

**CONSULTATION REPORT**

**COMPLIANCE FUNCTION AT MARKET INTERMEDIARIES**



**OICU-IOSCO**

**TECHNICAL COMMITTEE  
OF THE  
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS**

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**This paper is for public consultation purposes only. It has not been approved for any other purpose by the IOSCO Technical Committee or any of its members.**

## Preamble

The IOSCO Technical Committee has publicly released the consultation report entitled *Compliance Function at Market Intermediaries*. The consultation report sets out a number of supplementary principles with measures for implementation to assist market intermediaries to increase the effectiveness of their compliance function. After the consultation process, the IOSCO Technical Committee Standing Committee on the Regulation of Market Intermediaries (SC3) will review the comments received from the international financial community and present a final report on compliance function at market intermediaries to the IOSCO Technical Committee for approval.

### How to Submit Comments

Comments may be submitted by one of three methods **at the latest on 15 July 2005**. To help us process and review your comments more efficiently, please use only one method<sup>1</sup>.

#### 1. E-mail

- Send comments to mail@oicv.iosco.org.
- The subject line of your message must indicate “Public Comment on *Compliance Function at Market Intermediaries*.”
- If you attach a document, indicate the software used (e.g., WordPerfect, Microsoft WORD, ASCII text, etc.) to create the attachment.
- DO NOT submit attachments as HTML, PDF, GIF, TIFF, PIF, ZIP, or EXE files.

OR

#### 2. Facsimile Transmission

Send by facsimile transmission using the following fax number: 34 (91) 555 93 68.

OR

#### 3. Paper

Send a copy of your paper comment letter to:

Mr. Philippe Richard  
IOSCO Secretary General  
Oquendo 12  
28006 Madrid  
Spain

Your comment letter should indicate prominently that it is a “Public Comment on *Compliance Function at Market Intermediaries*.”

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<sup>1</sup> **Important:** All comments will be publicly made available, unless anonymity is specifically requested. Comments sent via e-mail will be posted on the IOSCO Internet Home Page. Comments sent via fax or paper will be converted to PDF format and then posted on the IOSCO Internet Home Page. Personal identifying information will not be edited from submissions.

## **Discussion Paper on the Compliance Function at Market Intermediaries**

### **I. Introduction**

Market intermediaries should conduct themselves in a way that protects the interests of their clients and helps to preserve the integrity of the markets.<sup>2</sup> Compliance with securities laws, regulations and rules<sup>3</sup> (referred in this paper as “securities regulatory requirements”) is part of the essential foundation of fair and orderly markets as well as investor protection.

The compliance function is intrinsic to the operations of market intermediaries because they must have systems or processes in place to ensure that they are complying with all applicable laws, codes of conduct and standards of good practice in order to reduce their risk of legal or regulatory sanctions, financial loss, or loss to reputation. Market intermediaries should establish effective policies and operational procedures and controls in relation to their day-to-day business operations in order to achieve compliance with all relevant regulatory and legal requirements.<sup>4</sup>

Market intermediaries have become more innovative on how they structure their businesses in order to maximize profits and provide different services to their clients. For example, there has been unbundling of services to clients, partnering with other firms to meet all the needs of their clients, and outsourcing to other parties. The complexity of their business has increased, which makes the compliance function both increasingly important as well as more complicated.

Although different jurisdictions may have different approaches and policies to help ensure compliance with their securities regulatory requirements, they share a common belief that the compliance function at market intermediaries plays an essential role in preventing possible misconduct and in promoting ethical behavior, which in turn can lead to fair and orderly markets and investors’ confidence in the markets.

Due to the changing nature and importance of the compliance function, the IOSCO Technical Committee believes it is important to identify and discuss principles that should be considered by all market intermediaries and their regulators. This paper reviews the current IOSCO Principles for Market Intermediaries and recent initiatives by some regulators in the area of compliance. It also proposes supplementary principles and raises some issues for discussion through a consultation process. The Technical

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<sup>2</sup> IOSCO. Objectives and Principles of Securities Regulation. May 2003: Section 12.5.

<sup>3</sup> These include laws, regulations and rules promulgated by the legislature, regulators and self-regulatory organizations (SRO).

<sup>4</sup> IOSCO. Objectives and Principles of Securities Regulation. May 2003: Section 12.5.

Committee believes that publication of this paper and consultation with market participants will bring greater clarity and focus on the compliance function.

#### **A. IOSCO Principle**

Principle 23 of the *IOSCO Objectives and Principles of Securities Regulation* for market intermediaries states the following:

Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.

Although IOSCO acknowledges that the internal organization of a market intermediary will vary according to its size, the nature of its business and the risks it undertakes, the market intermediary should still have a compliance function. Specifically, IOSCO notes that a market intermediary's compliance with securities regulatory requirements and internal policies and operating procedures and controls should be monitored by "a separate compliance function"<sup>5</sup>.

In addition, the Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation supporting Principle 23 focuses on management and supervision and internal controls, and their roles in a market intermediary's compliance. It considers accountability, adequate internal structure and controls, and monitoring of the effectiveness of the procedures and controls as key issues<sup>6</sup>.

#### **B. Recent Initiatives by International Regulators Regarding Compliance Function**

In Europe, the implementation of the directive on Markets in Financial Instruments that replaces the current Investment Services Directive, and which constitutes the cornerstone of the European Community regulations in the field of securities, will lead to the adoption of so-called "level-2" measures aimed at further convergence of national laws in the European Union through the implementation of a more harmonized regime governing a wide range of conduct of business and organizational issues within investment firms, including the compliance function. In its advice to the European Commission related to compliance, CESR proposes a set of principles – including the role of the compliance function, compliance policies and procedures, the role of senior management, responsibility for compliance oversight – based on the overarching principle that investment firms must maintain a permanent and effective compliance function, which must function independently, have documented status and the necessary authority within the investment firm to discharge its functions.

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<sup>5</sup> *Id.*

<sup>6</sup> See items 1, 2 and 7 of the Key Issues section in the IOSCO's [Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation \(October 2003\)](#).

In Australia, recent financial services law reform will subject licensed service providers to specific risk management and compliance obligations. The Australian Securities & Investments Commission (ASIC) expects that, as a minimum to comply with these new specific obligations, all licensed financial service providers will establish and maintain compliance measures, processes and procedures that ensure, as far as reasonably practicable, the provider will comply with all its statutory obligations. Further, ASIC expects, as a minimum compliance measure even where there is not a structurally separate compliance function, that a licensed financial service provider will allocate to a director or senior manager responsibility for overseeing the compliance measures and reporting to the governing body of the provider.

In Canada, the Ontario Securities Commission (OSC), the Autorité des marchés financiers (AMF) and the Investment Dealers Association of Canada (IDA), the SRO for investment dealers, have revised the requirements regarding compliance function at market intermediaries. Under the new requirements, advisers (in Ontario only) and investment dealers must implement a two-level compliance system, with a designated senior officer who is ultimately responsible to the regulators for compliance with securities regulatory requirements and a chief compliance officer who carries out compliance tasks and reports to the designated senior officer. The IDA has also recently introduced a qualifying examination for chief financial officers at investment dealers to help ensure that they understand prudential regulatory requirements, and is also considering a qualifying examination for chief compliance officers.

In the U.S., there has been increased focus on compliance systems. For example, the SEC has adopted new rules that would require investment companies and investment advisers to adopt written compliance procedures, review the adequacy of those procedures annually, and designate a chief compliance officer responsible for their administration<sup>7</sup>. In addition, with respect to broker-dealers, Rule 3013 of the National Association of Securities Dealers, Inc. (NASD) requires each member firm to designate a chief compliance officer<sup>8</sup>. The Rule also requires each member's chief executive officer or equivalent officer to certify annually to having in place a process to establish, maintain, review, modify and test policies and procedures reasonably designed to achieve compliance with NASD and Municipal Securities Rulemaking Board (MSRB) rules, and the federal securities laws. It also requires the chief executive officer to hold one or more meetings with the chief compliance officer in the preceding 12 months to discuss such process.

In addition, a number of international organizations have conducted studies on compliance functions at firms or have proposed guidance on the compliance function. For instance, the SRO Consultative Committee of IOSCO (SROCC) published its study

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<sup>7</sup> Rule 206(4)-7 under the *Investment Advisers Act of 1940*.

<sup>8</sup> See Securities Exchange Act Release No. 50347 (Sept. 10, 2004), 69 FR 56107 (September 17, 2004). Available at: <http://www.sec.gov/rules/sro/nasd/34-50347.pdf>.

on the function of compliance officers in October 2003.<sup>9</sup> The Basel Committee on Banking Supervision (Basel Committee) has also published in October 2003 a consultative document entitled “The compliance function in banks,” which proposes basic guidance for banks and sets out the banking supervisors’ views on compliance in banking organizations.<sup>10</sup>

Given the increased focus on compliance by regulators in different jurisdictions, the IOSCO Technical Committee prepared this paper to set out a number of supplementary principles to Principle 23 with measures for implementation to assist intermediaries to increase the effectiveness of their compliance function. The discussion section identifies current regulatory practices based on a survey of the members of the Technical Committee Standing Committee on the Regulation of Market Intermediaries (SC3) members. This paper is also intended to promote a dialogue between regulators and intermediaries on these issues, and it contains questions in areas where IOSCO would like specific feedback or input from the industry. Commentators are invited to provide feedback on any aspects of this paper, and some or all of the questions identified.

### **C. Definition of the Compliance Function and Scope**

For the purposes of this paper, “compliance function<sup>11</sup>,” is defined as follows:

A function that, on an on-going basis, identifies, assesses, advises on, monitors and reports<sup>12</sup> on a market intermediary’s compliance with securities regulatory requirements, including whether there are appropriate supervisory procedures in place.<sup>13</sup>

Other than *monitoring* for compliance with securities regulatory requirements, a compliance function should also engage in the *identification* and *prevention* of violation of these securities regulatory requirements. For example, a compliance function may be involved when considering new business lines. In this case, the compliance function will be involved in compliance risk management. Compliance also speaks to the culture and ethics of a market intermediary, and is an important tool in managing the risk of legal or regulatory sanctions, financial loss, or loss to reputation resulting from violation of regulatory requirements. A compliance function of a firm should also have mechanisms

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<sup>9</sup> SROCC. *The Function of Compliance Officer – Study of What the Regulations of the Member’s Jurisdictions Provide for the Function of Compliance Officer*(Oct. 2003). Available at: <http://www.iosco.org/pubdocs/pdf/IOSCOPD160.pdf>.

<sup>10</sup> Available at: <http://www.bis.org/publ/bcbs103.pdf>.

<sup>11</sup> In this paper, the expression “function” refers to the staff or group of staff responsible for carrying out specific compliance activities and responsibilities. The expression does not intend to denote any particular organizational structure.

<sup>12</sup> “Reporting” in this paper refers to reporting within a market intermediary, and “notification” refers to reporting externally to third parties, such as regulators. See topics 1 and 2 for discussion on reporting obligations and topic 6 for discussion on notification obligations.

<sup>13</sup> This definition is similar to the definition of “compliance function” for banks. See paper published in October 2003, by the Basel Committee. The Basel Committee incorporates the concept of independence in its definition of compliance function.

in place to protect the firm from any liability arising from abuses committed by its customers.

Market intermediaries range in size from two-person firms to multi-national organizations, and they may carry one simple business offering limited services and products or multiple businesses of different complexity. A market intermediary should consider the nature, scale and complexity of its business and the risks it undertakes when establishing its compliance function, including:

- The products and services it offers;
- The type of its clients, for example retail or institutional;
- The structure and diversity of its operations (including the geographical spread of its operations);
- The volume or size of transactions for which it is responsible; and
- The number of people, registered and unregistered, that it employs or contracts to conduct business.

The principles set forth in this paper are intended to be sufficiently flexible to adapt to the nature, scale and complexity of the market intermediary's business and operations.<sup>14</sup> Even where a market intermediary has a small operation with a simple business, it should consider the appropriateness of adopting the means for implementation outlined under each principle.

#### Specific Questions for Comment

1. Do you agree with the definition and description of the scope of a compliance function? Please explain.
2. What is the relationship between the compliance function and risk management function? For example, is the compliance function part of or separate from the risk management function; and if they are separate, how do they interact when dealing with compliance issues?

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<sup>14</sup> In most of the jurisdictions of SC3 members, it is generally acknowledged that the compliance structures, arrangements, and/or processes will differ among firms based on the nature and complexity of their businesses, although the general requirement of having a structure or processes in place is the same for all firms. In Germany, requirements on compliance function vary based on the nature of a firm's business, for instance whether they possess compliance-relevant facts. Japan, the Netherlands and Pakistan do not have different requirements on the compliance function for firms whose businesses differ in nature and size. The final CESR advice under Article 13(2) of the MiFID requires that firms maintain a permanent and effective compliance function. This particular obligation is not weighted to take account of the firm's size, nature or complexity.

## II. Principles and Topics for Discussion and Consultation

### Topic 1: Establishing a Compliance function

#### *Principles:*

(a) *Each market intermediary should establish and maintain a compliance function.*

(b) *The role of the compliance function is to identify, assess, advise on, monitor and report on a market intermediary's compliance with securities regulatory requirements and the appropriateness of its supervisory procedures.*

The expectations of regulators with regards to the scope, structure and activities of the compliance function will not be the same for full service market intermediaries that conduct complex businesses and for smaller market intermediaries that conduct a single service.<sup>15</sup>

#### *Means for Implementation*

(a) An effective compliance function should have the necessary authority and resources<sup>16</sup> to properly discharge its functions.

(b) The scope, structure and activities of the compliance function should be proportionate to the nature, scale and complexity of a market intermediary's business. The compliance function should generally perform the following:

(1) Identify, measure, and monitor the key securities regulatory requirements of the market intermediary and assist in the management of these requirements and compliance risks;

(2) Establish, communicate, monitor and enforce effective compliance policies and procedures<sup>17</sup> to address compliance requirements and risks;

(3) Provide information to the board of directors<sup>18</sup> and/or senior management on applicable laws and regulations to assist them with their compliance responsibilities;

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<sup>15</sup> See Part I.C. on discussion of compliance function and scope for additional discussion.

<sup>16</sup> Some larger market intermediaries may consider using technology or automating their process to increase the efficiency of the compliance function. For example, some firms may have systems designed to highlight unusual activities and to track outstanding compliance matters.

<sup>17</sup> Some market intermediaries have different sets of policies and procedures for different purposes or for different users. For example, some intermediaries may have one set of policies and procedures that outline guidelines with respect to required and prohibited actions under the regulatory framework, a second set that outlines the supervisory structure for the business units, and a third set that describes the activities of the compliance function. The term "policies and procedures" is used here in a general sense to include, among other things, procedures for supervision and procedures on required and prohibited activities.



- (4) Provide assistance, guidance and/or training to business units and staff in relation to compliance;
- (5) Report periodically to the board of directors and/or senior management on the market intermediary's overall compliance with securities regulatory requirements and internal compliance policies and procedures, including significant breaches; and
- (6) Where required by law or regulation, notify regulators, in a timely manner, of any material breach by the firm of securities regulatory requirements; where notification is not required by law or regulation, consider notifying the regulators of any misconduct by the firm and the firm's actions with respect to such misconduct, including efforts to prevent future violations.
- (c) The mandate of the compliance function should be communicated to appropriate individuals within the firm; and depending on the size and nature of the business, should have formal documented status.
- (d) The market intermediary should encourage staff to consult with compliance personnel regarding compliance with securities regulatory requirements. For this purpose, staff should be made aware of how to consult with the compliance function.

## Discussion

### *Purpose of the compliance function*

A majority of SC3 members indicated that the purpose of a compliance function is to ensure that the market intermediary is complying with securities regulatory requirements. This purpose is either explicitly stated or implicit in the legislation. A small number of SC3 members do not have requirements for market intermediaries to establish a compliance function or to designate compliance officers. Instead they place the responsibility for compliance on senior management.

### *Scope and activities of the compliance function*

In jurisdictions where there is a requirement to establish a compliance function or to designate compliance officers, the accountability of the compliance function or designated compliance officers do not vary, regardless of the nature, scale and

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<sup>18</sup> In some jurisdictions, the board of directors has the main, if not exclusive, function of supervising the executive body (e.g. senior management, general management) so as to ensure that the latter fulfils its tasks. For this reason, in some cases, it is known as a supervisory board. This means that the board has no executive functions. In other countries, by contrast, the board has a broader competence in that it lays down the general framework for the management of a firm. Owing to these differences, the notions of the board and senior management are used jointly in this paper to identify the body that has executive functions in regards to compliance responsibilities.

complexity of the market intermediary's business. However, most jurisdictions recognize that the scope and activities of the compliance function or designated compliance officers, and the structure of a compliance function, will differ based on the nature, scale and complexity of the business. The differences lie in how the compliance function or designated compliance officers carry out their responsibilities. In general, smaller firms with simple business are expected to have simpler compliance functions and less complex policies and operational procedures and controls, provided that the firm is able to demonstrate that its compliance arrangements are effective.

#### *Keeping informed of all relevant laws and amendments thereof*

Pakistan has a specific requirement, in statutes or under a Code of Conduct, that intermediaries keep informed of all relevant laws and amendments. In Australia, Germany, Hong Kong, Ontario and Quebec (Canada), Spain, Switzerland, the UK and the US (SEC), there is no specific statutory requirement, however the obligation to keep informed could be implicitly understood from the wording of the legislation, for example from continuing education requirements or from requirements to comply with securities regulatory requirements. In Japan, the heads of the compliance departments are obliged to maintain contact with government agencies and SROs to keep up to date. In France, compliance officers, as part of their obligation to prepare a procedures handbook, are required to inform staff and agents of some or all of the provisions mentioned in the handbook.

In Ontario and Quebec (Canada) and the U.S., the SROs impose a continuing education program on registered individuals, which serves as a tool to ensure that these individuals are kept informed of current regulatory requirements.

#### *Designation of a specific organizational structure for compliance*

Although most jurisdictions require the establishment of a compliance system or function, they do not specify a particular organizational structure. Germany, Italy, Spain and Switzerland require the establishment of a compliance structure that ensures compliance with relevant laws and regulations, but no specific requirements are imposed. Similarly, Australia, France, Hong Kong, Ontario and Quebec (Canada), the U.K., and US (CFTC and SEC), require market intermediaries to have compliance arrangements, measures and/or procedures in place to ensure compliance with relevant regulatory requirements but do not specifically refer to a structure. Singapore does not mandate the establishment of a compliance structure.

In the U.S., NASD member firms are required to establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with NASD rules. NYSE member firms are required to establish a compliance structure based on their size, type of business, customer base, and product mix. For example, each office, department, or business activity of a member or member organization (including foreign incorporated branch offices) must be under the

supervision and control of the member or member organization establishing it and of the personnel delegated such authority and responsibility. The NYSE has also adopted a rule that requires members and member organizations to develop and maintain adequate internal controls over each of its business activities and include procedures for independent verification and testing of those business activities.

The Technical Committee has included a question at the end of this section to obtain the industry's view on the necessity of prescribing a specific structure.

#### *Supervision of registered or licensed individuals*

In most cases, the requirement to supervise individuals is part of the general statutory requirement (Ontario and Quebec (Canada), Australia, France, Germany, Japan, Hong Kong, Mexico, Pakistan, Spain, Singapore, US (SEC and CFTC).

In Ontario and Quebec (Canada), SROs also place specific requirements on their members for the supervision of individuals who conduct regulated activities.

In the U.K., firms are required to put in place appropriate supervision arrangements with respect to relevant personnel within the firm.

#### *Internal reporting by the compliance function*

The internal reporting requirements for independent compliance personnel differ by jurisdiction. Germany, Italy, Mexico and Spain require compliance personnel to report directly to the board of directors, while Hong Kong requires a report to senior management and France requires the compliance officer to report to senior management on the conditions under which investment services are supervised. Likewise, in Japan, the head of compliance must report immediately to the president of the company in the case of a serious issue. In the U.S., the NYSE requires its members to submit to its chief executive officer or managing partner an annual report on the member's supervision and compliance effort during the preceding year. In Ontario and Quebec (Canada), the SROs for investment dealers and mutual fund dealers require that the compliance officer report periodically to the board of directors or senior management on the dealer's compliance with securities regulatory requirements.

#### *Notification of breaches of securities regulatory requirements*

Many jurisdictions require an intermediary to timely notify the regulator of breaches of specific conduct of business requirements and/or financial regulations. For example, in Australia, a licensee must notify ASIC in writing within five days of a significant breach of its obligations under the Corporations Act taking into account whether the breach impacts the licensee's ability to provide its financial services or results in an actual or potential financial loss to clients or the licensee itself. Similarly, in Singapore, member companies of the Singapore Exchange are required

to inform the exchange in writing if any of its employees or agents breaches any relevant law or regulation, the Exchange's rules or directives, the rules of any other exchange, any provision involving fraud or dishonesty, or is the subject of any written complaint or investigation involving fraud or dishonesty.

Other jurisdictions require the intermediary to promptly notify regulators of any breach of financial regulations. For example, the regulator and SROs in Ontario and Quebec (Canada) and the US CFTC require registrants to give immediate notice to the regulator if its adjusted net capital at anytime is less than certain minimums. US SEC rules require intermediaries to send telegraphic or facsimile notice to the Commission upon the occurrence of certain events, including when a broker-dealer's or an OTC derivatives dealer's net capital falls below required levels, if a broker-dealer or OTC derivatives dealer fails to make and keep current the books and records required by exchange rules, if a consolidated supervised entity (CSE) or a supervised investment bank holding company (SIBHC) becomes aware that any financial regulatory agency or SRO has taken significant enforcement or regulatory action against a material affiliate, and if an SIBHC becomes ineligible to be supervised by the Commission as a supervised investment banking holding company. In Singapore, once a license holder becomes aware of its non-compliance with capital requirements, it should immediately notify the MAS, as well as the securities exchange, futures exchange or clearing house of which the licensee is a member, of the non-compliance.

In Japan, intermediaries must notify the regulator of all breaches of all laws and regulations. If a breach of the Securities and Exchange Law is significant, the regulator will take administrative action.

In the U.K., the FSA requires firms to notify it immediately of any significant rule breach by the firm or any of its employees.

#### Specific Questions for Comment

3. Should a specific organizational structure for compliance be prescribed? Please explain.
4. Are there any essential roles, responsibilities or activities for the compliance function that should be mandated or otherwise identified by regulators?
5. Please identify responsibilities other than those described above that are carried out by the compliance function at market intermediaries.
6. How and when should the compliance function be responsible for managing compliance risk?
7. Are there any practical concerns for requiring documentation of policies and procedures for smaller, less complex, market intermediaries? Please explain. If

policies and procedures should be documented, what degree of detail should regulators expect to see for smaller, less complex, market intermediaries?

**Topic 2: Role and Responsibilities of the Board of Directors or Senior Management**

*Principles:*

(a) *The board of directors or senior management is responsible for the firm's compliance with securities regulatory requirements.*

(b) *The board of directors or senior management should establish and maintain a compliance function, and compliance policies and procedures designed to ensure compliance with securities regulatory requirements. The board of directors or senior management should assess whether the compliance policies and procedures are being observed and are appropriate on an on-going basis.*

Due to differences in their size and internal organization, market intermediaries will employ different structures to ensure compliance with securities regulatory requirements. Placing ultimate responsibility on the highest levels of management enables accountability and promotes a compliance culture, by ensuring that the compliance function is given a proper level of attention within the organization and that appropriate resources are devoted to the compliance function.

*Means for Implementation*

(a) The board of directors or senior management should consider the following:

- Designating a senior officer, who has the appropriate competence, to have the day-to-day responsibilities for the intermediary's compliance with securities regulatory requirements,
- Being available to compliance personnel to discuss material compliance issues,
- Assessing at least annually the overall compliance of the market intermediary, including its adherence to internal compliance policies and procedures and the effectiveness of its compliance function, and
- Ensuring that any compliance issues are resolved effectively and expeditiously.

(b) The board of directors or senior management should directly oversee the scope, structure and activities of the compliance function<sup>19</sup> to ensure that the compliance function is carrying out its mandate.

(c) The board of directors or senior management should encourage the business units to consult with the compliance function with respect to their operations when appropriate.

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<sup>19</sup> The board of directors or senior management may delegate certain activities of the compliance function to a designated senior officer, but retain oversight responsibilities.

(d) The compliance policies and procedures of a market intermediary should identify procedures to be followed when breaches of securities regulatory requirements or internal policies are detected, such as:

- methods for identifying breaches,
- steps to be taken when a breach is identified,
- parties (internal or external) to be notified when a breach occurs and the time frame within which the breach must be reported,
- measures to be taken to correct the breach and to ensure that it does not reoccur, and
- methods for keeping records of breaches.

Appendix A provides a list of topics that maybe covered in the compliance policies and procedures.

## Discussion

### *Accountability*

All jurisdictions hold the market intermediary responsible for establishing a proper compliance function and policies and procedures. Some jurisdictions specifically refer to the board of directors, while others refer to senior management. Nine jurisdictions place ultimate accountability to regulators for compliance with securities regulatory requirements on the board of directors of an intermediary.<sup>20</sup> Seven jurisdictions hold senior management accountable for compliance.<sup>21</sup> In Italy, however, while the board of directors is ultimately responsible to regulators, there are a number of minor infringements (such as violations or infringement of a non-systematic nature) where the responsibility would not be directly allocated to the board of the firm but to management. Singapore's securities legislation explicitly holds the chief executive officer and directors of an intermediary liable for any non-compliance. Topic 6 also contains discussion on certification requirements on senior management.

Six jurisdictions, including France, Japan, Ontario and Quebec (Canada), Singapore, US (CFTC and SEC), place responsibility for compliance on registered/licensed persons as well as senior management. For example, the US CFTC statute states that any CFTC registrant who, directly or indirectly, controls any person who has violated any provision of the *statute or regulations* may be held liable for such violation to the same extent as the controlled person, unless the controlling person acts in good faith.

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<sup>20</sup> The board of directors is ultimately responsible for compliance in Australia, Germany, Italy Mexico, The Netherlands, Pakistan, Singapore, Spain and Switzerland.

<sup>21</sup> Senior Management is ultimately responsible for compliance in Ontario and Quebec (Canada), Hong Kong, France, US (CFTC and SEC) and the U.K. The US SEC may hold a board responsible under appropriate circumstances.

### *Establishment of internal policies and procedures*

Most jurisdictions have specific statutory obligations that require intermediaries to establish, maintain and comply with effective policies and procedures to prevent violation of securities regulatory requirements (France, Germany, Hong Kong, Japan, Mexico, Ontario and Quebec (Canada), Singapore, Spain, Switzerland and the U.S.).

In Ontario and Quebec (Canada), requirements are also established under rules of the SROs to which the intermediaries belong. In Australia, the requirements are set by a general license condition applied by ASIC and it is a statutory requirement for a licensee to comply with their license conditions.

In Pakistan, the requirement is implied, as intermediaries are subject to a statutory requirement for annual audit reviews.

### *Designation of a compliance officer*

France, Germany (for some of the regulated firms), Hong Kong (for fund managers only), Japan (Japan SRO sets such requirements), Mexico, The Netherlands, Ontario and Quebec (Canada), Pakistan, and US (SEC) and its SROs, require the designation of a “chief compliance officer” or some other designated title such as “internal supervisor”. The U.K. requires investment firms to allocate to a director or senior manager the function of (a) having responsibility for oversight of the firm’s compliance and (b) reporting to the governing body in respect of that responsibility.

The US SEC requires that the board of directors of a registered investment company appoint a chief compliance officer. The rule requires the chief compliance officer to provide a written report to the board, no less frequently than annually, that addresses, among other things, each Material Compliance Matter (a defined term) that has occurred since the date of the last report. In addition, persons designated as compliance officers under NASD and NYSE rules must meet certain requirements.

### Specific Questions for Comment

8. Please describe the level of accountability for compliance at your firm for each of the following: board of directors, senior management, designated compliance officer, business unit personnel, where applicable. For example, in the case of the failure to establish proper procedures to prevent sales practices violations, who would be accountable and what would be the extent of their accountability? Please explain your answers.
9. Do you distinguish among responsibility, accountability and liability? Please explain.
10. Should a senior officer be designated for the day-to-day compliance responsibilities? Please explain.



### **Topic 3: Independence and Ability to Act**

#### *Principle:*

*The compliance function should be able to operate on its own initiative, without improper influence from other parts of the business, and should have access to and should report to the board of directors or senior management.*

Independence of the compliance function is critical to ensuring that the board of directors or senior management, who are ultimately responsible to regulators, receive accurate and unbiased reports on the market intermediary's compliance with securities regulatory requirements.

Independence means that a compliance function should be able to operate without improper or undue influence by other parts of the business. Improper influence is mitigated by providing the compliance function with the authority and resources (including human resources) to carry out their responsibilities, and by allowing them access to all level of the organization. In addition, in order to ensure that a market intermediary can hire and retain highly qualified compliance personnel, their compensation and opportunities for advancement should not be directly dependent on the performance and/or opinion of a specific business line, product or transaction.

Regulators need to recognize, however, the difficulty of achieving complete independence for the compliance function in the smallest firms. In the smaller firms, there may be an overlap between senior management who trade or provide advice and the compliance functions. In such a case, procedures are required to prevent conflicts of interest or other problems regarding the performance of their compliance responsibilities.

#### *Means for Implementation*

- (a) To achieve independence, the budget for the compliance function and compensation for compliance personnel should not be directly dependent on the financial performance or revenues generated by a specific business line, product or transaction; however, the compensation for compliance personnel may be dependent on the performance or revenues of the firm as a whole. The compliance budget should receive sufficient resources to enable compliance personnel to carry out their responsibilities effectively. The independence of the compliance function may also be undermined if the tenure (i.e. prospects of staff, position) of compliance personnel is dependent on the business lines.
- (b) Compliance personnel should have the ability on their own initiative to communicate with any employees and to obtain access to records or other information necessary to carry out their responsibilities, including the ability to

conduct investigations of possible breaches of securities regulatory requirements or the internal compliance policies and procedures.

(c) Compliance personnel should have unrestricted access to the board of directors and senior management to discuss significant compliance matters.

(d) In cases where individuals perform both business and compliance activities, they should not be supervising their own business activities.

## Discussion

### *Independence*

About half of the jurisdictions responding to the survey have requirements pertaining to the independence of the compliance function.<sup>22</sup> Generally, these jurisdictions require compliance personnel to operate separately from any business unit they monitor. For example, Spanish regulations require that individuals in the compliance function must not be involved in the businesses they monitor. Here, the budget and remuneration for the compliance function must ensure objectivity and must not be linked to the financial performance of the firm. Similarly, France and Hong Kong require compliance officers or function to operate independently of all the business units they monitor.

Nearly half of the jurisdictions responding appear not to have independence requirement at all.<sup>23,24</sup> Some regulators recognize the difficulty in ensuring independence for the compliance function in some market intermediaries. In a small organization or branch office, it maybe difficult to have complete independence as the person with primary responsibility for compliance may also trade and/or provide advice. In this regard, the NYSE has adopted NYSE Rule 342.19, which addresses the independent review of producing branch office managers.<sup>25</sup> The NASD has amended its Rules 3010 and 3012, to align certain supervisory control and inspection requirements with the corresponding supervisory control and inspection requirements in NYSE Rule 342.19 and NYSE Interpretation Handbook provision 342(a)(b)/03<sup>26</sup>.

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<sup>22</sup> General independence requirements exist in France, Italy, Japan, Hong Kong, Mexico, Singapore, Spain, Switzerland and the U.K.

<sup>23</sup> Germany does not have specific independence requirements on small firms, but requires compliance personnel in larger firms to be independent from all operational and business functions.

<sup>24</sup> Jurisdictions with no independence requirements for the compliance function include Australia, The Netherlands, Ontario and Quebec (Canada), Pakistan, US (CFTC and SEC).

<sup>25</sup> It is worth noting that the US CFTC and the US SEC both require financial audits and anti-money laundering audits to be completed by independent personnel.

<sup>26</sup> See SEC Release No. 34-50477; File No. SR-NASD-2004-116; 69 FR 59972.

*Prescribed human and/or material resources*

No jurisdiction responding to the survey has a specific requirement regarding human and/or material resources that should be devoted or available to the compliance function. Each jurisdiction has a general requirement that the compliance function should be provided with sufficient resources to carry out the activities required by appropriate regulations.

Specific Questions for Comment

11. What requirements relating to independence and ability to act are relevant to a small firm?
12. In cases where individuals perform both business and compliance activities, should they be allowed to supervise their own business activities? If so, how can the regulators ensure that they supervise their own business activities in an objective manner?
13. Are the means of implementation of independence set out above sufficient to achieve independence? Please explain.
14. How do you ensure that compensation of compliance personnel is not subject to undue influence? Please explain.

#### **Topic 4: Qualification of Compliance Personnel**

##### *Principle:*

*Staff exercising compliance responsibilities should have the necessary qualifications, experience and professional and personal qualities to enable them to carry out their duties effectively.*

##### *Means for Implementation*

Market intermediaries should consider subjecting persons responsible for compliance activities to the following:

- (a) Completion of relevant courses and/or training prior to accepting compliance responsibilities;
- (b) Successful completion of prescribed examinations that will confirm their knowledge and experience concerning securities regulatory requirements;
- (c) Continuing education requirements; and/or
- (d) Relevant work experience.

##### Discussion

Current requirements in the jurisdictions of all SC3 members conform to the above principle. However, jurisdictions vary widely on how they implement this principle. For example, France, Japan, Ontario and Quebec (Canada) and the US SROs have detailed requirements, including registration as a sales representative, successful completion of prescribed courses, successful completion of prescribed examinations, and/or participation in a continuing education program. Other jurisdictions have no specific requirements, but, nonetheless, require that compliance personnel be “competent.” It should also be noted that a few jurisdictions have implemented continuing training or education requirements on market intermediaries to ensure that they are kept up-to-date on securities regulatory requirements under a fast changing business and regulatory landscape.

In the US, under NASD Rule 1120, governing continuing education requirements, compliance staff that are registered as principals are required to take the appropriate "Regulatory Element" of the continuing education requirement on the second anniversary of the initial securities registration and every three years thereafter. Under NYSE rules, a Branch Office Manager must take the General Securities Sales Supervisor Qualification Examination (Series 9/10) and the General Securities Registered Representative Examination (Series 7). The Chief Compliance Officer must take the Compliance

Official Qualification Examination (Series 14). In addition, NYSE Rule 342.13 (a) (Acceptability of Supervisors) requires that the supervisors of any branch office, regional or other group of offices, or any sales department or activity must have a creditable three year record as a registered representative or equivalent experience in addition to passing the Series 9/10, or another examination acceptable to the Exchange that demonstrates competency relevant to assigned responsibilities. NYSE Rule 342.13 (b) requires that the person (or persons) designated to direct day-to-day compliance activity (such as the Compliance Officer, Partner or Director) and each other person at the member organization directly supervising ten or more persons engaged in compliance activity should have overall knowledge of the securities laws and Exchange rules and must pass the Series 14 test. NYSE Rule 345(A) states that no member or member organization shall permit any registered person to continue, and no registered person shall continue, to perform duties as a registered person, unless such person has complied with the continuing education requirements. Each registered person must complete the Regulatory Element of the continuing education program upon their second registration anniversary date and every three years thereafter or as otherwise prescribed by the Exchange.

In Canada, rules of the AMF, the OSC, the IDA and the Mutual Fund Dealers Association of Canada impose specific proficiency requirements on compliance officers at advisers and dealers. Specifically, compliance officers at advisers must complete one of the prescribed courses and certain practical experience and compliance officers at dealers must complete one of the prescribed courses. In addition, the IDA imposes continuing education requirements on the compliance officers of its members and an examination requirement on the Chief Financial Officers (CFO) of its members (the CFO is generally responsible for a member's compliance with the IDA's prudential requirements).

In Japan, compliance personnel, referred to as internal administration supervisors (IAS), must first be qualified as a sales representative. Second, they must pass a special IAS examination administered by the Japan Securities Dealers Association (JSDA). Third, they must be a manager or hold higher position. Finally, they must participate annually in a JSDA administered training program, and also in a training program of his/her own securities company.

#### Specific Questions for Comment

15. What are the appropriate qualifications for compliance professional?
16. Should the qualifications vary depending on functions, responsibility or seniority?
17. How do you evaluate the adequacy of courses and training for compliance personnel?

## **Topic 5: Assessment of the Effectiveness of the Compliance Function**

### *Principles:*

*(a) Each market intermediary should periodically assess the effectiveness of its compliance function.*

*(b) In addition to any internal evaluations, the compliance function should be subject to periodic review by independent third parties, such as the intermediary's external auditors, SROs or regulators.*

In order to ensure that a compliance function is adequately identifying, assessing, advising on, monitoring and reporting on the market intermediary's compliance with securities regulatory requirements, its effectiveness should be periodically assessed.

### *Means for Implementation*

(a) The policies and procedures and controls put in place to identify, assess, monitor and report on compliance with regulatory requirements should be evaluated.

(b) The effectiveness of the compliance function should be reported to the board of directors or senior management, by either the designated senior officer responsible for compliance or by individuals independent from the compliance function.

(c) Any deficiencies of the compliance function should be addressed in a timely manner; and where appropriate, additional training should be provided to compliance personnel.

### Discussion

#### *Role of external auditors in the effectiveness of a compliance function*

External auditor's role differs from jurisdiction to jurisdiction, in terms of the scope of its responsibility regarding a firm's compliance, as well as its obligation to notify the regulators of its findings.

In the majority of the jurisdictions surveyed, external auditors are required to notify the regulators of their findings (e.g. Australia, Germany, Hong Kong, Ontario and Quebec (Canada), Singapore, Spain, Switzerland and the U.K.). However, there are some jurisdictions that only require external auditors to report their findings to the firm's management (who may, in turn, be required to notify the regulators). In the US, broker-dealers and OTC derivatives dealers are required to file with the US SEC an annual audit report conducted by an independent accountant, and where there are material

inadequacies with the accounting system, the independent accountant is required, under special circumstances, to report directly to the US SEC on such material inadequacies<sup>27</sup>.

The scope and focus of an external auditor's review differs in different jurisdictions. External auditors may review (i) the intermediary's compliance with securities regulatory requirements, or (ii) the adequacy of the intermediary's compliance function (for instance, external auditor will report on issues such as internal controls). However, it is noted that jurisdictions focusing on (ii) are also concerned with breaches of securities regulatory requirements by the market intermediary, and require external auditors to notify them of such breaches.

Germany, Italy, Mexico, Pakistan, Singapore and Switzerland require external auditors of their intermediaries to report on the adequacy of the intermediaries' compliance function. Germany requires the compliance function to be assessed in relation to the intermediary's size, business structure, and number of accounts and volume of transactions. Italy requires the compliance function to be assessed on its independence from the intermediary's business operations, its authority within the intermediary, its working methods and the skills of its staff.

In Ontario and Quebec (Canada), the SROs require the external auditors of their members to report on the existence of specific internal controls; however, the external auditors are not required to report on the overall effectiveness of a compliance function. The French Banking Commission requires their intermediaries to submit annual report on internal control to external auditors for review. UK FSA requires external auditors to submit an auditor's report but this report is not explicitly required to cover compliance issues. However, auditors are required by accounting standards to assess the extent to which a firm has complied with relevant laws and regulations.

#### Specific Questions for Comments:

18. Who, within or external to a market intermediary, is best placed to assess the effectiveness of the compliance function? Please explain.
19. What should be the role of an external party in assessing the effectiveness of a compliance function?
20. What are the practical concerns of requiring an external party to conduct periodic assessment of a compliance function?
21. What should be the scope and frequency of the assessment by an internal party and/or an external party?

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<sup>27</sup> Exchange Act Rule 17a-5 (h) (2) and Exchange Act Rule 17a-12 (i) (2).

## **Topic 6      Regulators' Supervision**

### *Principles:*

*(a) Regulators' supervision of market intermediaries should include the assessment of the compliance function, taking into account the intermediary's size and business.*

*(b) Regulators should take steps to encourage market intermediaries to improve their compliance function, particularly when the regulators become aware of deficiencies. In addition, regulators should have the authority to bring enforcement actions, or other appropriate disciplinary proceedings, against market intermediaries relating to their compliance function.*

Monitoring the organization put in place by market intermediaries for compliance and the performance of the compliance function may allow regulators to identify weaknesses in a market intermediary before a serious problem arise. In such circumstances, regulators would then be in a position to require the necessary enhancements.

The manner in which regulators supervise their market intermediaries may differ. Some regulators may choose to conduct regular examinations of their intermediaries to assess the effectiveness of their compliance function. Other regulators may choose to supervise their market intermediaries using a risk-based approach. In the latter case, the frequency and the scope of a regulator's examination may depend on a number of factors, such as the number of complaints filed against an intermediary and the compliance history of the intermediary. Alternatively, some regulators rely on SROs to directly regulate and monitor the compliance function at market intermediaries. Lastly, regulators may also require their market intermediaries to notify them of significant breaches of securities regulatory requirements and/or customer complaints. These regulators believe that this approach allows them to assess the overall compliance of an intermediary, and thus, the effectiveness of its compliance function.

### *Means for Implementation*

Regulators could consider the following measures:

- (a) Direct examination, by the regulator, of the compliance function of a market intermediary at the time of license application;
- (b) Direct examination, by the regulator, of the compliance function as part of the general on-site inspections of market intermediaries, which may be conducted either on a regular basis or on a risk-based approach;
- (c) Direct examination, by the regulator, of the internal policies and operational procedures and controls of market intermediaries and subsequent amendments;



- (d) Examination of a market intermediary, including its compliance function, by external auditors appointed by the market intermediary, and the forwarding of the results of the examination to the regulator;
- (e) Examination by SROs, either on a periodic or “for cause” basis<sup>28</sup>, of market intermediaries; or
- (f) Periodic self-assessment and/or certification by the board of directors or senior management of market intermediaries, which should be filed with the regulators for review.

The above examinations, self-assessments and certifications may cover: the adequacy of the firm’s policies and procedures, the structure of the compliance function (such as the degree of independence and lines of reporting), human and material resources dedicated to the compliance function, qualifications and fitness of the person(s) responsible for compliance, and possible measures taken to address deficiencies previously identified.

## Discussion

### *Examinations by regulators and/or SROs*

Most jurisdictions conduct examinations of compliance function as part of their general oversight or surveillance of market intermediaries, whether regularly or on a risk-based approach (Australia, France, Hong Kong, Italy, Japan, Mexico, The Netherlands, Ontario and Quebec (Canada), Singapore, Spain, Switzerland, the U.K. and US (SEC)). In addition, in four jurisdictions, examinations are conducted via SROs for the firms they regulate (Ontario and Quebec (Canada), Pakistan, and US (SEC)). In two other jurisdictions, regular examinations are conducted via external auditors (Germany and Switzerland).

In addition, Spain explicitly refers to the examination of the compliance function they conduct at the time of license application, and requires the filing of the internal code of conduct of market intermediaries. France and Italy conduct examinations via the review of annual report from compliance officer.

### *Examination and notification requirements on external auditors*

A large majority of jurisdictions (12 out of 16) replied that external auditors had a role to play in ensuring an intermediary’s compliance. Australia, Hong Kong, The Netherlands, Ontario and Quebec (Canada) and Spain require the external auditor of a market intermediary to notify the regulators of the intermediary’s compliance with (part or all of) securities regulatory requirements. In the US, broker-dealers<sup>29</sup> and OTC derivatives

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<sup>28</sup> SROs are, in turn, examined by the regulator, in order to assess the adequacy of the SROs’ supervision and examinations of market intermediaries.

<sup>29</sup> Exchange Act Rule 17a-5.

dealers<sup>30</sup> must all file with the US SEC an annual audit report conducted by an independent accountant. If, during the course of the audit or interim work, the accountant determines that any material inadequacies exist in the accounting system, internal accounting control, procedures for safeguarding securities, or as otherwise defined, the accountant must call it to the attention of the broker-dealer's chief financial officer, who must inform the US SEC and the broker-dealer's designated examining authority by telegraphic or facsimile notice within 24 hours and furnish the accountant with a copy of the notice. If the accountant fails to receive such notice from the broker-dealer, or if the accountant disagrees with the statements contained in the notice, the accountant must inform the US SEC and the designated examining authority by report of material inadequacy within 24 hours thereafter. Similar requirements apply to commodity brokers regulated by the US CFTC. Germany, Italy, Mexico, Pakistan, Singapore, and Switzerland require the external auditors of their market intermediaries to review or report on the adequacy of the intermediary's compliance function.

Some jurisdictions further highlight the requirement that external auditors notify the regulator of an intermediary's non-compliance with relevant rules and regulations. These jurisdictions include Australia, Germany, Hong Kong, Italy, Singapore and The Netherlands. Australia specifically requires an external auditor to notify within seven days any breach of financial requirements. Australia and Singapore specify further that any adverse effects on the licensee's ability to meet its license conditions or any cases of fraud/dishonesty respectively must be reported.

In the UK, auditors have a role to play to the extent that they are required to assess the extent to which a firm has complied with relevant laws and regulations. Auditors also have a duty to report contraventions by the firm of any relevant requirement, where that contravention would be of material significance to the UK FSA. Meanwhile, firms should consider notifying the FSA if the firm receives a written communication from its auditor commenting on internal controls.

#### *Reporting and notification requirements*

In addition, nine jurisdictions require a periodic report relating to part or all of the compliance functions to be filed with the regulator<sup>31</sup>. France requires an annual report to the AMF by the supervisor of investment services on the conditions in which investment services and assimilated services are supervised. In addition, a report on internal controls should be established each year and sent to the senior management of the market intermediary, its board, its audit committee, external auditors, and the Banking Commission.

One jurisdiction, Mexico, requires a compliance report to be filed with the regulator "if necessary." In Mexico, regulations empower the Commission to require, at any

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<sup>30</sup> Exchange Act Rule 17a-12.

<sup>31</sup> Compliance reports must be filed with the regulator in the following jurisdictions: France, Germany, Italy, Ontario and Quebec (Canada), Pakistan, Spain, Switzerland, US (CFTC and SEC).

moment, any information it deems necessary to perform its supervisory functions, including a compliance report.

### *Certification*

Those jurisdictions that require a certification as to the adequacy of part or all of an intermediary's compliance arrangements place at least part of this burden on the external auditor, which must examine the financial controls, and sometimes other aspects of the compliance function and attest to their adequacy. Five jurisdictions require such a certification<sup>32</sup>, where the external auditor is required to notify regulators annually of a market intermediary's compliance with internal conduct rules. Of the five jurisdictions requiring certification, three jurisdictions further require senior management to certify the adequacy of the intermediary's compliance function.<sup>33</sup>

In the US, NASD Rule 3013 requires that each member's CEO (or equivalent officer) certify annually that the member has in place processes to establish, maintain, review, test and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with applicable NASD rules, MSRB rules and federal securities laws and regulations.

While Hong Kong and Singapore do not require a formal certification, auditors are required to express an opinion on the adequacy of systems of controls relating to compliance with client asset protection rules and the intermediary's compliance with other specified rules. Upon becoming aware of any non-compliance issues, intermediaries should report to the Commission. While Australia has no specific requirement for certification of the adequacy of the compliance arrangements as a whole, all directors of a managed investment scheme's responsible entity must sign the compliance plan of the scheme.

Examples of jurisdictions requiring no formal certification of the compliance function include The Netherlands. France, which has no procedure of certification, holds senior management responsible for ensuring compliance with the general rules of conduct that the firm and persons acting on its behalf must comply with.

### *Enforcement actions*

All regulators have the authority to bring enforcement actions against market intermediaries relating to their compliance function. This authority is set within the wider context of the regulators' power to bring enforcement action against the intermediaries they have licensed for breaches of the law or of the license obligations or conditions. Regulators have the ability to impose penalties and remedies, including requiring enhancement to the intermediaries' compliance function.

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<sup>32</sup> Certification requirements exist in Germany, Pakistan, Spain and Switzerland. The US CFTC requires certification relating to financial compliance.

<sup>33</sup> These jurisdictions include Ontario and Quebec (Canada) and Pakistan.

Penalties may include:

- reprimand or warning to the management,
- fines towards a market intermediary or natural persons placed under its authority or acting on its behalf,
- imposing additional license conditions,
- suspension or revocation of the license of a market intermediary and/or its licensed or registered persons,
- suspension or expulsion from membership of SROs,
- actions on the corporate officers involved in breach of the compliance duty in relation to market misconduct (such as requiring dismissal and temporary interdiction of taking new functions as manager or director in another licensed intermediary),
- requiring that the intermediary be compelled to undertake the assistance of an independent consultant, at its own expense, to perform a review of its compliance function and implement any recommendations made by the independent third party,
- a letter to the board of the intermediary raising certain issues and asking for a response to those issues in writing,
- issuing a media release identifying the licensee's offences and the remedy imposed by the regulator,
- liquidation of the intermediary, and
- criminal prosecution by judicial authorities.

Specific Questions for Comments:

22. Please identify the methods of monitoring that are the most effective from your perspective and explain why.
23. What factors are indicative of a strong compliance culture and a weak compliance culture? Please explain.
24. Are there other means for implementation that we should consider?

## **Topic 7      Cross-border issues.**

Many market intermediaries operate globally. For example, some market intermediaries have branches (i.e. the same legal entity as the market intermediary), affiliates and/or subsidiaries in a number of jurisdictions, while other market intermediaries deal with customers in different jurisdictions through electronic means. Different jurisdictions may have different legal and regulatory requirements. The need to consider and comply with varying legal and regulatory requirements in different jurisdictions creates difficult compliance issues.

Market intermediaries that have cross-border activities should carefully consider the applicable regulatory requirements. Regulators, too, should be cognizant of the implication of cross-border issues for the performance of the compliance function. Regulators should consider whether market intermediaries have arrangements for compliance with all applicable regulatory requirements.

### Specific questions for comment

25. Please identify the specific issues that arise for the compliance function of a market intermediary if it is operating in more than one jurisdiction.
26. What are the effective means to ensure that you or your related entities are complying with securities regulatory requirements in all jurisdictions you and your related entities operate? For example, local and/or centralized compliance function?

## **Topic 8        Outsourcing of the Compliance Function**

Some market intermediaries may consider outsourcing certain compliance tasks to third party service providers. The market intermediaries, however, still retain full legal liability and accountability to the regulator for any and all functions or tasks that they outsource to a service provider. The IOSCO Technical Committee has issued a report on *Principles on Outsourcing of Financial Services for Market Intermediaries*, which sets forth a framework that is designed to assist intermediaries in determining the steps they should take when considering outsourcing activities. This report can be found on the IOSCO website at <http://www.iosco.org/pubdocs/pdf/IOSCOPD187.pdf>.

### III. Conclusion

It is acknowledged that there is increasing focus on the compliance function. The purpose of this paper is to identify possible supplementary principles to Principle 23 of the *IOSCO Objectives and Principles of Securities Regulation* and to raise issues for discussion through a consultation process.

You are encouraged to comment on any aspect of this paper. In particular, you are asked to respond to, or otherwise comment on, some or all of the specific questions set out in the paper. These questions are reproduced below.

1. Do you agree with the definition and description of the scope of a compliance function? Please explain.
2. What is the relationship between the compliance function and risk management function? For example, is the compliance function part of or separate from the risk management function; and if they are separate, how do they interact when dealing with compliance issues?
3. Should a specific organizational structure for compliance be prescribed? Please explain.
4. Are there any essential roles, responsibilities or activities for the compliance function that should be mandated or otherwise identified by regulators?
5. Please identify responsibilities other those described above that are carried out by the compliance function at market intermediaries.
6. How and when should the compliance function be responsible for managing compliance risk?
7. Are there any practical concerns for requiring documentation of policies and procedures for smaller, less complex, market intermediaries? Please explain. If policies and procedures should be documented, what degree of detail should regulators expect to see for smaller, less complex, market intermediaries?
8. Please describe the level of accountability for compliance at your firm for each of the following: board of directors, senior management, designated compliance officer, business unit personnel, where applicable. For example, in the case of the failure to establish proper procedures to prevent sales practices violations, who would be accountable and what would be the extent of their accountability? Please explain your answers.
9. Do you distinguish among responsibility, accountability and liability? Please explain.
10. Should a senior officer be designated for the day-to-day compliance responsibility? Please explain.

11. What requirements relating to independence and ability to act are relevant to a small firm?
12. In cases where individuals perform both business and compliance activities, should they be allowed to supervise their own business activities? If so, how can the regulators ensure that they supervise their own business activities in an objective manner?
13. Are the means for implementation of independence set out above sufficient to achieve independence? Please explain.
14. How do you ensure that compensation of compliance personnel is not subject to undue influence? Please explain.
15. What are the appropriate qualifications for compliance personnel?
16. Should the qualifications vary depending on functions, responsibility or seniority?
17. How do you evaluate the adequacy of courses and training for compliance personnel?
18. Who, within or external to a market intermediary, is best placed to assess the effectiveness of the compliance function? Please explain.
19. What should be the role of an external party in assessing the effectiveness of a compliance function?
20. What are the practical concerns of requiring an external party to conduct periodic assessment of a compliance function?
21. What should be the scope and frequency of the assessment by an internal party and/or external party?
22. Please identify the methods of monitoring that are the most effective from your perspective and explain why.
23. What factors are indicative of a strong compliance culture and a weak compliance culture? Please explain.
24. Are there other means for implementation that we should consider?
25. Please identify the specific issues that arise for the compliance function of a market intermediary if it is operating in more than one jurisdiction.
26. What are the effective means to ensure that you or your related entities are complying with securities regulatory requirements in all jurisdictions you and your related entities operate? For example, local and/or centralized compliance function?



## **Appendix A Compliance Procedures Topics**

Specific issues that should be considered for the internal compliance policies and procedures of an intermediary are:

- Measures to identify and document qualifications of individual employees to provide regulated services;
- Training of individual employees regarding securities regulatory requirements and how to comply with such requirements;
- Prevention of undue disclosure of confidential information;
- Detection, prevention and management of conflicts of interest;
- Compliance with conduct of business rules by the firm and its staff;
- Monitoring of employees personal transactions;
- Supervision of opening of new client accounts;
- Supervision of trading practices, including proprietary trading of the firm;
- Supervision of portfolio management processes;
- Supervision of advice provided to clients;
- Supervision of the various duties relating to information to clients and marketing information;
- Controlling compliance with prudential rules;
- Records and documentation, including safeguards for the privacy protection of client records and information;
- Prevention of money laundering;
- Dealing with customer complaints;
- Reporting and supervisory structure; and
- Business continuity plans.