

Record Breaking Fines

- JP Morgan Securities fined £33.2 million for failing to segregate client money;
- Barclays Capital fined £1.2 million for failing to segregate client money on an intra day basis
- And Courts held that even where not segregated client money was impressed with a trust and thus "ring fenced" from the general creditors

Market Manipulation and Insider Trading

Setting the Scene for Emulex

- Reporting requirements for public listed companies are as follows:
 - Annual reporting;
 - Quarterly reporting;
 - Special Event reporting; and
 - ongoing disclosure requirements
- Emulex Corporation is listed on NYSE;
- Founded in 1979;
- 900 employees; and
- Develops and manufactures products that connect servers, storage, and networks within the data center

Mark Jacobs

- Mark Jacobs was a 23 year old University student;
- He was also a part-time employee of a press release distribution company which issued public announcements for the stock markets;
- He had an interest in the Stock Market and gambling: perhaps to supplement his income and pay for his tuition; and
- He was very "computer literate"

Mark Jacobs

- On 17th and 18th August using an on line brokerage account he sold "short" 3,000 Emulex shares;
- He gambled that the market price would fall below \$81 and he would make a profit;
- Short selling is selling stock you do not own and buying these back at a later date for a lower price (in theory);
- It is a margin transaction so if the shorted stock goes up there will be a call for extra collateral from the broker

Mark Jacobs

- On 24th August while Jacobs was on holiday in Las Vegas the Emulex share price climbed to over \$113.00 from \$81.00;
- This meant that potentially Jacob's had an unrealised loss of over \$92,000.00;
- Jacob's broker issued a margin call for collateral to cover the potential losses;
- And Jacob did not have the funds

Jacob's Plan Unfolds

- Immediately cancelled his holiday;
- On the same day 24th August he flew back to Los Angeles;
- On the evening of 24th August Jacob using an alias and purporting to act on Emulex's behalf used a personal computer at his California University to send an email instructing Internet Wire to issue a press release for Emulex that Jacobs had written;
- Remember Jacob worked part time at a wire service and knew their systems

Jacob's "Emulex" Press Release

- It was an excellent fraudulent document;
- The release contained formats similar to previous Emulex announcements; and
- It listed an actual investor relations executive at Emulex as a contact!
- It instructed Internet Wire on 25th August at 9:30 am EDT (6:30 am on the West Coast) to issue the press release; and
- Jacobs paid Internet Wire \$275.00 to issue the release

The "Emulex" Press Release

- On 25th August between 9.30 and 10.13 am EDT the "Emulex" press release was picked up by online news services namely The Street.com, Bloomberg News, CBS, Market Watch and Dow Jones;
- It is likely they tried (and failed) to check its authenticity due to the time zone differences;
- Because Emulex is headquartered on the West coast 3 hours behind the East coast no one was at the Emulex office to field calls about the release when the stock markets opened

The "Emulex" Press Release

Stated that:

- The SEC had initiated an investigation into Emulex's accounting practices,
- Emulex's Chief Executive Officer had resigned, and
- Emulex was revising and lowering its previously reported figures for the last quarter's earnings to report a loss instead of a profit

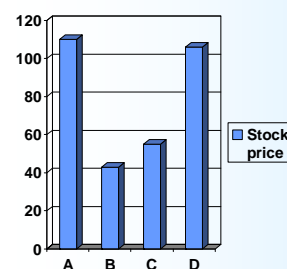
Impact of Press Release on NASDAQ Trading

- At 10:13 am one of the news services went ahead and issued a headline containing information from the false press release;
- During the next 16 minutes, the Emulex stock price plummeted from \$104.00 to \$ 43.00 in a 16 minute period;
- There were 2.3 million shares traded and losses of \$2.2 billion in market capitalization that 16 minute period.

Trading Halt Called

- The Emulex CEO appeared at least twice on TV news to reassure investors that the release was a hoax and contained all false information;
- Officials with NASDAQ halted trading in Emulex at 10:29 am EDT, after being notified by the company that the release was a hoax; and
- Emulex resumed trading later that morning after it was announced there had been a hoax;

Emulex NASDAQ Price Movement From Opening to Close



- (A) Stock price opened at \$110.00
- (B) Stock price plummeted to \$43.00 on 2.3 million shares traded losing \$2.2 billion in market capitalization during 16 minutes after the fake press release
- (C) Following a trading halt shares begin trading at \$55.00 after the hoax was discovered
- (D) Stock price rebounds to close at \$106.00

Jacob Decides to Cash In on fall in price

- On 25th August 25 just after the false press release went out and just before the trading halt Jacob covered his short position and made a profit of over \$54,000.00
- Minutes later he bought another 3,500 shares Emulex shares which he then sold 3 days later on 28th August at a profit of over \$186,000.00
- In total Jacob made a profit of over \$241,000.00 from the hoax

Emulex Investigation Team

- The SEC, the local Federal Prosecutor, the FBI, Nasdaq, all assisted by the Emulex CEO, and the Internet Wire Service teamed together to investigate the hoax and they believed to be fraudulent activity;
- The FBI was able to track internet protocol numbers leading to a computer at a University in Torrance, California;
- The computer provided evidence that the false press release had been prepared on it; and
- Witnesses stated that Jacob had used the computer at the specified time

Broker Trading Records

- The SEC:
- obtained records from an online brokerage firm that showed Jacob used his account to trade Emulex stock;
 - traced brokerage records back to suspicious trades one week before the hoax started, which were Jacob's short sales;
 - found the 3,500 Emulex share purchases by Jacob on 25th August and their sale on 28th August; and
 - discovered Jacob's bank account details

The Civil Court Case: Freeze the money

- 31st August SEC filed civil proceedings for securities law breaches and fraud;
- Court granted an immediate order freezing \$400,000.00 in Jacob's bank account;
- An injunction for disgorgement of profits;
- An order prohibiting the destruction of documents, including computer records;
- Order immediately served on Jacob's bank; and
- FBI meanwhile had obtained a warrant for Jacob's arrest

Jacob's Wild Summer Comes to a Bad End

- Six days after the fraud was committed Jacob was found and arrested by the FBI in Los Angeles and charged with criminal securities fraud
- Later Jacob was sentenced to 44 months in prison, an order which forfeited all of his \$240,000.00 gains plus a fine of \$103,000.00

The Rogue Trader

UBS and the "Rogue Trader"

- Kweku Adoboli: former UBS trader accused of having lost the Swiss bank \$2.3 billion;
- Found guilty of 2 counts of fraud
- acquitted of 4 counts of false accounting;
- Sentenced to 7 years imprisonment

Adoboli



UBS and the "Rogue Trader"

- Internship at UBS London 2008;
- Impressed management; promoted to work on an exchange-traded funds (ETF) desk;
- Was earning £250,000 a year in bonuses;
- After the departure of more senior traders, Adoboli and a colleague, John Hughes, were left in charge of the desk and its \$50 billion book at the ages of 28 and 26 respectively.

UBS and the "Rogue Trader"

- Set up a secret account nicknamed "umbrella" to hide losses;
- Booked fake trades to offset the risk exposure he had created;
- Risk exposure peaked at \$12 billion in August 2011; and
- September UBS back office started asking questions

The Phone Call

- UBS accountant, William Steward asked Adoboli to explain "strange" entries on his trading record.
- "I'll come back to you in a few minutes," Adoboli promised;
- After the call Adoboli walked out of the UBS headquarters in the City;
- Told colleagues he had to see a doctor; but
- Instead went straight back to his flat;

The Bombshell email

- Adoboli then write the so called "bombshell email";
- Admitted a series of off-book trades, hidden from his managers and colleagues;
- And he said "*I take full responsibility for my actions and the shit storm that will now ensue,*"
- the email ended with "*I am deeply sorry to have left this mess for everyone and to have put my bank and my colleagues at risk.*"

The Bombshell email

- By 3.35am the next morning Adoboli was under arrest;
- And a senior police officer had to tell the custody sergeant filling out the relevant forms how many zeros there are in a billion.

The UBS Culture

- In his defence Adoboli argued:
- that his colleagues knew of and even occasionally used the same trading methods;
 - UBS's management had encouraged him to take greater risk; and
 - UBS's management told him to bring in higher profits.
- Remember Adoboli was not stealing money for himself just loosing the company money.....

The UBS Culture

- Adoboli said at his trial "There's a difference between policy and practice,"
- 2008 internal memo warns UBS staff of fate of Jérôme Kerviel, the rogue trader at Société Générale; but
- Oswald Grubel, who became CEO in 2009 (and resigned in the wake of the rogue-trader scandal said in November 2009 "I'd actually like to see us put more risk on the table,"

Adoboli Sentence

- admitted causing the loss, but
- said it wasn't done dishonestly;
- unanimous verdict in finding Adoboli guilty of one count of fraud during the period in which the loss was caused but,
- majority verdict on the second fraud charge, which dated back to 2008; and
- acquitted on all the false accounting charges.

Adoboli Sentence

- Sentence was seven years imprisonment
- Adoboli was ordered to serve at least half of the seven-year term;
- He's already been in custody for more than a year, including his time in jail before trial; and
- Is currently appealing the conviction in the Court of Appeal.

The UBS Culture

- Risk limits at Adoboli's ETF desk were successively increased;
- UBS punishment for taking excessive risk was weak;
- Adoboli received only a warning for exceeding risk limits in January 2011; and
- a mechanism for verifying trades was mysteriously switched off until his activities were exposed.

UBS Punishment

- November 2012: UBS fined £29.7million for “significant control breakdowns” that allowed a Adoboli to lose \$2.3billion in 2011; and
- FSA said UBS had ineffective computer risk controls and “poorly executed and ineffective supervision” that allowed Adoboli repeatedly to breach risk limits and book fictitious trades.

UBS Punishment

- By the early settlement mechanism UBS fine was reduced from £50 million to just over £30 million; and
- UBS has also been fined £160 million for the LIBOR fixing;
- A total of almost £200 million in regulatory fines in UK within 12 months!
- But UBS said it had made progress over the year “reinforcing our position as one of the most financially sound global banks”.

Fraud in Investment Funds

Morgan Grenfell

- Old, established and well respected investment bank;
- Had investment fund management subsidiary company;
- Morgan Grenfell Asset Management which also had an impeccable reputation;
- Fund manager was licensed and regulated;

Peter Young

- Graduate of Oxford;
- Joined Morgan Grenfell Asset Management;
- Worked his way up through the firm;
- In charge of three “European Funds” whose value was over 1 billion sterling;
- Funds were open ended and offered to the public

Spread of Investment Assets

- Regulations set limits (percentages) of the portfolio asset spread;
- Peter Young started off cautiously investing some of the portfolios in unlisted stocks: not permitted by regulation or fund documents;
- The gamble paid off and the profits were spectacular; and the bonuses were spectacular too!

Peter Young



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The Unlisted Stocks

- To maintain his reputation as a “stellar” fund manager and continue his bonuses Young continued to take more and more risks;
- He began to find ways round the regulations on how much a fund could invest in any asset class; as well as continuing with unlisted securities;

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Accounts Suspended

- Internal compliance department got suspicious;
- Minor breaches of the regulations began to appear with regularity;
- Young could not explain them all away;
- Morgan Grenfell's compliance team started a full internal investigation;
- Morgan Grenfell suspended Young and his three accounts

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Accounts Suspended

- Morgan Grenfell compliance team then called in the regulators;
- At that time there was an SRO for fund management (LAUTRO); and
- The statutory lead regulator at that time called the Securities and Investments Board (SIB) later to be FSA and now FCA

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The Fraud Investigation

- A full investigation was started with SIB and with Morgan Grenfell's co-operation;
- as the pieces were put together SIB called in the Serious Fraud Office (SFO);
- SFO investigates and prosecutes financial crime over 5 million sterling;
- SFO are experts in financial crime detection

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The Fraud

- Young had used the three funds to invest well over three times the legal limit for holdings a variety of asset classes;
- He had created a web of shell/false companies (which he owned) and which purported to be investors in the fund; and used these to vehicles to onwardly transfer the profits into his own offshore accounts.

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Criminal Proceedings

- The total amount of the fraud was estimated to be 220 million sterling;
- Morgan Grenfell were required by the regulators to reimburse their accounts so no investor losses; and
- Some monies (a small percentage of the total fraud) were recovered from Young's off shore accounts

The Trial

- Young was not remanded in custody pending trial: he had no previous criminal record;
- But his behaviour began to change;
- He began to turn up for his bail hearings pending the trial dressed in women's clothing; and
- Would only answer to the name "Elizabeth"

Young outside the Old Bailey



Young's defence

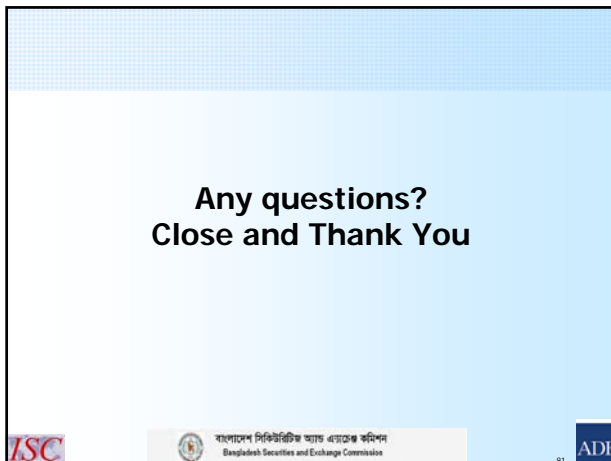
- At first Young' antics were seen as a means of avoiding a trial;
- Psychiatric reports were ordered;
- The Crown said he was fit to plead (and be tried for fraud);
- The Defence ran "unfit to plead" which would mean no trial and committal to a mental institution

Matters Get Worse

- Young attempted a do-it-yourself sex change using fishing line, a craft knife and a pair scissors;
- The attempt was not successful but the defence succeeded in securing a hearing where the Judge said Young was unfit to stand trial by reason of insanity and sectioned him under the Insanity Act

Peter Young

- Young is still in a mental institution;
- Still answering only to the name of Elizabeth; and
- Still cross dressing; and
- The majority of the off shore funds were never traced despite extensive further investigations over many years.....



Appendix 2.5: Industry Consultation Workshop Handout (5 June 2014)

This workshop is accredited by the General Council of Bar of England and Wales

Industry Consultation Workshop

Hotel Purbani International Limited
Dhaka, Bangladesh
5 June 2014

Prepared by: Michele Parnell
ISC consultant
(& International Capital Markets Tribunal Expert)

ADB TA-8228 BAN: Enhancing Efficiency of the Capital Market
Component 2: Expedited adjudication of enforcement actions

ISC
The International Securities Consultancy Limited

Introduction and Welcome

Michele Parnell:

- Practising Barrister: commercial law;
- Part Time Judge of the Supreme Court in the UK;
- Former General Counsel at the Financial Services Authority in the UK and Head of Enforcement;
- Former General Counsel to the Bank of England; and
- Fellow of the Chartered Institute of Arbitrators in the UK;

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Enhancing the Efficiency of Capital Markets

ADB project to enhance efficiency in capital/securities markets:

Components on:

- Enforcement actions (investigations, sanctions and penalties) that Bangladesh Securities and Exchange Commission (BSEC) as the statutory regulator may impose on capital markets licence holders' for breaches of the law and regulations; and
- To consider alternative means of challenging BSEC enforcement actions for licence holders;

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International Bench Marks

- International Organisation of Securities Commissions (IOSCO) set the standards for securities markets worldwide;
- BSEC is a full member of IOSCO and committed to follow its standards;
- IOSCO Principles of Securities Regulation (sets out the basic standards of behaviour for the market and the regulator) require that a regulator (BSEC) is **accountable** in the exercise of its functions and powers (particularly enforcement): withdrawal of a licence means the end of a securities business

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International Bench Marks

3 IOSCO core objectives of securities regulation are:

- Protection of investors;
- Ensuring that markets are fair, efficient and transparent; and
- Reduction of systemic risk.

Regulators have a tough balancing act between the need to protect investors and the need to take swift and proportionate enforcement action;

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International Bench Marks

Accountability in IOSCO terms requires that the Regulator is subject to appropriate scrutiny and review, including:

- Transparency in the regulator's process and conduct;
- A system permitting licence holders to challenge regulatory decisions; (and receive reasons for those decisions) and
- A ultimately a system permitting judicial review of the exercise of the decisions of the regulator;

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International Bench Marks

Challenges to regulatory decisions:

- IOSCO requires that the mechanism for challenge is to an independent forum;
- It is not best practice for the decision maker to review its own decisions;
- Nor should the investigative team be part of the decision making team inside the regulator; and
- There must be clear separation of these roles



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International Bench Marks

IOSCO envisages:

- A “staged / layered” means of challenging regulatory decision making;
- A decision making process that is clearly in accordance with the principles of natural justice;
- That provides clear reasons for the decision;
- That provides an opportunity to make representations to a body other than the original decision maker; and
- A means of ultimate recourse to the Courts as the final arbiters of justice



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Enhancing the Efficiency of Capital Markets

- Currently challenges to BSEC decisions are made to the Courts;
- Cases can be complex; time consuming for the parties; expensive and subject to long delays before ultimate determination;
- Purpose of ADB project is to consider the viability of creating a forum for fast track adjudication (the proposed Tribunal) as a alternative to going to the Courts; and
- A Tribunal would be in line with the IOSCO principles



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Purpose of the Consultation Exercise

- Tribunal arrangements will only work with Industry confidence in the integrity and independence of the Tribunal;
- Model rules drafted have been drawn up in line with international best practices;
- Tribunals operate in numerous developed and developing jurisdictions world wide; and
- Provide an effective and swift alternative to the Courts



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The Regulatory Framework

- Increasing similarities word wide in securities laws and regulations;
- The laws and regulations create three categories of regulatory response for transgressions:
 - Criminal offences: insider trading, market manipulation and trading without a licence are the most common as well as plain theft offences;
 - Civil causes of action: usually injunctions granted to freeze assets or winding up proceedings; and
 - Regulatory offences: ranging from rule breaches to withdrawal or suspension of a licence



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Criminal Offences

- Regulators (save with a few notable exceptions) are not prosecuting agencies;
- Prosecutions require a higher standard of proof (beyond reasonable doubt);
- Prosecutions require evidence to be presented to in accordance with a the criminal evidential and procedural requirements;
- Even in the most developed legal systems its much more difficult to secure a successful prosecution



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Criminal Offences

- Public perception that insider dealing and market abuse are victimless crimes;
- Members of the public who suffer loss at the hands of licensed firms are only interested in getting their savings back and not the jail sentence;
- Madoff in USA sentenced to 150 years imprisonment but public interest was in the liquidator charged with recovering and distributing the assets;
- Generated so much public interest that Court ordered liquidator to create his own web site and publish his up to date progress on a monthly basis



Criminal Offences

- Increasing international trend to select only the most egregious cases for prosecution;
- Or use fines as a means of punishment combined with a prohibition from working in the securities markets industry again
- For example on 14th May the Monetary Authority of Singapore imposed a civil penalty of \$50,000 for insider trading; and
- Also prohibited the individual from working in the securities industry for a period of 3 years.



Civil Cases

- Injunctions (asset freezing orders and restitution):
- Winding up licensed firms;
- Interpretation of legislation by the Judges e.g. the Client Money Regulations "loophole" in the UK and Lehman's;
- Oversight of regulators to deal with allegations abuse of powers;
- Overnight of Tribunals by way of appeals where the Tribunal may have misapplied the Law



The Client Money "loophole"

- Lehman's put client money in to their general bank accounts;
- The money was then invested and Lehman's made a profit;
- Client money was then reconciled and transferred into segregated accounts;
- Client money rules required segregation as soon as reasonably possible and not forthwith – supported by specialist legal advice



The Lehman's Collapse

- Client money was transferred to a bank that was a wholly owned subsidiary of Lehman's;
- That bank held \$1 billion of what was undisputed client money; but
- Lehman's then went into administration before a reconciliation and segregation could occur;
- So client funds were in the general account and in theory available to all the general creditors of the bank



The client money "loophole"

- Strong criticism by Courts of FSA's rules that allowed this "temporary mixing" of client money and the firms money;
- FSA reviewed and quickly changed the client money regulations; and
- There was a "crack down" on firms for breaches of the principles (high level statements of conduct as there was no breach of law or regulations) as it was discovered the practice was widespread in the City of London;



Record Breaking Fines

- JP Morgan Securities fined £33.2 million for failing to segregate client money;
- Barclays Capital fined £1.2 million for failing to segregate client money on an intra day basis

But Courts came to the rescue and held that even where not segregated client money was impressed with a trust and thus “ring fenced” from the general creditors: demonstrated an understanding of regulatory policy and intent



Regulatory Offences

Ranges from:

- Minor rule breaches to breaches of client money;
- Misconduct that causes the regulator to suspend or withdraw a licence;
- Regulatory offences attract the civil standard of proof – balance of probabilities; and
- Because of this lower standard regulators have deliberately de-criminalised certain conduct for example market abuse in the UK is not a criminal offence



Rationale for Tribunals in capital markets

- Courts are under increasing pressure from ever larger case loads;
- International recognition that alleviating the burden on the Courts by introducing alternative mechanisms of resolution is desirable, speedy and cost effective for the parties;
- Seen a steady increase in use of arbitration, ADR in all types of commercial claims; and
- An increase in the development of Tribunals for specialist areas of law



Tribunals: Important Cogs in the Machinery of Justice

- In UK until mid 1950's Tribunals were the “Cinderella's” of administrative justice, receiving little professional or academic attention;
- Perceived as poor persons' courts operating relatively informally and inexpensively in welfare cases;
- Perceived as too close to government departments to be truly independent, and
- Too informal in their procedures to bear comparison with real courts of law.



Tribunals: Important Cogs in the Machinery of Justice

In the UK two significant incremental changes:

- Report of the Franks Committee on Tribunals and Enquiries 1957: status of Tribunals changed to become part of Judicial System (governed by a Committee on Tribunals) rather than as creatures of the government administration; and
- Report of Sir Andrew Leggatt (Court of Appeal) new legislation: the Tribunals, Courts and Enforcement Act 2007 Tribunal system fully integrated and on a firm statutory footing in the Judicial System



Tribunals: within the Justice system or not?

- Ideally Tribunals should be part of the Justice system;
- But that is not always feasible (parliamentary time for new legislation) or an advantage (the justice system may not have developed sufficiently to allow for case management – the courts drive the timescale for hearings and not the parties);
- The Take Overs and Mergers Panel in the UK developed in the 1980's and operated totally outside the Justice system till 2006 and dealt with the largest and most legally complex acquisitions and mergers



Case Management: a fundamental building block in hearings

- In the UK parallel to the development of the “specialist” Tribunal was the then “radical” and strongly opposed (initially) recommendations on case management in the 1980/90’s;
- Driven by:
 - criticism of the arcane procedural requirements in the High Court;
 - The ability of Counsel to take advantage of the Supreme Court Rules on technical points and adjournments; and
 - Criticism of the delay and cost of getting to Trial



Case Management: a fundamental building block in hearings

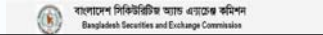
- Case management now an integral part of all Courts (criminal and civil) and Tribunals and Arbitrations;
- Phenomenal success in improving access to justice;
- Reduced lead time to trial significantly;
- Reduced case back log so virtually non existent;
- Combines case management with use of new technology:
 - E filing;
 - Cloud disclosure;



Expertise in Capital Markets is Essential

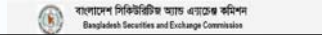
Capital markets are fast moving;

- Encompass many areas of law not just those dedicated securities and banking laws but also:
 - Contract;
 - Company and partnership;
 - Take overs and Mergers and competition;
 - Trust;
 - Insolvency (bankruptcy and winding up);
 - Intellectual property;
 - IT and data protection; and the list goes on
- All of which needs a high degree of specialism and expertise



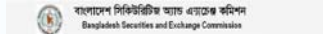
The Role of the Judiciary in Capital Markets

- Currently there is no specialist “commercial” court with Judges who have training in securities markets laws and practice unlike other jurisdictions;
- Criminal prosecutions for “white collar crime”; insider trading and market abuse are few and far between; however there is now the Special Criminal Tribunal for these cases;
- But the current criminal procedure code does not provide for any fast track case management; and
- There is a lack of expertise in prosecuting financial crime



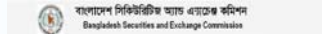
Criminal Tribunals

- Not many dedicated Criminal Tribunals internationally;
- Criminal offences are normally left to the ordinary Criminal Courts where there are a specialist cadre of Judges, lawyers who deal with these cases supported by a specialist agency (not the regulator) who investigate and prepare the cases;
- Where there are Criminal Tribunals these are supported by an up to date criminal procedure code which allows for case management; and speedy disposition of the matter



Administrative or Disciplinary Tribunals

- Internationally accepted best practice to create such Tribunals;
- Where possible created in primary legislation and in the judicial system; and funded by the Ministry of Justice;
- Otherwise created by condition of licensing and funded by the industry;
- Transparent, accountable (annual reports and web site);
- Independent and effective



Enforcement: where the regulators should rely on the Courts

- Regulatory sanctions must be swift and proportionate;
- Follow the money; seize, freeze, and restore;
- Injunctive relief is the most effective and most regulatory remedy in the UK (and the USA);
- Criminal prosecutions are the least effective and least used remedy (in the UK: but the USA has a better criminal track record!)



The Role of the Tribunal

- Fills the middle ground between freeze and seize and/or prosecute;
- Majority of regulatory cases relate to day to day conduct of licensed firms;
- Decisions that are challenged are regulatory;
 - Grant; suspension or withdrawal of licence;
 - Disciplinary matters; (e.g. breach of client money rules);
 - Penalties; and
 - official listing



Financial Services Tribunal UK

- UK Financial Conduct Authority 2012/2013:
 - 5 civil actions in the High Court; and
 - 4 criminal actions; and
 - 150 regulatory decision notices

40% of the UK's regulatory decisions notices are challenged in the Tribunals and those mainly relate to the amount fines imposed (regulator has an unlimited power to fine)



Financial Services Tribunal UK

- £160m: UBS - Libor rigging;
- £87.5m: Royal Bank of Scotland - Libor rigging;
- £59.5m: Barclays - Libor rigging;
- £33.2m: JP Morgan - failing to protect client money;
- £30m: Prudential - failing to inform FSA of acquisition plans;
- £29.7m: UBS - failing to prevent unauthorised trading;
- £17.5m: Goldman Sachs - weaknesses in controls;
- £17m: Shell - market abuse;
- £13.96m: Citigroup - failing to conduct its business properly; and
- £10.5m: Card Protection Plan - mis-selling insurance



Financial Services Tribunal UK

Forthcoming Hearings and Register
(Updated 23/05/2014)

| Reference No. | Applicant | Respondent | Date of receipt | Hearing Date | Page of Application | Outcome and reasons |
|---------------|-----------------------|------------|-----------------|--|------------------------------|---------------------|
| FS20140001 | John Smith-Jones | FCA | 19/05/2014 | 10 June 2014 @ 10.00am @ 40 Bedford Square London WC1R 4EU | 1 | |
| FS20140002 | John Garry Williams | FSM | 20/05/2014 | To Be Fixed | | |
| FS20140003 | Robert Lynn Huxley | FSM | 20/05/2014 | To Be Fixed | | |
| FS20140004 | Priority Application | FCA | 19/05/2014 | 18 February 2014 @ 10.00am @ 40 Bedford Square London WC1R 4EU | Priority Application Hearing | Dismissed |
| | | | | 17-18 March 2014 @ 10.00am @ 40 Bedford Square London WC1R 4EU | Substantive | Dismissed |
| FS20140005 | Haroldson Capital Ltd | FCA | 21/01/2014 | Not Reported | | Withdrawn |
| FS20140006 | Priority Application | FCA | 1/01/2014 | To Be Fixed | | |
| FS20140007 | Patric Thomas-Carson | FCA | 18/12/2013 | 23 March 2014 @ 10.00am @ 40 Bedford Square | Application | |



The Proposed Tribunal: Consultation

- Crucial that the Tribunal is impartial and perceived to be impartial;
- Practical Industry expertise of Tribunal members;
- Means of selection: ideally by advertisement but then who chooses panel members? Ministry of Justice; Professional bodies such as Industry Associations; Accountancy or Legal Associations?
- It cannot and should not be the regulator choosing the panel members



The Proposed Tribunal

The Tribunal Panel

- Legal chairman and two industry experts provides balance and day to day expertise and practical experience;
- Pool of legal chairman;
- Pool of industry experts;
- All to be called on an as and when basis: not full time appointments;
- Remuneration (to be fixed and made public) and paid on basis of actual sitting days



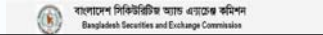
Venue ?

- Courts already busy and overcrowded;
- Bangladesh International Arbitration Centre has purpose built arbitration facilities – a possible venue?
- Tribunals need support staff to deal with notices; case papers etc: proposal is part time as and when function not full time employee until proposed Tribunal is up and running with actual cases to hear



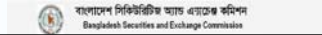
The Proposed Tribunal

- Not bound by strict evidential rules;
- Parties pay their own legal costs but they need **not** use lawyers;
- Case management best practices and procedures are built into the rules;
- So the Panel drives the case and not the parties; and
- Appeal **only** on a point of law to the Supreme Court so the Panel are the arbiters of fact (save where the decision was so unreasonable as to trigger judicial review)



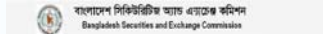
Why Use Tribunals rather than the Courts

- Speed; six month time frame from start to finish of the case; and
- Cost: litigation is expensive (and slow):
- In Parliamentary debate in the UK (on a revised legislative framework for the securities markets) it was accepted that licence holders already face a significant disincentive against contesting regulatory action in the Courts in the UK since win or lose they must continue to live with the regulator; but
- Tribunals can and do provide a cheaper alternative



Does the Tribunal have any effect on the Regulators conduct of enforcement actions?

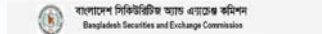
- Tribunal decisions are significant and change regulatory practices;
- For example Legal and General Assurance Society Ltd v the FSA
- Strong criticism of the FSA's enforcement process by the Tribunal Panel led to the FSA making significant changes to its internal procedures;
- But Tribunals are only as effective as the choice made by the person against whom the decision is made determining to challenge that decision before a Tribunal



Legal and General: Lessons for the FSA

The Facts

- The FSA sought to discipline Legal & General for:
 - failing to have sales and compliance procedures which would ensure that their flexible mortgage plans were sold only to customers for whom they were suitable and
 - selling fixed mortgage plans to customers for whom they were not suitable.



Legal and General: Lessons for the FSA

Legal & General referred the decision to the Financial Services and Markets Tribunal on the grounds:

- that there were appropriate sales and compliance procedures; and
- that the allegations of mis-selling were flawed, in that the investigative methodology simply could not sustain the conclusions the FSA was seeking to draw.

They won the case



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Legal and General: Lessons for the FSA

- FSA contended that policies were “mis-sold” either because the customer would not accept, or did not understand, the risk of a capital shortfall;
- To sustain its case, the FSA commissioned a sample review of 250 randomly selected customers described as low risk.
- The review closed 171 cases as “no further action” and 19 as “inconclusive”. The remaining 60 were categorised as “redress payable” on the basis that “there exists persuasive evidence for a judgment to be formed on whether the customer was risk-averse and/or did not understand the capital shortfall risk and may, therefore, have been sold a policy that was not suitable for them”.



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Legal and General: Lessons for the FSA

The Tribunal found as a matter of fact that of the 60 cases:

- 8 were mis-sales with potentially 14 more;
- 25 were too unclear to decide;
- 4 were not mis-sales with potentially another 9 in that category.

The Tribunal found that such a pattern could be representative of sales to low-risk customers generally; and ruled against the FSA.



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Legal and General: Lessons for the FSA

Tribunal criticised FSA for:

- initiating disciplinary proceedings on the basis of merely 250 samples; and
- Inadequate scrutiny of the evidence;

FSA changed its procedures for reviewing the evidence



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Questions and Feed back




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Appendix 2.6: Informal Presentation to BSEC Chairman and Commissioners (11 June 2014)

**Presentation to BSEC Chairman and Commissioners
11th June 2014**



ADB TA-8228 BAN: Enhancing Efficiency of the Capital Market
Component 2: Expedite adjudication of enforcement actions





The International Securities Consultancy Limited


Component 2: Expedited Adjudication of Enforcement Actions: progress update

Special Criminal Tribunal:

- Created a criminal court with jurisdiction over securities markets cases;
- Hampered in administering expedited justice by existing Criminal Procedure Code which does not provide for case management;
- Drafted fast track procedural case management rules but not within BSEC's power to impose these: for the Rules Committee of the Supreme Court and Ministry of Justice; and
- Consulted with senior Judiciary all keen to see case management introduced






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Component 2: Expedited Adjudication of Enforcement Actions: progress update

- Criminal Tribunal:
 - will not achieve expedited hearings; and
 - has no jurisdiction over disciplinary/administrative sanctions imposed by BSEC;
- So explored other possibilities for expedited adjudication in line with IOSCO Principles and international best practices; and
- Started the process of consultation with the industry and the Judiciary of an "Administrative Tribunal"



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International Bench Marks

IOSCO envisages:

- A "staged / layered" means of challenging regulatory decision making;
- A decision making process that is clearly in accordance with the principles of natural justice;
- That provides clear reasons for the decision;
- That provides an opportunity to make representations to a body other than the original decision maker; and
- A means of ultimate recourse to the Courts as the final arbiters of justice






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Enhancing the Efficiency of Capital Markets

- Currently challenges to BSEC decisions are made to the Courts;
- Cases can be complex; time consuming for the parties; expensive and subject to long delays before ultimate determination;
- Consultation is a means of considering the viability of creating a forum for fast track adjudication (the proposed Tribunal) as a alternative to going to the Courts; and
- A Tribunal would be in line with the IOSCO principles






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Purpose of the Consultation Exercise

- Tribunal arrangements will only work with Industry confidence in the integrity and independence of the Tribunal;
- Model rules drafted have been drawn up in line with international best practices;
- Tribunals operate in numerous developed and developing jurisdictions world wide; and
- Provide an effective and swift alternative to the Courts

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The Regulatory Framework

- Increasing similarities word wide in securities laws and regulations;
- The laws and regulations create three categories of regulatory response for transgressions:
 - Criminal offences: insider trading, market manipulation and trading without a licence are the most common as well as plain theft offences;
 - Civil causes of action: usually injunctions granted to freeze assets or winding up proceedings; and
 - Regulatory offences: ranging from rule breaches to withdrawal or suspension of a licence



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Enforcement: Criminal Offences

- Regulators (save with a few notable exceptions) are not prosecuting agencies;
- Prosecutions require a higher standard of proof (beyond reasonable doubt);
- Prosecutions require evidence to be presented to in accordance with a the criminal evidential and procedural requirements;
- Even in the most developed legal systems its much more difficult to secure a successful prosecution



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Rationale for Tribunals in capital markets

- Courts are under increasing pressure from ever larger case loads;
- International recognition that alleviating the burden on the Courts by introducing alternative mechanisms of resolution is desirable, speedy and cost effective for the parties;
- Seen a steady increase in use of arbitration, ADR in all types of commercial claims; and
- An increase in the development of Tribunals for specialist areas of law



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Case Management: the fundamental building blocks

- Introduced following recommendations of a Senior Judge in the UK in the 1980/90's;
- Applies to all cases (civil, criminal, Administrative Tribunals, Arbitration and ADR)
- Driven by:
 - criticism of the arcane procedural requirements in the High Court;
 - The ability of Counsel to take advantage of the Supreme Court Rules on technical points and adjournments; and
 - Criticism of the delay and cost of getting to Trial



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The Role of the Tribunal

- Fills the middle ground between freeze and seize and/or prosecute;
- Majority of regulatory cases relate to day to day conduct of licensed firms;
- Decisions that are challenged are regulatory;
 - Grant; suspension or withdrawal of licence;
 - Disciplinary matters; (e.g. breach of client money rules);
 - Penalties; and
 - official listing



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Tribunals deal with Regulatory Offences

Ranges from:

- Minor rule breaches to breaches of client money;
- Misconduct that causes the regulator to suspend or withdraw a licence;
- Regulatory offences attract the civil standard of proof – balance of probabilities; and
- Because of this lower standard regulators have deliberately de-criminalised certain conduct for example market abuse in the UK is not a criminal offence



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De Criminalising Offences

- Increasing international trend to select only the most egregious cases for prosecution;
- Or use fines as a means of punishment combined with a prohibition from working in the securities markets industry again
- For example on 14th May the Monetary Authority of Singapore imposed a civil penalty of \$50,000 for insider trading; and
- Also prohibited the individual from working in the securities industry for a period of 3 years.



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Financial Services Tribunal UK

- UK Financial Conduct Authority 2012/2013:
 - 5 civil actions in the High Court; and
 - 4 criminal actions; and
 - 150 regulatory decision notices

40% of the UK's regulatory decisions are challenged in the Tribunals and those mainly relate to the amount fines imposed (unlimited power of fines)



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Financial Services Tribunal UK

- £160m: UBS - Libor rigging;
- £87.5m: Royal Bank of Scotland - Libor rigging;
- £59.5m: Barclays - Libor rigging;
- £33.32m: JP Morgan - failing to protect client money;
- £30m: Prudential - failing to inform FSA of acquisition plans;
- £29.7m: UBS - failing to prevent unauthorised trading;
- £17.5m: Goldman Sachs - weaknesses in controls;
- £17m: Shell - market abuse;
- £13.96m: Citigroup - failing to conduct its business properly; and
- £10.5m: Card Protection Plan - mis-selling insurance



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The Proposed Tribunal

- Proposed rules - consultation exercise;
- Industry must have confidence in the Tribunal;
- Primarily confidence will come from the reputation, gravitas and experience of the panel members;
- Legal chairman and two industry experts provides balance and day to day expertise;
- Pool of legal chairman;
- Pool of industry experts;
- All called on "on an as and when" basis: not full time appointments



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The Proposed Tribunal

- Not bound by strict evidential rules;
- Parties pay their own legal costs but they need NOT use lawyers;
- But case management best practices and procedures are built into the rules;
- Panel drives the case and not the parties; and
- Appeal only on a point of law to the Supreme Court so the Panel are the arbiters of fact (save where the decision was so unreasonable as to trigger judicial review)



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Tribunals: within the Justice system or not?

- Ideally Tribunals should be part of the Justice system;
- But that is not always feasible (parliamentary time for new legislation) or an advantage (the justice system may not have developed sufficiently to allow for case management – the courts drive the timescale for hearings and not the parties);
- The Take Overs and Mergers Panel in the UK developed in the 1980's and operated totally outside the Justice system till 2006 and dealt with the largest and most legally complex acquisitions and mergers



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The Consultation Exercise

- No regulatory agency can rely on legal certainty;
 - Regulators are (quite rightly) subject to suit;
 - Dealing with a multiplicity of legal proceedings in the Courts is resource intensive;
 - Consultation will gauge the Industry's enthusiasm for a fast track independent forum for challenge of BSEC decisions;
 - If the Industry have confidence in the Tribunal they are likely to use it
- BSEC will be able to base any regulatory policy decision it makes following the consultation exercise



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Questions



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Appendix 2.7: The International Requirements and Best Practices for Capital Market Tribunals (October 2013)



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ADB TA-8228 BAN: Enhancing Efficiency of the Capital Market
COMPONENT 2: EXPEDITED ADJUDICATION OF ENFORCEMENT ACTIONS

INTERNATIONAL REQUIREMENTS AND BEST PRACTICES FOR CAPITAL MARKET TRIBUNAL

October 2013



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SUMMARY OF ISSUES FOR THE ESTABLISHMENT OF A CAPITAL MARKETS TRIBUNAL

INTRODUCTION

It is a condition precedent for the release of the second tranche of the loan of the ADB RRP Project of November 2012 that the following actions are completed:

“Establish a special tribunal for capital market related cases. Issue regulations that: (i) define the powers, functions and jurisdiction of the tribunal, (ii) determine status of appeals and adjournments, and (iii) determine appointment of qualified judges and their training”.

CAPITAL MARKETS TRIBUNALS: INTERNATIONAL REQUIREMENTS AND BEST PRACTICE

IOSCO as the leading international group of securities market regulators has established what are globally accepted as the regulatory standards and best practices for securities markets though (inter alia) their revised Principles of 2011. These Principles are considered by the Financial Stability Board¹ as vital to sound financial systems and deserve priority implementation.

IOSCO takes the view that the complex character of securities transactions and of fraudulent schemes requires strong enforcement for investor protection. And, more generally it takes the view that there must be an appropriate and effective legal framework within which securities markets operate as securities laws and regulation cannot (and do not) exist in isolation from other laws.

The Principles have the advantage of avoiding prescriptive requirements while at the same time providing essential guidance as to the core elements of a regulatory framework for securities markets.

There no single correct approach or solution to any one regulatory issue as legislation and regulatory structures vary between jurisdictions and reflect domestic market conditions as well as historical developments. IOSCO recognises this contextual distinction and in consequence there is some scope for flexibility in the interpretation of certain aspects of the Principles however this does not apply to with regard to the Enforcement and Co-operation Principles which underpin the provisions of the IOSCO Multilateral Memorandum of Understanding and which is a benchmark among securities regulators at the international level.

OVERVIEW AND OBSERVATIONS ON THE IOSCO PRINCIPLES RELATING TO A TRIBUNAL STRUCTURE

The following principles are pertinent (and inter related) when considering a Tribunal structure:

- **Principles Relating to the Regulator (in this case the Bangladesh Securities and Exchange Commission (BSEC))**

Principle 2: The Regulator should be operationally independent and accountable in the exercise of its powers and functions

Principle 4: The Regulator should adopt clear and consistent regulatory processes.

Principle 5: The staff of the Regulator should observe the highest professional standards, including appropriate standards of confidentiality.

¹ The FSB has been established to coordinate at the international level the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies in the interest of financial stability.

- **Principles for the Enforcement of Securities Regulation**

Principle 12: The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.

A regulator should be accountable and independent (and seen to be accountable and independent) under the law. Without such accountability and independence investors and securities market participants may come to doubt the regulator's objectivity and fairness, with consequent deleterious effects on the integrity of the regulator. Although a regulator should detect, deter and penalise breaches of the law and rules it is also under a duty to implement the regulatory framework responsibly, fairly, effectively and proportionately.

A fundamental prerequisite to establish this independence and accountability is a robust enforcement process that culminates in a reasoned and evidentially sound decision which may then be challenged by way of a review of the regulators decision.

However in the fast moving field of securities markets it is accepted that many jurisdictions may be fettered by time, cost and potentially damaging publicity constraints² in respect of challenges to regulatory decision making by way of the process of "Judicial Review" in the higher courts. Thus the "Tribunal" process has developed as an effective and speedy mechanism for review of regulatory decisions.

Principle 2 expects the Regulator to:

- provide written reasons for its decisions;
- permit those affected by the decision to make representations prior to that decision being taken³; and
- establish an independent review process prior to any ultimate Judicial Review by the higher courts

Principle 4 expects the Regulator in exercising its powers and discharging its functions to adopt processes which are:

- consistently applied;
- comprehensible;
- transparent to the industry and the public; and
- procedurally fair and equitable (a regulator should publicly disclose the mechanism it establishes for challenges to its decisions).

² Challenges to regulatory decisions in a Tribunal forum are ordinarily held in "camera" and there is no public announcement of any decision until the rights of appeal from the Tribunal to the High Court have expired or are exhausted to minimise the potential of any cause of action against the Regulator for reputational damage were the decision challenged to be dismissed or varied save in the most exceptional of cases and where the need to protect investors outweighs the need for confidentiality.

³ This usually will involve an extra statutory process being built into the decision making by way of a "Notice of Proposed Decision" that way representations can be made by affected parties before the decision is actually made. Such a process must be clear, fair and transparent and must involve a review of the proposed decision and any representations by persons in the Regulator who have not (my emphasis) been involved in the investigation or enforcement action culminating in the Proposed Decision.

FIRST QUARTERLY REPORT

Principle 5 expects the staff of the regulator to abide by the highest standards of professional integrity in the performance of their duties and to observe procedural fairness. In the context of enforcement decisions and the Tribunal this will mean that those involved in the preparation, drafting and presentation of enforcement cases will need the skills and expertise that would be expected in a criminal or commercial litigation department of a law firm.

There must in addition (and for the protection of regulatory staff) be clear and unequivocal legal “gateways” for onward disclosure of regulatory confidential information to any proposed Tribunal which is established to review regulatory decisions⁴.

Principle 12 requires the regulator to demonstrate how the regulatory system in place, and within its own organisation, provides for an effective and credible use of supervisory and enforcement powers. In particular, the regulator should be able to demonstrate that there is a system to take effective inspection, investigation and enforcement actions and that, where necessary, such actions, have been undertaken to address misconduct or abuses. Thus there needs to be a procedural (and policy) framework that combines a variety of means to identify, detect, deter and sanction such misconduct.

Whilst there are may be a wide range of possible sanctions could be imposed Principle 12 requires that the regulator must be able to produce documentation that demonstrates that sanctions imposed are effective, proportionate and dissuasive.

SUMMARY OF TRIBUNAL (AND ENFORCEMENT) STRUCTURES IN OTHER JURISDICTIONS

The UK, India and Hong Kong have broadly similar enforcement and Tribunal procedures and arrangements however all of these jurisdictions have the benefit of the legislative certainty of specific powers in primary legislation which clearly enable the establishment of Tribunal arrangements and provide for dedicated Tribunal procedural rules to be made to enable them to deal with challenges to regulatory decisions within a short time frame (usually 6 months).

The Financial Services and Markets Tribunal (FSMT) of the United Kingdom, the Securities Appellate Tribunal (SAT) of India and the Hong Kong Market Misconduct Tribunal (MMT) procedural rules combine the general precepts natural justice applicable in the High Court with the responsiveness, flexibility, speed and cost effectiveness associated with alternative disputes resolution (ADR) systems. Each of these Tribunals comprises of three members who collectively bring a specialised practical and legal knowledge of the securities markets laws and operations which are applied in deciding each case brought before it.

Each Tribunal has administrative and operational support from its own “Secretariat” in addition to other external expert advice (including legal advice from Counsel to the Tribunal) which may be sought and obtained as the need arises.

Whilst these Tribunals are not bound (in general) by the strict rules of evidence applicable in traditional courts⁵ their rules do allow for the Tribunal to:

- summon and enforce the attendance of any witness;
- examine persons on oath;
- receive affidavit evidence;
- require the discovery and production of documents;
- dismiss an application for default;
- decide matters ex-parte;
- grant stays of execution against regulatory decisions prior to a full hearing;

⁴ Disclosure of confidential regulatory information interlinks with the Principles relating to co-operation and the requirements of the IOSCO MMoU.

⁵ Save for criminal cases since in India and Hong Kong the Tribunal has a criminal jurisdiction

FIRST QUARTERLY REPORT

- set aside any order or dismissal of any application for default or any order made by it ex-parte or inter parties;
- do anything, which in the opinion of the Tribunal is incidental or ancillary to its functions; and
- review the original regulatory decision and impose any regulatory sanction that may have been available to the regulatory agency; vary the original regulatory decision or dismiss the original regulatory decision.

Challenges to such Tribunals decisions are limited by operation of law to an appeal to the High Court on a point of law or on the basis of “unreasonableness” namely that the decision of the Tribunal was so perverse that no reasonable Tribunal could have arrived at that particular decision on the basis of the evidence before it.

There is one fundamental difference between the FSMT in the UK and the SAT and MMT in India and Hong Kong in that both of the latter the Tribunals have criminal jurisdiction in addition to the power to deal with civil and disciplinary/administrative decisions. However all Tribunals have their own “fast track” procedural rules.

In the UK the Financial Conduct Authority⁶ is also a prosecuting authority for offences under the securities laws. However, in practice the FCA rarely prosecutes an offence itself since it quite properly recognises that it does not have the expertise or resources to of a dedicated prosecuting authority and generally refers criminal matters to the Serious Fraud Office⁷. It is also noteworthy that the FCA has found both as a matter of practice and policy that the imposition of disciplinary (or administrative) sanctions for the licensed community and that of injunctive relief from the High Court by way of asset freezing and ultimate restitution to investors for the “perimeter” or unlicensed firms (who are usually fraudsters) is a much more effective deterrent than prosecution as the highest priority of the investors is invariably the return of their money.

However all the regulators in the UK, India and Hong Kong have well established procedures and practices for the investigation and preparation of enforcement actions and the referral of these matters to the Tribunal. Their enforcement departments comprise of experienced criminal and civil litigators who are not only well versed in securities markets law but are also accustomed to the preparation of regulatory notices and evidence to the requisite criminal and civil procedural standards imposed by the Courts in accordance with their domestic laws and codes.

In the UK and Hong Kong the regulators have furthermore adopted the code of conduct⁸ used by their respective prosecution agencies as best practice in determining which cases merit consideration of prosecution. This code provides guidance to prosecutors on the general principles and standards to be applied when making recommendations or decisions about prosecutions.

THE LEGAL FRAMEWORK IN THE SECURITIES MARKETS IN BANGLADESH

The overarching legal framework in Bangladesh should be considered in the context of the following:

- The design perspective: namely the powers conferred on the regulator, the relevant provisions of the applicable laws and rules and the procedures intended to implement these; and
- The practical perspective: how these powers, laws and rules are being exercised in practice and whether enforcement of the legal framework is in fact effective

⁶ Formerly the Financial Services Authority

⁷ The Serious Fraud Office has statutory powers to investigate and prosecute case involving financial fraud where the proceeds of the alleged fraud exceed a value of £5 million all other cases are dealt with by the Crown Prosecution Service

⁸ See the Code for Crown Prosecutors issued by the UK Director of Public Prosecutions under the Prosecution of Offences Act 1985

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Careful consideration of the wording of clause 25B the amendment to the Securities Markets Ordinance which creates the Special Tribunal has led to the inescapable and firm conclusion that since the Special Tribunal is clearly governed by Criminal Procedure Act 1898 BSEC has no power to create or impose rules of procedure on such a Tribunal. Were BSEC to purport so to do any such rules would be unenforceable and ultra vires.

To create a framework for the Special Tribunal an amendment would be needed to the Criminal Procedure Act 1898. Whilst it is understood that wider procedural reforms to create a fast track framework for adjudication and determination of cases in the Supreme Court are being considered by the Ministry of Justice an amendment to the Criminal Procedure Act 1898 solely to deal with a newly created Special Tribunal appears at first blush an unlikely and fragmented approach in the context of the wider reforms under consideration.

Furthermore the new Special Tribunal will operate as a Sessions court under the auspices of the High Court and its administration will be like that of any other court of law. BSEC does not have the power to create or impose an administrative framework on the Special Tribunal.

Finally BSEC does not have the power to determine the appointment of Judges to the Special Tribunal nor provide for their training. These are matters for the Ministry of Justice and the Judicial Training Institute.

However, there is no legal obstacle to a Judge (or Judges) being appointed to the newly created Special Tribunal and the Tribunal taking on cases under the Securities Markets Ordinance forthwith provided of course that the Ministry of Justice is satisfied that the Judge or Judges so appointed have the requisite skills and experience. However these cases will not be “fast tracked” in any way and will be dealt with like any other matter subject to the existing rules of criminal procedure.

Thus there are both design and practical obstacles in the implementation of section 25B of the Securities Markets Ordinance both of which are out with the scope of BSEC powers. And no Tribunal procedures prevents any securities markets participant exercising their right of challenge to a regulatory decision by way of Judicial Review before the higher courts however a Tribunal mechanism will limit the circumstances in which such a right is exercised.

PROPOSED WAY FORWARD

1. FAST TRACK PROCEDURAL RULES FOR THE “CRIMINAL” SPECIAL TRIBUNAL

Notwithstanding the comments in the preceding section it is suggested that draft “fast track” procedural are nonetheless submitted for consideration by the Ministry of Justice to seek to provide the possibility of expedition in this venue.

2. CREATION OF A DEDICATED SECURITIES MARKETS TRIBUNAL

A practical alternative that would not require recourse to primary legislation is to make it a condition of the “registration and licensing” of securities markets participants by BSEC that all enforcement actions taken by BSEC are subject to challenge and review by a Securities Markets Arbitration Tribunal.

Such a Tribunal would operate under the general auspices of the Arbitration Act 2001 which requires that arbitration proceedings are first exhausted before any matter can be referred to the High Court. This would reduce the opportunity of challenges to the High Court of BSEC’s decisions as a pre-emptive and delaying tactic to an adjudication on the merits. Furthermore it is proposed that the Tribunal would have the power, on application as opposed to referral acting as an automatic stay, to stay a decision made by BSEC as an interim measure pending review by the Tribunal of the substantive decision. This would address the apparent “common” market practice of applications for stays being made to the High Court and in those cases where such stays are granted the then considerable delays before determination.

FIRST QUARTERLY REPORT

The Tribunal would, as with any other Tribunals have its own dedicated rules enabling references to be determined within a short time scale. Furthermore the Tribunal would (again in line with the FSMT, SAT and the MMT) be composed of a number of panel members comprising retired industry specialists; judiciary and accountants thus providing the gravitas, competence, integrity and independence to inspire market confidence in their decisions. The Tribunal itself would comprise three members namely a legal Chairman, an industry specialist and an accountant.

A further step which it is suggested merits careful consideration is inviting the securities industry to nominate the industry specialists and accountancy panel members to the Tribunal and for their selection together with that of the Legal Chairman to be determined by the a body other than BSEC: perhaps the recently established Institute of Arbitrators of Bangladesh either alone or in conjunction with recommendations as to Legal Chairman being made by the Ministry of Justice.

The pre-existing expertise brought by the combination of skills of panel members would mean that training for such a Tribunal would only be needed in relation to the dedicated Tribunal rules. Although it is proposed that the Tribunal operates under the Arbitration Act unlike the Arbitration Act the Tribunal rules would not enable either party to select its own arbitrator but rather proposed members of the Tribunal would be selected by The Institute of Arbitrators on the basis of expertise in the particular area of the securities markets that is required for each individual case such as fund management, investment advice, or brokerage.

Funding of the Tribunal both as to remuneration and administration also falls to be addressed. In the FSMT, the SAT and the MMT the Tribunal are administered by the Ministry of Justice who provide the venues, administrative support and remuneration for panel members. In the UK the fees of Tribunal members are set annually and published by the Ministry of Justice and panel members are only remunerated as and when they were charged with hearing a matter. However when the FSMT was first established in the UK it was not under the auspices of the Ministry of Justice but in fact run in combination by the FCA and the Ministry of Finance and its costs were funded by a levy on the securities markets industry. The cost of this levy was kept at a low level by the remuneration of panel members being on the basis of sitting on actual cases and by the secretariat also being staffed on a “part time” basis and only becoming fully operational in response to a request for a referral to the Tribunal.

In contrast to the Arbitration Acts it is suggested that remuneration and costs of the Tribunal should not be set by the members of the panel but be funded initially by way of levy. As regulatory fees and levies usually attract significant industry interest (and opposition) this aspect merits further exploration and consideration. However, the objective would be to ensure that the Tribunal offered a cost effective and substantially cheaper mechanism for challenging BSEC decisions than the instigation of formal legal proceedings in the Courts and as an incentive legal costs would not be recoverable in the Tribunal save where the Tribunal determined that a reference to it was “frivolous or vexatious”.

It is also suggested that the Institute of Arbitrators of Bangladesh should be approached with a view to them to providing the administrative and operational support and secretariat to the proposed Tribunal as well as the venue for hearings. This would serve to support the perception and fact of the independence of the Tribunal from BSEC.

3. INDUSTRY CONSULTATION

If, in principle BSEC are supportive of the above proposals industry consultation is considered an integral component to the potential success of this proposed Tribunal.

NEXT STEPS

Again, if in principle BSEC are supportive of the above proposals the next steps would be as follows:

- drafting proposed “fast track” procedural rules for the Special Tribunal;
- drafting dedicated procedural rules for the Tribunal;
- engaging in preliminary consultation with the industry; and
- engaging in discussions with the Institute of Arbitrators as to administration and operational matters.

APPENDICES

COMPONENT 3:

**IMPROVED REGULATION, GOVERNANCE AND
OPERATION OF STOCK EXCHANGES**

Appendix 3.1: Report on Fit and Proper Criteria (24 February 2014)



বাংলাদেশ সিকিউরিটিজ অ্যান্ড এক্সচেঞ্জ কমিশন
Bangladesh Securities and Exchange Commission

ADB TA-8228 BAN: Enhancing Efficiency of the Capital Market

REPORT ON FIT AND PROPER CRITERIA

24 February 2014



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INTRODUCTION

1. The Exchange Demutualisation Act, 2013 (the Demutualisation Act) requires that an exchange submit to the Bangladesh Securities and Exchange Commission (the Commission) within 90 days of commencement of the Act a scheme of demutualisation together with the requisite information set out in Section 5 of the Demutualisation Act.
2. Section 5(a) of the Demutualisation Act requires that an exchange submit a:

“Proposal for changing its memorandum and articles of association, which shall contain, among other, details of the qualifications and experiences necessary to become a member of the board of directors”.
3. The following is an extract from the Demutualisation Scheme approved by the Commission and issued by the exchanges in connection with the General Meeting to approve the demutualisation of the exchange:

4.1 Fit and Proper Criteria for Directors

- a) A Director elected by the Shareholders shall hold office for no more than 2 (two) consecutive terms and shall be eligible to be elected as Director after a gap of 1 (one) year;
- b) An Independent Director shall be nominated for a term of 3 (three) years and may be renewed for another term by the Commission on recommendation of the Exchange. Thereafter however, he/she shall not be eligible to be nominated as an Independent Director until after a gap of 1 (one) year;
- c) The Managing Director shall be nominated for a term of not more than 3 (three) years and may be renewed for another term by the Commission on recommendation of the Board.
- d) No person shall be eligible to be elected or appointed as, or continue to occupy the office of a Director if:-
 - i) He is found lunatic or becomes of unsound mind or incapable of efficient attention to business; or
 - ii) He absents himself from three consecutive meetings of the Board of Directors or from all meetings of the Board of Directors for a continuous period of three months, whichever is the longer, without leave of absence from the Board of Directors; or
 - iii) He is convicted of any criminal offence and sentenced to imprisonment;
 - iv) He is a loan defaulter as per CIB report of Bangladesh Bank.
 - v) He has entered into any business transaction with the Exchange.
 - vi) Without prejudice to the above he fails to pass “Fit and Proper” criteria as may be framed by the Commission from time to time.
- e) In addition to the above, a person shall not be considered as an Independent Director if:-
 - i) He is or has been an employee of the Exchange, any of its subsidiaries or holding company within the preceding 3 (three) years of his proposed date of appointment;
 - ii) He is or has been the CEO/MD of any subsidiary, associated company, associated undertaking or holding company of the Exchange within the preceding 3(three) years of his proposed date of appointment;
 - iii) He has, or had within the preceding 3 (three) years of his proposed date of appointment, a material business relationship with the Exchange either directly, or indirectly as a partner, substantial shareholder or director of a body that has such a relationship with the Exchange;
 - iv) He has received remuneration within the preceding 3 (three) years of his/her appointment as a director or receives additional remuneration, excluding retirement benefits from the Exchange apart from a director’s fee or has participated in the Exchange’s share option or a

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- performance-related pay scheme;
- v) He is a family member or connected person, as defined in the Exchanges Demutualization Act, 2013, of any of the Directors, TREC holders or shareholders of the Exchange or the Exchange itself;
- vi) He has or had any relationship with any of the TREC holders or Shareholders of the Exchange or Directors thereof;
- vii) He is or has been an employee or director of any capital market intermediary including Merchant
- viii) Banker or Asset Management Company within the preceding 3 (three) years of his proposed date of appointment;
- ix) He acts as a Director of any other exchange;
- x) He is an employee of any shareholder of any exchange;
- xi) He is an employee of any regulatory organization;
- xii) He is a director or holds any office of a listed company.
- f) An Independent Director must have at least any of the following educational qualification and professional experience:-
 - i) Master in business, economics, statistics, computer science, mathematics, public administration or law including not less than 10 (ten) years professional experience;
 - ii) Bachelor in business, economics, statistics, computer science, mathematics, public administration or law including not less than 15 (fifteen) years professional experience ;
 - iii) Professional designation like CFA, CA, CMA, CS, CPA etc, including not less than 10 (ten) years professional experience.

4. The process for the nomination of candidates as independent directors of an exchange is that names are submitted to the Commission prior to their appointment. The purpose of the submission to the Commission is to ensure that the candidates are fit and proper.
5. The assessment to determine the fitness and properness of independent directors should also be carried out on candidates for election as non-independent (shareholder) directors, the appointment of the Managing Director and Chief Executive Officer of an exchange and for the appointment of any relevant person within an exchange, such as the Chief Regulatory Officer, who will oversee a regulatory function.
6. The purpose of a fit and proper assessment is to ensure that the applicant is not likely to have significant implications for the sound and prudent management of a regulated institution. This is achieved by the Commission exercising judgement and discretion in assessing fitness and propriety and taking into account all relevant matters including:
 - a) Competence and capability;
 - b) Honesty, integrity, fairness, ethical behaviour, and
 - c) Financial soundness.
7. The same assessment can also be applied to other positions within institutions regulated by the Commission. Indeed, the International Organization of Securities Commissions (IOSCO), in the Report of the Emerging Markets Committee entitled Fit and Proper Assessment – Best Practice, dated December 2009, cited 21 key persons, to whom the fit and proper assessment should be applied.
8. In Singapore, the Monetary Authority has established guidelines on the fit and proper criteria applicable to all relevant persons in relation to the carrying out of any activity regulated by the Monetary Authority of Singapore. In Hong Kong, the Securities and Futures Authority has established a Code that applies to all licensed and registered persons; a breach of which

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may be used in evidence against the person in Court. In Malaysia, the fit and proper criteria is established in the Capital Markets and Services Act, 2007 with the power to remove from office any person that does not meet the criteria.

9. The purpose of this Report is to identify and draft the fit and proper criteria for directors and relevant persons within a stock exchange but the same criteria can also be applied to all relevant persons within institutions over which the Commission has regulatory authority. This can be achieved by including in the Rule a list of the relevant persons to whom the fit and proper assessment will be applied. Following discussions with the Commission, the draft Rules (Appendix A) have been drafted so as to apply to all directors and relevant persons in all institutions regulated by the Commission. It is recommended that the work in assessing the fitness and properness of directors and other relevant persons should be carried out by the Registration and Licensing Department.
10. In addition to undertaking the assessment test at the time of appointment, election or registration, it is recommended that a continuing and cumulative test be applied which takes into account the ongoing conduct of business and the history of compliance with all applicable laws, rules and regulations. A failure to continue to be fit and proper should result in action being taken by the Commission to remove the relevant person from the position held in the regulated institution.
11. Whilst it is the Commission that will undertake responsibility for the final assessment, the onus should always be on the individual and their employer to establish that the person is fit and proper rather than for the Commission to show otherwise.

FIT AND PROPER ASSESSMENT

Competence and capability

12. An applicant must be able to show that they are competent to undertake the relevant role or regulated activity including, where appropriate, demonstrate that they have detailed knowledge of the structure, purpose and risks of the products associated with the activity.
13. To demonstrate competence, the director or relevant person involved in carrying out the regulated activity must act in a knowledgeable, professional and efficient manner, complying with the prevailing legislation. The nature and extent of the competence required will depend upon the services being offered or to be offered.
14. In determining a person's competence and capability, the Commission should have regard to matters including, but not limited to:
 - (a) the person's satisfactory past performance or expertise in the nature of the business being conducted;
 - (b) whether the person has an appropriate range of skills and experience to understand, operate and manage the regulated activities/financial affairs;
 - (c) whether the person has the technical knowledge and ability to perform prescribed duties for which they are engaged, including holding recognised professional qualifications and membership of relevant professional institutions.

Honesty, integrity, fairness, ethical behaviour

15. Persons who are honest, diligent and independent-minded, who act ethically and with integrity and fairness are essential to the good reputation and trustworthiness of the financial services industry in general and of individual entities in particular.
16. In determining the honesty, integrity and reputation of the applicant/relevant person, the Commission may consider among other things, whether the applicant/relevant person has been convicted, on indictment, of dishonesty, fraud, money laundering, theft or financial crime within the last ten years. This may be regarded by the Commission as an indication that a person is not fit and proper and will, in principle, bar a person from holding a position in a regulated entity. Where a person has a conviction dating beyond ten years, such information should be notified to the Commission in order for it to adjudicate on the application.
17. The Commission may treat each candidate's application on a case-by-case basis taking into account the seriousness of, and circumstances surrounding, the offence, the explanation offered by the convicted person, the relevance of the offence to the proposed role, the passage of time since the offence was committed, and evidence of the individual's rehabilitation.

Financial soundness or solvency

18. In assessing the financial soundness of the person the Commission should assess whether the person can maintain solvency and prudent financial control. It includes meeting liabilities as they become due and ensuring adequate control over financial risks on a continuing basis. It also involves taking proper care of customers. Financial soundness is an important element in determining the fitness and probity of applicants.
19. In determining the financial soundness of the relevant person, the Commission may consider matters such as, but not limited to:
 - (a) whether there are any indicators that the person will not be able to meet his debts as they fall due;
 - (b) whether relevant solvency requirements are met;
 - (c) whether the person has been subject to any judgment debt or award that remains outstanding or has not been satisfied within a reasonable period;
 - (d) whether the person has made arrangements with creditors, filed for bankruptcy or been adjudged bankrupt or had assets sequestered; and
 - (e) whether the person has been able to provide the Commission with a satisfactory credit reference.
20. When assessing an application the Commission may, in addition to the fit and proper criteria, consider other factors that may be relevant, such as whether the relevant person has a good standing in the profession in respect of which the application is submitted. If the relevant person fails to satisfy the Commission that he is fit and proper, the Commission may refuse the person's application, revoke the person's registration or authorisation, or take other appropriate regulatory action, as may be applicable and necessary.

OPERATION OF THE ASSESSMENT

21. Fitness, propriety or other qualification assessments may be applied at the registration/authorisation stage and thereafter, and on the occurrence of specified events such as the nomination or election of directors. The fitness and probity assessment primarily fulfills a gatekeeper role ensuring that an applicant to a key position has the required level of competence and integrity.

Recruitment or selection

22. The Commission would expect that the recruitment or selection process of each regulated entity would normally cover the following:
- Consideration of the duties and responsibilities of the position to be filled;
 - A selection/appointment process that matches the selected person to the requirements of the position;
 - Verification of qualifications, experience, references and membership of professional bodies;
 - Some probity checks;
 - In relation to directors of exchanges and larger institutions, how the exchange/institution determined that the individual would be a strategic and effective fit with the other members of the Board and that they had suitable relevant experience; and
 - In relation to independent directors, that they meet the qualifying criteria to be an independent director under the Exchanges Demutualisation Act or the Corporate Governance Guidelines, as appropriate.

Submission of necessary documents and forms

23. Each applicant must provide to the Commission the following documents and forms:
- a) Personal Questionnaire and Declaration form;
 - b) An updated, signed Curriculum Vitae;
 - d) Criminal Record (if applicable); and
 - e) Any other document that the Commission deems necessary.

Verification of information by Proposing Entity

24. The proposing entity should verify the information necessary in its opinion to establish that the applicant has the experience necessary and is capable of fulfilling the designated role and that there are no issues arising from the material that would cause the entity to reconsider its proposal to nominate or appoint the person. The proposing entity should then carry out checks on the information to ensure its accuracy.
25. By signing the declaration the proposing entity confirms that it is prepared to proceed with the nomination or appointment, and confirms that it has verified to the best of its ability the information in the completed forms and is seeking approval of the proposed nomination or appointment.

Determination by the Commission

26. The application of fitness, propriety or other qualification tests to directors and other relevant persons may vary depending on the degree of their influence and on their responsibilities in the affairs of regulated institution. It is recognised that an individual considered fit for a particular position within an institution may not be considered fit for another position with different responsibilities or for a similar position within another institution, and conversely, an individual considered unfit for a particular position in a particular institution may be considered fit in different circumstances.

Appointment

27. No appointment should be made until the Commission has been assured that the proposed person is fit and proper.

CONTINUING REQUIREMENTS OF FITNESS AND PROPERNESS STANDARDS

Fitness

28. The Director or relevant person will be expected to remain competent for the positions they hold. Failure to maintain appropriate qualifications or memberships, where they are relevant, would raise doubts about the person's continuing fitness and would have to be reviewed by the proposing entity and by the Commission.
29. The person's character, competence and experience relative to the duties involved, including if the person:
- a) has sufficient skills, knowledge, competence, diligence and soundness of judgment to undertake and fulfill the particular duties and responsibilities of the position in question; and
 - b) has demonstrated the appropriate competence and integrity in fulfilling professional responsibilities previously during his/her career.

Probity

30. Probity is an issue not just at the moment of appointment, but on an ongoing basis. Industry professionals are expected to be in full compliance with their contract of employment. This would include adherence to the entity's internal code of ethical behaviour.
31. Where there has been wrongdoing, the regulated institution may make all reasonable efforts to establish grounds for taking disciplinary action and where appropriate take the action. In any case, where such matters come to light, they must be reported immediately to the Commission.
32. A person will not generally be regarded as fit or proper whenever he/she:
- a) is found lunatic or becomes of unsound mind or incapable of efficient attention to business;

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- b) has demonstrated a lack of willingness to comply with legal obligations, regulatory requirements or professional standards, or has been obstructive, misleading or untruthful in dealing with regulatory bodies or a court;
- c) has breached a fiduciary obligation;
- d) has perpetrated or participated in negligent, deceitful, or otherwise discreditable business or professional practices;
- e) has been reprimanded, or disqualified, or removed by a professional or regulatory body in relation to matters relating to the person's honesty, integrity or business conduct;
- f) has seriously or persistently failed to manage personal debts or financial affairs satisfactorily in circumstances where such failure caused loss to others;
- g) has been substantially involved in the management of a business or company which has failed, where that failure has been occasioned in part by deficiencies in that management;
- h) has defaulted on a loan in Bangladesh or elsewhere;
- i) is of bad repute in any business or financial community or any market;
- j) has been convicted of any criminal offence and sentenced to imprisonment, in Bangladesh or elsewhere; or
- k) was the subject of civil or criminal proceedings or enforcement action, in relation to the management of an entity, or commercial or professional activities, which were determined adversely to the person (including by the person consenting to an order or direction, or giving an undertaking, not to engage in unlawful or improper conduct) and which reflected adversely on the person's competence, diligence, judgment, honesty or integrity.

ANNEX A: FIT AND PROPER ASSESSMENT RULES, 2014

Bangladesh Securities and Exchange Commission

NOTIFICATION

[date] xxxxxxxxxxxx

No. xxxxxxxxxxx In exercise of the powers conferred by section 33 of the Securities and Exchange Ordinance, 1969 (XVII of 1969), the Securities and Exchange Commission makes, with prior publication, the following rules, namely :-

1. **Short title.**- These rules may be called the Fit and Proper Assessment Rules, 2014.
2. **Definitions.**- In these rules, unless the context otherwise requires,-
 - (a) “board of directors” or “board” means the board of directors of an institution;
 - (b) “company” means any company incorporated and registered under the Companies Act, 1994 (Act XVIII of 1994);
 - (c) “Commission” means Bangladesh Securities and Exchange Commission established under section 3 of the Bangladesh Securities and Exchange Commission Act, 1993 (XV of 1993);
 - (d) “depository” means any depository established under the Depository Act, 1999 (VI of 1999);
 - (e) “exchange” means a stock exchange or commodity exchange as defined in the Securities and Exchange Ordinance, 1969 (Ordinance No. XVII of 1969);
 - (f) “form” means a form annexed to these rules;
 - (g) “independent director”:
 - i. in relation to an exchange, has the same meaning as the Exchange Demutualisation Act, 2013 (XV of 2013);
 - ii. in relation to any other institution registered by the Commission, has the same meaning as the Corporate Governance Guidelines.
 - (h) “institution”, in relation to a relevant person whose activity is regulated by the Commission means a registered:
 - i. stock exchange;
 - ii. commodity exchange;
 - iii. clearing house;
 - iv. depository;
 - v. depository participant
 - vi. merchant bank;
 - vii. credit rating company;
 - viii. securities custodian;
 - ix. trustee of asset backed securities;
 - x. trustee of mutual funds;
 - xi. asset management company;
 - xii. stock-broker/stock-dealer;

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- xiii. commodity-broker/commodity-dealer
 - xiv. investment adviser;
 - xv. independent research firm.
- (i) “Ordinance” means the Securities and Exchange Ordinance, 1969 (XVII of 1969);
- (j) “person” means any company, partnership business or firm or any club or association of more than one persons whether incorporated or not, and natural person;
- (k) “relevant person” means, in relation to an institution:
- i. director;
 - ii. substantial shareholder;
 - iii. chief executive officer/managing director;
 - iv. chief regulatory officer;
 - v. chief financial officer;
 - vi. compliance officer;
 - vii. employees of an institution assigned to oversee a regulatory function;
 - viii. head of treasury;
 - ix. authorised representative;
 - x. any other person by whatever name described, who has responsibilities or functions similar to any of the persons referred to in sub-paragraphs a to i; and
 - xi. any other person responsible for managing or overseeing, either alone or together with another responsible person, the activities of an institution.
- (l) “regulatory function” means those functions of an institution which contribute directly to the satisfaction by the institution of a registration requirement;
- (m) “securities” means securities as defined in clause (1) of section 2 of the Securities and Exchange Ordinance, 1969 (Ordinance No. XVII of 1969);
- (n) “substantial shareholder” means any person owning 5% or more of the issued share capital.
- 3. Applicability.** – (1) These rules apply to an institution and all relevant persons of an institution regulated by the Commission.
- (2) A person may be disqualified from holding office as a relevant person if found by the Commission not to be fit and proper.
- 4. Responsibilities.** – (1) It is the responsibility of the relevant person to establish that they are fit and proper rather than for the Commission to show otherwise.
- (2) It is the responsibility of the institution to satisfy the Commission that:
- (a) each of its relevant persons, meet the fit and proper criteria of these rules; and
 - (b) it has in place appropriate recruitment policies, adequate internal control systems and procedures that would reasonably ensure that the persons that it employs, authorises or appoints to act on its behalf, in relation to its conduct of the activity regulated by the Commission, meet the fit and proper criteria of these rules.
-

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- 5. Fit and proper test** – (1) The criteria for considering whether a relevant person is fit and proper include but are not limited to competence, capability, honesty, integrity, fairness, ethical behaviour, and financial soundness.
- (2) The failure by a relevant person to meet any one of the criteria set out in paragraph 5(1) may not lead to an automatic refusal of an application or the revocation of an existing approval or registration by the Commission. The significance and relevance of a relevant person failing to satisfy the Commission that he or it meets a specific criteria depends on:
- (a) the seriousness of, and surrounding circumstances resulting in, the relevant person not meeting the specific criteria;
 - (b) the relevance of the failure by the relevant person to meet the specific criteria to the duties that are, or are to be, performed and the responsibilities that are, or are to be, assumed by the relevant person; and
 - (c) the passage of time since the failure by the relevant person to meet the specific criteria.
- 6. Competence and capability** – (1) The factors that are pertinent to the assessment of the competence and capability of a relevant person include but are not limited to:
- (a) whether the relevant person has satisfactory past performance or expertise, having regard to the nature of the relevant person's business or duties, as the case may be, whether in Bangladesh or elsewhere;
 - (b) whether the person has an appropriate range of skills and experience to understand, operate and manage the regulated activities/financial affairs;
 - (c) where the relevant person is assuming concurrent responsibilities, whether such responsibilities would give rise to a conflict of interest or otherwise impair his ability to discharge his duties in relation to any activity regulated by the Commission under the relevant legislation;
 - (d) whether the person has the technical knowledge and ability to perform prescribed duties for which they are engaged, including recognised professional qualifications and membership of relevant professional institutions
 - (e) whether the relevant person has satisfactory educational qualification, professional qualification, experience, relevant skills and knowledge, whether obtained in Bangladesh or elsewhere, having regard to the nature of the duties he is required to perform.
- (2) A person who is found lunatic or becomes of unsound mind or incapable of efficient attention to business will not be regarded as fit and proper.
- 7. Honesty, integrity, fairness, ethical behaviour** – (1) The factors pertinent to the assessment of the honesty, integrity and reputation of a relevant person include but are not limited to whether the person:

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- (a) has been refused the right or restricted in its or his right to carry on any trade, business or profession for which a specific license, registration or other authorisation is required by law in Bangladesh or elsewhere;
- (b) has been issued a prohibition order under any Act administered by the Commission or has been prohibited from operating in any jurisdiction by any regulatory authority;
- (c) has been censured, disciplined, suspended or refused membership or registration by the Commission, any other regulatory authority, an operator of a market or clearing facility, any professional body or government agency, whether in Bangladesh or elsewhere;
- (d) has been the subject of any complaint made reasonably and in good faith, relating to activities that are regulated by the Commission or under any law in any jurisdiction;
- (e) has been the subject of any proceedings of a disciplinary or criminal nature or has been notified of any potential proceedings or of any investigation which might lead to those proceedings, under any law in any jurisdiction;
- (f) has been convicted of any offence, or is subject to any pending proceedings which may lead to such a conviction, under any law in any jurisdiction;
- (g) has had any judgment (in particular, that associated with a finding of fraud, misrepresentation or dishonesty) been entered against the relevant person in any civil proceedings or is the relevant person a party to any pending proceedings which may lead to such a judgment, under any law in any jurisdiction;
- (h) has accepted civil liability for fraud or misrepresentation under any law in any jurisdiction;
- (i) has had any enforcement action taken against the relevant person by the Commission or any other regulatory authority under any law in any jurisdiction;
- (j) has contravened or abetted another person in the breach of any laws or regulations, business rules or codes of conduct, whether in Bangladesh or elsewhere;
- (k) has been the subject of any investigations or disciplinary proceedings or been issued with a warning or reprimand by the Commission, any other regulatory authority, an exchange or clearing facility, any professional body or government agency, whether in Bangladesh or elsewhere;
- (l) has demonstrated an unwillingness to comply with any regulatory requirement or to uphold any professional and ethical standards, whether in Bangladesh or elsewhere;
- (m) has been untruthful or provided false or misleading information to the Commission or been uncooperative in any dealings with the Commission or any other regulatory authority in any jurisdiction;
- (o) is or has been a director, partner, substantial shareholder or concerned in the management of a business that has been censured, disciplined, prosecuted or convicted of a criminal offence, or been the subject of any disciplinary or criminal investigation or proceeding, in

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Bangladesh or elsewhere, in relation to any matter that took place while the person was a director, partner, substantial shareholder or concerned in the management of the business;

- (p) is or has been a director, partner, substantial shareholder or concerned in the management of a business that has been suspended or refused membership or registration by the Commission, any other regulatory authority, exchange or clearing facility, any professional body or government agency, whether in Bangladesh or elsewhere;
- (q) has been a director, partner, substantial shareholder or concerned in the management of a business that has gone into insolvency, liquidation or administration during the period when, or within a period of one year after, the relevant person was a director, partner, substantial shareholder or concerned in the management of the business, whether in Bangladesh or elsewhere;
- (r) has been a director, partner, substantial shareholder or concerned in the management of a business that has been found by the Commission or other regulatory authority or exchange to have contravened the Corporate Governance Guidelines, or its equivalent in another jurisdiction, during the period when, or within a period of one year after, the relevant person was a director, partner, substantial shareholder or concerned in the management of the business, whether in Bangladesh or elsewhere;
- (s) has been dismissed or asked to resign from —
 - i. office;
 - ii. employment;
 - iii. a position of trust; or;
 - iv. a fiduciary appointment or similar position;whether in Bangladesh or elsewhere;
- (t) is or has been subject to disciplinary proceedings by his current or former employer(s), whether in Bangladesh or elsewhere;
- (u) has been disqualified from acting as a director or disqualified from acting in any managerial capacity, whether in Bangladesh or elsewhere;
- (v) has entered into any business transaction with an exchange in Bangladesh;
- (w) has been convicted of any criminal offence and sentenced to imprisonment, in Bangladesh or elsewhere; and
- (x) has been a director, partner, substantial shareholder or concerned in the management of a business found liable for an offence committed by a body corporate as a result of the offence having proved to have been committed with the consent or connivance of, or neglect attributable to, the relevant person, whether in Bangladesh or elsewhere.

8. Financial Soundness – (1) The factors pertinent to the assessment of the financial soundness of a relevant person include but are not limited to, whether the person:

- (a) is or has been unable to fulfill any of his financial obligations, whether in Bangladesh or elsewhere;

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- (b) has entered into a compromise or scheme of arrangement with his creditors or made an assignment for the benefit of his creditors, being a compromise or scheme of arrangement or assignment that is still in operation, whether in Bangladesh or elsewhere;
- (c) is subject to a judgment debt which is unsatisfied, either in whole or in part, whether in Bangladesh or elsewhere;
- (d) has defaulted on a loan in Bangladesh or elsewhere;
- (e) is or has been the subject of a bankruptcy petition, whether in Bangladesh or elsewhere;
- (f) has been adjudicated a bankrupt and the bankruptcy is undischarged, whether in Bangladesh or elsewhere.

9. Application – (1) No application will be considered by the Commission unless it is accompanied by:

- (a) Form I, duly completed;
 - (b) An applicant as an independent director or relevant person of an exchange must also complete form IA;
 - (b) An up-to-date and signed curriculum vitae; and
 - (d) Criminal record (if applicable).
- (2) In considering an application, the Commission may request further information or documentation as it deems necessary.
- (3) No appointment should be made until the Commission has confirmed in writing that the applicant is fit and proper.

10. Continuing Assessment – (1) Where a person becomes aware of a change in his circumstances or the circumstances of any relevant person of an institution regulated by the Commission that would result in an affirmative answer to any of the questions contained in form I of these rules, the person must immediately inform the Commission.

- (2) In light of information received under paragraph 10(1) or however otherwise received, the Commission will undertake a re-assessment of the relevant person's fitness and properness.
- (3) In the event that the Commission finds that a person is no longer fit and proper, it may take such action as it deems appropriate including but not limited to:
- (a) suspension or cancellation of the registration/authorisation of the relevant person; and
 - (b) instruction to the institution to terminate the directorship or employment of the relevant person.

FORM I

DECLARATION AND UNDERTAKING WITH REGARD TO DIRECTORS AND OTHER RELEVANT PERSONS

Notes:

- (1) *Please answer all questions, and if a question is answerable in the negative, please answer "No". Do not leave any section blank.*
- (2) *If insufficient space is provided for completion of any paragraph, additional information may be entered into on a separate sheet of paper duly signed and attached.*
- (3) *In this form, the term "company" includes any body corporate wherever incorporated.*
- (4) *In determining the honesty, integrity and reputation of the applicant/relevant person, the Commission may consider among other things, whether the applicant/relevant person has been convicted, on indictment, of dishonesty, fraud, money laundering, theft or financial crime within the last ten years. This may be regarded by the Commission as an indication that a person is not fit and proper and will, in principle, bar a person from holding a position in a regulated institution. Where a person has a conviction dating beyond ten years, such information should be notified to the Commission in order for it to adjudicate on the application. The Commission may treat each application on a case-by-case basis taking into account the seriousness of, and circumstances surrounding, the offence, the explanation offered by the convicted person, the relevance of the offence to the proposed role, the passage of time since the offence was committed and evidence of the individual's rehabilitation.*
- (5) *The declaration must be signed by the applicant and certified as a true signature by a director or the secretary of the institution.*
- (6) *The undertaking must be signed by a director, other than the applicant, and such signature must be certified as a true signature by another director or the secretary or, where such director is also the secretary, another director of the institution before submission to the Commission.*

To
Chairman
Bangladesh Securities and Exchange Commission
Dhaka

-
1. State:
 - (a) present surname and any former surname(s)
 - (b) present forename(s) and any former forename(s)
 - (c) date and place of birth

REPORT ON FIT AND PROPER CRITERIA

-
- (d) residential address
- (e) nationality and former nationality, if any
- (f) educational qualifications
- (g) professional qualifications, if any
-

2 Are you a director, partner, substantial shareholder or concerned in the management of any other companies? If so, state the names of such companies, nature of business where this is not indicated in the title, position held, and date of commencement of each appointment.

3 Have you at any time been refused the right or restricted from carrying on any trade, business or profession for which a specific license, registration or other authorisation is required by law in Bangladesh or elsewhere? If so, give particulars.

4 Have you at any time been censured, disciplined, suspended or refused membership or registration by the Commission, any other regulatory authority, an operator of a market or clearing facility, any professional body or government agency, whether in Bangladesh or elsewhere? If so, give particulars.

5 Have you at any time been the subject of any complaint made reasonably and in good faith, relating to activities that are regulated by the Commission or under any law in any jurisdiction? If so, give particulars.

6 Have you at any time been the subject of any proceedings of a disciplinary or criminal nature or been notified of any potential proceedings or of any investigation which might lead to those proceedings, under any law in any jurisdiction? If so, give particulars.

7 Have you at any time been convicted of any offence, or are you subject to any pending proceedings which may lead to such a conviction, under any law in any jurisdiction? If so, give particulars.

8 Have you at any time had any judgment (in particular, that associated with a finding of fraud, misrepresentation or dishonesty) entered against you in any civil proceedings or are you a party to any pending proceedings which may lead to such a judgment, under any law in any jurisdiction? If so, give particulars.

9 Have you at any time accepted civil liability for fraud or misrepresentation under any law in any jurisdiction? If so, give particulars.

REPORT ON FIT AND PROPER CRITERIA

-
- 10 Have you at any time had any enforcement action taken against you by the Commission or any other regulatory authority under any law in any jurisdiction? If so, give particulars.
-
- 11 Have you at any time contravened or abetted another person in the breach of any laws or regulations, business rules or codes of conduct, whether in Bangladesh or elsewhere? If so, give particulars.
-
- 12 Have you at any time been the subject of any investigations or disciplinary proceedings or been issued with a warning or reprimand by the Commission, any other regulatory authority, an exchange or clearing facility, any professional body or government agency, whether in Bangladesh or elsewhere? If so, give particulars.
-
- 13 Have you at any time been accused of demonstrating an unwillingness to comply with any regulatory requirement or to uphold any professional and ethical standards, whether in Bangladesh or elsewhere? If so, give particulars.
-
- 14 Has it been alleged at any time that you have been untruthful or provided false or misleading information to the Commission or been uncooperative in any dealings with the Commission or any other regulatory authority in any jurisdiction? If so, give particulars.
-
- 15 Have you at any time been a director, partner, substantial shareholder or concerned in the management of a business that has been censured, disciplined, prosecuted or convicted of a criminal offence, or been the subject of any disciplinary or criminal investigation or proceeding, in Bangladesh or elsewhere, in relation to any matter that took place while you were a director, partner, substantial shareholder or concerned in the management of the business? If so, give particulars.
-
- 16 Have you at any time been a director, partner, substantial shareholder or concerned in the management of a business that has been suspended or refused membership or registration by the Commission, any other regulatory authority, exchange or clearing facility, any professional body or government agency, whether in Bangladesh or elsewhere? If so, give particulars.
-
- 17 Have you at any time been a director, partner, substantial shareholder or concerned in the management of a business that has gone into insolvency, liquidation or administration during the period when, or within a period of one year after, you were a director, partner, substantial shareholder or concerned in the management of the business, whether in Bangladesh or elsewhere? If so, give particulars.
-

REPORT ON FIT AND PROPER CRITERIA

-
- 18 Have you at any time been a director, partner, substantial shareholder or concerned in the management of a business that has been found by the Commission or other regulatory authority or exchange to have contravened the Corporate Governance Guidelines, or its equivalent in another jurisdiction, during the period when, or within a period of one year after, you were a director, partner, substantial shareholder or concerned in the management of the business, whether in Bangladesh or elsewhere? If so, give particulars.
-
- 19 Have you at any time been dismissed or asked to resign from:
- office;
 - employment;
 - a position of trust; or;
 - a fiduciary appointment or similar position;
- whether in Bangladesh or elsewhere? If so, give particulars.
-
- 20 Have you at any time been subject to disciplinary proceedings by your current or former employer(s), whether in Bangladesh or elsewhere? If so, give particulars.
-
- 21 Have you at any time been disqualified from acting as a director or disqualified from acting in any managerial capacity, whether in Bangladesh or elsewhere? If so, give particulars.
-
- 22 Have you at any time entered into any business transaction with an exchange in Bangladesh? If so, give particulars.
-
- 23 Have you at any time been convicted of any criminal offence and sentenced to imprisonment, in Bangladesh or elsewhere? If so, give particulars.
-
- 24 Have you at any time been a director, partner, substantial shareholder or concerned in the management of a business found liable for an offence committed by a body corporate as a result of the offence having proved to have been committed with your consent, connivance, or negligence, whether in Bangladesh or elsewhere? If so, give particulars.
-
- 25 Have you at any time been unable to fulfill any of your financial obligations, whether in Bangladesh or elsewhere? If so, give particulars.
-
- 26 Have you at any time entered into a compromise or scheme of arrangement with your creditors or made an assignment for the benefit of your creditors, whether in Bangladesh or elsewhere? If so, give particulars.
-
- 27 Have you at any time been subject to a judgment debt, whether in Bangladesh or elsewhere? If so, give particulars.
-

REPORT ON FIT AND PROPER CRITERIA

28 Have you at any time defaulted on a loan in Bangladesh or elsewhere? If so, give particulars.

29 Have you at any time been the subject of a bankruptcy petition, whether in Bangladesh or elsewhere? If so, give particulars.

30 Have you at any time been adjudicated a bankrupt, whether in Bangladesh or elsewhere? If so, give particulars.

Declaration by the Applicant

I declare that the answers to all the above questions are true and I hereby give my authority to the Commission to disclose any of the foregoing particulars given by me to such other regulatory bodies as the case may, in its absolute discretion, thinks fit.

Signature:

Name:

Dated :

Certified as the true signature of.....by

.....
(Signature) Secretary/Director

Undertaking by Proposing Entity

We (name of proposing entity)..... confirm that we have carried out checks on the information provided by the applicant to ensure its accuracy and that in our opinion, the applicant has the experience necessary and is capable of fulfilling the designated role and that there are no issues arising from the material that would cause us to reconsider our proposal to nominate or appoint the person.

Signature:

Name:

Dated :

Certified as the true signature of..... by.

.....
(Signature) Secretary/Director

REPORT ON FIT AND PROPER CRITERIA

By signing the undertaking the proposing entity confirms that it is prepared to proceed with the nomination or appointment, and confirms that it has verified to the best of its ability the information in the completed form and is seeking approval of the proposed nomination or appointment.

FORM IA

ADDITIONAL DECLARATION AND UNDERTAKING WITH REGARD TO AN INDEPENDENT DIRECTOR OR RELEVANT PERSON WITHIN AN EXCHANGE

Notes:

- (1) *Please answer all questions, and if a question is answerable in the negative, please answer "No". Do not leave any section blank.*
- (2) *If insufficient space is provided for completion of any paragraph, additional information may be entered into on a separate sheet of paper duly signed and attached.*
- (3) *In this form, the term "company" includes any body corporate wherever incorporated.*
- (4) *This additional declaration must be signed by the applicant and certified as a true signature by a director or the secretary of the exchange.*
- (5) *The undertaking must be signed by a director, other than the applicant, and such signature must be certified as a true signature by the secretary of the exchange before submission to the Commission.*

To
Chairman
Bangladesh Securities and Exchange Commission
Dhaka

31 Have you been an employee of the exchange, any of its subsidiaries or holding company within the preceding 3 (three) years of your proposed date of appointment? If so, give particulars.

32 Are you or have you been the CEO/MD of any subsidiary, associated company, associated undertaking or holding company of the exchange within the preceding 3(three) years of your proposed date of appointment? If so, give particulars.

33 Do you or have you had within the preceding 3 (three) years of your proposed date of appointment, a material business relationship with the exchange either directly, or indirectly as a partner, substantial shareholder or director of a body that has such a relationship with the exchange? If so, give particulars.

34 Have you received remuneration within the preceding 3 (three) years of your appointment as a director or received additional remuneration, excluding retirement benefits from the exchange

REPORT ON FIT AND PROPER CRITERIA

apart from a director's fee or participated in the exchange's share option or a performance-related pay scheme? If so, give particulars

35 Are you a family member or connected person, as defined in the Exchanges Demutualization Act, 2013, of any of the directors, TREC holders or shareholders of the exchange or the exchange itself? If so, give particulars.

36 Do you have or have you had any relationship with any of the TREC holders or Shareholders of the exchange or directors thereof? If so, give particulars.

37 Are you or have you been an employee or director of any capital market intermediary including merchant banker or asset management company within the preceding 3 (three) years of your proposed date of appointment? If so, give particulars.

38 Do you act as a director of any other exchange? If so, give particulars.

39 Are you an employee of any shareholder of any exchange? If so, give particulars .

40 Are you an employee of any regulatory organization? If so, give particulars.

41 Are you a director or hold any office of a listed company? If so, give particulars.

Declaration by the Applicant

I declare that the answers to all the above questions are true and I hereby give my authority to the Commission to disclose any of the foregoing particulars given by me to such other regulatory bodies as the case may, in its absolute discretion, thinks fit.

Signature:

Name:

Dated :

Certified as the true signature of.....by

.....
(Signature) Secretary

REPORT ON FIT AND PROPER CRITERIA

Undertaking by exchange

We (name of the exchange)..... confirm that we have carried out checks on the information provided by the applicant to ensure its accuracy and that in our opinion, the applicant has the experience necessary and is capable of fulfilling the role of independent director or relevant person and that there are no issues arising from the material that would cause us to reconsider our proposal to nominate or appoint the person.

Signature:

Name:

Dated :

Certified as the true signature of..... by.

.....
(Signature) Secretary/Director

By signing the undertaking the exchange confirms that it is prepared to proceed with the nomination, and confirms that it has verified to the best of its ability the information in the completed form and is seeking approval of the proposed nomination.

Appendix 3.2: Report on Exchange Registration Rules, 2014 (24 February 2014)



বাংলাদেশ সিকিউরিটিজ অ্যান্ড এক্সচেঞ্জ কমিশন
Bangladesh Securities and Exchange Commission

ADB TA-8228 BAN: Enhancing Efficiency of the Capital Market

EXCHANGE REGISTRATION RULES, 2014

24 February 2014



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INTRODUCTION

1. The purpose of this Report is to identify changes required to the Securities and Exchange Rules, 1987 (“the 87 Rules”) in light of the passage of the Exchanges Demutualization Act, 2013 to bring about the demutualization of the Dhaka and Chittagong stock exchanges.
2. The 87 Rules set out the following:

1. Short title
2. Definitions
3. Qualification etc of members of a stock exchange
4. Manner of transacting a member’s business
- 4A. Regulation of trading in a stock exchange
5. Maintenance of accounts and audit (of a member)
6. Application for registration of a stock exchange
7. Maintenance of books of account and other documents by a stock exchange
8. Maintenance of books of account etc, by members
- 8A. Maintenance of consolidated customers’ accounts by members
- 8B. Separate preservation of customers’ securities by members
9. Submission of periodical returns by a stock exchange
10. Submission of the annual report by a stock exchange
11. Listing of a security
12. Submission of the annual report by issuers
13. Submission of periodic reports by issuers
14. Mode of filing or submission of returns/reports etc (by a stock exchange, member or issuer)
15. Risk-based capital adequacy requirements of members.

FORM I sets out the Form of Application for Registration of a Stock Exchange.
FORM II relates to the Periodic Returns to be submitted monthly by a stock exchange.
FORM III is the Form of Application for Listing.

3. The 87 Rules therefore deal with three separate matters:
 - stock exchanges (rules 6, 7, 9, and 10),
 - members of a stock exchange (rules 3, 4, 5, 8, 8A, 8B and 15), and
 - listing on a stock exchange (rules 11, 12, 13 and 14).
4. Quite apart from the fact that there is considerable jumping around within the 87 Rules from one matter to another, it would seem appropriate to separate the three subject matters into their own Rules and unify those matters in the 87 Rules relating to members of a stock exchange with the Securities and Exchange Commission (stock-broker, stock-dealer and authorized representative) Rules, 2000.
5. This Report deals with the first of these three matters – namely the application and maintenance of registration of a stock exchange. However, in consultation with the Commission, it has been agreed to include Commodity Exchanges into new Rules to be called

the Exchange Registration Rules, 2014. Ideally, registration provisions for separate clearing houses would also be included within the new Rules. However, at this juncture, the Securities and Exchange Ordinance, 1969 (“the Ordinance”) does not allow the Commission to prescribe rules for the separate registration of a clearing house. The Commission does have under section 33(3)(b) the power to make Rules relating to “any of the matters with respect to which a Stock Exchange may make regulations” and in section 34(2)(xiv) a stock exchange has the power to make regulations for “setting up of a clearing house in relation to transactions in securities”. Therefore, any rules published by the Commission could only apply in relation to a clearing house operated by a registered stock exchange. In consultation with the Commission, provision has therefore been included within the Exchange Registration Rules, 2014 to allow for one or more clearing houses to be established under the registration requirements (license) of an exchange. Whilst this would enable each stock exchange to establish its own clearing house, it may also allow both exchanges to agree on a single clearing house that would fit within the license of one of them. This could be a clearing house owned by both exchanges and indeed banks and other institutions could also be shareholders. However, only one exchange would apply for its license to be amended to include this clearing house.

6. The Dhaka and Chittagong stock exchanges have signed an agreement on the establishment of a joint clearing house for both markets. Regardless of who handles clearing and settlement of securities transactions in Bangladesh, a single clearing house would be preferable to multiple clearing houses.
7. Pakistan has a single national clearing house (National Clearing Company of Pakistan). The National Clearing & Settlement System (NCSS) was developed to replace the separate and individual Clearing Houses of the three Stock Exchanges in Pakistan, namely Karachi Stock Exchange, Lahore Stock Exchange and Islamabad Stock Exchange by a single and centralised entity. The National Clearing Company of Pakistan Limited (NCCPL) was incorporated on July 3, 2001 to manage and operate NCSS, a fully automated electronic settlement system. NCSS commenced live operations on December 24, 2001. It became fully operational in 2003-04 when clearing and settlement of all book-entry securities was implemented through NCSS. Any security which is introduced to the Central Depository System, is automatically added into NCSS. NCCPL is owned in proportion to the capital required for the project funding by the three exchanges plus a holding by Pakistan Kuwait Investment Company (Pvt.) Ltd. A 15% equity holding remains available for institutional subscription subject to the approval of the Securities and Exchange Commission, Pakistan (SECP). The project to develop NCSS was initiated by the Asian Development Bank. NCCPL is regulated by SECP under The National Clearing Company of Pakistan Limited Regulations, 2003.
8. India, on the other hand has two principal clearing houses. The Indian Clearing Corporation Limited (ICCL) which was incorporated in 2007 as a wholly owned subsidiary of the Bombay (Mumbai) Stock Exchange (BSE) and The National Securities Clearing Corporation Ltd. (NSCCL) a wholly owned subsidiary of the National Stock Exchange of India (NSEI), which was incorporated in August 1995. It was the first clearing corporation in India to introduce a settlement guarantee. It commenced clearing operations on April 1, 1996. India also has two central depositories. Central Depository Services (India) Ltd owned and operated by the BSE and the National Securities Depository Limited owned and operated by the NSEI. Today, there are links between the clearing houses and the depositories. Previously, there were also separate derivatives segments within each of the above entities which made for interesting challenges when trading simultaneously in equities and derivatives across both markets. By following the example of Pakistan in having a single clearing house for clearance and

settlement of securities transactions, Bangladesh can eliminate many of the problems faced in India and avoid increasing to cost of doing securities transactions by having more than one national clearing house and one national securities depository.

9. The trend in securities settlement is towards central counterparties (CCPs). This is largely brought about by the requirement of large institutional investors to minimise risk. A CCP interposes itself between counterparties to contracts traded in one or more financial markets, becoming the buyer to every seller and the seller to every buyer and thereby ensuring the performance of open contracts. A CCP becomes counterparty to trades with market participants through novation, an open-offer system, or through an analogous legally binding arrangement. CCPs have the potential to reduce significantly risks to participants through the multilateral netting of trades and by imposing more-effective risk controls on all participants. For example, CCPs typically require participants to provide collateral (in the form of initial margin and other financial resources) to cover current and potential future exposures. CCPs may also mutualise certain risks through devices such as default funds. As a result of their potential to reduce risks to participants, CCPs also can reduce systemic risk in the markets they serve. The effectiveness of a CCP's risk controls and the adequacy of its financial resources are critical to achieving these risk-reduction benefits. However, these benefits also come with a cost. Presently, with the absence of a large number of foreign institutional investors in the Bangladesh securities market, other than some from other South Asian countries who are used to dealing in markets that have limited guarantee provisions in place, there is no immediate requirement to bring in an existing international CCP or to create a new one in Bangladesh. However, if the Bangladesh securities market is to attempt to attract large institutional investors from Europe and or North America and to seek international recognition for its markets, it will in time have to consider the introduction of CCPs.
10. Further major work is required by the Commission to register a separate clearing house, including ensuring that the Ordinance allows for the issue of Rules so that it can be separately registered and regulated. However, this is beyond the scope of this project which can only hope to ensure that a clearing house established and operated by a stock exchange under its registration requirements, meets the "Principles for financial market infrastructures" set out by the Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions in their report dated April 2012.
11. In drafting the new Rules, the Consultant has reviewed the 87 Rules, the Exchanges Demutualization Act, 2013, and The Securities and Exchange Ordinance, 1969 and the recent amendment, the Securities and Exchange (Amendment) Act, 2012.

THE ORDINANCE

12. Chapter II of the Ordinance lays down the requirements for the Registration and Regulation of Stock Exchanges. In summary, it states that no stock exchange shall operate without registration; it details the eligibility for registration; gives authority to the Commission to deal with applications; a requirement to maintain annual accounts etc; and power to the Commission to suspend or cancel registration, supersede the governing body, and remove from office any director, officer or member from office or membership of an exchange. These are all matters that one would expect to see in a modern securities law although the current trend is to set out in greater detail within Law the requirements for exchange registration. However, as the Ordinance (clause (1) of section 5) provides adequately for the Commission

to prescribe the form and manner of the application, the matter can effectively be dealt with, in this case, by Rules.

INTERNATIONAL CONVENTION

13. The IOSCO Objectives and Principles of Securities Regulation, June 2010 states in Principle I (Principles for Secondary Markets):

- 33. The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.
- 34. There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.
- 35. Regulation should promote transparency of trading.
- 36. Regulation should be designed to detect and deter manipulation and other unfair trading practices.
- 37. Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.
- 38. Securities settlement systems and central counterparties should be subject to regulatory and supervisory requirements that are designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.

14. Principles 33 through 38 examine how a jurisdiction's overall regulatory structure ensures the integrity of regulated markets.
15. Principles 33 and 34 examine the general requirements for authorisation of exchanges and trading systems and their on-going supervision. Specifically, Principle 33 examines the criteria that are required when an exchange or trading system is *initially* authorised in a jurisdiction. Principle 34, on the other hand, examines the procedures by which the regulator is assured of the *on-going compliance* by an authorised exchange or regulated trading system with the relevant conditions thought necessary as pre-requisites to authorisation.
16. Principles 35, 36 and 37 focus on specific regulatory objectives that are intended to promote market integrity. Principle 35 focuses on the extent to which the regulatory structure promotes transparency (defined in terms of the availability of pre-trade and post-trade information). Principle 36 focuses on the regulations and mechanisms that prohibit, detect and deter manipulative, fraudulent, and deceptive conduct or other market abuses. Principle 37 focuses on the mechanisms in place to ensure the proper management of large exposures, defaults and market disruptions. Principle 37 also addresses the need for short selling regulatory requirements in equity security markets. Principle 38 makes clear that because of the potential for disruptions to securities and derivatives markets and to payment and settlement systems, both domestic and non-domestic, securities settlement systems and central counterparties should be subject to effective regulation and oversight to ensure that they are fair, effective and efficient and that they reduce systemic risk.
17. The new Exchange Registration Rules, 2014 govern the application and maintenance of registration of a stock and commodities exchange and cover all of IOSCO Principles 33 to 38.

EXCHANGE REGISTRATION RULES, 2014

18. The Ordinance sets the broad conditions that an applicant is required to comply with in order to be registered and to maintain its registration as a stock exchange. The 2012 amendment to the Ordinance included a new section 32A: “The business of Commodity Futures Contract or Options Contract, in the Commodities Exchange, shall be regulated in such manner and on payment of such fees and charges as may be prescribed”.
19. The Registration Requirements contained in the Exchange Registration Rules, 2014 cover the following matters:
- a) fitness and propriety;
 - b) proper markets;
 - c) financial resources;
 - d) human and technology resources;
 - e) systems and controls;
 - f) TREC holders’ access to facilities;
 - g) Market surveillance and prevention of market misconduct, financial crime and money laundering
 - h) promotion and maintenance of standards;
 - i) whistleblowing;
 - j) transaction recording;
 - k) clearing and settlement and clearing houses;
 - l) default;
 - m) initial and continuing compliance with regulations;
 - n) complaints;
 - o) listing, regulations and compliance with them;
 - p) commodity futures or options contracts
 - q) submission of reports by and exchange
 - r) amendments to exchange regulations
 - s) notification of changes to directors and other relevant persons;
 - t) maintenance of books and accounts;
 - u) timing of submission of accounts and records;
 - v) fee and charges; and
 - w) investigation, inspection, discipline and appeal.
20. Some of the 87 Rules have been retained, namely those Rules relating to:
- Maintenance of books of account and other documents by stock exchange;
 - Submission of periodical returns by stock exchange; and
 - Submission of annual report by stock exchange.
21. The Exchange Registration Rules should be used to vet all future applications for registration as an Exchange and any change in the scope of an existing Registration. They should also be used to ensure compliance by an exchange with the continuing obligations of Registration.

ANNEX A: EXCHANGE REGISTRATION RULES, 2014

Bangladesh Securities and Exchange Commission

NOTIFICATION

[date] xxxxxxxxxxxx

No. xxxxxxxxxxx In exercise of the powers conferred by section 33 of the Securities and Exchange Ordinance, 1969 (XVII of 1969), and in supersession of all rules and orders made in this behalf, the Securities and Exchange Commission makes, with prior publication, the following rules, namely :-

1. **Short title.**- These rules may be called the Exchange Registration Rules, 2014.
2. **Definitions.**- In these rules, unless the context otherwise requires,-
 - (a) “board of directors or board” means the board of directors of an exchange;
 - (b) “broker/dealer” means a person registered under the Broker Dealer Rules, 2014 [Securities and Exchange Commission (stock-broker, stock-dealer and authorized representative) Rules, 2000];
 - (c) “clearing house” means a clearing house established by an exchange for the clearing and settlement of transactions in securities and/or commodity futures or options contracts;
 - (d) “clearing participant” means a person registered with an exchange to perform clearing and settlement functions on that exchange in accordance with regulations issued by that exchange;
 - (e) “company” means any company incorporated and registered under the Companies Act, 1994 (Act No. XVIII of 1994);
 - (f) “Commission” has the same meaning as Commission in the Bangladesh Securities and Exchange Commission Act, 1993 (Act No. XV of 1993);
 - (g) “committee” means any committee formed by an exchange;
 - (h) “commodity futures contract” has the same meaning as commodity futures contract in the Ordinance;
 - (i) “exchange” means a stock exchange or commodity exchange as defined in the Ordinance;
 - (j) “form” means a Form annexed to these rules;
 - (k) “independent director” means any director of an exchange who is not connected to the management, business, service, trading and any substantial shareholder of the exchange;
 - (l) “market misconduct” means any prohibition referred to in the Ordinance and in any rule issued by the Commission;

- (m) “Ordinance” means the Securities and Exchange Ordinance, 1969 (Ordinance No. XVII of 1969);
- (n) “person” means any company, partnership business or firm or any club or association of more than one persons whether incorporated or not, and natural person;
- (o) “regulation” means by-law issued by an exchange with the approval of the Commission;
- (p) “regulatory function” means those functions of an exchange which contribute directly to the satisfaction by the exchange of a registration requirement;
- (q) “relevant person” means the chief executive officer/managing director, chief regulatory officer, chief financial officer or any member of the senior management team and any employee of an exchange assigned to oversee a regulatory function;
- (r) “section” means a section of the Ordinance;
- (s) “securities” means securities as defined in section 2 of the Ordinance;
- (t) “strategic investor” means any domestic or foreign entity approved by the Commission;
- (u) “subsidiary” means any company in which the exchange exercises or controls more than half of the total voting power or any company which engages in a service regulated by the Commission in which the exchange exercises or controls more than **ten per cent (10%)** of the total voting power;
- (v) “TREC” means a trading right entitlement certificate as defined in the Exchanges Demutualisation Act, 2013;
- (w) “TREC holder” means the holder of a trading right entitlement certificate or a trading participant of any exchange how-so-ever called;
- (x) “warehouse” means any building, structure or other protected enclosure licensed by the **[Minister ofinsert name of appropriate Ministry or Ministries if more than one]** (or its delegate) to be used for the storage or conditioning of commodities for the purposes of commodity exchange trading.

3. Application. – (1) These rules apply to every person who operates, or intends to operate as an exchange or as a clearing house operated by an exchange in or from Bangladesh.

(2) These rules also apply to a person who is, or proposes to become, a strategic investor as specified in rule 7.

4. Submission of application. – (1) An application for registration shall be made to the Commission in form A.

(a) demonstrating how the applicant intends to satisfy the registration requirements and any other applicable requirements; and

(b) with copies of any relevant agreements or other information in relation to (a).

- (2) The Commission will only consider an application for registration from an applicant who is:
 - (a) incorporated as a public company limited by shares; and
 - (b) demutualised.
- (3) An applicant for registration must provide details of:
 - (a) the proposed governance structure of the exchange;
 - (b) its proposed committee structure;
 - (c) how it will deal with conflict of interest and public interest concerns;
 - (d) how it will ensure separation of its business activities from its self-regulatory role;
 - (e) any restrictions or limits on individual ownership and at what level and how this will be controlled and enforced; and
 - (f) the requirements for entrants to the market in terms of entry qualifications, fees and other charges.
- (4) An applicant will only be registered if the Commission is satisfied that the applicant:
 - (a) complies with or would have complied with the Exchanges Demutualization Act, 2013;
 - (b) has satisfied or will satisfy the registration requirements in relation to the nature of the services concerned;
 - (c) is fit and proper; and
 - (d) will conduct and manage its affairs in a sound and prudent manner.
- (5) In making the assessment as to whether an applicant is fit and proper, the Commission will consider:
 - (a) the applicant's connection with its strategic investor, if applicable, or any other person;
 - (b) the services concerned;
 - (c) any matter which may harm or may have harmed the integrity or the reputation of the Commission;
 - (d) the activities of the applicant, the associated risks and accumulation of risks, that those activities pose to the Commission's objectives;

- (e) the fitness and properness of the applicant's directors and other relevant persons; and
 - (f) any other relevant matters.
- (6) In assessing an application for registration, the Commission may:
 - (a) carry out any enquiries which it considers appropriate (including enquiries independent of the applicant);
 - (b) require the applicant to provide additional information in such form as the Commission considers appropriate;
 - (c) require any information submitted by the applicant to be verified in such manner as the Commission may specify; and
 - (d) take into account any information which the Commission considers appropriate in relation to the applicant.
- 5. Application to change the scope of registration.** – (1) An exchange applying to change the scope of its registration must provide the Commission with written details of the proposed changes including an assessment of how it intends to satisfy the registration requirements in relation to the new registration scope.
 - (2) A change in scope of registration would include, inter alia, the offering of clearing house services and the introduction of new products or markets hitherto not traded by the exchange including, but not limited to, derivatives and commodities.
 - (3) Where a new product, market or service is to be offered via a subsidiary company of the exchange or the product, market or service will have a material effect on the exchange's existing registration, the applicant will be required to comply with these rules in respect of that product, market or service as if it were a new exchange.
- 6. Withdrawal of registration at an exchange's request.** – (1) An exchange must continue to carry on the services it is authorised to conduct under its registration until its registration is withdrawn or the Commission consents in writing.
 - (2) An exchange seeking to have its registration or any part thereof withdrawn must submit a request in writing stating:
 - (a) the reasons for the request;
 - (b) the date on which it will cease to carry on services in or from Bangladesh;
 - (c) where applicable, how persons with securities admitted to listing are affected and any alternative arrangements made for the listing, trading and clearing and settlement of the relevant securities;
 - (d) where applicable, how persons holding derivative or commodity futures or options contracts are affected and any alternative arrangements made for the trading and

clearing and settlement of the relevant derivative or commodity futures or options contracts;

- (e) the alternative arrangements, of any, to maintain or offer any other service currently offered by the exchange; and
- (f) that it has discharged, or will discharge, all obligations owed to its users in respect of whom the exchange has carried on services in or from Bangladesh.

7. Strategic investor. - A strategic investor is a person who, either alone or with any other person and with the approval of the Commission:

- (1) holds more than five per cent (5%) of an exchange's shares;
- (2) is entitled to exercise, or control the exercise, of more than five per cent (5%) of the voting rights in respect of an exchange;
- (3) is able to exercise significant management influence over management via a shareholding in an exchange; or
- (4) meets one or more of conditions of (1), (2), or (3) in respect of a holding company of an exchange.

8. Applications and notifications concerning a strategic investor. – (1) A person must not act as a strategic investor in an exchange unless it, or the exchange, has obtained prior approval in accordance with rule 8(5);

- (2) An exchange must take reasonable steps to monitor changes or proposed changes concerning:
 - (a) a strategic investor;
 - (b) the level of control of existing strategic investors; and
 - (c) significant changes in the circumstances of existing strategic investors which might reasonably be considered to affect the fitness and propriety of the exchange.
- (3) Where a person proposes to become a strategic investor or, in respect of an existing strategic investor, the level of control changes in regard to the kind of shareholding and influence set out in rule 7, as a result of the events described in (4) below, the exchange must submit a notification or application to the Commission as applicable.
- (4) Those events mentioned in (3) which trigger a written application for prior approval are:
 - (a) a person proposes to become a strategic investor;
 - (b) when a holding is increased from five per cent (5%) or below to more than five per cent (5%);
 - (c) when a holding is increased from below twenty-five per cent (25%) to twenty-five per cent (25%) or more;

- (d) any increase where a holding is above twenty-five per cent (25%); or
 - (e) when any significant management influence as identified under rule 7 (3) or (4), occurs which has not previously been disclosed to the Commission.
 - (5) Where a strategic investor is a holding company, details of the beneficial ownership of that holding company and any changes thereto must be disclosed to the Commission either at the time of application or at the time of change, whichever applies.
 - (6) An exchange must submit the notification or application required in rule 8(3) not less than 28 days in advance of a proposed change or, where this is not reasonably possible, immediately on becoming aware of a proposed or actual change.
 - (7) Where an exchange is not reasonably able to comply with (6), the person identified in rule 7 must submit the required notification or application for approval.
 - (8) In the event of (7), an exchange must notify the Commission in writing of the relevant circumstances and must also, at the same time, notify the person in (7) of their obligations under this rule.
- 9. Annual reporting of strategic investors.** – (1) An exchange must submit to the Commission a report on its strategic investors within [one] month of the end of its financial year end.
- (2) The report must include:
- (a) the name and address of each strategic investor; and
 - (b) the current holding of each strategic investor (expressed both as a number of shares and as a percentage of issued capital).
- 10. Continuing obligation of registration requirements.** – (1) An exchange must be able to satisfy the registration requirements to the satisfaction of the Commission at the time registration is granted and at all times thereafter.
- 11. Fit and proper - constitution, regulation and governance.** – (1) An exchange must:
- (a) be fit and proper;
 - (b) be appropriately constituted; and
 - (c) have taken appropriate measures to:
 - (i) satisfy the registration requirements; and
 - (ii) perform its regulatory functions.
- (2) In particular, the board must:
- (a) demonstrate integrity, competence and commitment to satisfying its obligations under the registration requirements;

- (b) assign relevant persons with appropriate levels of experience, knowledge and qualifications to oversee the regulatory functions;
 - (c) have independent directors constituting a majority of the total number of directors of the board and ensure that these independent directors are provided with direct access to:
 - (i) relevant persons when required; and
 - (ii) all relevant information concerning the satisfaction of registration requirements and the performance of regulatory functions; and
 - (e) ensure that relevant persons have unfettered, direct access to the board.
- (3) For the purposes of this rule, regulatory functions are those functions of an exchange which contribute directly to the satisfaction by the exchange of the registration requirements.
- (4) An exchange is required to ensure that it, any clearing house operated by it, and all directors and relevant persons comply with the Fit and Proper Assessment Rules, 2014 prior to their appointment.
- (5) An exchange must make provision in its articles of association so that:
- (a) In the absence of the president, meetings of the board will be chaired by an independent director; and
 - (b) The quorum for a meeting will be at least one third of the directors; the majority of whom must be independent directors.
- (6) The board must appoint at least the key committees relating to the functions of nomination and remuneration, audit and risk management, regulatory affairs, appeals, and conflict mitigation.
- (7) Subject to the prior approval of the Commission, the board shall appoint a person as a full-time chief executive officer of the exchange.
- (8) Subject to the prior approval of the Commission, the board shall appoint a person as a full-time chief regulatory officer of the exchange.
- (9) The persons appointed as the chief executive officer and chief regulatory officer shall not be a TREC holder or clearing participant of the exchange, nor shall they, in any way whatsoever, be associated with any TREC holder or clearing participant of the exchange or with any issuer, and shall not engage themselves in any business, directly or indirectly, including trading or dealing in any securities or commodity futures or options contracts.
- (10) The term of office of the chief executive officer shall be not more than three years, which may be renewed for another term with the prior approval of the Commission.

- (11) The board must appoint an executive committee comprising solely the executive management of the exchange.
- (12) An exchange is required to seek the prior written approval of the Commission for the charter for each committee setting out the role and responsibilities, composition and structure, frequency and attendance at meetings, and reporting of each committee together with any subsequent changes thereto.
- (13) Where an exchange intends to circulate any notice or other document proposing any amendment to its regulations, memorandum or articles of association, or other document relating to its constitution, to:
 - (a) its shareholders or any group or class of them;
 - (b) persons granted access to its facilities or any group or class of them ; or
 - (c) any other group or class of persons which has the power to make that amendment or whole consent or approval is required before it may be made:that exchange must submit the proposed change to the Commission for approval as soon as it is aware of it, setting out:
 - (d) the proposed amendment;
 - (e) the reasons for the proposal; and
 - (f) a description of the group or class of persons to whom the proposal is to be circulated.

12. Proper markets. – (1) An exchange must have systems, policies and procedures which ensure that only:

- (a) securities or commodity futures or options contracts in which there is a proper market are admitted to trading; and
 - (b) those securities which are admitted to its official list are domiciled in a jurisdiction that is acceptable to the Commission.
- (2) For a proper market to exist:
- (a) arrangements must be in place for relevant market information to be made available fairly and consistently to persons engaged in dealing;
 - (b) all TREC holders must have equal opportunity to connect and maintain the connection to any electronic trading system of the exchange
 - (c) rules and procedures must be in place with respect to precedence of client orders and prohibition of front-running or trading ahead of client orders;
 - (d) there must be a sufficient range and number of investors willing and able to generate sufficient supply and demand in the securities or commodity futures or options contracts;

- (e) where appropriate, there must be a sufficiently liquid underlying cash or physical commodity market;
- (f) where appropriate, there must be capacity to make and take delivery of the securities and commodities; and
- (g) the TREC holder, trading and listing regulations of an exchange must allow for the discontinuance or suspension of trading in securities and commodity futures or options contracts when disclosure obligations have not been complied with and in other appropriate circumstances.

13. Financial resources. – (1) An exchange must have and maintain at all times, in addition to the minimum financial resource requirement in (2), financial resources of a type acceptable to the Commission which are adequate in relation to the nature, size and complexity of its business to ensure that there is no significant risk that liabilities cannot be met as they fall due.

- (2) The minimum financial resource requirement for an exchange is:
 - (a) an amount equal to one half of the estimated gross operating costs of the exchange for the next twelve-month period; or
 - (b) such other base capital amount as may be set by the Commission under (4).
- (3) When calculating its twelve-month gross operation costs, an exchange must also include any penalty payments for which it has become liable as part of any outsourcing or other arrangements which are integral to its being able to function as an exchange.
- (4) The Commission may prescribe a base capital amount for an exchange and will determine such amount by reference to other international jurisdictions deemed by the Commission to be comparable.
- (5) An exchange must have systems and controls to enable it to determine and monitor whether its financial resources are sufficient for the purposes of the additional financial resource requirement in (1) and the minimum financial resource requirement in (2).
- (6) For the purposes of (5), the systems and controls must take into account the following factors with any others that are appropriate:
 - (a) the scale, nature and activities of the operation;
 - (b) the systemic, legal, credit, liquidity, general business, custody, operational and other risks to which the exchange is exposed;
 - (c) the amount and composition of its available financial resources; and
 - (d) its access to additional financial resources if required.
- (7) An exchange must seek the prior written approval for any acquisition or disposal of its assets whether by a single or multiple transactions where such change would amount to greater than five (5) percentage of the net asset value of the exchange.

- (8) Unless with the prior written approval of the Commission, an exchange must limit the amount of its assets in a single investment to a maximum of ten (10) percentage of its net asset value.

14. Human and technology resources. – (1) An exchange must have sufficient human and technology resources to operate and supervise its facilities.

- (2) An exchange must ensure, as far as reasonably practical, that its staff are:
- (a) fit and proper;
 - (b) appropriately trained for the duties they perform; and
 - (c) trained in the requirements of the legislation applicable in Bangladesh.
- (3) The exchange must satisfy the Commission that its technology resources are established and maintained in such a way as to ensure that they are secure and maintain the confidentiality of the data they contain.
- (4) In assessing an exchange's systems and controls used to operate and carry on its functions, the Commission requires an exchange to provide information relating to:
- (a) the organisation, management and resources of the information technology department of the exchange;
 - (b) the arrangements for controlling and documenting the design, development, implementation and use of technology systems; and
 - (c) the performance, capacity and reliability of information technology systems.
- (5) The Commission shall also, during its assessment of technology systems, require an exchange to provide:
- (a) procedures for the evaluation and selection of information technology systems;
 - (b) procedures for problem management and system change;
 - (c) arrangements for testing information technology systems before live operations;
 - (d) arrangements to monitor and report system performance, availability and integrity;
 - (e) arrangements made to ensure information technology systems are resilient and not prone to failure;
 - (f) arrangements made to ensure business continuity in the event that an information technology system fails;
 - (g) arrangements made to protect information technology systems from damage, tampering, misuse or unauthorised access;

- (h) arrangements made to ensure the integrity of data forming part of, or being processed through, information technology systems; and
 - (i) any third party outsourcing arrangements.
- (6) Where an exchange changes any of its plans for action in response to a failure of any of its information technology systems resulting in disruption to the operation of its facilities, it must immediately give the Commission notice of that event, and a copy of the revised or new plan.
- (7) Where any reserve information technology system of an exchange fails in such a way that, if the main information technology system of that exchange were also to fail, it would be unable to operate any of its facilities during its normal hours of operation, the exchange must immediately give the Commission notice of that event, and inform the Commission of:
 - (a) what action that exchange is taking to restore the operation of the reserve information technology system; and
 - (b) when it is expected that the operation of that system will be restored.
- 15. Systems and controls.** - (1) An exchange must ensure that its systems and controls are adequate and suitable for the performance of its functions and appropriate to the scale and nature of its operations. In particular, systems and controls should exist in relation to:
 - (a) the transmission of information to users of its facilities;
 - (b) the assessment and management of risks including conflicts of interest;
 - (c) the operation of its functions;
 - (d) the safeguarding and administration of assets belonging to its users; and
 - (e) the fitness and propriety of its employees and the adequacy of its technology resources.
- (2) An exchange must also have systems and controls in relation to the supervision and monitoring of transactions on its facilities.
- (3) An exchange must undertake regular reviews of its systems and controls.
- (4) If a commodities exchange, ensure that only licensed warehouses and warehouse operators are used in connection with commodity exchange trading.
- 16. TREC holders' access to facilities.** - (1) An exchange must restrict access to its facilities to persons:
 - (a) who if a commodity futures exchange are registered by the Commission as a commodity broker/dealer; or

- (b) who if a stock exchange, are registered by the Commission as a broker/dealer or authorized representative; or
 - (c) who are granted access on the basis of criteria which have been approved by the Commission and which are designed to protect the orderly functioning of its facilities and the interests of investors.
- 17. Market surveillance.** - An exchange must have in place effective surveillance systems and procedures that ensure that business conducted on or through its facilities is conducted in an orderly manner so as to afford proper protection to investors.
- 18. Market misconduct, financial crime and money laundering.** - An exchange must:
- (1) operate appropriate measures to identify, deter and prevent market misconduct, financial crime and money laundering on and through the exchange's facilities; and
 - (2) report to the Commission any market misconduct, financial crime and money laundering.
- 19. Promotion and maintenance of standards.** - An exchange must be able and willing to:
- (1) promote and maintain high standards of integrity and fair dealing in the carrying on of business on or through its facilities; and
 - (2) co-operate with the Commission or other appropriate regulatory authorities with regard to regulatory matters when required.
- 20. Whistleblowing.** - An exchange must have appropriate procedures and protections for allowing employees to disclose any information to the Commission or other appropriate bodies involved in the prevention of market misconduct, financial crime or money laundering.
- 21. Transaction recording.** - An exchange must ensure that satisfactory arrangements are made for:
- (1) recording the activity and transactions effected on its facilities;
 - (2) maintaining the activity and transaction records for at least five (5) years; and
 - (3) providing the Commission with these records in a timely manner if required by the Commission.
- 22. Clearing and settlement:** - An exchange must ensure that satisfactory arrangements are in place for securing the timely discharge of the rights and liabilities of the parties to transactions conducted on or through its facilities.
- 23. Clearing house:** - Where an exchange operates a clearing house or undertakes its own clearing and settlement it must ensure that it or the clearing house:
- (1) has a sound risk management framework for comprehensively measuring, monitoring and managing legal, credit, liquidity, operational and other risks;

- (2) can effectively measure, monitor, and manage its credit exposure to clearing participants and those arising from its payment, clearing and settlement processes;
 - (3) accepts collateral with low credit, liquidity, and market risks to manage its or its clearing participants credit exposure;
 - (4) sets and enforces appropriately conservative haircut and concentration limits;
 - (5) provides clearly stated obligations with respect to the delivery of physical securities or commodities and identifies, monitors, and manages the risks associated with such physical deliveries;
 - (6) holds sufficient liquid net assets to cover potential general business losses so that it can continue operations and services as a going concern if those losses materialise. Furthermore, liquid net assets should at all times be sufficient to ensure a recovery or orderly wind-down of critical operations and services;
 - (7) has appropriate systems, policies, processes and controls in place to safeguard its own and its clearing participants assets and minimise risk of loss on or delay in access to these assets;
 - (8) has systems that are designed to ensure a high degree of security and operational reliability with adequate, scalable capacity and business management continuity aimed at a timely recovery of operations and fulfilment of the obligations of the clearing house including in the event of a wide-scale or major disruption;
 - (9) has in place relevant internationally accepted communication protocols, procedures and standards to facilitate efficient payment, clearing, settlement and recording;
 - (10) has clear and comprehensive regulations and procedures together with objective risk-based and publicly disclosed criteria that permit fair and open access for clearing participants;
 - (11) shall preserve confidentiality with regard to all information in its possession concerning its clearing participants and their clients, except that such information may be disclosed by the clearing house when required in writing by the Commission or exchange, or if it is ordered to do so by a court;
- 24. Default.** - An exchange must have default regulations, procedures and arrangements in place which in the event of a TREC holder or clearing participant being, or appearing to be, unable to meet his obligations in respect of one or more transactions, enables action to be taken in respect of unsettled market transaction to which the TREC holder or clearing participant is a party.
- 25. Regulations.** - An exchange must have clear and fair regulations which are legally enforceable against its TREC holders and clearing participants and which are published and made freely available.
- 26. Compliance with regulations.** – An exchange must have compliance procedures in place to ensure:
- (1) its regulations are monitored and enforced;

- (2) disputes concerning persons granted access to its facilities are investigated;
- (3) appeal procedures are in place; and
- (4) where appropriate, disciplinary action resulting in financial and other types of penalties is available.

27. Complaints. – (1) An exchange must have effective arrangements in place for the investigation and resolution of complaints made against it or against any of its TREC holders or clearing participants.

- (2) An exchange must establish and maintain a register of complaints made against it or its TREC holders or clearing participants and their resolution. Records of the complaints must be maintained for a minimum of five (5) years.
- (3) Where an exchange has investigated a complaint made against it or against any of its TREC holders or clearing participants, and the conclusion is that the exchange or the TREC holder or clearing participant should:
 - (a) make a compensatory payment to any person; or
 - (b) remedy the matter which was the subject of that complaint

the exchange must immediately notify the Commission of that event and give the Commission a copy of the report and particulars of the recommendation as soon as that report or those recommendations are available to it.

28. Listing of securities. – (1) A stock exchange wishing to admit securities to listing must have listing regulations which must have the prior approval of the Commission and must be made by an exchange in accordance with rules issued by the Commission for the issuance and listing of securities.

- (2) Listing regulations must be clear and fair, legally enforceable and published and made freely available.
- (3) The listing regulations of a stock exchange should include, where appropriate for the type the securities being admitted to the official list, requirements in respect of:
 - (a) an issuer's financial reporting in respect of how regular reports are made and to what international standards they are produced;
 - (b) auditing standards;
 - (c) an issuer's track record in terms of profit or operating history;
 - (d) the amount of securities in the class of securities which can be considered as free float;
 - (e) any restrictions that may exist on transferability;

(f) any other matter deemed necessary by the Commission.

29. Compliance with listing regulations. - A stock exchange must have compliance procedures in place to ensure:

- (1) its listing regulations are monitored and enforced;
- (2) complaints regarding persons subject to the listing regulations are investigated;
- (3) appeal procedures are in place; and
- (4) where appropriate, disciplinary action resulting in financial and other types of penalties is available.

30. Commodity futures or options contracts. - A commodity futures exchange must clearly defined regulations in place, approved by the Commission with respect to the terms and conditions under which commodity futures or options contracts may be made.

31. Registration of commodity futures or options contract.- (1) Every commodity futures or options contract shall be registered with the Commission under these rules to become eligible for dealing on an exchange.

- (2) An exchange shall submit an application for registration of a standardised commodity futures or options contract with the Commission.
- (3) Upon receipt of an application under (2) and if it is satisfied after making such inquiry as it may consider necessary that the application fulfills the conditions as it may specify in this behalf, the Commission may register the standardized commodity futures or options contract for dealing on the exchange.
- (4) If after having registered the standardized commodity futures or options contract the Commission finds the application is deficient in any material respect or that the exchange has failed to comply with any prescribed condition or requirement and/or that the continued registration of the standardized commodity futures or options contract would not be in the public interest, the Commission may by order either require the exchange to correct the deficiency or comply with the prescribed condition or requirement within the time specified in the order or amend the specification of any standardize commodity futures or options contract.
- (5) No application submitted under (2) shall be refused and no registration of standardized commodity futures or options contract shall be revoked unless the exchange has been given the opportunity of being heard.
- (6) The Commission or an exchange may, if it considers it to be in the interest of trading or in the public interest so to do, suspend for a period not exceeding sixty days, the trading of any commodity futures or options contract and may from time to time, for the said reasons and in the said manner extend the suspension for further period not exceeding sixty (60) days at any time.

32. Approval for new class of securities or commodity futures or options contracts. – Where an exchange proposes to admit to trading, by means of its facilities, a class of securities or

commodity futures or options contract which it has not previously traded, it must submit to the Commission for approval a proposal setting out;

- (1) a description of the securities or commodity futures or options contract to which the proposal relates;
 - (2) where that security is a derivative product, the proposed terms of that derivative;
 - (3) in the case of a commodity futures or options contract, the contract specification;
 - (4) in the case of a security, any draft amendment to the listing regulations;
 - (5) proposed amendments to any other regulation resulting from the proposal;
 - (6) a risk assessment relating to the security or commodity futures or options contract to which the proposal relates; and
 - (7) the name of any clearing or settlement facility in respect of that security or commodity futures or options contract.
- 33. Official list. -** An exchange must immediately notify the Commission of any decision to suspend, restore from suspension or de-list any securities or commodity futures or options contracts from its official list and the reasons for the decision.
- 34. Ongoing general obligations. -** An exchange must at all times do all things necessary to ensure that its market is fair, orderly and efficient.
- 35. Reports. -** An exchange must deliver to the Commission a report in writing at such times as the Commission may direct addressing those matters contained in section 6 of the Ordinance and such other matters as the Commission may reasonably require.
- 36. Submission of annual report by an exchange.-** (1) The annual report relating to the affairs of an exchange shall be submitted to the Commission not less than fourteen (14) days before the meeting of the shareholders of the exchange before which it is to be laid.
- (2) Every such report shall be accompanied by a copy of the balance sheet and profit and loss account of such year audited by an auditor who is a chartered accountant.
- 37. Submission of periodical returns by an exchange.-** The periodical returns relating to the affairs of an exchange shall be submitted to the Commission monthly in form B within fifteen (15) days of the close of the month to which it relates.
- 38. Amendments to exchange regulations. –** (1) Any amendment to regulations issued by an exchange must, prior to the amendment becoming effective, be:
- (a) available for market and public consultation for a period of not less than thirty (30) days; and
 - (b) approved by the Commission.

- (2) In urgent cases, the Commission may, on written application by the exchange, dispense with the requirement in (1)(a) or reduce the period of consultation.
 - (3) An exchange must have procedures for notifying users of these changes.
- 39. Relations with regulators.** - (1) An exchange must deal with regulatory authorities in an open and co-operative manner and keep the Commission promptly informed of significant events or anything else concerning the exchange to which the Commission would reasonably expect to be notified in relation to activities wherever they are carried on.
- (2) An exchange must advise the Commission immediately it becomes aware, or has reasonable grounds to believe, that a significant breach of a rule by the exchange or any of its employees may have occurred or may be about to occur.
- 40. Directors and relevant persons.** - Where an individual becomes or ceases to be a director or relevant person of an exchange including any subsidiary of the exchange, that exchange must immediately give written notice to the Commission of that event setting out the following information:
- (1) where an individual has been appointed or elected as a director or relevant person:
 - (a) that individual's name;
 - (b) his date of birth;
 - (c) a description of the responsibilities which he will have in the position to which he has been appointed or elected;
 - (d) the relevant experience and qualifications of the individual; or
 - (2) where an individual has resigned as or otherwise ceased to be a director or relevant person, that individual's name and the date of resignation or other form of cessation.
 - (3) Where any director or relevant person of an exchange or a subsidiary of the exchange;
 - (a) is the subject of any:
 - (i) disciplinary action arising out of alleged misconduct; or
 - (ii) criminal prosecution arising out of alleged misconduct involving fraud or dishonesty;
 - (b) resigns as a result of an investigation into alleged misconduct; or
 - (c) is dismissed for misconduct;
- the exchange must immediately give the Commission notice of that event together with:
- (d) the name of the director or relevant person and his responsibilities within the Exchange;

- (e) details of the alleged acts of misconduct by that director or relevant person;
 - (f) details of any disciplinary action which has been imposed or is proposed to be taken by the exchange in relation to that director or relevant person.
- (4) Where an exchange becomes aware that any of the following events have occurred in relation to a director or relevant person, it must immediately give the Commission notice of that event:
- (a) a petition of bankruptcy is presented against that director or relevant person;
 - (b) a bankruptcy order is made against him; and
 - (c) he enters into a voluntary arrangement with his creditors.

41. Maintenance of books of account and other documents by an exchange and clearing house.

- (1) Every exchange and clearing house shall prepare and maintain such books of account and other documents as will accurately disclose a true and fair picture of the state of affairs of the exchange or clearing house at any point of time.

- (2) The books of account and other documents referred to in (1) shall include-
- (a) journals (or other comparable record), cash book and any other records of original entry forming the basis of entries into any ledger;
 - (b) ledgers (or other comparable record) reflecting assets, liability, reserve capital, income and expense;
 - (c) ledgers (or other comparable record) showing the position in respect of each TREC holder and/or clearing participant as on the settlement day of the securities or commodity futures or options contracts bought or sold since the last preceding settlement day and which had been transferred through a clearing house;
 - (d) daily record of quotations and transactions of the exchange showing the time at which each transaction took place;
 - (e) record of transactions with banks;
 - (f) record of security deposits or deposits in relation to commodity futures and options contracts;
 - (g) register of shareholders;
 - (h) register of TREC holders and clearing participants;
 - (i) register of authorised representatives; and
 - (j) minute books of the meetings of shareholders, the board and any committee of the board.

- (3) The books of accounts and documents specified in this rule shall be preserved for a period not less than five years.

42. Financial and other information. – (1) An exchange must give the Commission:

- (a) a copy of its annual report and accounts; and
- (b) a copy of any consolidated annual report and accounts of any group of which the exchange is a member;

not later than when the first of the following events occurs:

- (c) four (4) months after the end of the financial year to which the document relates;
 - (d) the time when the documents are sent to persons granted access to the facilities or shareholders of the exchange; or
 - (e) the time when the document is sent to a holding company of the exchange
- (2) Where the board or a committee of an exchange has received a report in relation to any period or any matter relating to any regulatory functions of that exchange, the exchange must immediately give the Commission a copy of that report.
- (3) An exchange must give the Commission a copy of its quarterly management accounts within one (1) month of the end of the period to which they relate.
- (4) An exchange must give the Commission:
- (a) a statement of its anticipated income, expenditure and cash flow for each financial year; and
 - (b) an estimated balance sheet showing its position as it is anticipated at the end of each financial year;

before the beginning of that financial year.

43. Fees and charges. - An exchange must give to the Commission, for approval, a summary of any proposal for changes to fees or charges levied on users of its facilities, or any group or class of them, prior to the proposal being communicated to the relevant users.

44. Inability to discharge regulatory functions. - Where, because of the occurrence of any event or circumstances, an exchange is unable to discharge any regulatory function, it must immediately give the Commission written notice of its inability to discharge that function, and inform the Commission of:

- (1) what event or circumstance has caused it to become unable to do so;
- (2) which of its regulatory functions it is unable to discharge; and
- (3) what action, if any, it is taking or proposes to take to deal with the situation and, in particular, to enable it to recommence discharging that regulatory function.

45. Investigation, inspection, discipline and appeal - An exchange must have:

- (1) effective arrangements in place for the investigation of suspected breaches of its regulations;
- (2) adequate powers of inspection over its TREC holders and clearing participants; and
- (3) clearly defined disciplinary and appeal regulations and procedures.

46. Disciplinary action relating to persons granted access to its facilities. – (1) Where an exchange or its clearing house has taken disciplinary action against a person granted access to its facilities, or any employee of such person, in respect of a breach of its regulations the exchange must immediately notify the Commission of that event, and give:

- (a) the name of the person concerned;
 - (b) details of the disciplinary action taken by the exchange or clearing house; and
 - (c) the exchange's or clearing house's reasons for taking that disciplinary action.
- (2) Where an appeal is lodged against any disciplinary action referred to in (1), the exchange must immediately give the commission notice of that event and:
- (a) the name of the appellant and the grounds on which the appeal is based; and
 - (b) the outcome of the appeal, when known.

47. Criminal offences and civil prohibition. - Where an exchange or its clearing house has information tending to suggest that any person has:

- (1) been undertaking securities business or trading in commodity futures or options contracts in Bangladesh in contravention of the Ordinance;
- (2) engaged in market misconduct; or
- (3) engaged in financial crime or money laundering;

it must immediately give the Commission notice of that event, along with full details of that information in writing.

48. Investigation by other regulatory authorities. Where an exchange becomes aware that a person other than the Commission has been appointed by any regulatory authority to investigate:

- (1) any business transacted on or through its facilities; or
- (2) any aspect of the clearing or settlement services which it provides

it must immediately give the Commission notice of that event.

- 49. Contravention.**—Contravention of any of the provisions of these rules will attract relevant provisions of the Securities and Exchange Ordinance, 1969.
- 50. Repeal and savings.** - (1) Rules 6, 7, 9 and 10 together with forms I and II of the Securities and Exchange Rules, 1987 are hereby repealed.
- (2) Notwithstanding the repeal of the said rules of the Securities and Exchange Rules, 1987 any recognition or clearance given, document or agreement made, fee received or paid, resolution passed, direction given, proceeding taken, instrument executed or issued or things done under or in pursuance of the said rules shall, if in force before the commencement of these rules, continue to be in force and shall have effect as if made, directed, passed, given, taken, executed, issued or done under or in pursuance of these rules.

By order of the Commission

Professor Dr. M. Khairul Hossain
Chairman
Bangladesh Securities and Exchange Commission

FORM - A
(See Rule 4)

**FORM OF APPLICATION FOR REGISTRATION OF A
STOCK OR COMMODITY FUTURES EXCHANGE UNDER THE SECURITIES AND EXCHANGE
ORDINANCE, 1969.**

To
Chairman
Securities and Exchange Commission
Dhaka

Dear Sir,

I/We hereby apply for registration of (name of the stock or commodity futures exchange).

I/We confirm that has not:

- a) been refused the right or restricted in its or his right to carry on any trade, business or profession for which a specific license, registration or other authorisation is required by law in any jurisdiction;
- b) been issued a prohibition order under any Act administered by the Commission or has been prohibited from operating in any jurisdiction by any financial services regulatory authority;
- c) been censured, disciplined, suspended or refused a license or registration by the Commission, any other regulatory authority, an operator of a market or clearing facility, any professional body or government agency, whether in Bangladesh or elsewhere;
- d) been the subject of any complaint made reasonably and in good faith, relating to activities that are regulated by the Commission or under any law in any jurisdiction;
- e) been the subject of any proceedings of a disciplinary or criminal nature or has been notified of any potential proceedings or of any investigation which might lead to those proceedings, under any law in any jurisdiction;
- f) been convicted of any offence, or is being subject to any pending proceedings which may lead to such a conviction, under any law in any jurisdiction;
- g) had any judgment (in particular, that associated with a finding of fraud, misrepresentation or dishonesty) entered against the relevant person in any civil proceedings or is a party to any pending proceedings which may lead to such a judgment, under any law in any jurisdiction;
- h) accepted civil liability for fraud or misrepresentation under any law in any jurisdiction;
- i) had any civil penalty enforcement action taken against it or him by the Commission or any other regulatory authority under any law in any jurisdiction;
- j) contravened or abetted another person in breach of any laws or regulations, business rules or codes of conduct, whether in Bangladesh or elsewhere;
- k) been the subject of any investigations or disciplinary proceedings or been issued a warning or reprimand by the Commission, any other regulatory authority, an operator of a market or

clearing facility, any professional body or government agency, whether in Bangladesh or elsewhere;

- l) demonstrated an unwillingness to comply with any regulatory requirement or to uphold any professional and ethical standards, whether in Bangladesh or elsewhere;
- m) been untruthful or provided false or misleading information to the Commission or been uncooperative in any dealings with the Commission or any other regulatory authority in any jurisdiction.

Five copies of the following documents are submitted in support of this application:

- Certificate of incorporation or registration as applicable
- Scheme for demutualisation, if appropriate
- Memorandum and articles of association of the exchange company
- Proposed Board and Administration Regulations
- Organogram together with duties and responsibilities of key staff
- Codes of conduct of board and staff
- Regulations (by-laws) of the exchange
- Last three years annual reports and accounts (if available)
- Financial valuation of the exchange including the basis of that valuation, duly signed by a person qualified to undertake that valuation
- Valuation of the assets of the exchange, duly signed by a person qualified to undertake that valuation
- At minimum, three year business plan with a policy statement on dividends and a capital expenditure estimate and sources of funds statement
- Form A (this form)
- Form I and form IA of the Fit and Proper Assessment Rules, 2014 in respect of each director and relevant person.

Yours faithfully,

.....

Name, position and signature of the person signing this application.

Annex to Form A

PART I – General

1. Name of the applicant exchange

.....

2. Address

.....

3. Date of establishment

.....

4. Is your exchange a joint stock company registered under the Companies Act, 1994?

If not, the basis of organisation must be stated.

.....

5. Give details of your capital structure (authorised and issued share capital)

.....

6. Give details of the shareholders or proposed shareholders and the number of shares (expressed both in number and percentage of the issued share capital) held by each of them or proposed to be held by each of them

.....

7. Give details of any strategic partner or proposed strategic partner and the percentage of issued share capital held or proposed to be held by them

.....

8. Give details of the name and address where the company share register is maintained

.....

9. Give details of the securities or commodity futures or options contracts for which this application is made. If the application is in respect of more than one type of security or commodity futures or options contracts, an early consultation with the Commission is advisable.

.....

10. Give details of restrictions or limits on individual shareholdings in the exchange company and how this is monitored and enforced

PART II – Fit and proper (Rule 11)

11. Give the name of each member of the board of directors of the exchange identifying whether they are independent or non-independent and the period of office remaining until re-election.

.....

12. Give the name of the president and any vice-presidents.

.....

13. Give the name of the chief executive officer, the chief regulatory officer, and other members of the executive committee together with their titles, areas of responsibility, levels of experience, knowledge and qualifications.

.....

14. Give the names, titles, areas of responsibility, levels of experience, knowledge and qualifications of all employees responsible for oversight of a regulatory function.

.....

15. Give the name of each committee of the board, its chairman and other members of the committee; together with the charter of the committee including its role, responsibility, composition, structure and frequency of meetings.

.....

16. Give the charter of the executive committee including its role, responsibility, composition, structure and frequency of meetings.

.....

17. Give details of the checks carried out by the exchange to ensure that each director, executive and relevant person is fit and proper.

.....

18. Give details of the arrangements in place to ensure that independent directors have direct access to relevant persons when required.

.....

19. Give details of the arrangements in place to ensure that relevant persons have unfettered, direct access to the board.

.....

PART III – Proper markets (Rule 12)

20. Give details of the way in which the exchange will ensure that a proper market exists for the securities or commodity futures or options contracts listed and traded on the exchange – refer to Rule 12(2).

.....

PART IV – Financial resources (Rule 13)

21. Give details of the financial resources available to the exchange – refer to Rule 13

.....

22. Give details of the systems and controls in place within the exchange to monitor the financial resources of the exchange.

.....

PART V – Human and technology resources (Rule 14)

23. Give details concerning how the exchange ensures that its staff are fit and proper, appropriately trained for the duties they perform, and trained in the requirements of the legislation applicable in Bangladesh.

.....

24. Give details concerning the security and maintenance of the exchange technology resources.

.....

25. Give details of the organisation, management and resources of the IT department of the exchange.

.....

26. Give details of the arrangements for controlling and documenting the design, development, implementation and use of IT systems.

.....

27. Give details of the performance, capacity and reliability of IT systems.

.....

PART VI – Systems and controls (Rule 15)

28. Give details regarding how the exchange ensures that its systems and controls are adequate and suitable for the performance of its functions and appropriate to the scale and nature of its operations – Refer to Rule 15

.....

PART VII – TREC holders’ access to facilities (Rule 16)

29. Give details regarding how and to whom the exchange restricts or proposes to restrict access to its facilities. This must include any current or proposed restriction on TREC holders and the method and timeframe by which such restrictions will be removed.

.....

PART VIII – Market surveillance (Rule 17)

30. Give details of the market surveillance systems and procedures in place to ensure that business conducted on or through the Exchange is conducted in an orderly manner so as to afford proper protection for investors.

.....

PART IX – Market misconduct, financial crime and money laundering (Rule 18)

31. Give details of the measures in place to identify, deter and prevent market misconduct, financial crime and money laundering.

.....

PART X – Promotion and maintenance of standards (Rule 19)

32. Give details of how the exchange is able to promote and maintain high standards of integrity and fair dealing in the carrying on of business transacted through its facilities.

.....

PART XI – Whistleblowing (Rule 20)

33. Give details of the procedures and protections in place to allow employees to disclose any information to the Commission or other appropriate body involved in the prevention of market misconduct, financial crime or money laundering.

.....

PART XII – Transaction recording (Rule 21)

34. Give details of the arrangements in place for recording the activity and transactions on the exchange and the maintenance of those records.
.....

PART XIII – Clearing and settlement (Rule 22)

35. Give details of the arrangements in place for securing the timely discharge of the rights and liabilities of the parties to transactions conducted on or through the exchange's facilities.
.....

PART XIV – Clearing house (Rule 23)

36. Give details of the policies, processes, controls, procedures and systems in place to satisfy each of the requirements of rule 23.
.....

PART XV – Default (Rule 24)

37. Give details of the Regulations, procedures and arrangements in place to handle the default of a including the size and source of the default fund.
.....

PART XVI – Regulations (Rule 25)

38. Give details of how the exchange ensures that its regulations are clear, fair and legally enforceable.
.....

PART XVII – Compliance with Regulations (Rule 26)

39. Give details of the compliance procedures in place to ensure that the exchange's regulations are enforced, that disputes are investigated. This should include details of the disciplinary process, proposed penalties and the appeal process.
.....

PART XVIII – Complaints (Rule 27)

40. Give details of the arrangements in place for the effective investigation and resolution of complaints.

.....

PART XIX – Listing of securities (Rule 28)

41. Give details of how the exchange ensures that its listing regulations are fair, legally enforceable, and made available.

.....

PART XX – Compliance with listing regulations (Rule 29)

42. Give details of the procedures in place to ensure compliance with the listing regulations.

.....

PART XXI – Commodity futures or options contracts (Rule 30)

43. Give details of how the exchange ensures that its commodity futures or options contracts are fairly and legally enforceable.

.....

PART XXII – Amendment to exchange regulations (Rule 38)

44. Give details of the procedures in place to ensure TREC holder, clearing participant and public consultation on proposed amendment to the exchange's regulations.

.....

PART XXIII – Fees and Charges (Rule 43)

45. Give details of the proposed fees and charges to be levied on users of the Exchange.

.....

PART XXIV – Investigation, inspection, discipline and appeal (Rule 45)

46. Give details of the powers, arrangements and procedures in place relating to investigation, inspection, discipline and appeal.

.....

FORM B
(See Rule 37)

PERIODICAL RETURN RELATING TO THE AFFAIRS OF
..... FOR THE MONTH OF

To
Chairman
Securities and Exchange Commission
Dhaka

Dear Sir,

I/We hereby submit the following in compliance with the provision of rule 37 of the Exchange Registration Rules, 2014 for your information and necessary action:

1. Name of the exchange
.....
2. (a) Particulars of application for listing received
.....

 (b) Particulars of those admitted to listing

 (c) Particulars of those refused listing and reasons thereon in each case

3. Particulars of new commodity futures or options contracts listed
.....
4. Particulars of securities and commodity futures or options contracts delisted
.....
5. Particulars of persons disciplined and nature of offense/violation committed
.....
6. Particulars of TREC holders and clearing participants declared defaulters
.....
7. Particulars of TREC holders and clearing participants whose net capital balance fell below the prescribed amount
.....
8. Particulars of non-compliance of any regulations of the Stock Exchange by any company whose securities are listed on the stock exchange
.....
9. Number of market surveillance alerts raised during the period
.....

10. Number of market surveillance investigations:

- a) open at the start of the period
- b) new investigations
- c) closed investigations
- d) pending resolution at the close of the period.

11. Number of complaints:

- a) open at the start of the period
- b) new complaints
- c) closed complaints
- d) pending resolution at the close of the period.

11. Trading volume during the month-

- (a) Spot
- (b) Ready
- (c) Forward

13. Particulars of securities which registered a rise/decline of ten percent or more in value during the month

.....

14. Particulars of securities in which no transactions took place during the month

.....

15. Brief analysis of the stock market trend during the month

.....

Yours faithfully,

Signature.....

Designation.....

Place

Date.....

Appendix 3.3: Report on Self-listing of the Dhaka and Chittagong Stock Exchanges (24 February 2014)



বাংলাদেশ সিকিউরিটিজ অ্যান্ড এক্সচেঞ্জ কমিশন
Bangladesh Securities and Exchange Commission

ADB TA-8228 BAN: Enhancing Efficiency of the Capital Market

REPORT ON SELF-LISTING OF THE DHAKA AND CHITTAGONG STOCK EXCHANGES

24 February 2014



The International Securities Consultancy Limited

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SUPERVISION OF LISTING

1. Where a demutualised exchange operates a dual role, as regulator and commercial enterprise, it is inevitable that conflicts will arise. Conflict handling arrangements must therefore be embedded in the practices of the exchange's operational structure and must anticipate that such conflicts will be resolved in different ways.
2. For example, conflicts may arise between commercial business development considerations and the allocation of resources to supervisory activities. In such circumstances, allocation of resources to commercial activities must be matched by a corresponding focus on supervisory issues and resources. Whilst it is assumed that in terms of reputation it would be in the exchange's business interests to maintain adequate resources for supervision, in the real world it is easy to focus more on cost centres and direct profits. Such a focus is usually to the detriment of functions such as compliance and supervision where the benefits are less direct. Similarly, in cases where business development staff also have a day-to-day responsibility for monitoring supervision (for example enforcing listing rules), it is crucial that business development activities do not detract from staff's ability or willingness to undertake that supervision appropriately.
3. Appropriate and robust governance arrangements are an extremely important part of ensuring that there are adequate accountability and control systems in place to make sure that the exchange continues to meet its supervisory obligations.
4. The Governance structure of an exchange needs to guarantee independent regulatory thinking and must be of a structure that reflects and encourages this. It is therefore vital that the exchange has in place appropriate formal structures for monitoring, testing and reviewing its own compliance with its obligations to supervise its market, including assessing how well it is delivering a fair, orderly and transparent market. And, it is important that senior management and ultimately the Board of an exchange, is able to satisfy itself that it is able to comply with these supervisory obligations.
5. The structural separation of supervisory and commercial roles further enhances supervisory independence and is generally be supported by:
 - Quarantining information between commercial and supervisory areas;
 - The use of internal management reports that identify incidents or exceptions to compliance with an exchange's obligations to supervise the market; and
 - Recording supervisory decisions so as to facilitate scrutiny of all significant supervisory activity.
6. In this regard, each exchange in Bangladesh has created a Conflict Mitigation Committee and a Regulatory Affairs Committee and restructured its supervisory activities by creating a single division that is responsible for managing and administering all of the exchange's core supervisory activities. This was in response to the Exchanges (Demutualization) Act, 2012 which requires that the exchanges put in place, inter alia:
 - an appropriate governance and committee structure;
 - a method of dealing with conflict of interests and public interest concerns; and

- the separation of an exchange's business activities from its self-regulatory role.

SELF-LISTING

7. An exchange listing on itself presents a more fundamental conflict of interest than those inherent in the listing supervision by a mutual exchange. In addition to the issue of whether an exchange can function as its own regulator is the issue of whether self-listing increases the conflicts of overseeing competing entities that are also listed on the exchange. The report of the Technical Committee of the International Organization of Securities Commissions (IOSCO), "Issues Paper on Exchange Demutualization", dated 3, June 2001, available online at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD119.pdf> cites two factors that act as controls against discriminatory treatment of competitors: (a) competition for listings among exchanges; and (b) the risk to the exchange's reputation.
8. These potential conflicts are lessened by the government regulator's oversight over the regulatory duties of the exchange. When the Stockholm and the Australian exchanges went public, government was assigned the task of overseeing the exchange's disclosure to its shareholders. Also the Australian Securities and Investments Commission (ASIC) supervises the Australian Stock Exchange's (ASX) listing and undertakes the day-to-day supervision to ensure that the ASX is subject to independent scrutiny.
9. ASX itself is a listed entity on the ASX market. Clearly, ASX would have a conflict in supervising its own conduct as a listed company under the listing rules. To address this, the Corporations Act 2001 and Chapter 20 of the ASX listing rules provide that ASIC is responsible for supervising ASX and monitoring ASX's compliance with the listing rules. ASX does not perform this function in relation to itself.
10. The Australian Corporations Act, 2001 (Sect 798C) sets out the provisions for the listing on a market of a market licensee or related body corporate etc. It states that any of the following kinds of entity or scheme (the listed entity) may be included in a market's official list:
 - a. the market licensee for the market;
 - b. a related body corporate of the market licensee;
 - c. a managed investment scheme whose responsible entity is a related body corporate of the market licensee; and
 - d. a trust whose trustee is a related body corporate of the market licensee.
11. The market's listing rules must contain a section on self listing before such an entity or scheme is included in the official list. The market's listing rules allow for the delegation of some activities but they must provide for ASIC, instead of the market licensee, to make decisions and to take action (or to require the market licensee to take action on ASIC's behalf) in relation to the following:
 - a. the admission of the listed entity to the market's official list; and
 - b. the removal of the listed entity from that list; and
 - c. allowing, stopping or suspending the trading on the market of the listed entity's financial products.

Self-Listing of the Dhaka and Chittagong Stock Exchanges

12. It is a simplistic solution that avoids the need to produce a separate set of listing rules for a single entity or for ASIC to take over day-to-day responsibility for vetting compliance with the disclosure obligations and publication of price sensitive announcements.
13. ASIC charges a fee to ASX for these services.
14. There are two other alternatives that are used to avoid a conflict of interest in an exchange regulating its own listing but these are not recommended for Bangladesh. For example the Toronto Stock Exchange uses the Investment Industry Regulatory Organisation of Canada to regulate its market and its listing whereas in London, it is the Financial Conduct Authority that is responsible for all listing matters in the UK.
15. The proposal that BSEC undertake responsibility for overseeing the self-listing of an exchange is consistent with the DSE and CSE (Listing) Regulations, 2013 recently approved by the Commission. Regulation 3(4) of which states (words in bold type are relevant):

3 (4) The Exchange will be the sole authority to grant, defer or refuse such permission and may for that purpose, relax any of these regulations.

Provided that in case of an application to list the shares of the Exchange on itself, the Commission will be the authority to grant, defer or refuse such application.

16. Where an application is made to the Commission for a listing of a stock exchange, the applicant exchange must comply with the requirements set out in the Exchange (Listing) Regulations, 2013 and the Exchange (Direct Listing) Regulations, 2006, if applicable.
17. There are two additional issues that are relevant and have been considered in the drafting of the following Order and Regulations. First, it can only apply to an exchange regulated by the Commission and would not apply to, for example, a secondary listing of a foreign exchange on the DSE or CSE. Second, it would also apply in the case of CSE seeking a listing on DSE or vice versa thereby avoiding conflict of interest and dual regulation.

RECOMMENDATIONS

18. The following recommendations do not require to be implemented at this point in time as neither the DSE nor the CSE is intending to list itself in the near future. The Commission should therefore keep this Report in reserve for such time as one or more of the exchanges begin discussions pertaining to their self-listing.

Recommendation 1: BSEC to issue the following Order to DSE and CSE

Where an exchange regulated by the Commission, or any related scheme, trust or body corporate of the exchange (related entity) seeks a listing on an exchange regulated by the Commission, the Commission will be the authority responsible for all matters in relation to the exchange or entity's listing.

The Commission will identify and agree with the stock exchange processes and procedures whereby some matters in the listing regulations may be delegated to an officer of the stock exchange to carry out. These may include such matters as receipt of:

Self-Listing of the Dhaka and Chittagong Stock Exchanges

- Notice of record date
- Announcements of a price sensitive nature
- Dividend and other entitlement notices
- Copies of notices
- Financial results
- Statutory reports
- Compliance report re dividend disbursement
- Minutes of AGM
- Summarized list of shareholders
- Certificate of membership of BAPLC
- Notifications requiring publication to the market

The exchange's listing regulations must contain a section on self listing before such exchange or any related entity is admitted to the official list. The exchange's listing regulations must provide for the Commission, instead of the exchange, to make decisions and to take action (or to require the exchange to take action on the Commission's behalf) in relation to the following:

- (a) the admission of the exchange or related entity to the exchange's official list;
- (b) the removal of the exchange or related entity from that list;
- (c) allowing, stopping or suspending the trading on the exchange of the securities of the exchange or related entity; and
- (d) extension of time for holding AGM.

The Commission shall charge a fee for such services at the same rate set out in regulation 33 of the Exchange (Listing) Regulations, 2013 and if a direct listing, regulation 3 of the Exchange (Direct listing) Regulations, 2006.

Recommendation 2: Exchanges to add the following regulations to the Exchange (Listing) Regulations, 2013¹:

XIII: SELF-LISTING OF A STOCK EXCHANGE

61. Requirements for a stock exchange's admission to the official list

For a stock exchange regulated by the Commission to be admitted to its official list or the official list of another stock exchange regulated by the Commission it must meet the requirements set out in the Dhaka Stock Exchange (Listing) Regulations, 2013 and/or the Dhaka Stock Exchange (Direct Listing) Regulations 2006, as appropriate. However, the applicant stock exchange must complete the forms set out in schedule 3 instead of schedule 2 of the Dhaka Stock Exchange (Listing) Regulations, 2013.

62. Powers and functions of the Commission

The Commission has the following powers and functions in relation to the admission of securities to listing of a stock exchange regulated by the Commission.

- (1) The stock exchange must not exercise powers or perform functions in relation to its own application except under a delegation of powers or functions from the Commission.

¹ Substitute Chittagong for Dhaka as appropriate

Self-Listing of the Dhaka and Chittagong Stock Exchanges

- (2) If a stock exchange is admitted to its own official list it must not exercise those powers or functions that it has in relation to a listed entity in respect of its own listing, except under a delegation of powers or functions from the Commission.
- (3) If a stock exchange regulated by the Commission is admitted to the official list of another stock exchange regulated by the Commission the stock exchange on whose official list the stock exchange is admitted must not exercise those powers or functions that it has in relation to a listed entity in respect of that stock exchange's listing, except under a delegation of powers or functions from the Commission.
- (4) Except as provided in (5) below, the Commission may delegate any of its powers or functions under the listing regulations to any person, including the stock exchange or an officer of the stock exchange.
- (5) The Commission may not delegate the following powers:
 - (a) the admission of a stock exchange or related entity to a stock exchange's official list; and
 - (b) the removal of the stock exchange or related entity from that list; and
 - (c) allowing, stopping or suspending the trading on a stock exchange of the securities of the stock exchange or related entity; and
 - (d) extension of time for holding AGM.

Note: A 'related entity' for the purposes of this regulation is any related scheme, trust or body corporate of the stock exchange.

63. Rights and obligations of a stock exchange as a listing applicant and listed company

- (1) A stock exchange (as an applicant for admission to the official list) has all the rights and obligations that another applicant for admission to the official list has, except that the Commission acts in place of the stock exchange as a stock exchange.
- (2) A stock exchange (as a listed company) has all the rights and obligations that another listed company has, except that the Commission acts in place of the stock exchange as a stock exchange.

64. Rights and obligations of the Commission

The Commission acting in place of a stock exchange as a stock exchange has all the rights and obligations in relation to the stock exchange that the stock exchange (as a stock exchange) has in relation to another listed company.

SCHEDULE 3
FORMS

1. Application for self-listing of securities

FORM I
(See regulation 6(i))

To:
Chairman
Bangladesh Securities & Exchange Commission
Dhaka

APPLICATION FOR LISTING

Dear Sir,

We hereby apply for the self-listing of Dhaka Stock Exchange Ltd on the Dhaka Stock Exchange (and Chittagong Stock Exchange*). *delete as appropriate

Necessary information and documents as required in the annexure to this form are furnished.

Yours faithfully,

Signature & Address

ANNEXURE TO FORM

The following particulars and authenticated documents shall be annexed to the listing application, namely:

1. Memorandum and Articles of Association and, in case of Participatory Redeemable Capital, a copy of the trust deed;
2. Copies of prospectus issued by the company in respect of any security already listed on the Stock Exchange.
3. Copies of balance sheets and audited accounts for the last five completed years or for a shorter number of years if the Company has been in existence only for such shorter years/period;
4. A brief history of the company since incorporation giving details of its activities including any re-organization, changes in its capital structure and borrowings.
5. A statement showing :
 - a) dividends and cash bonus and/or bonus shares or right shares issued during a last 10 years or such shorter period as the company may have been in existence;
 - b) dividends or interest in arrears, if any.
6. Certified copies of agreements or other documents relating to arrangements with or between:
 - a) vendor and/or promoters.
 - b) underwriters.
 - c) brokers.
7. Certified copies of agreements with;
 - a) managing agents.
 - b) selling agents.
 - c) managing director and technical directors.
8. A statement containing particulars, dates of and parties to all material contracts, agreements (including agreements for technical advice and collaboration), concessions and similar other documents except those entered into in the normal course of the company's business or intended business together with a brief descriptions of the terms of such agreements or contracts.
9. Certified copies of the agreements with the BDBL, ICB and any other financial institutions.
10. Names and address of the directors and persons holding five percent or more of any class of equity security as on the date of application together with the number of shares of debentures held by each.
11. Particulars of security for which listing is sought.
12. Additional/information/documents that may be called by the Commission.

2. Form for submission of undertaking and payment of fees

FORM II
(Regulation 6)

Dated.....

To

Chairman

Bangladesh Securities & Exchange Commission

Dhaka

SELF-LISTING ON THE STOCK EXCHANGE

Dear Sir,

With reference to our listing application under Section 9 of the Securities and Exchange Ordinance, 1969, we enclose herewith the following:

- (1) An unconditional undertaking under the Common Seal of the company duly signed in accordance with the provisions contained in our Articles of Association.
- (2) A remittance of TK. toward initial Listing Fee at the rate as mentioned in regulation 33.(1) of TK.....
- (3) A remittance of TK.toward annual Listing Fee.
- (4) A remittance of TK.toward the service charge.

Yours faithfully,

Signature & Address

ANNEXURE TO FORM II

FORM OF UNCONDITIONAL UNDERTAKING ON NON-JUDICIAL STAMP PAPER

(Regulation 5)

Dated.....

To

Chairman

Bangladesh Securities & Exchange Commission

Dhaka

Dear Sir,

UNDERTAKING

We undertake, unconditionally, to abide by the Listing Regulations of the Dhaka Stock Exchange Limited which presently are, or hereinafter may be in force.

We further undertake:

- (1) That our shares and securities shall be quoted on the trading system of the Exchange at the discretion of the Commission.
- (2) That the Commission shall not be bound by our request to remove the shares or securities from the trading system of the Exchange.
- (3) That the Commission shall have the right, at any time to suspend or remove the said shares or securities for any reason which the Commission considers sufficient in public interest.
- (4) That such provisions in the Articles of Association of our Company or in any declaration or basis relating to any security as are or otherwise not deemed by the Commission to be in conformity with the Listing Regulations of the Exchange shall, upon being called upon by the Commission, be amended to supersede the Articles of Association of our company or the declaration or basis relating to any security; and
- (5) That our company and / or the security may be delisted by the Commission in the event of non-compliance and breach of the Regulations and/or of this undertaking after giving an opportunity of being heard to us.

Yours faithfully,

NAME AND SIGNATURE OF
AUTHORISED PERSON (S) WITH
COMMON SEAL OF THE COMPANY

Appendix 3.4: Report on Margin Rules (26 February 2014)



বাংলাদেশ সিকিউরিটিজ অ্যান্ড এক্সচেঞ্জ কমিশন
Bangladesh Securities and Exchange Commission

ADB TA-8228 BAN: Enhancing Efficiency of the Capital Market

REPORT ON MARGIN RULES

26 February 2014



The International Securities Consultancy Limited

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MARGIN TRADING

1. The purpose of this Report is to identify changes required to the Margin Rules, 1999 (“the Margin Rules”) in light of the passage of the Exchanges Demutualization Act, 2013 to bring about the demutualization of the Dhaka and Chittagong stock exchanges.
2. During 2012, the Bangladesh Securities and Exchange Commission (the Commission) undertook a review of the Margin Rules and produced a draft rule dated 30th September 2012 (draft Margin Rules). This draft makes significant changes to the Margin Rules. To date, the draft margin rules have not been implemented.
3. In addition to reviewing the Margin Rules for consistency with the Exchanges Demutualisation Act, the consultant has compared the Margin Rules and the draft Margin Rules with similar margin trading rules from India and Pakistan. Both these jurisdictions have modernised their margin trading rules in recent years.
4. Normally investors trade in securities on the strength of owned funds and owned securities. However, sometimes, based on their outlook about the market and some specific securities in particular, they seek to trade beyond resources they already own. This trading is supported by a borrowing facility for funds and securities. While trading with borrowed resources, investors are required to put up a margin (good faith deposit) with their broker and this phenomenon is called margin trading. This margin is usually a percent of the value of the proposed transaction.
5. Therefore, broadly speaking, margin trading is trading in the securities market with borrowed resources – either funds or securities. Because margin trading is providing a facility to investors to trade in the market with margin money, it is essentially a leverage mechanism. Globally, in all major markets the facility of margin trading and securities lending is available to investors. However, the business models for margin trading and securities lending are different in different markets e.g.
 1. Financing by brokers.
 2. Financing by a clearing corporation/exchange e.g. a product as in Mauritius.
 3. Direct financing to investors by banks and financial institutions.
 4. Financing by the specialized institutions such as “limited purpose banks”.
6. However, all the above business models are not exclusive of each other. There may be a situation where the financing takes place from brokers and brokers in turn are financed from banks and financial institutions.
7. The consultant has not carried out a full scale review of margin trading in Bangladesh and the comments set out in this Report are based purely on an assessment of any changes necessary as a result of demutualization and a desk-topped review of the margin trading rules in two neighbouring countries where margin trading is highly active.
8. In view of the revision of the Margin Rules carried out in 2012, the consultant confines comments to the 2012 draft of the Margin Rules.

MARGIN RULES

9. The consultant confirms that no changes are required to be made to the 2012 draft margin rules as a result of the demutualization of the Bangladesh stock exchanges. The comments that follow are principally related to points of drafting and not of substance.

COMMENTS ON THE DRAFT 2012 MARGIN RULES

SECURITIES AND EXCHANGE COMMISSION, BANGLADESH

Dhaka, the 30th September, 2012

NOTIFICATION

In exercise of powers conferred by section 33 read with section 16 of the Securities and Exchange Ordinance, 1969 (XVII of 1969) and also read with Deaviv L of aviv 8 and aviv 24 of wmwKDwiwUR I G·†PÄ Kwgkb AvBb, 1993, the Securities and Exchange Commission makes the following rules, namely:-

Margin Rules, 2012

1. (1) These rules may be called the Margin Rules, 2012.

(2) These shall come into force at once.

2. **Definitions.**__ (1) In these rules unless there is any thing repugnant in the subject or context,-

(a) “Act” means the wmwKDwiwUR I G·†PÄ Kwgkb AvBb, 1993;

(b) “marginable securities” means securities approved by the Stock Exchange for the purpose of margin trading and financing;

(c) “bank” means a banking company as defined in the eˆvsK †Kvœúvwb AvBb, 1991 (1991 m†bi 14 bœ^i AvBb);

(d) “stock-broker” means any stock-broker of the stock exchange registered with the Commission as a stock-broker under wmwKDwiwUR I G·†PÄ Kwgkb (÷K-wWjvi, ÷K-†e^vKvi I Aby†gvw`Z cÖwZwbwa) wewagvjv, 2000;

MARGIN RULES

(e) “portfolio manager” means any merchant banker who is registered with the Commission as a portfolio manager under the Securities and Exchange Commission (SEC) established under the Securities and Exchange Commission Act, 1993 (1993 m. 15 of the Acts of 1993);

(f) “central depository” [ISC comment - “central depository” is not used anywhere other than in the definition of “trustee” which is not used anywhere other than in the definitions] means a central depository as defined in the Securities and Exchange Commission Act, 1993 (1993 m. 11 of the Acts of 1993), and registered with the Commission;

(g) “client” means a person who executes margin agreement to borrow money from a stock-broker or portfolio manager to buy securities as specified by the Stock Exchange for the purpose of margin trading;

(h) “Commission” means the Securities and Exchange Commission (SEC) established under the Securities and Exchange Commission Act, 1993 (1993 m. 15 of the Acts of 1993);

(i) “portfolio value” means the aggregate amount of cash and market value of securities in a client's margin account, including value of all receivables at current market price basis;

(j) “loan balance” means the cash amount owed by a client in his margin account including accrued expenses or interest;

(k) Loan determinant: Allowable loan balance in a margin account shall be calculated using the value of loan determinant in the following manner:

Allowable loan balance = Margin amount x loan determinant

Example 1: If in a margin account, margin amount is Tk.100 and value of loan determinant is 1.50 then allowable loan balance would be Tk.150 = (100 x 1.5).

Dhaka Stock Exchange Limited will time to time declare the value of loan determinant based on some market data on the manner described in Rule

(l) “margin” means the aggregate amount of cash and market value of marginable securities deposited or carried by a client into his margin account for the purpose of margin financing and margin trading, this will also mean net value of the margin account after deducting loan balance from portfolio value;

(m) “margin account” means an account maintained with the stock-broker or portfolio manager, which records transactions of margin trading;

(n) “margin agreement” means the agreement between the stock-broker or portfolio manager and his client for the administration of margin account for the purpose of margin trading;

(o) “maintenance margin” means the minimum amount of margin that must be maintained by a client in a margin account;

MARGIN RULES

(p) “margin financing” means financing to the client by the stock-broker or portfolio manager for the purpose of margin trading;

(q) “margin call” means a notice issued in writing by a stock-broker or portfolio manager to his client in the form of a letter by courier or registered post or fax or by hand subject to acknowledgement or by electronic mail (with the onus on the stock-broker or portfolio manager to prove issuance of such notice) requiring the client to provide additional margin in order to keep maintenance margin;

(r) “net capital” means net capital as defined under clause (c) of rule 2 of the Securities and Exchange Rules, 1987;

(s) “Ordinance” means the Securities and Exchange Ordinance, 1969 (XVII of 1969);

(t) “rules” means the Margin Rules 2012; and

(u) “trustee” ISC comment - “trustee” is not used anywhere other than in the definitions means a financial institution or a central depository having legal title to securities, and holding such securities in trust for the benefit of another person or entity and owes a fiduciary duty to that beneficiary.

(2) All other words and expressions used but not defined in these rules shall have the same meanings as are assigned to them in the *Kvôivbx AvBb, 1994 (1994 m#bi 18 bs AvBb)* and the Securities and Exchange Ordinance, 1969 (XVII of 1969).

3. Pre-requisite- (1) Margin financing and margin trading shall be carried out by only those stock-brokers and portfolio managers who are registered with the Commission and meet the minimum net capital and capital adequacy requirements ISC comment - Does BSEC set minimum net capital and capital adequacy requirements for portfolio managers?.

(2) The Commission may fix from time to time the capital adequacy requirements for margin financing and margin trading as provided in subrule (1) of rule 3 in consultation with the Stock Exchanges. ISC comment - It is not appropriate that the stock exchanges should be consulted on the capital adequacy requirements for portfolio managers

(3) Margin trading shall be permissible only in scrips fixed by the Commission ISC comment - Factors in determining the securities would include, market capitalization, free float, liquidity and compliance with the listing regulations of the exchange. India for example categorises its securities into three groups and only those in Group 1 (the most liquid and frequently traded securities) can be traded on margin. In addition, securities that are the subject of an IPO are permitted to be traded on margin. in consultation with the Stock Exchanges and shall be subject to a maintenance margin.

4. Margin agreement (1) The stock-broker or portfolio manager shall execute a margin agreement with a person who intends to be his client for the purpose of margin financing and margin trading.

MARGIN RULES

(2) The margin agreement shall contain, *inter alia*, provisions which authorize the stock-broker or portfolio manager to :-

(a) pledge or hypothecate the securities deposited or bought on behalf of client by the stock-broker or portfolio manager, for a sum not exceeding the outstanding balance in the margin account;

(b) use his discretion and on best effort basis to sell or dispose of any or all the securities, in any lawful manner in order to meet the fixed margin requirements as are specified in rule 6; and

(c) extend margin trading and margin financing facilities to the client up to an approved limit subject to the range fixed by the Commission in consultation with the Stock Exchanges ISC comment - Not appropriate in the case of portfolio managers under sub rule (3) of rule 6.

5. Restrictions ISC comment - It is normal to state that a stock-broker may only use his own funds or borrow from approved banks and/or other institutions regulated by the securities regulator and that a stock-broker shall not be permitted to borrow funds from any other source. In addition, neither a stock-broker nor a portfolio manager may use the funds of any client for providing margin to another client, even if it is authorised by the client.

.- No stock-broker or portfolio manager shall extend margin trading and margin financing facilities to the following persons, namely:-

(i) any of its partners, directors, agents or employees;

(ii) any firm or company in which any of its partners, directors, agents or employees is interested as a partner, director, agent, employee or guarantor;

(iii) any company in which any of its partners, directors, agents or employees hold shares except: –

a) where its partners, directors, agents or employees hold less than ten per cent of the issued share capital of that company; and

b) in respect of any listed company, where a partner, director, agent or employee of the stock-broker or portfolio manager holds directly or indirectly less than five per cent of the issued share capital of that company;

(v) any other person as may be fixed by the Commission.

Explanation.- For the purposes of this clause the term “director” or “employee” shall include the spouses, parents or children of the director or employee or partner or agent.

6. Margin maintenance requirements.- (1) The stock-broker or portfolio manager and client shall ensure that maintenance margin in the margin account shall be maintained at all times. If as a result of market fluctuations, the value of the deposited margin falls below the maintenance margin level, the stock-broker or portfolio manager shall be required to give his client a margin call.

MARGIN RULES

(2) If the client fails to deposit additional cash or securities as a margin within two market days of the margin call and clients' margin in the margin account falls below 50% of maintenance margin, the stock-broker or ~~merchant-banker~~portfolio manager shall have absolute discretion without notice to such client to liquidate his margin account, including the securities deposited or purchased and carried in such account, to the extent that the margin is maintained at the required level.

(3) Limit of margin financing: The amount of margin financing facility that a stock-broker or portfolio manager may extend to any single client shall not be more than a range fixed by the Commission [ISC comment - Exposure to a single client in Pakistan and India is measured as a percentage of the broker's total margin exposure (10% in the case of both)].

(4) The Commission may specify a range within which separate limits may be fixed for individual and corporate clients.

Explanation.- For the purposes of this clause in computing the total amount of margin financing and margin trading facilities given to any single client the term "single client" is defined as follows:

(a) where such single client is an individual, the margin financing and margin trading facilities shall be deemed to include the margin financing and margin trading facilities given to the individual, spouse, parents or children of the individual, the partnership firm of which he is a partner, any partner of the individual, the spouse parents or children of that partner and all the companies over which the individual exercises control.

Furthermore, for the purpose of this clause, an individual is deemed to exercise "control" over a company if the individual or the individual's spouse, severally or jointly:-

(i) holds, directly or indirectly, more than fifty one per cent [ISC comment - Absolute control is more than 50%. de facto control is generally considered to be anything over 40% and in some jurisdictions as low as 30%] of the shares of that company;

(ii) has the power to appoint, or cause to be appointed, a majority of the directors'; or

(iii) has the power to make, or cause to be made, decisions in respect of the business or administration of that company, and to give effect to such decisions, or cause them to be given effect to; and

(b) where such single client is a company, any financing and margin trading facilities extended to the company and its associated companies shall be deemed to be margin financing and margin trading facility extended to such a single client.

7. Deposit of margin.- (1) The credit amount of margin accounts of clients shall be kept by the stock-broker or portfolio manager in his separate bank account titled "Client Margin Account" and shall not be used by the stock-broker or portfolio manager for his own business.

(2) The securities either deposited as margin or purchased on margin financing shall be kept by the stock-broker or portfolio manager in the respective Beneficiary Owners' (BO) account [ISC comment

MARGIN RULES

- Can the BO account contain securities not purchased on margin or is this a separate BO account in the name of the client entitled client BO margin account? Unclear] of the client and this account shall be used only for the purpose of margin trading.

(3) The deposit [ISC comment – Deposit where?] of any government security as margin of a client shall be used only for the purpose of margin trading.

8. Withdrawal.- A client may only withdraw from his margin account, sales proceeds or any part thereof in cash and any securities for the time being deposited into his margin account, provided that the value of the margin amount in the said margin account does not fall below the maintenance margin after such withdrawal.

Example 2: If in a margin account, portfolio value is Tk.500, loan balance is Tk.200 and margin amount is Tk.300, sale proceeds is Tk.300 and value of loan determinant is 2 (two) then maximum amount of cash the client may withdraw is Tk.200 which is calculated as under:

$$\begin{aligned}\text{Maintenance margin} &= \frac{\text{loan balance}}{\text{loan determinant}} \\ &= 200 / 2 \\ &= 100\end{aligned}$$

In the above case, the client may be allowed to withdraw maximum Tk.200 (300 – 100).

9. Valuation of securities.- The securities that a client may deposit into his margin account and the method of valuation thereof shall be limited to the following, namely :-

(a) for securities quoted on the Stock Exchange the value shall be based on the last quoted price [ISC comment - The quoted price is normally a bid and offer price. Is this the mid price of the bid and offer? What if there is a bid and no offer price? Should it be the “closing price”] of the securities on the preceding market day at the Exchange; and

(b) for government securities the value shall be based at the last done price on the preceding day.

10. Limit of collective outstanding balances.- (1) The stock-broker or portfolio manager shall ensure that the aggregate outstanding balances, in the margin accounts maintained by all clients of a stock-broker shall not exceed collectively the fixed level as provided in sub rule (2).

(2) The aggregate outstanding balances in the margin accounts maintained by all clients of a stock-broker or portfolio manager shall not exceed collectively a level as may be fixed by the Commission and shall be linked to the capital adequacy requirements with the approval of the Commission.

11. Administrative, operational and reporting requirements.- (1) The stock-broker or portfolio manager shall ensure that the margin maintenance requirements specified under these rules are complied with at all times.

MARGIN RULES

(2) The stock-broker shall report and disclose the value of margin transactions to the Stock Exchange and the Stock Exchange then submit a summary report to the Commission and portfolio managers shall report directly to the Commission as under:

(a) Daily: number of shares traded daily on margin, traded value, amount of margin financing provided to clients, value of securities against margin financing; and

(b) Weekly: client wise weekly report (indicating clients codes only) of total shares traded on margin, traded value, amount of margin financing provided to clients, value of securities against margin financing, loans taken from banks by the stock-broker or portfolio manager for margin trading.

(3) If the Commission or the Stock Exchange, as appropriate, is of the opinion that the stock-broker or portfolio manager has extended margin financing to its client to a level which may cause problems for the stock-broker or portfolio manager to honour its obligation to the Exchange or cause systemic risk for the market, the Commission or the Stock Exchange, as appropriate, may order the stock-broker or portfolio manager to do *inter alia* the following, namely:-

(a) reduce the outstanding position of client to a level within the time specified by the Commission or the Stock Exchange;

(b) prohibit the stock-broker or portfolio manager from allowing client to trade on margin; and

(c) any other action the Commission or the Stock Exchange may deem fit and appropriate.

12. Enhancement and reduction of margin maintenance requirements.- The Commission may enhance or reduce the margin maintenance requirements by changing the loan determinant in consultation with the Stock Exchanges as deemed necessary and appropriate for reasons to be recorded in writing on a case-to-case basis.

13. Internal procedures for granting margin financing and margin trading facilities by ~~Broker stock-broker~~.- (1) The Stock Exchanges shall make the detailed regulations subject to prior approval of the Commission for ~~the stock-brokers or portfolio manager-s~~ [ISC comment - Regulations made by a stock exchange can only apply to stock-brokers and not portfolio managers. Who will make regulations governing portfolio managers and who will be responsible for enforcement of them?] relating to grant of margin financing and margin trading facilities in relation to any margin account.

(2) The Stock Exchanges shall ensure implementation of the regulations as specified in sub-rule (1) of rule 13.

(3) In particular and without prejudice to the generality of the foregoing powers, such regulations may provide *inter alia* for any of the following matters, [ISC comment - There should be a strict regime of know your client including the physical identification of the client. It is not clear a stock-broker may reject a client for credit reasons or other reasons] namely:-

a) detailed procedures to process applications for margin financing facilities (application forms for margin financing to be specified by the Stock Exchanges with the prior approval of the Commission);

MARGIN RULES

- b) criteria to assess the credit risk of a client;
- c) documentation in respect of margin financing and margin trading facilities extended to a client;
- d) an effective monitoring system; and
- e) taking disciplinary action and fixation of penalty in case of violation of the regulations ISC comment - Can only apply in the case of stock-brokers. What about portfolio managers?].

14. Non compliance of margin trading requirements.- (1) If a stock-broker or portfolio manager does not comply with any provision of the Ordinance, these Rules or any direction of the Commission under the Ordinance or the Act relating to margin trading, the Commission, may *suo moto* or on a complaint from the Stock Exchange or any person and after giving him an opportunity of hearing, by order,

- (a) direct the stock-broker or portfolio manager to pay a fine not exceeding hundred thousand rupees per default ; and
- (b) Suspend the stock-broker or portfolio manager ship of the stock-broker or portfolio manager .

15. Interest on loan balance:

Interest rate on loan balance will be determined as per agreement between the stock-broker or portfolio manager and the client. But interest will be charged on quarterly basis, based on daily outstanding loan balance and a year of 360 days basis.

Example 3: If in a margin account, loan balance in a quarter was Tk.1000 for 35 days, Tk.2000 for 65 days and Tk.500

For any sale proceeds, loan balance will be reduced by that amount.

MARGIN RULES

Example - I :

1. An individual client Mr. 'A' opened a margin account on 01.02.20XX with stock-broker 'B' by depositing Tk.1000 in cash and by carrying 100 units of security 'X' & 100 units of security 'Y' into the account from stock-broker 'C'.
2. The value of security X & Y was Tk.25 and Tk.15 respectively on 31.01.20XX.
3. Value of loan determinant is 2 (two).

Calculation:

$$\begin{aligned}\text{Margin amount} &= \text{Tk.1000} + \{(100 \times \text{Tk.25}) + (100 \times \text{Tk.15})\} \\ &= \text{Tk.1000} + \text{Tk.2500} + \text{Tk.1500} \\ &= \text{Tk.5000}.\end{aligned}$$

$$\begin{aligned}\text{Allowable loan} &= \text{Margin amount} \times \text{loan determinant} \\ &= \text{Tk.5000} \times 2 \\ &= \text{Tk.10,000}.\end{aligned}$$

Example - II :

1. The closing price of security 'X' & 'Y' was Tk.20 and Tk.12 respectively on 09.02.20XX.
2. Client Mr. 'A' wants to purchase maximum units of security 'Z' using margin loan at a price of Tk.40 on 10.02.20XX. Price of security X and Y remained same.

Calculation:

$$\begin{aligned}\text{Margin Amount} &= (\text{available cash} + \text{market value of securities}) - \text{loan balance} \\ &= 1,000 + \{(100 \times \text{Tk.20}) + (100 \times \text{Tk.12})\} \\ &= \text{Tk.1,000} + \text{Tk.2,000} + \text{Tk.1,200} \\ &= \text{Tk.4,200}.\end{aligned}$$

$$\begin{aligned}\text{Allowable loan} &= \text{Margin amount} \times \text{loan determinant} \\ &= \text{Tk.4,200} \times 2 \\ &= \text{Tk.8,400}.\end{aligned}$$

Maximum units of security 'Z' that can be purchased at a price of Tk.40

MARGIN RULES

$$\begin{aligned}
 &= (\text{available cash in the account} + \text{allowable loan}) / 40 \\
 &= (\text{Tk.1,000} + \text{Tk.8,400}) / 40 \\
 &= \text{Tk.9,400} / 40. \\
 &= 235 \text{ units.}
 \end{aligned}$$

Portfolio value after purchase of security 'Z' using available cash and loan =

$$\begin{aligned}
 &\{(\text{units of security X} \times \text{close price}) + (\text{units of security Y} \times \text{close price}) + \\
 &(\text{units of security Z} \times \text{close price})\} \\
 &= \{(100 \times \text{Tk.20}) + (100 \times \text{Tk.12}) + (235 \times \text{Tk.40})\} \\
 &= \text{Tk.2,000} + \text{Tk.1,200} + \text{Tk.9,400.} \\
 &= \text{Tk.12,600.}
 \end{aligned}$$

Example - III :

The closing price of security 'X', 'Y' & 'Z' was Tk.18, Tk.10 and Tk.35 respectively on 28.02.20XX. Loan balance was Tk.8,400 on that date.

Calculation:

$$\begin{aligned}
 \text{Portfolio value} &= \{(100 \times \text{Tk.18}) + (100 \times \text{Tk.10}) + (235 \times \text{Tk.36})\} \\
 &= 1,800 + 1,000 + 8,460 \\
 &= \text{Tk.11,260.}
 \end{aligned}$$

$$\begin{aligned}
 \text{Margin Amount} &= \text{Portfolio value} - \text{loan balance} \\
 &= \text{Tk.11,260} - \text{Tk.8,400} \\
 &= \text{Tk. 2,860.}
 \end{aligned}$$

$$\begin{aligned}
 \text{Maintenance margin} &= \frac{\text{loan balance}}{\text{loan determinant}} \\
 &= \text{Tk.8,400} / 2 \\
 &= \text{Tk. 4,200}
 \end{aligned}$$

$$\begin{aligned}
 \text{Margin Call for} &= \text{Tk. 4,200} - \text{Tk. 2,860} \\
 &= \text{Tk. 1,340}
 \end{aligned}$$

$$\begin{aligned}
 \text{Force sell stage} &= \text{When margin amount falls below 50\% of maintenance margin} \\
 &= \text{below Tk. 4,200} \times 50\% = \text{below Tk.2,100}
 \end{aligned}$$

Appendix 3.5: Presentation to Board of the BSEC (24 February 2014)

Presentation to Board of the Bangladesh Securities and Exchange Commission

Dhaka, Bangladesh
24 February 2014

ADB TA-8228 BAN: Enhancing Efficiency of the Capital Market



The International Securities Consultancy Limited

Self-Listing of DSE and CSE

Self-Listing of DSE and CSE

- Clear conflict of interest in an exchange regulating its own listing
- Three options:
 - Third party regulator e.g. IIROC in Canada
 - FCA in London for all listings
 - BSEC for listing of exchange only e.g. ASIC in Australia
- Recommendations:
 1. BSEC issues Order to exchanges that it will replace exchange as regulator of self-listed exchange company
 2. Exchanges to amend Listing Regulations accordingly

Matters which may be delegated:

Receipt of:

- Notice of record date
- Announcements of a price sensitive nature
- Dividend and other entitlement notices
- Copies of notices
- Financial results
- Statutory reports
- Compliance report re dividend disbursement
- Minutes of AGM
- Summarized list of shareholders
- Certificate of membership of BAPLC
- Notifications requiring publication to the market

Matters which cannot be delegated:

- the admission of the exchange or related entity to the exchange's official list; and
- the removal of the exchange or related entity from that list; and
- allowing, stopping or suspending the trading on the exchange of the securities of the exchange or related entity
- extension of time for holding AGM.

Fit and Proper Criteria

Fit and Proper Criteria

- Fit and proper criteria for directors of a stock exchange prepared under demutualisation project
- IOSCO (Emerging Markets Report December 2009) recommend fit and proper guidelines for all regulated persons
- Recommendation – extend fit and proper criteria to all relevant persons within institutions over which the Commission has regulatory authority

“Institution” means

- Stock exchange
- Commodity exchange
- Clearing house
- Depository
- Depository participant
- Merchant bank
- Credit rating company
- Securities custodian
- Trustee of asset backed securities
- Trustee of mutual funds
- Asset management company
- Stock-broker/stock-dealer
- Commodity-broker/commodity-dealer
- Investment adviser
- Independent research firm

“relevant person” in relation to an institution means

- Director
- Substantial shareholder
- Chief executive officer/managing director
- Chief regulatory officer
- Chief financial officer
- Compliance officer
- Employees of an institution assigned to oversee a regulatory function
- Head of treasury
- Authorised representative
- Any other person responsible for managing or overseeing the activities of an institution

Responsibilities

- Responsibility of the relevant person to establish fit and proper not the Commission to show otherwise
- Responsibility of the institution to satisfy the Commission:
 1. Each of its relevant persons meets the fit and proper criteria; and
 2. It has in place appropriate recruitment policies, adequate internal control systems and procedures to ensure that persons it employs meet the fit and proper criteria

Criteria

- Competence and capability
 - Expertise, skills, knowledge, educational qualifications, of sound mind
- Honesty, integrity, fairness and ethical behaviour
 - Past refusal of license, discipline, complaint, criminal or fraud conviction, reprimand, past directorships, breach of corporate governance code, been dismissed, disqualified as a director
- Financial soundness
 - Has been unable to fulfil financial obligations, entered into scheme with creditors, has outstanding debt judgement, a defaulter, bankrupt

Continuing assessment

- Responsibility of the relevant person or the institution to advise the Commission of a change of circumstances

Do not propose any alteration to specific criteria to be a director of an exchange – i.e. No if:

- A lunatic
- Absent from meetings without leave of absence
- Convicted of a criminal offence
- Loan defaulter
- Enter into a business arrangement with the exchange
- Fail to pass the 'Fit and Proper' criteria set by the Commission
- Other specific criteria for an independent director.

Exchange Registration Rules

Exchange Registration Rules

- Securities and Exchange Rules, 1987 deal with:
 - Stock exchanges (rules 6, 7, 9 and 10)
 - Listing on a stock exchange (rules 11, 12, 13 and 14)
 - Members of a stock exchange (rules 3, 4, 5, 8, 8A, 8B, and 15)
- Broker/Dealer Rules 2000
- Advice – split into three
 - Combine '87 Rules on membership with broker/dealer rules and bring to IOSCO standards (Principles 29-32) – work ongoing
 - Revisit the work that John Carson did on listing rules (outside scope)
 - Prepare new exchange registration rules to IOSCO Principles 33-38 and add commodity markets and clearing house

Exchange Registration Rules v '87 Rules

What's new – (principal not all)

- Must be demutualised
- Must prove fit and proper
- Change in scope may require re-registration
- Details of strategic investors for approval
- Appointment of key persons inc. CRO
- Must have proper markets
- Must have systems and controls
- Commission approval of IT systems and changes thereto
- Whistle blowing protection
- Clearing house (IOSCO Principles for financial market infrastructures April 2002)
- Complaints
- Commodity futures and options contracts

Questions

Appendix 3.6: Report on stock broker and stock dealer rules, 2014 (31 July 2014)



বাংলাদেশ সিকিউরিটিজ অ্যান্ড এক্সচেঞ্জ কমিশন
Bangladesh Securities and Exchange Commission

ADB TA-8228 BAN: Enhancing Efficiency of the Capital Market

REPORT ON STOCK BROKER AND STOCK DEALER RULES, 2014

31 July 2014



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REPORT ON STOCK BROKER AND STOCK DEALER RULES, 2014

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REPORT ON STOCK BROKER AND STOCK DEALER RULES, 2014

INTRODUCTION

1. The purpose of this Report is to identify changes required to the Securities and Exchange Rules, 1987 (“the 87 Rules”) and the Securities and Exchange Commission (stock-broker, stock-dealer and authorized representative) Rules, 2000 (“the 2000 Rules”) in light of the passage of the Exchanges Demutualization Act, 2013 to bring about the demutualization of the Dhaka and Chittagong stock exchanges.
2. The 87 Rules, in-so-far as they relate to members of a stock exchange are set out in the following rules governing:
 3. Qualification etc of members of a stock exchange
 4. Manner of transacting a member’s business
 - 4A. Regulation of trading in a stock exchange
 5. Maintenance of accounts and audit (of a member)
 8. Maintenance of books of account etc, by members
 - 8A. Maintenance of consolidated customers’ accounts by members
 - 8B. Separate preservation of customers’ securities by members
 15. Risk-based capital adequacy requirements of members.
3. Quite apart from the fact that there is considerable jumping around within the 87 Rules from one matter to another, it was agreed with the Commission that it would appropriate to separate the three subject matters into their own Rules and unify those matters in the 87 Rules relating to members of a stock exchange with the 2000 Rules.
4. The 2000 Rules govern registration, books of accounts, inspection and conduct of business of stock brokers, stock dealers and authorised representatives.
5. In reviewing the 87 and 2000 Rules and in drafting these new rules (to be called the Stock Broker and Stock Dealer Rules, 2014, the consultant has placed considerable emphasis on compliance with the IOSCO Principles governing market intermediaries namely:

PRINCIPLES FOR MARKET INTERMEDIARIES

29. Regulation should provide for minimum entry standards for market intermediaries.
30. There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.
31. Market intermediaries should be required to establish an internal function that delivers compliance with standards for internal organization and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters.
32. There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.

REPORT ON STOCK BROKER AND STOCK DEALER RULES, 2014

6. In drafting the new Stock Broker and Stock Dealer Rules, 2014, the consultant also compared the proposed draft with similar rules of other jurisdictions in the region although the over-riding considerations were compliance with IOSCO Principles and appropriateness to the circumstances and market conditions of Bangladesh.

KEY CHANGES TO THE EXISTING RULES

7. The principal changes contained in the draft Stock Broker and Stock Dealer Rules, 2014 are the strengthening of the existing rules to ensure compliance with the IOSCO Principles relating to market intermediaries and the consequential effect of the enactment of the Exchanges demutualization Act, 2013.
8. The draft rules set the procedures whereby the Commission can register, inspect, investigate, and discipline by way of fine, suspension or cancellation of the registration of stock brokers and stock dealers. There are also appeal procedures in place. They also strengthen the entry requirements to ensure that the applicant has the necessary structure, resources, controls, systems and procedures in place appropriate to the level of business that it will undertake and in particular for the management of risk.
9. Although separately registered, authorised representatives are merely employees or agents of stock brokers and therefore it is the stock broker who is ultimately responsible for their actions which are done in the name of the broking firm. Whilst still retaining separate registration of authorised representatives, the new draft rules ensure that responsibility for their actions lies with their employer.
10. In the event of a failure of a stock broker or stock dealer and in order to minimize damage and loss to investors and to contain systemic risk, the draft rules state that the Commission will suspend registration of the stock broker or stock dealer to take effect immediately and without appeal. The Commission shall also approve the regulations of an exchange for dealing with the default or failure of a stock broker or stock dealer.
11. There is a requirement that Authorised Representatives and Compliance Officers must undergo a Commission approved training programme and examination prior to their appointment and an approved refresher training programme and examination every 3 years thereafter.
12. The draft rules require a standard of conduct of stock brokers and stock dealers and require them to be responsible at all times for the actions of their directors, employees, authorised representatives, agents and contractors.
13. There are also KYC rules and rules governing dealing with conflict of interest, client agreements and client confidentiality together with a complaints procedure to be in place at each stock broker.
14. New rules have been added concerning market offences including that of insider dealing thereby ensuring that stock brokers stock broker are required to take reasonable steps to ascertain if any of its clients are insiders and to maintain records to assist in the monitoring of insider dealing. There is a similar requirement in respect of money laundering.

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15. The rules on segregation of client money and accounting and use of client funds are extended in the new draft rules in accordance with international practice and there are new rules on maintenance of records and audit trail.
16. There are also new rules concerning the appointment and removal of auditors and what is to be set out in the auditor' report together with the qualification of accounts by an auditor.
17. The final section deals with repeal and savings of the 87 and 2000 Rules and the continuation of existing rules.

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ANNEX A: STOCK BROKER AND STOCK DEALER RULES, 2014



বাংলাদেশ সিকিউরিটিজ অ্যান্ড এক্সচেঞ্জ কমিশন
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Bangladesh Securities and Exchange Commission

NOTIFICATION

[date] xxxxxxxxxxxx

No. xxxxxxxxx In Exercise of the power conferred by section 33 of the Securities and Exchange Ordinance, 1969 (XVII of 1969), the Securities and Exchange Commission makes, with prior publication, the following rules, namely:–

Stock Broker and Stock Dealer Rules, 2014

1. Short Title

These rules may be called the Stock Broker and Stock Dealer Rules, 2014.

2. Interpretation & Definition In these rules –

“Act” means the Securities and Exchange Commission Act, 1993;

“authorised representative” means a natural person who is employed by a stock broker to serve his employing stock broker’s clients;

“board” means the board of directors of a stock broker and/or stock dealer;

“client bank account” means a bank account established for the purposes of these rules;

“client funds” means money of any currency that, in the course of carrying on its regulated activity, a Stock broker holds or receives on behalf of a client, or which it owes to a client;

“Commission” means the Bangladesh Securities and Exchange Commission;

“compliance officer” means a natural person who is employed by a stock broker or stock dealer to serve the employer and shall be responsible as well as the employer for enforcement of these rules;

“exchange” means a stock exchange or derivatives exchange for any asset class registered with and regulated by the Commission under the Exchange Registration Rules, 2014;

“financial year” means the period in which any profit and loss account of the company and its constituent laid before it in general meeting is made up, whether that period is a year or not;

Stock Broker and Stock Dealer Rules, 2014

“money” includes any form of money, whether represented by a cheque or other payable order, or otherwise;

“Ordinance” means the Securities and Exchange Ordinance, 1969;

“person” means any company, partnership business or firm or any club or association of more than one persons whether incorporated or not, and natural person;

“regulated activity” means a securities activity permitted under registration condition;

“representing director” means a board member of the stock broker and/or stock dealer who is nominated by the board to represent itself to the Commission, a stock exchange, and any other external bodies as and when required;

“stock broker and stock dealer” means any and all persons whether an individual natural person or a body corporate registered by the Bangladesh Securities and Exchange Commission to buy, sell or otherwise trade in securities;

“stock broker” means a person who buys and sells securities for the accounts of others;

“stock dealer” means a person who buys and sells securities only for his own account;

“TREC” a trading right entitlement certificate as defined in the Exchanges Demutualisation Act, 2013.

3. Application of the Rules

These rules apply to all stock brokers and stock dealers and their constituents.

4. Eligibility of Registration

(1) **Stock Broker / Stock Dealer:** No person is eligible for registration as a stock broker and/or stock dealer, if –

- a) he is not eligible to hold a trading right entitlement certificate (TREC) issued by an exchange;
- b) he is a merchant banker, portfolio manager, trustee of any mutual fund, custodian or asset management company;
- c) it is a company limited by shares incorporated under the Companies Act, 1994 and its minimum paid up capital is less than Taka 10 million or any other amount the Commission may require from time to time;

Provided that –

- i) If it is an application to act as a stock broker or stock dealer of more than one exchange then its minimum paid up capital shall be a multiple of the number of the exchanges the stock broker or stock dealer intend to hold a TREC for;
- ii) If an applicant apply for to act both as a stock broker and a stock dealer, than its minimum paid up capital shall be a double; and
- iii) It also provided that, those stock brokers and stock dealers who are acting with current registration shall become eligible and

Stock Broker and Stock Dealer Rules, 2014

fulfil the requirements set out in these rules within one year from the date of gazette publication of these rules;

- d) itself or any member of its board of directors has committed any criminal offence;
- e) itself or any member of its board of directors is declared bankrupt or lunatic by a court in Bangladesh;
- f) is adjudicated as defaulter by the report of Credit Information Bureau (CIB) of Bangladesh Bank and fails to clear his dues within 12 months;
- g) itself or any member of its board of directors is engaged for the last three years with any stock broker or stock dealer whose registration has been cancelled for unlawful activities; and
- h) it has not appointed a compliance officer, who is qualified, experienced and able to take personally and collectively the responsibilities of enforcement of these rules.

(2) **Skills and internal controls:** An applicant for registration must demonstrate to the Commission –

- a) that its directors and key personnel have the appropriate knowledge, skills and experience for the role that they will undertake;
- b) that it has in place necessary controls, procedures and systems for the management of risk;
- c) that it has in place an internal audit function appropriate to the size of business that it will undertake;
- d) that it has adequate resources in terms of its personnel and systems;
- e) that it adopts strong corporate governance principles in its internal organisational structure; and
- f) that in its business conduct it has a sound ethical attitude that places the interests of its clients above its own interests.

(3) **Representing director:** The applicant stock broker or stock dealer must appoint from among its board of directors a natural person to represent the company to the Commission, a stock exchange and any external bodies. The representing director –

- a) shall be a member of the governing board of the stock broker or stock dealer and shall be appointed for 2 years, a term which is renewable by the company's board;
- b) in case of temporary absence or inability of the representing director, another director may act as a proxy provided the proxy director is named beforehand; and
- c) the representing director and his proxy shall attend professional workshops, forum and or training as guided by the Commission.

(4) **Compliance Officer:** Stock brokers and/or stock dealers must submit the appointment letter of the compliance officer along with their curriculum vitae to the Commission. A person will not be acceptable as a compliance officer in a company acting as stock broker or stock dealer subject to any rules of the Commission, if he –

Stock Broker and Stock Dealer Rules, 2014

- a) is not a natural person;
- b) is not more than 21 (twenty one) years of age;
- c) is not graduated and certified by an institution recognised by the Commission;
- d) is not passed a qualification examination directed by the Commission;
- e) is not employed by a registered stock broker/stock dealer;
- f) is convicted by any fraudulent criminal offence; or
- g) is punished for any offence by the Commission or any exchange.

The Commission may impose further condition or waive any requirement about the qualification of the compliance officer if it thinks fit.

- (4) **Authorised Representative:** A person is not eligible for registration as an authorised representative in a company acting as stock broker subject to any rules of the Commission, if he –

- a) is not a natural person;
- b) is not more than 21 (twenty one) years of age;
- c) has not graduated from any accredited university;
- d) has not passed a qualification examination directed by the Commission;
- e) is not employed by a registered stock broker;
- f) has been declared bankrupt by the court;
- g) has been convicted by any fraudulent criminal offence; or
- h) has been found guilty of any offence by the Commission or any exchange and explicitly barred from acting as a stock broker, stock dealer or authorised representative

5. Application for Registration and Consideration Over the Matter etc.

- (1) An applicant for registration must complete the registration form and pay the required fees as prescribed by the Commission from time to time.
- (2) The fees specified under the sub-clause (1) have to be paid by a bank draft or pay order in favour of the Bangladesh Securities and Exchange Commission.
- (3) If the Commission approves the application it shall complete the registration within not more than forty five days after receiving the necessary completed documents relating the application.
- (4) In the event that the Commission does not approve the application, it shall, within the time aforesaid inform such decision to the applicant by letter specifying the cause of non approval.

6. Validity and Renewal of Registration

- (1) For a stock broker and stock dealer the validity period of registration under these rules will be perpetual unless the Commission under these rules or on request of an exchange with adequate reason revokes the registration or a court of justice terminates.

Stock Broker and Stock Dealer Rules, 2014

- (2) For an authorised representative, the validity period of registration under these rules will be [3] years unless the person wishes to renounce his registration voluntarily or loses the qualification for authorised representative as mentioned in these rules, or the Commission cancels his registration.
- (3) A stock broker, stock dealer or authorised representative may voluntarily cease operation only on permission of the Commission as provided under these rules.
- (4) The stock broker and stock dealer shall pay an annual renewal fee to the Commission as set by the Commission from time to time.
- (5) An authorised representative shall pay an annual renewal fee to the Commission as set by the Commission from time to time.

7. Duties of a Registered Stock Broker and Stock Dealer

Every stock broker and stock dealer shall do its activities to the highest level of its honesty and trust and properly follow all the conditions of the Act, Ordinance and rules issued by the Commission.

8. Investigation, Suspension, and Cancellation of Registration

- (1) The Commission may appoint one or more inspector if it thinks fit and as necessary to investigate a complaint or possible breach of the Act, Ordinance or any rule issued by the Commission and such inspector after completing the investigation shall submit a report of the same according to the direction by the Commission.
- (2) The inspector may, if he considers it necessary, enter the offices of the stock broker or stock dealer without notice, interrogate any employee of the concerned stock broker or stock dealer and examine any document and, if necessary, take a duplicate of the same and in this case every person concerned is bound to co-operate with the inspector.
- (3) Without prejudice to the provision of sub-clause (6) in the event that a stock broker or stock dealer becomes ineligible for registration or has contravened any Act, Ordinance or rule or any condition of registration or has failed to comply with these, the Commission may suspend or cancel its registration or impose a fine.

Provided that, in any circumstance other than loss of eligibility, the Commission, if it thinks fit, may suspend the registration for not more than one year without cancelling it.

It also provided that, before imposing such fine, suspension or cancellation of registration under these rules the Commission shall give at least ten days notice to the stock broker or stock dealer indicating such intention of imposing a fine,

suspension or cancelation of registration and giving an opportunity of filing an appeal.

- (4) A stock dealer or stock broker after receiving such notice may present its appeal in writing within ten days of receipt of the notice whereupon, the Commission may at its own discretion give him an opportunity of being heard in person or through a representative. The Commission shall thereafter take a final decision on the proposed fine, suspension or cancelation and inform the decision to the party in written. In this case the decision of the commission is final.
- (5) If any registration has been suspended or cancelled under these rules, the copy of such decision shall be sent to the concerned stock exchange.
- (6) If the Commission is satisfied, in the interests of market order and efficiency, that before taking any formal decision under sub-clause (3), it is necessary to suspend the registration of a stock broker or stock dealer, it shall provide an opportunity of an instant hearing. Any suspension resulting from that instant hearing shall last for a period of not more than thirty days. The Commission may extend the period of suspension following a second or subsequent instant hearing.
- (7) If any registration is suspend according to the sub-clause (3) or (6) any stock broker or stock dealer concerned cannot conduct its activities on the basis of such registration.

9. Failure of Stock Broker or Stock Dealer

In the event of a failure of a stock broker or stock dealer, the Commission shall, in order to minimize damage and loss to investors and to contain systemic risk, suspend registration of the stock broker or stock dealer. Such suspension shall take effect immediately and without appeal. The Commission shall approve the regulations of an exchange for dealing with the default or failure of a stock broker or stock dealer.

10. Continued Training and Qualification

Authorised representatives and compliance officers must undergo a Commission approved training programme and examination prior to their appointment. All authorised representatives and compliance officers must attend a Commission approved refresher training programme and examination every [3] years. The Commission shall from time to time determine or approve the course content and examination standard and determine qualification criteria of the examination authorities.

A stock broker shall retain a minimum number of authorised representatives with required qualification as determined by the Commission from time to time, provided the number is not less than 2 at any time.

11. Standards of Conduct

In the conduct of a regulated activity, a stock broker, stock dealer and all their employees shall at all times act according to the principles of best practice and, in particular, shall –

- a) Observe a high standard of integrity and fair dealing;
- b) Act with due skill, care and diligence; and
- c) Observe high standards of market conduct.

12. Responsibility

- (1) A stock broker and stock dealer shall at all times be responsible for the actions of its directors, employees, authorised representatives, agents and contractors including compliance with the Act and these rules.
- (2) In the event of a breach of the Act or these rules by a director, employee, authorised representative, agent or contractor of a stock broker or stock dealer, the stock broker or stock dealer may face disciplinary proceedings instituted by the Commission.
- (3) In the event of a breach of the Act or these rules by an authorised representative, the authorised representative may also face disciplinary proceedings in addition to those brought against his employer.

13. Know Your Client

- (1) A stock broker shall seek sufficient information about the client and the client's circumstances to ensure that the services provided are consistent with those circumstances and, in particular –
 - a) a stock broker shall not give investment advice or recommend to its client without a separate registration as an investment advisor under any rules of the Commission;
 - b) where a stock broker, or is recommending investments to a client or has discretion to act for a client, it shall take reasonable steps (and document those steps) to satisfy itself that the recommendation (or discretionary action) is suitable for the client, taking account of all the reasonably available alternatives;
 - c) a stock broker shall not recommend, or where the stock broker has discretion to act, execute sales or purchases of a frequency that does not benefit the client regardless of the Commission that this might produce; and
 - d) a stock broker may execute an order of a client without satisfying itself as to its suitability only where the client agreement makes clear that the client is acting without the advice of the stock broker.
- (2) A stock broker shall take all necessary steps to ensure that it does not give advice to, nor effect a transaction with or for, a client unless that advice or transaction is suitable for the client having regard to the facts disclosed by that client and other relevant facts about the client of which the stock broker is or ought reasonably to be aware.

14. Independence

Where a stock broker is advising or acting for a client it shall ensure that any claim it makes as to its independence or impartiality adequately includes any limitation that there may be on either.

15. Fair and Clear Communications

A stock broker shall take all necessary steps to ensure that any agreement, written communication, notification or information that it gives or sends to clients to whom it provides the service of a regulated activity is presented fairly and clearly in such a language that the client can understand.

16. Clients' Understanding of Risk

(1) No stock broker shall –

- a) recommend a transaction to a client, or effect a transaction with or for him, unless it has taken all reasonable steps to enable the client to understand the risks involved;
- b) knowingly mislead a client as to any advantages or disadvantages of a contemplated transaction; or
- c) promise a return unless such return is contractually guaranteed.

A stock broker will clearly explain to its clients the scope of business as authorised and limited by the Commission.

(2) A stock broker shall give sufficient information to the client to ensure that the client's decisions are informed and, in particular, where the stock broker is making recommendations to a client, the stock broker shall take all reasonable steps to satisfy itself that the client has a full understanding of –

- (a) the risks of the investment;
- (b) the nature of the investment;
- (c) the fees and charges associated with the investment;
- (d) the factors that are likely to affect the performance of the investment;
- (e) the terms and conditions of the investment; and
- (f) the consequences of departing from the terms and conditions (such as seeking early withdrawal of an investment that is made for a fixed term).

(3) Where a stock broker has satisfied itself of the client's understanding by giving the client a written explanation, that explanation shall be kept in the client's file; where the explanation is given orally, a note of the advice shall be sent to the client in writing and a copy retained on file; where the stock broker considers that an explanation is not required because of the client's existing knowledge, this fact shall be documented.

17. Fees and Other Charges

(1) A stock broker shall only charge fees in accordance with the customer agreement, or as may be prescribed by the exchange he is trading on.

Stock Broker and Stock Dealer Rules, 2014

- (2) Before a stock broker provides the service of a regulated activity to a client it shall disclose to him the basis or amount of its charges for the provision of those services and the nature of and amount of any other remuneration receivable by it and attributable to them.
- (3) A stock broker shall always provide a statement of fees and charges (either for each transaction or monthly for a client on whose behalf many transactions are undertaken).

18. Clients' Rights

- (1) A stock broker shall not, in any written communication or agreement, seek to exclude or restrict –
 - a) any duty or liability to a client which it has under any law or under any rules made by the Commission;
 - b) any other duty to act with skill, care and diligence that is owed to a client in connection with the provision to him of the service of a regulated activity; and
 - c) any liability owed to a client for failure to exercise the degree of skill, care and diligence that may reasonably be expected of it in the provision of the service of a regulated activity.
- (2) A purported exclusion or restriction prohibited by these rules shall be void and of no effect and the stock broker shall be liable to make compensation for any loss to its client in this regard.

19. Cessation of Business

Where a stock broker, stock dealer or authorised representative decides to withdraw from a regulated activity, it shall –

- a) forthwith notify the Commission and, where appropriate, each of its clients of such decision; and
- b) ensure to the satisfaction of the Commission that any such business which is outstanding is properly completed or transferred to another stock broker, stock dealer or authorised representative.

20. Conflicts of Interest

- (1) A stock broker, and where appropriate, a stock dealer shall –
 - a) identify the conflicts of interest that are likely to occur in the course of its securities business;
 - b) adopt appropriate policies designed to minimise those conflicts either by identifying circumstances where it would refuse to act and, where this is not necessary, making arrangements to minimize the risk of any loss to the client; and
 - c) seek to avoid any conflict of interest between itself and a client and where such a conflict exists shall either decline to act, or if it considers that the conflict can be managed, disclose it to the client and follow its policies designed to minimize damage to the client and to put the client's interests ahead of its own.

Stock Broker and Stock Dealer Rules, 2014

- (2) A stock broker, and where appropriate, a stock dealer shall take no advantage of information gained from services provided to one client to benefit another client or itself; where there is a danger of such an eventuality, it shall –
- a) adopt procedures such as the erection of information barriers, barriers between information technology systems, physical barriers or even separate office locations, designed to minimise the possibility of information from one client being used for the benefit of another, employees or itself;
 - b) train employees in respect of the conflicts of interest and the procedures to avoid them; and
 - c) obtain undertakings from employees that they will not use information gained from clients for their personal benefit.
- (3) Where a stock broker has a material interest in a transaction to be entered into with or for a client, or a relationship which gives rise to a conflict of interest in relation to such a transaction, the stock broker shall not knowingly either advise, or deal in the exercise of discretion, in relation to that transaction unless it has –
- a) disclosed that material interest or relationship, as the case may be, to the client; or
 - b) taken reasonable steps to ensure that neither the material interest nor relationship adversely affect the interests of the client.
- (4) A stock broker shall take all necessary steps to ensure that neither it nor any of its directors, employees or agents either offers or gives, or solicits or accepts, any inducement that is likely to conflict with any duties owed to clients.

21. Client Agreement Required

- (1) No stock broker shall provide the service of a regulated activity except under and in accordance with a written agreement (“client agreement”) signed by the client and returned to the stock broker.
- (2) A stock broker shall give the client a copy of the signed client agreement.
- (3) The client agreement shall set out in adequate detail in clear language the basis on which the stock broker’s services are provided and in particular shall contain –
- a) essential information about the stock broker including its name, address and contact information;
 - b) the services to be provided;
 - c) the fees to be charged (or the way in which the fees will be calculated);
 - d) the nature or basis of commissions and fees to be received by the stock broker from third parties where these are related to the services provided to the client;
 - e) the obligations of the client, including the way in which instructions shall be given;
 - f) the rights of the client, including –
 - i) the right to receive title for any securities purchased;
 - ii) the right to a statement of all fees and charges;

Stock Broker and Stock Dealer Rules, 2014

- iii) the right for information on the remuneration received by the stock broker from third parties for the services provided;
- iv) the right to ask for information on the experience, qualifications and disciplinary history of the stock broker;
- v) the right to interest on funds held by the stock broker (or if there is no such right, the fact that this is so);
- vi) the right to receive payment for securities sold within a set period;
- vii) the right to see the stock broker's material interest and possible conflict of interest policy; and
- viii) the right to make a complaint and to have that complaint dealt with fairly and promptly;
- g) the obligations of the stock broker;
- h) the arrangements for securing title to and the arrangements for custody of securities bought including the use of nominee accounts, the use of a custodian (where appropriate) and other matters;
- i) any other terms and conditions of the agreement, including the notice to be given in respect of any changes to it or its termination;
- j) any conflicts of interest on the part of the stock broker;
- k) any connections between the stock broker and other relevant third parties that could affect the services being provided, such as a requirement on the part of the stock broker only to deal through certain third parties or only to recommend certain investment products; and
- l) the fact that the stock broker is regulated by the Commission and any other authorities.

- (4) A stock broker shall abide by the terms of a client agreement.

22. Contract Notes

- (1) A stock broker shall, in respect of every contract for the purchase or sale of securities entered into by him (whether as principal or agent), not later than the end of the next trading day after the contract was entered into, make out a contract note which complies with paragraph (2) and –
- a) where the contract was entered into by the stock broker as agent, deliver the original paper contract note or in digital form with digital signature to the person on whose behalf it entered into the contract; or
 - b) where the contract was entered into by the stock broker as principal, retain the contract note for himself.
- (2) The contract note shall state whether it is in respect of a purchase or sale of securities and shall include –
- a) the name of the stock broker and the address of the principal place at which it so carries on business;
 - b) where the stock broker is acting as principal, a statement that it is so acting;

Stock Broker and Stock Dealer Rules, 2014

- c) the name and address of the person (if any) to whom the stock broker is required to give the contract note and (if different) the name of the person for whom the transaction was undertaken;
- d) the date of the contract, and the date on which the contract note is made out;
- e) the quantity and description of the securities the subject of the contract;
- f) the price per unit of the securities;
- g) the rate or amount of commission and fees payable in respect of the contract;
- h) the date of settlement; and
- i) such other information as may be prescribed by the Commission to ensure that there shall be a complete audit trail in respect of the execution of client instructions and the settlement of market transactions.

23. Client Confidentiality

- (1) All information in the possession of a stock broker relating to a client shall be kept confidential.
- (2) A stock broker shall adopt documented policy and procedures that are designed to ensure that information obtained from clients and others is kept confidential and secure; the policies and procedures shall include –
 - a) employee undertakings to maintain confidentiality as part of their contract of employment;
 - b) policies that determine which employees may have access to which information;
 - c) procedures that effectively restrict access to confidential information to such employees through the use of locked cupboards and encryption protected information with sufficient back up within the stock broker's IT system; and
 - d) systems that are designed to safeguard the integrity of any electronic record or transaction recording system.
- (3) Notwithstanding paragraph (1), a stock broker may disclose information relating to a client when required to do so by the Commission or any stock exchange, or if it is ordered to do so by a court of competent jurisdiction.

24. Complaints Procedure

- (1) A stock broker shall adopt internal procedures that ensure the proper handling of complaints from clients and ensure that any appropriate remedial action on those complaints is promptly taken.
- (2) The complaints procedure shall be disclosed to the client.
- (3) A stock broker shall deal with complaints in a fair, appropriate and timely manner, and shall inform the client of the outcome.
- (4) Depending on the nature of the complaint, the stock broker shall provide appropriate restitution where the complaint is justified, and shall address the weaknesses in the internal systems that led to the action causing the complaint.

Stock Broker and Stock Dealer Rules, 2014

- (5) All actions taken under the complaints procedure shall be documented.
- (6) The complaints procedure shall provide a process for dealing with complaints, including –
 - a) the allocation of responsibility to a person other than that about whom a complaint was made or who was responsible for the actions that led to the complaint;
 - b) the target timetable for dealing with the complaint;
 - c) the deadlines for informing the complainant of progress with dealing with the complaint, which shall not leave the complainant without information for more than three months; and
 - d) an appeal to the chief executive of the stock broker (or another appropriately senior officer nominated by the chief executive) where the complaint cannot otherwise be resolved.
- (7) A stock broker shall forthwith inform the Commission of any complaint still unresolved three months after it was received.
- (8) A stock broker shall maintain a record of complaints that identifies –
 - a) the client or other person from whom the complaint was received;
 - b) the nature of the complaint;
 - c) the officer dealing with the complaint;
 - d) the officer(s) about whom the complaint was made or who was responsible for the action that led to the complaint;
 - e) the progress in dealing with the complaint;
 - f) the way the complaint was resolved; and
 - g) the time it took to resolve the complaint.
- (9) A stock broker shall also maintain a summary register of complaints for seven years.

25. Client Order Priority

A stock broker shall execute an order only when the client has made sufficient arrangements for the necessary funds or securities, and shall always give priority to outstanding client orders.

26. Timely Execution

Where a client order has been received it shall effect the execution of that order without delay. Each order received by the stock broker shall be time stamped denoting the time of receiving the order.

27. Best Execution

Where a stock broker deals for a client, it shall deal on the terms which are the best available to the client.

28. Timely Allocation

A stock broker shall ensure that a transaction it executes is allocated forthwith.

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29. Fair Allocation

Where a stock broker has aggregated an order for a client transaction with an order for an own account transaction, or with an order for another client transaction, then in the subsequent allocation –

- a) it shall not give unfair preference to itself or to any of those for whom it dealt; and
- b) if all orders cannot be satisfied, it shall give priority to satisfying orders for client transactions.

30. Front Running and Syndication

Where a stock broker and stock dealer has a client order to execute, or where it intends to publish to clients a price-sensitive recommendation or research or analysis, it shall not knowingly effect an own account transaction, or any transaction through an account in which it has an interest, in the securities concerned or in any related securities until the order has been executed or until the clients for whom the publication was principally intended have had, or are likely to have had, a reasonable opportunity to react to it.

31. Circular Trade

A stock broker and stock dealer shall not make any transaction where the trades do not represent a real change in the beneficial ownership of the security.

32. Churning

A stock broker shall not –

- (a) deal or arrange a deal in the exercise of discretion for any client; or
- (b) advise a client to deal,

if the dealing could in the circumstances reasonably be regarded as too frequent or too large.

33. Insider Dealing

- (1) A stock broker shall take reasonable steps to ascertain if any of its clients are insiders and maintain records accordingly to assist in the monitoring of insider dealing.
- (2) A stock broker and stock dealer shall not knowingly deal on or cause dealing to take place on the basis of insider information.

34. Prevention of Money Laundering, etc.

- (1) On each occasion that a client places an investment order with a stock broker, the stock broker shall obtain from the client –
 - a) details as to the origin and source of the money or funds used or to be used for the investment;
 - b) where the money or funds originate from outside Bangladesh, a confirmation from the remitting entity of the nature of its business and details as to the source of the money or funds; and
 - c) a written declaration by the client confirming –
 - i) the accuracy of all information given under subparagraph (a) or (b); and

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ii) that the money or funds used for the investment in securities does not arise from the proceeds of any money laundering or other illicit activities.

(2) The client information obtained under paragraph (1) shall be maintained by the stock broker as part of the records required under the provision of these rules.

35. Inheritance

A stock broker may transfer securities and money from deceased client's account only on receiving legal document confirming succession of inheritance.

36. Gift

A stock broker may execute a transfer of securities and money from the account of a client on receiving on authenticated instruction from the beneficiary owner.

In all other cases the instruction of the Commission or any court of justice shall be abided by.

37. Relations with Commission

(1) A stock broker and stock dealer shall at all times act in compliance with the Act, the Ordinance and rules made under the Act and with any other regulatory requirements of the Commission.

(2) A stock broker and stock dealer shall cooperate with the Commission and give it all such reasonable assistance as is necessary for the Commission to discharge its functions under the Act.

(3) A stock broker and stock dealer shall inform the Commission immediately of the occurrence of any of the following events –

- a) any event which could reasonably be expected to affect the Commission's assessment of its ongoing fitness and properness;
- b) a material breach of the regulatory requirements applicable to the stock broker or stock dealer or a material change in any of the information provided to support an application for registration;
- c) a reduction in working capital or net worth requirements or financial resource requirements below 120% of the minimum specified or a reduction in either of 50% since the previous report to the Commission;
- d) any concern by the stock broker that it may not be able to meet its obligations to clients as they fall due;
- e) any shortfall in the funds held in the client account as compared with the total obligations to clients;
- f) any inability to comply with any instruction or direction of the Commission imposed under the Act or Ordinance;
- g) any misstatement in any return previously submitted to the Commission, as soon as it is detected;
- h) any fraud on the stock broker or stock dealer or by any of its directors, employees, agents, contractors or clients, as soon as it is detected;
- i) any disciplinary action against any of its key personnel and the intermediaries, its agent or authorised representative;

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- j) any investigation, finding or conviction relating to the stock broker or stock dealer or any of the key personnel of the stock broker or stock dealer by a law enforcement agency, other regulatory authority, or professional association;
 - k) any civil claim against the stock broker or stock dealer in excess of 25% of the stock broker and stock dealer's minimum financial resource requirement; and
 - l) any action against it that may lead to bankruptcy or administration.
- (4) A stock broker and stock dealer shall notify the Commission not less than four weeks in advance if it is anticipated that there is likely to be –
- a) a change in name, business name (if different), business address and nature of business;
 - b) a new appointment to the position of chief executive, director or compliance officer;
 - c) a new auditor appointment;
 - d) a decision to seek a license from another regulatory authority in Bangladesh or abroad;
 - e) a change to its financial year and hence its annual reporting date;
 - f) any substantial changes to its capital structure;
 - g) any change in ownership or in substantial shareholdings;
 - h) a substantial acquisition; and
 - i) a decision to surrender its registration to the Commission or any other license, permission and registration obtained from any other regulator.
- (5) A stock broker and stock dealer shall keep records of all returns sent to and correspondence with the Commission.

38. Clients' Funds

- (1) Clients' funds shall be held by a stock broker on trust for and on behalf of the respective clients for whom those clients' funds are received or held according to their respective shares in it.
- (2) Clients' funds shall not form part of the assets of the stock broker, for any purpose and shall not be available in any circumstances for payment of any debt of the stock broker or taken as debt.

39. Segregation of Clients' Funds

- (1) A stock broker who receives or holds clients' funds shall open one or more client bank accounts with a bank.
- (2) A client bank account shall be kept segregated from any account holding money belonging to the stock broker.
- (3) A stock broker shall forthwith pay into a client bank account all clients' funds coming into its hands for or from a client which account shall clearly identify the deposits as clients' funds and show that they are properly segregated as required by these rules.

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- (4) A stock broker shall keep records of –
 - a) all amounts paid into a client bank account kept by the stock broker, specifying the persons on whose behalf the amounts are held and the dates on which they were paid into the account;
 - b) all withdrawals from a client bank account, the dates of those withdrawals, and the names of the persons on whose behalf the withdrawals are made;
 - c) all borrowed and lent securities from the client's account; and
 - d) such other particulars as may be prescribed by the Commission.
- (5) A stock broker shall reconcile daily its records showing the money being held on behalf of each client with the amounts shown in the client bank account held for each client with the aggregate of clients' money held in the client account or being held by third parties on behalf of clients; where there is more than one client account, the reconciliation shall apply to each client account separately as well as to all client accounts in aggregate.
- (6) The reconciliation shall be conducted by an officer who is different from the officer with responsibility for authorising payments from the client account.
- (7) A stock broker shall obtain and retain in its records a written acknowledgement from the bank that clients' funds deposited with the bank is held in trust for the client and is not available in any circumstances to offset an obligation of the stock broker.

40. Accounting for and Use of Clients' Funds

- (1) A stock broker shall account properly and promptly for clients' funds and, in particular, shall ensure that –
 - a) clients' funds and other money do not become mixed;
 - b) clients' funds are not commingled;
 - c) the stock broker can at all times be sure as to the amount of clients' funds standing to the credit of each client; and
 - d) money belonging to one client is not used for another client.
- (2) A stock broker shall not withdraw money received by him and deposited in a clients' bank account otherwise than for the purpose of –
 - a) making a payment to, or in accordance with the instructions of, a person entitled to the money;
 - b) purchasing, margining, guaranteeing, securing, transferring, adjusting or settling dealing in securities effected by the stock broker on the instructions of a client of the stock broker;
 - c) defraying brokerage and other proper charges incurred in respect of dealing in securities effected by the stock broker on the instructions of a client of the stock broker; or
 - d) making a payment that is otherwise authorised by law.

41. Segregation of Other Client Property

- 1) All securities and other property held or received by a stock broker on account of a client in connection with its regulated activity shall be segregated and separately accounted for.
- 2) A stock broker shall at all times keep such books as is necessary –
 - a) to show all its dealings with a client's securities and other property held or received by it; and
 - b) to distinguish such securities and other property held or received by it on account of each separate client and to distinguish such securities and other property from its own securities and property and other securities and other property held or received by the stock broker.
- 3) A stock broker shall undertake a reconciliation no less frequently than monthly of the record of assets held by the stock broker on behalf of clients, both individually and in aggregate, and compare that with the evidence of title of assets controlled by the stock broker, whether in the form of dematerialised or immobilised securities or those held in certificated form (if any).
- 4) Where a stock broker appoints a custodian to hold client assets, the stock broker shall maintain records of all assets held by the custodian of assets within the control of the stock broker and shall reconcile such records no less frequently than monthly with the stock broker's own records of the assets held on behalf of the clients both individually and collectively.
- 5) A stock broker shall maintain safely all evidence of title to client assets.
- 6) A stock broker shall not dispose of client assets except on the instructions of the client, and shall only accept written instructions or electronically with digital signature.
- 7) A stock broker's internal systems and controls shall ensure that officers of the stock broker do not dispose of, pledge, lend or otherwise deal with client assets except in accordance with these rules.

42. Net Capital Balance

A stock broker and stock dealer shall all times maintain a net capital balance in the capital account of an amount as directed by the Commission by gazette notification from time to time.

43. Requirements in Respect of Accounting Records

- (1) A stock broker and stock dealer shall keep accounting and other records as will sufficiently show and explain the transactions (whether effected on its own behalf or on behalf of others) and the financial position of its regulated activity, and shall be such as to –
 - a) disclose with reasonable accuracy, at any time, its financial position at that time;

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- b) enable it to prepare a balance sheet and a profit and loss account as at any time and which comply with the requirements of these rules; and
 - c) demonstrate whether it is maintaining in its regulated activity adequate financial resources to meet its business commitments and withstand the risks to which its business is subject
- (2) The stock broker and stock dealer shall –
- a) have, at all times, adequate controls, procedures and systems in place to ensure the proper management of risk appropriate to the business function it is undertaking;
 - b) maintain adequate technology resources in a way as to ensure they secure and maintain confidentiality of all data they contain; and
 - c) the Commission may assess the controls, procedures, systems and technology resources of a stock broker and stock dealer at anytime and direct for improvement or alteration in any part of them.
- (3) Without prejudice to the generality of paragraph (1), the accounting records shall in particular contain –
- a) entries from day to day of all sums of money received and expended by the stock broker and stock dealer and the matters in respect of which the receipt and expenditure takes place;
 - b) a record of all assets and liabilities of the stock broker and stock dealer including any commitments or contingent liabilities;
 - c) entries from day to day of all purchases and sales of securities by the stock broker and stock dealer distinguishing those which are made by the stock broker and stock dealer on its own account and those which are made by it on behalf of others;
 - d) entries from day to day of the receipt and dispatch of documents of title, or documents evidencing title, to securities which are in the possession or control of the stock broker and stock dealer;
 - e) entries from day to day of –
 - i) all clients' funds which is paid into or out of a client bank account maintained for the purposes of these rules;
 - ii) receipts and payments of clients' funds not passed through such a client bank account, identifying the persons to whom each such receipt or payment relates;
 - f) a record of –
 - i) aggregate balances on client bank accounts;
 - ii) individual clients balances stating the name of each client and the amount held or received for that client;
 - iii) sufficient information to explain the stock broker's dealings with each client bank account;
 - iv) the time, date and complete particulars of instructions received from and trades executed for clients;
 - v) the time, date and complete particulars of the stock broker and stock dealer's own orders and trades;

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- g) details of any credit extended or loans made in respect of margin or otherwise;
- h) Provided that the stock broker may advance money as margin loan subject to clients risk profile and not exceeding the limit, if any, set by the commission; and
- i) details of all securities –
 - (i) that are the property of the stock broker and stock dealer, showing by whom they are held and whether, if held otherwise than by the stock broker and stock dealer himself, they are so held as collateral against loans or advances; and
 - (ii) that are not the property of the stock broker and stock dealer but for which the stock broker and stock dealer is accountable, showing by whom and for whom they are held distinguishing those which are deposited with a third party whether as security for loans or advances made to the stock broker and stock dealer or any related person or for any other purpose;
- j) any other particulars required from time to time by the commission to be reflected in the accounts or records of the stock broker and stock dealer.

44. Records to be Up to Date

- (1) The obligations under these rules are continuing obligations and continuous performance of them is required so as to ensure that records are updated daily.
- (2) A stock broker and stock dealer shall adopt procedures to ensure that it is at all times in compliance with its financial resource requirements, client asset and working capital requirements, and which procedures shall include –
 - a) daily reconciliations of the obligations to the client with the funds available in the client account;
 - b) daily calculations of the working capital and financial resource requirements; and
 - c) the maintenance of the daily calculations and reconciliations on file.

45. Audit Trail

- (1) Information that is required to be recorded by these rules shall be recorded in such a way as to enable a particular transaction to be identified at any time and traced through from initiation of the order to final settlement.
- (2) All records shall be arranged, filed, indexed and cross- referenced so as to permit prompt access to any particular record.

46. Conformity with Accounting Standards

The accounting records required to be kept by a stock broker and stock dealer shall conform with the requirements of the Bangladesh Financial Reporting Standards.

47. Retention of Records

A stock broker and stock dealer shall preserve the accounting records which it is required to keep under these rules for 7 years from the date on which they are made.

48. Inspection of Records

Accounting records which are required to be kept under these rules shall, at any time during the period in which they are required to be preserved, be produced to the Commission, or to any person with the authority of the Commission, on demand at such reasonable time and place as may be specified by the Commission or that person.

49. The Commission may impose Additional Requirements on Stock Broker and Stock Dealer

Nothing in these rules shall prevent the Commission from imposing on stock broker and stock dealer who are any further obligations or requirements that it considers necessary with respect to –

- a) the keeping of accounts, books and records;
- b) the making of periodic financial reports to the exchange in the form and manner required by the exchange;
- c) the audit of accounts;
- d) the information to be given in reports by auditors; or
- e) spot order checks.

50. Requirements in Respect of Annual Financial Statements

A stock broker and stock dealer shall prepare for each of its financial years annual financial statements that shall consist of –

- a) a balance sheet as at the last day of the financial year; and
- b) a profit and loss account for the financial year.

51. Balance Sheet to Give a True and Fair View

The balance sheet shall give a true and fair view of the state of affairs of the stock broker and stock dealer as at the end of the financial year.

52. Profit and Loss Account to Give a True and Fair View

The profit and loss account shall give a true and fair view of the profit or loss of the stock broker and stock dealer for the financial year certified by an auditor who is a member of the Institution of Chartered Accountant of Bangladesh.

53. Form and Content of Financial Statements

The financial statements of a stock broker and stock dealer shall be prepared in accordance with Bangladesh Financial Reporting Standards.

54. Commission May Require Returns

- (1) The Commission may by written notice require market stock broker and stock dealer to submit to the Commission such periodic returns as it may direct.
- (2) In addition to any periodic returns required under paragraph (1), the Commission may by written notice require stock broker and stock dealer either generally or in a particular case or class of case, to submit to the Commission such exceptional returns as it may direct.

55. Annual Financial Statements, etc. to be Submitted to Commission

- (1) A stock broker and stock dealer shall submit, within [2] months after the end of each financial year, its auditor's report to the Commission together with –
 - a) its audited annual financial statements; and
 - b) confirmation in writing that it has complied with each and every one of these rules with which it is required to comply and such further information or confirmation as the commission may require from time to time.
- (2) Where the auditor's report is qualified on the grounds of the auditor's uncertainty as to the completeness or accuracy of the accounting records, that report shall when submitted by the stock broker and stock dealer to the Commission be accompanied by a written document signed by two directors stating –
 - a) whether all the accounting records of the stock broker and stock dealer have been made available to the auditor for the purposes of its audit;
 - b) whether all transactions undertaken by the stock broker and stock dealer have been properly reflected and recorded in its accounting records; and
 - c) whether all other records of the stock broker and stock dealer and related information have been made available to the auditor.

56. Engagement Letters

A stock broker and stock dealer shall ensure that the external auditor it appoints has the powers and duties specified in these and that –

- a) those powers and duties are set out in an engagement letter;
- b) the engagement letter is signed by the CEO of stock broker and stock dealer and the auditor; and
- c) the stock broker and stock dealer retains a copy of the engagement letter.

57. Notification to Commission

A stock broker and stock dealer shall, within 7 days, give written notice to the commission of the appointment, removal or resignation of an auditor.

58. Powers and Duties of Auditors

- (1) An auditor shall have –
 - a) a right of access at all times to the accounting and other records of the stock broker and stock dealer and all other documents relating to its business; and
 - b) a right to require from the stock broker and stock dealer such information and explanations as it considers necessary for the performance of its duties as auditor.
- (2) In preparing an auditor's report for the purposes of these rules, the auditor shall carry out such investigations as will enable him to form an opinion as to the matters required by this rule to be stated in its report.

59. Contents of Auditor's Report

- (1) The auditor's report shall state whether the annual financial statements of the stock broker and stock dealer have been audited in accordance with such auditing standards as may be ordered by the commission.

- (2) The auditor's report shall also state whether in the opinion of the auditor –
- a) the annual financial statements of the stock broker and stock dealer have been properly prepared in accordance with these rules;
 - b) in the case of the balance sheet, a true and fair view is given of the financial state of affairs of the stock broker and stock dealer as at the end of the financial year;
 - c) in the case of the profit and loss account, a true and fair view is given of the profit or loss of the stock broker and stock dealer for the financial year;
 - d) the stock broker and stock dealer has, throughout the financial year, kept proper accounting records in accordance with the requirements of these rules;
 - e) the stock broker has kept clients' funds and other property properly segregated in accordance with these rules;
 - f) the balance sheet and the profit and loss account are in agreement with the stock broker and stock dealer accounting records;
 - g) it has obtained all the information and explanations which, to the best of its knowledge and belief, are necessary for the purposes of its audit;
 - h) the stock broker has maintained throughout the financial year systems adequate to enable him to identify documents of title, or documents evidencing title, to securities title in safekeeping for the stock broker's clients in accordance with these rules; and
 - i) the stock broker and stock dealer was in compliance with the requirements of these rules as at the date on which the balance sheet was prepared.

60. Qualified Reports

- (1) If the auditor is of the opinion that one or more of the requirements of these rules have not been met, it shall state that fact in its report and shall specify the relevant requirements and the respects in which they have not been met.
- (2) If the auditor fails to obtain all the information and explanations that, to the best of its knowledge and belief, are necessary for the purposes of its audit, it shall state that fact in its report.
- (3) If the auditor is unable to form an opinion as to whether one or more of the requirements of these rules have been met, it shall state that fact in its report and shall specify those requirements and give the reasons why it has been unable to form an opinion.

61. Resignation or Removal of Auditors

- (1) Where an auditor resigns or is removed by a stock broker or stock dealer, a notice to that effect sent to the Commission under these rules shall contain either –
 - a) a statement signed by the auditor to the effect that there are no circumstances connected with its resignation or removal which the auditor considers should be brought to the attention of the Commission; or

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- b) a statement signed by the auditor detailing any circumstances connected with its resignation or removal which the auditor considers should be brought to the attention of the Commission.

- (2) For the purposes of these rules, a failure to appoint an auditor at the end of its term of office shall be deemed to be removal of that auditor.

62. Waiver

- (1) Subject to paragraphs (2) and (3), on written application being made by a stock broker or stock dealer the Commission may, where it considers it appropriate in the special circumstances of the particular stock broker or stock dealer, in its absolute discretion exempt the stock broker or stock dealer from any specified requirement of these rules.
- (2) The written application of the stock broker or stock dealer shall give full reasons for seeking a waiver and shall specify any other alternative arrangements that it will put in place.
- (3) Notwithstanding an application under paragraph (1), the stock broker or stock dealer shall comply with the regulatory requirement until it is formally waived in writing by the Commission

63. Disciplinary Offences

A stock broker or stock dealer that contravenes a requirement of these rules commits a disciplinary offence that may lead to disciplinary action under the Act or other rules of the Commission and may be declared null and void before any Court of Justice and Tribunal.

64. Repeal and savings

- (1) The provisions of the Securities and Exchange Commission (Broker, Dealer and Authorised Representative) Rules, 2000 are hereby superseded and repealed.
- (2) Rules 3, 4, 4A, 5, 8, 8A, 8B, and 15 together with form IA of the Securities and Exchange Rules, 1987 are hereby repealed.

65. Continuation of Previous Rules

Notwithstanding the repeal of the said rules any recognition or clearance given, document or agreement made, fee received and paid, resolution passed, direction given, proceeding taken, instrument executed or issued things done under or in pursuance of the said rules shall, if in force before the commencement of these rules, continue to be in force and shall effect as if made, directed, passed, given, taken executed, issued or done under and in pursuance of these rules.

By order of the Commission
Professor Dr M Khairul Hossain
Chairman
Bangladesh Securities and Exchange Commission

Form A

Application to BSEC for the Registration as Stock Broker and/or Stock Dealer

1. Name of the applicant : _____
2. Registered office address of the applicant : _____
(if the address has been changed,
please inform the Stock Exchange
and the Commission in written within
3 working days) _____
3. Address of working office of the CEO : _____
and the Board _____
4. Contact details
 - a. Office Telephone, Fax & Email : _____
 - b. CEO's Residence Mobile/Telephone, : _____
Fax & Email _____
5. Applicant is TREC of
 - a. Exchange name : _____
 - b. TREC number : _____
 - c. Date of obtaining TREC :

| | | |
|----|----|------|
| dd | mm | yyyy |
|----|----|------|
6. Application for registration as
 - a. Stock dealer ☐
 - b. Stock broker ☐
 (Please tick the appropriate one)
7. Tax Identification Number (TIN) : _____
8. Certificate of incorporation with RJSC : Date:

| | | |
|----|----|------|
| dd | mm | yyyy |
|----|----|------|

Number:

| |
|--|
| |
|--|
9. List of directors with their holdings of more : Sl. Name DOB Shareholding Address
than 10% share of the company
(Please attach a separate sheet)
10. Representing Director on behalf of the : _____
applicant and details of the authorization
(Please attach the resolution by the Board)
11. Paid up capital : _____
(as on)
12. Is the applicant a merchant banker, :

| |
|-----|
| Yes |
|-----|

| |
|----|
| No |
|----|

portfolio manager, trusty of mutual fund,
custodian or asset management

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company? If yes, please give details

13. Is the applicant or any of its director convicted by the criminal court for any kind of fraudulent activities in last 10 years? If yes, then when, where and what penal code was involved? : ☐ Yes ☐ No
14. Is the applicant or any of its directors are declared bankrupt or mentally unfit by the court? If yes, please attach details : ☐ Yes ☐ No
15. Other relevant information :
(Please attach details)

I hereby declare that in accordance to my knowledge and belief the above information are true and correct.

Date:

.....
Applicant's Signature

List of Attachments (copies):

- | | |
|--|---|
| 1. Certificate of Incorporation | 6. Bank Statement (not older than 1 weak) |
| 2. Memorandum & Articles of Association | 7. Directors' filled up CIB form |
| 3. Trade License | 8. Organization Chart |
| 4. TIN Certificate | 9. Board resolution to apply for Stock |
| 5. Appointment letter and CV of compliance officer | Broker/Stock Dealer and the name of representing director |

Recent PP
size
photograph
attested by
the Stock
Broker/Stock
Dealer

Form B

Application to BSEC for the Registration as Authorized Representative

| | | | | |
|---|-------------------|------------------|------|--------------------------|
| 1. Name of the applicant | Mr. | Ms. | | |
| 2. Father's name | Mr. | | | |
| 3. Mother's name | Ms. | | | |
| 4. Address & telephone number (if the address has been changed, anytime during the employment please inform the Stock Exchange and the Commission in written through the Stock Broker within 3 working days) | | | | |
| 5. Date of birth & age | dd | mm | yyyy | |
| 6. Educational qualifications from (Attach the attested copy of the certificates) | Sl. | Institution/Exam | | Year |
| | 1. | | | |
| | 2. | | | |
| | 3. | | | |
| | 4. | | | |
| 7. Mandatory professional training/ certificate course completed at any BSEC designated institution. Training must not be more than 3 years old. (Attach the attested copy of the certificate) | Sl. | Institution/Exam | | Date |
| | | | | |
| 8. Date of appointment as Authorized Representative by any Stock Broker (if any) | dd | mm | yyyy | |
| | Not appointed yet | | | <input type="checkbox"/> |
| 9. Applicant's association | | | | |
| a. Name of Stock Broker/ Dealer and code number | | | | |
| b. Name of Exchange | | | | |
| c. Date and duration of the contract signed (Attach the copy of the contract attested | dd | mm | yyyy | Tennure |
| | | | | |

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by the Stock Broker)

10. Previous 3 employment (if any)

| Sl. | Institution | From | To |
|-----|-------------|------|----|
| 1. | | | |
| 2. | | | |
| 3. | | | |

11. Is the applicant ever been convicted by the criminal court for any kind of fraudulent activities? If yes, then when, where and what penal code was involved?

Yes

No

12. Other relevant information

Please attach

I hereby declare that in accordance to my knowledge and belief the above information are true and correct.

Date:

.....

Applicant's Signature

.....

CEO of Appointing Stock broker

Recommendation of the Stock Exchange Exam Body

This is to certify that the above

applicant..... (name) is appointed by the

Stock broker of exchange/ is not

appointed yet. He/she is has successfully passed the exam

..... on We recommend to give him/her

registration as an Authorized Representative.

.....

Chief Executive Officer / Secretary

Name

Designation & seal

Name of the exchange

Date:

| | | |
|----|----|------|
| dd | mm | yyyy |
|----|----|------|