Bursa Malaysia Derivatives Berhad

Date : 30 March 2012	Trading Participant Circular: 6/ 2012

1. AMENDMENTS TO THE RULES OF BURSA MALAYSIA DERIVATIVES BERHAD ("RULES OF BURSA DERIVATIVES") IN RELATION TO FINANCING TO RELATED CORPORATIONS AND REPORTING TO MANAGEMENT

2. AMENDMENTS TO COMPLIANCE GUIDELINES FOR FUTURES BROKERS

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1. INTRODUCTION

1.1 Kindly be advised that Bursa Malaysia Derivatives Bhd ("Exchange") has amended the Rules of Bursa Derivatives in relation to the following:

(a) financing to related corporations; and

(b) reporting to management.

These rule amendments are made to clarify and strengthen the regulatory framework. The details of the rule amendments are explained in **paragraph 2** below.

1.2 The Compliance Guidelines for Futures Brokers have been updated. For further details please see **paragraph 3** below.

2. AMENDMENTS TO THE RULES OF BURSA DERIVATIVES

2.1 Financing to related corporations

The salient amendments to the Rules of Bursa Derivatives in relation to financing to related corporations are as follows:

(a) Rule 618.2(1)(a) provides that the TP must have an effective implementation of policies and procedures to control and manage the risk exposure when carrying out such financing activities;

(b) Rule 618.2(1)(b) provides that the TP must manage any potential conflict of interest that may arise between the TP and its related corporation, in which the interest of the TP must prevail; and

(c) Rule 618.2(1)(c) provides that the TP must ensure that its policies and procedures on such financing activities are duly endorsed by the TP's Board of Directors, including policies and procedures on the authority and limits for the granting of financing to related corporations and prohibit any individual persons from being able to exercise an overriding authority over the provision of financing to related corporations.

2.2 Reporting to management

Rule 601.2E(1) of the Rules of Bursa Derivatives has been amended to clarify that a TP must ensure that relevant information about its business is regularly reported to its management as part of the TP's compliance with Rule 601.2E(1). The TP's management would include its senior management and its board of directors.

The above rule amendments on financing to related corporations and reporting to management ("Rule Amendments") are set out in **Annexure 1**.

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3. AMENDMENTS TO THE COMPLIANCE GUIDELINES FOR FUTURES BROKERS

The Compliance Guidelines for Futures Brokers issued via Trading Members Circular 37/99 on 26 November 1999 by the Kuala Lumpur Options & Financial Futures Exchange Bhd ("Guidelines") have been updated. The salient changes are as follows:

(a) terminologies and references in the Guidelines have been updated in line with the current Rules of Bursa Derivatives and the relevant Securities Laws to date; and

(b) the provisions that are no longer applicable for instance, Annex II and Annex III in relation to common areas of non-compliance and common internal control weaknesses respectively, have been deleted from the Guidelines.

The amended Guidelines are set out in **Annexure 2.**

4. EFFECTIVE DATE OF RULE AMENDMENTS AND AMENDMENTS TO THE GUIDELINES

Please be informed that the Rule Amendments and amendments to the Guidelines are effective from **2 April 2012.**

5. CONTACT PERSONS

In the event of any queries in relation to the Rule Amendments and amendments to the Guidelines, kindly contact the following persons:

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This Circular is available at
http://www.bursamalaysia.com/website/bm/regulation/rules/bursa_rules/bm_derivatives.html

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REGULATION

ANNEXURE 1
RULE AMENDMENTS
in relation to financing to related corporations
and reporting to management

RULES OF BURSA MALAYSIA DERIVATIVES BHD
RULE AMENDMENTS IN RELATION TO THE CLARIFICATION OF RULE 601.2E(1) AND FINANCING TO RELATED CORPORATIONS

	EXISTING PROVISIONS	**AMENDED PROVISIONS**
Rule 601.2E (1)	**Rule 601.2E Structures, policies, procedures and internal controls** (1) A Trading Participant must have in place structures, policies, procedures and internal controls reasonably designed to: (a) facilitate the supervision of the Trading Participant's business activities and the conduct of the Trading Participant's employees and agents; (b) identify, monitor and manage conflicts of interest and risks that may arise in the conduct of the Trading Participant's business; (c) achieve compliance with these Rules, the Directives, Securities Laws and the Trading Participant's written policies, procedures and internal controls; and (d) provide for investor protection.	**Rule 601.2E Structures, policies, procedures and internal controls** (1) A Trading Participant must have in place structures, policies, procedures and internal controls reasonably designed to: (a) facilitate the supervision of the Trading Participant's business activities and the conduct of the Trading Participant's employees and agents; (b) identify, monitor and manage conflicts of interest and risks that may arise in the conduct of the Trading Participant's business; (c) achieve compliance with these Rules, the Directives, Securities Laws and the Trading Participant's written policies, procedures and internal controls; and (d) provide for investor protection. For avoidance of doubt, a Trading Participant must ensure that relevant information about its business is regularly reported to its management as part of the Trading Participant's compliance with Rule 601.2E(1).
Rule 618	New Provision	**RULE 618 FINANCING TO RELATED CORPORATIONS**
Rule 618.1	New Provision	**Rule 618.1 DEFINITION** (1) For the purposes of this Rule 618 - "related corporation" – shall have the same meaning as 'related

	EXISTING PROVISIONS	AMENDED PROVISIONS
		corporation' under section 6 in the Companies Act.
Rule 618.2	New Provision	**Rule 618.2 GENERAL PRINCIPLES** (1) Subject to any restriction or prohibition under any law, a Trading Participant may extend financing to any related corporation of the Trading Participant if:- (a) the Trading Participant has an effective implementation of policies and procedure to control and manage the risk exposure when carrying out such financing activities; (b) the Trading Participant manages any potential conflict of interest that may arise between the Trading Participant and its related corporation, where the interest of the Trading Participant must prevail; and (c) the Trading Participant has ensured that the policies and procedures in Rule 618.2(1)(a): (i) are duly endorsed by the Trading Participant's Board of Directors; (ii) include the authority and limits for the granting of financing to related corporations; and (iii) prohibit any individual persons from being able to exercise an overriding authority over the provision of financing to related corporations.
Rule 618.3	New Provision	**RULE 618.3 INVESTMENT BANK** (1) This Rule 618 does not apply to an Investment Bank. The

EXISTING PROVISIONS		**AMENDED PROVISIONS**
		Investment Bank must comply with the Guidelines on Investment Bank and such other requirements of the Central Bank relating to financing to related corporations ("the Relevant Guidelines and Requirements"), if any.

[End of Rule Amendments]

Table of Contents

1. PREFACE

The compliance function in the derivatives industry is of critical importance in the context of the rapid change and growth taking place in the financial services sector. Increasing competition, pressure to operate profitably and to improve performance, introduction of new derivative products and rapid advancements in information processing and dissemination technology may result ~~have resulted~~ in risk management by futures brokers lagging behind in their emphasis on sound operational controls. ~~Findings from regulatory audits of futures brokers continue to reveal divergence between the actual compliance activities of futures brokers and the expected quality and standard of compliance work performed by Compliance Officers in the industry.~~

The most important message that this document intends to convey is that compliance should be looked upon as an entire system of –

a) complying with laws, rules and guidelines issued by the relevant authorities under the regulatory framework;

b) assuring a high quality of service to clients in order to maintain long-term profitable relationships with business partners;

c) managing risk, particularly operational risk, as part of an enterprise-wide risk management framework that is aimed at providing greater certainty for cashflow management purposes, and hence enhancing risk-adjusted returns to shareholders of a broking firm; and

d) encouraging one's peers to equally adopt a high standard in order to minimise credit, systemic and reputational risk in the interest of promoting long-term development of the industry.

Hence, this document is issued to address current compliance issues and to enhance compliance through guidance that will encourage self-regulation and sound risk management of derivatives. It is our expectation that senior management and compliance officers will play a more proactive and meaningful role in evaluating future brokers' internal controls system and cultivating a compliance culture in their organisation.

The compliance guidelines contained in this document are presented with the following functional objectives in mind:

a) to improve the quality and effectiveness of the compliance function;

b) to promote a compliance culture within, and self-regulation by the futures brokers; and

c) to provide a uniform practice guide on compliance which would serve as a basis for guidance and measurement of performance of the compliance function by the Compliance Officer.

Senior management and Compliance Officers may find these guidelines useful in reassessing their supervisory, monitoring and compliance procedures. This paper is organised into four major parts:

a) Part I encompasses an overview of the compliance function ~~of futures brokers in Malaysia.~~;

b) Part II covers compliance control and responsibilities. This part prescribes the requirement to establish a compliance culture within a futures broking organisation and outlines the roles to be played by the Board of Directors and employees;

c) Part III describes the role, duties and responsibilities of the Compliance Officer;

d) Part IV addresses the skills required by a Compliance Officer.

2. OVERVIEW OF THE COMPLIANCE FUNCTION ~~OF FUTURES BROKERS IN MALAYSIA~~

To comply means compliance with all relevant laws, policies, procedures, guidelines, directives, rules and regulations. Compliance essentially refers to proper supervision and competent system of internal controls within an organisation to maintain the integrity of its dealing practices, the safeguarding of its assets and compliance with all relevant regulatory requirements. Compliance is a component of proper business support and applies to all individual business activities and functions. Effective compliance requires the willingness of broker organisations to police their own activities, eliminate bad practices and to maintain routine contact with the regulators. ~~However, in Malaysia, the~~The biggest pitfalls of setting up a Compliance function ~~by futures brokers~~ are:

a) the compliance function is seen as being solely the province of the Compliance Department. No one sees a specific compliance dimension to their job nor has one been expressly communicated to them

b) personnel in the Compliance Department are inadequately trained and under-resourced

c) the organisational objectives or corporate mission has failed to recognised the Compliance function. The purpose of establishing a Compliance Department has not been communicated to the staff and the setting up of the Compliance Department is merely in response to the requirements of the Securities Commission and the Exchange~~s~~

d) lack of acceptance by the Board of Directors and senior management of the role and importance of the Compliance Department/Officer

e) the Compliance Officer is often distracted by other duties and has not been designated with the appropriate seniority for the job

f) failure to identify and manage conflict of interests

g) failure to maintain professional independence and

h) weak management supervision and control.

3. COMPLIANCE CONTROL AND RESPONSIBILITIES

~~The violations of the Futures Industry Act 1993, Futures Industry Regulations, Business Rules of the Exchanges and MDCH as revealed in the regulators' audit reports, the disciplinary actions and fines imposed by the regulators to the futures brokers reflect that the compliance function has not been established across the derivatives industry as a whole.~~

Compliance is a '*state of mind'* which needs to penetrate the whole fabric of the organisation in the way it is organised, managed and controlled. Each regulated business area of a futures broker e.g. dealing activities, customer documentation, payments and settlement activities, the handling of clients' funds, is responsible for complying with the relevant rules and laws and must maintain procedures that will ensure compliance.

Compliance Guidelines for Futures Brokers

Each futures broker needs to adopt a *'compliance mission statement'* that will cultivate an environment, which encourages compliance. Problems arising from daily operations or key decisions and actions taken may impose a strategic or financial impact on the broker's compliance. In these cases, the compliance mission statement serves as a reference to ensure the broker remains compliant.

Roles and Responsibilities of the Board of Directors

The Board of Directors, besides approving all significant policies and procedures throughout the organisation, should also ensure that:

a) a sound system of internal controls is maintained to safeguard shareholders' interests company's assets and clients' interests. This covers not only financial controls but operational and compliance controls, and risk management;

b) management effectively implements all policies and procedures set by the Board;

c) a fully-staffed compliance department is established and delegated with the responsibility of managing the organisation's compliance with all relevant laws, rules, regulations, directives, guidelines, policies and procedures;

d) competent compliance personnel are available to review the effectiveness of organisational controls and procedures as well as verify the reliability of information reported;

e) proper procedures are in place to anticipate likely changes in the regulatory regime and compliance requirements that may be against the interest of the organisation;

f) there are periodic discussions with management concerning the effectiveness of internal controls and risk management, and ensure the management has appropriately taken action on recommendations and concerns expressed by the ~~compliance~~ Compliance Officer and auditors (regulatory auditors, internal and external auditors) with regards to internal control weaknesses and issues on non-compliance.

A strong and pro-active Board will foster an environment of strong internal controls and compliant procedures and practices.

Establishment of compliance culture within the organisation

To establish an effective compliance culture within the organisation, the organisation needs to:

a) have a well-documented and up to date operations manual incorporating practices that ensure compliance. The operations manual should:
   i. contain procedures that are practical and able to explain the rationale behind each requirement and the consequences if that requirement is not met.
   ii. Clearly explain the individual responsibilities for each function to be performed;

b) have a proper system for record keeping. Complete and accessible records are vital in enabling the organisation to demonstrate it has complied effectively.

c) have effective channels of communication to ensure that all staff are fully aware of policies and procedures affecting their duties and responsibilities and any changes thereto.

d) provide induction training to new staff. Induction training should encompass explanation of the procedures relevant to the job and the corresponding compliance responsibilities.

e) assess staff for their competencies on a regular basis to identify training needs and promote personal development.

f) have a competent Compliance Officer to advise regulated business areas on key matters of compliance, to monitor that the business is complying in practice and to educate everyone in the organisation on how compliance is best achieved.

g) have a system of regular reporting. Regular reporting to Board is critical and should include both routine and exceptional matters. Compliance issues such as results of monitoring, changes in regulations, results of regulatory visits etc., should be compiled in a Compliance Report and be made a standing item to be discussed at Board Meetings.

h) have an effective internal control system. When establishing an internal control system, management should include the following:

   i. *Organisational structure*
   This sets out the hierarchical structure within and the division of functions across, the organisation. Its purpose is to provide a clear and accurate picture of:
      - which department is responsible for each business function.
      - the levels of responsibility and reporting structure within the department.
      - the levels of responsibility and reporting structure for the heads of department.
      - the levels of responsibility and reporting structure for the executive director or chief executive officer.

   ii. *Managerial Control*
   This control includes all manner of supervisory that is exercised by senior management.

   iii. *Segregation of duties*
   The segregation of duties is a crucial method of management control. It involves allocating certain tasks within a business activity amongst the employees in such a manner that one employee's task acts as a check and balance over another employee's task. This ensures that the activities of an organisation are being carried out in a proper and authorised manner and helps prevent the occurrence of fraudulent activities. In a futures broking company, the usual examples of segregation are between:

   - procurement of clients and credit risk analysis
   - trading activities and dealing duties and settlement transactions
   - funds transfer and transaction booking
   - daily maintenance of general ledger balance and validation of general ledger balance
   - maintenance of record balance and physical release of collateral

   The size of certain organisations may make it impracticable to separate tasks within an activity to 2 or more employees. The management will then have to rely on other methods of control such as audits and management reviews and conduct these on a frequent and in-depth basis.

iv. *Supervisory control*
Authorised and appropriate qualified personnel should independently supervise all activities~~. In this regard, the futures broker must submit the details of the respective supervisors/Heads of Department to the relevant Exchange(s).~~

v. *Review, authorisation and approval*
All transactions should require approval by an appropriate authorised official. Approval limits should ~~be~~ commensurate with the level of each individual's degree of authority. All transactions must be properly documented to provide for review and accountability.

vi. *Independent review*
An independent review conducted by an identified personnel functions to ensure that a task or process is carried out properly and efficiently.

vii. *Accounting control and arithmetical accuracy*
Accounting control is essentially a system for checking the accuracy of the information contained in the accounting records and books of the company on a daily basis. Accounting control activities encompass verifying the arithmetical methods used and their results as shown by the figures in financial statements such as account totals and trial balances, proving control account balances and performing reconciliations.

viii. *Physical security*
This control relates to the custody and safeguarding of assets, and restriction of access to business premises, systems and departmental records.

(**Annex III** details the common internal control weaknesses)

Compliance responsibilities

Management is responsible for setting the tone of the organisation to promote a compliance culture within the entity. It is imperative that management provides support to the compliance function and actions taken by management must be indicative of this. Weaknesses in the organisations' internal controls or inefficiencies in operating procedures must be identified and rectified immediately. Non-compliance must be dealt with to ensure that the breach will not occur again.

It is the responsibility of the staff to comply with relevant industry laws, and internal control policies and procedures set up by the organisation. Both management and staff must bear in mind that compliance is everyone's responsibility. An ethos of professionalism and best practice which is essential for an effective compliance can only be achieved if everyone plays his/her part rather than relying just on the Compliance Officer or Compliance Department.

The ultimate responsibility for proper supervision and compliance rests with the organisation and its Board of Directors. The Compliance Officer facilitates the attainment of these objectives and does not relieve the organisation or its Board of Directors of any of its responsibilities. The formulation of supervisory or compliance programmes may be within the Compliance Officer's job function but the effective implementation and maintenance of such programmes lies with the organisation and its Board of Directors. Any failure to effectively supervise and ensure compliance by the organisation or its employees will be deemed a failure on the part of the organisation and its Board of Directors.

4. ROLE OF THE COMPLIANCE OFFICER

An independent function

The Compliance Officer acts as the "conduit" through which a futures broker achieves the compliance objectives, whilst proving an independent check and balance within the futures broker, thereby ensuring that its activities are in compliance with the relevant securities laws, rules, regulations, directives, guidelines, policies and procedures.

To carry out his duties without any conflict of interest, the Compliance Officer must be independent of the back and the front offices. He must not have sales and operational functions, and must not be directly involved in trading, settlement, funding, processing or reconciliation activities of a futures broker, and should not act in a manner which may compromise his function and position. He should only be engaged in the compliance function. He must not engage in personal dealing in ~~futures contracts~~derivatives ~~(as defined in FIA 1993)~~.

Role of the Compliance Officer in relation to ~~existing~~ other departments or functions within the organisation

The Compliance Officer undertakes an overall supervisory responsibility over the trading and operational activities of a futures broker. He monitors on-going business activities on a pro-active basis to ensure compliance by the futures broker. He oversees and supplements other supervisory measures already in place within a futures broker and ensures that the relevant supervisors/Heads of Department perform their supervisory responsibilities effectively. However, the Compliance Officer does not relieve any supervisor/Head of Department of their responsibilities. The burden of executing designated job functions still remains with the respective supervisors/Heads of Department.

In this respect, the Compliance Officer should keep in constant communication and work closely with all supervisory heads within the future broker's structure, with a view to supplementing existing reviews of the supervisors and ensuring that the necessary policies and procedures are in place to effect proper supervision of the respective departments.

The Compliance Officer and the Internal Audit Department, if there is one, should strive to complement each other and work towards achieving a high standard of compliance. It is the duty of the Compliance Officer to review the work undertaken by the Internal Audit Department, and where necessary, make recommendations for improvement.

Futures brokers are encouraged to establish an Audit Committee, and the Compliance Officer ~~shall~~ should be one of the members of such committee, where it is established.

In respect of the futures broker, where an Audit Committee is established at the holding company (public listed company) of the futures broker, adoption of the following is encouraged:

a) the Audit Committee should appoint one of its member-directors to be responsible for tabling and presenting compliance matters in regard to the futures broker at the Audit Committee meeting. Where the group also comprise a stock broker (~~Member Company of KLSE~~Participating Organisation of Bursa Malaysia Securities Berhad), such member-director should represent the interests of the Compliance Officers of the futures broker and the stock broker,

b) the above-mentioned member-director of the Audit Committee should carry out the following:

   i. bring to the attention of the Audit Committee relevant issues on behalf of the Compliance Officer of the futures broker to be deliberated and decided upon; and

ii. convey any decision or instruction made by the Audit Committee for the attention of the Compliance Officer and the Board of Directors of the futures broker,

c) the Compliance Officer of the futures broker shall be invited and presented at the meeting of the Audit Committee on compliance matters pertaining to the futures broker provided that this should not discharge the duty of the appointed member-director of the Audit Committee to be responsible over compliance matters reported by the Compliance Officer of the futures broker.

(*Note: the above is in line with the ~~KLSE requirement~~ Listing Requirements that Public Listed Companies must establish and manage and Audit Committee~~ in accordance with the KLSE~~.)*

Role of the Compliance Officer in relation to the Board of Directors

The Compliance Officer shall report directly to the Board of Directors of the organisation. He should have access to the Board of Directors to report, update, inform and make recommendations on all matters pertaining to compliance, including events of non-compliance. However, in the course of his duties, the Compliance Officer may bring compliance matters to the attention of the Executive Director or other senior management personnel so as to enable appropriate action to be taken.

The Compliance Officer must submit monthly written reports to the Board of Directors on all matters pertaining to compliance, including matters that had been brought to the attention of the Executive Director or other senior management personnel and the actions taken. The Board of Directors must deliberate matters reported to it by the Compliance Officer at its proper meeting so that appropriate action or decision can be taken. Proper records of such deliberations must be maintained.

To maintain the independence of the Compliance Officer, his performance ~~shall~~ should preferably be appraised by the Board of Directors~~, and such function shall not be delegated to any person(s)~~.

Duties and Responsibilities of the Compliance Officer (Summary)

The main duties and responsibilities of the Compliance Officer are summarised below:

a) to advise on compliance matters

The Compliance Officer has the responsibility to ensure compliance with all relevant laws, rules, regulations, directives, guidelines, policies and procedures.

b) to review the adequacy of internal controls and risk management system

The Compliance Officer must continually review the adequacy of the organisation's internal control system, which includes the risk management system, in light of changes in internal and external conditions.

c) to review, monitor and supervise other supervisory measures to ensure compliance

One of the ways to ensure compliance by all levels of staff is to have effective monitoring which should cover front office, back office and accounting activities. It is the responsibility of the supervisors/Department Heads to ensure compliance by their staff members. In this respect, it is the duty of Compliance Officer to review the adequacy of the supervisory measures undertaken by the supervisors/Department Heads. The frequency of reviewing and monitoring should be determined by assessing the level of risk involved, and the frequency and nature of changes in the operating environment. The reviewing and monitoring should also focus on areas of risk. A checklist should be used for such purposes.

d) to assist in training and educating staff members on compliance matters

Training is critical to the successful implementation of a compliance culture. All new recruits and existing staff members must be adequately trained and equipped with the necessary capabilities to carry out the responsibilities assigned to them. The Compliance Officer must assist in the training and educating of staff members on compliance related aspects of their jobs and should ensure that they are kept up-to-date with changes in regulatory requirements.

e) to report to the Board of Directors

It is the duty of the Compliance Officer to inform and report to the Board on all matters pertaining to compliance at least once a month. However, he should immediately report to the Board and the relevant Exchange(s) if a matter requires urgent attention, e.g. breaches of the laws, and matters pertaining to segregation of clients' assets and risk position of the broker.

f) to liaise with the regulatory bodies on compliance matters

Due to the independence of the Compliance Officer's functions, he is the most suitable personnel in the organisation to play the role of liaison officer between the futures broker and the regulators for the purpose of information sharing, clarification of rules and regulations, requests for advice, and reporting of incidence of non-compliance.

(**Annex I** elaborates the main duties and responsibilities of the Compliance Officer)

5. ESSENTIAL SKILLS REQUIRED OF A COMPLIANCE OFFICER

It is important that the right person is employed as a Compliance Officer. The individual must have at least a minimum level of competence in the particular activities they are required to monitor, and must also be a person of an appropriate level of seniority to act independently and to effect decisions.

A Compliance Officer needs to have proper professional qualifications and experience appropriate to the duties that he/she is expected to perform.

A Compliance Officer needs to have some ***technical expertise*** in the areas of business he/she is to monitor, for example, general principles relating to the use of derivatives products in hedging, market making, portfolio management, arbitrage and yield enhancement, as well as the risks involved, services offered by the organisation and market practices. He/she must be ***professionally competent*** in assessing industry rules that apply to the business and able to interpret them in a practical business way.

As the Compliance Officer needs to work closely with colleagues within the organisation and with the regulators, it is essential that Compliance Officer possesses ***good communication and interpersonal skills***. He/she must be a good listener, open and approachable and have negotiation skills to be able to put over an argument in persuasive rather than dictatorial terms.

A Compliance Officer must be able to ***apply knowledge and experience*** gained to the business he/she works in and understand the critical problems and constraints faced by the business in order to gain credibility when discussing issues with management. Nevertheless, he/she must maintain an

independent frame of mind and be able to make an independent decision whether to report or discuss with the Board and regulators on particular issues as seen appropriate.

6. CONCLUSION

Obviously, compliance will result in a lower incidence of disciplinary actions imposed on an organisation e.g. fines and suspension from trading which may disrupt the business as well as damage the broker's reputation. More importantly, compliance by way of establishing control principles like segregation of duties and independent review serves to protect the business assets by decreasing the occurrences of unintentional errors or outright fraud through quick detection and rectification.

The effective penetration of a proper compliance culture into all business and administrative units of an organisation will bring about lower operational risk, facilitate earlier detection of market risk or concentration risk result in a higher level of operational efficiency which in turn will translate into a reduction of operating costs and financial risk.

ANNEX I - DUTIES AND RESPONSIBILITIES OF THE COMPLIANCE OFFICER

In order to maintain high standards of business conduct, strong internal controls and ensuring compliance with laws, rules and regulations, a futures broker is required to have a Compliance Officer to manage the compliance aspects of its futures broking business. The main duties and responsibilities of the Compliance Officer are:

a) to advise on compliance matters

In carrying out the above duty, the Compliance Officer should:

i. understand all relevant laws, rules, regulations, directives, guidelines, policies and procedures, and changes thereto, and interpreting them with regards to the size and complexity of the organisation

ii. advise all personnel of the organisation on how these requirements can be translated into practical procedures and all matters compliance

iii. ensure that the organisation has policies and procedures to govern all key activities

The Compliance Officer has the responsibility for ensuring that compliance is met within all business areas.

~~**Annex II** details some areas of non-compliance with Futures Industry Act 1993 and the Futures Industry Regulations 1995, Business Rules of Exchanges and MDCH arising from findings of the Exchanges and MDCH in the course of reviews and audits conducted over the last two years. These are critical areas which the Compliance Officer should focus on when carrying out his/her duties.~~

b) to review the adequacy of internal controls and risk management system

Internal control is defined as follows:

"*Internal control is the process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories*:

a) reliability of financial reporting
b) compliance with applicable laws and regulations and
c) effectiveness and efficiency of operations"

Internal control comprises five interrelated elements:

i. management oversight and the control culture
ii. risk assessment
iii. control activities
iv. information and communication and
v. monitoring activities

It is the responsibility of futures broker to maintain a sound system of internal controls, which covers not only financial controls but operational and compliance controls, and risk management.

In reviewing the adequacy of the internal control system with the organisation, the Compliance Officer needs to consider the degree of existence and effectiveness of the following **control factors**:

i. *evidence of control operation*

Once a control is introduced in the organisation, its effectiveness and reliability largely depend on the ability of the organisation to ensure and confirm that it is being operated. This confirmation should ideally take the form of documentary evidence such as a report or acknowledgement in writing from the person operating that control. The absence of such documentary evidence increases the risk that the control is not being operated and undermines the organisation's ability to detect any breaches of the control.

ii. *preventive and detective control*

The purpose of having controls is to discourage, and "blow the whistle" on improper or unauthorised activities. These preventive and detective elements can be put in place by locating controls beginning from the point at which the risk first arises within an activity or process. This will reduce the time between the occurrence of the unauthorised activity and the whistle being blown, and prevent the situation from becoming worse and irreparable without detection. A common example of this is the exposure or position limit that an individual futures broker is assigned by the management. Any breach in the limit is not left to be detected and reported by the broker himself, but also at the point of the position-keepers, limit monitors and risk management officers who would typically have controls at their end to ensure that they complete their tasks by the end of the day or before the beginning of the following trading day. This means that the breach should not continue undetected beyond a day and the situation should not have the opportunity to worsen past that day.

iii. *addressing missing controls or weak ones*

There should be procedures for improving or modifying the control system where weaknesses or gaps in the controls are discovered. The process of initiating and implementing the improvements should be prompt to reduce the organisation's exposure to the weakness or gap. The organisation should also be able to assess and quantify the risk to which it is exposed as a result of the weakness or gap.

The derivatives industry is a dynamic, rapidly evolving industry and as such, the Compliance Officer must continually review the adequacy of the organisation's internal control system, which includes the risk management system, in light of changes in internal and external conditions. In this respect, the Compliance Officer must review the assessment of the Internal Audit Department on the adequacy of the organisation's internal controls.

~~**Annex III** details some of the common internal control weaknesses noted in futures broker organisations, and the Compliance Officer is advised to focus on these areas when carrying out his/her compliance duties.~~ **Annex IV** lists some functional control standards of key broking activities that will serve as a guide for reviewing the organisation's overall internal control system.

c) to review, monitor and supervise other supervisory measures to ensure compliance

One of the ways to ensure compliance by all levels of staff is to have effective reviewing and monitoring. It is the responsibility of the supervisors/Department Heads to ensure compliance by their staff members. In this respect, it is the duty of the Compliance Officer to review the adequacy of the supervisory measures undertaken by the supervisors/

Department Heads. Compliance review and monitoring should cover front office, back office and accounting activities. Reviewing, monitoring and supervision include:

i. review of control procedures to ensure derivatives activities are conducted according to existing policies and guidelines laid down by the Board and management

ii. review of procedures carried out in opening and approving the opening of client accounts and ensure compliance with ~~Business rules of the Exchanges~~Rules of Bursa Derivatives and relevant statutory requirements

iii. review of operations to ensure that trading rules such as timely allocation of trades and transaction confirmations

iv. review execution of trades to ensure compliance with the Exchange~~s~~'s order taking rules

v. review of clients' deposits and withdrawals to ensure compliance with laws and business rules

vi. review of accounting entries processing and general ledger account validation

vii. review of general ledger account opening process. A control process must exist to prevent creating dummy or suspense ledger accounts which may be used to park unauthorised or loss making trades

viii. review of reconciliation activities of the back office

ix. ensuring proper segregation of clients' funds

x. review correspondence between futures broker representatives and clients pertaining to solicitation or execution of contracts from time to time

xi. review of Adjusted Net Capital level and any other internal or external minimum capital standard and ensure the organisation is able to meet minimum financial requirements at all times

xii. review of error trades

~~xiii. review of funds transfer from/to designated external accounts and ensure that they are in accordance with the requirements set out in MDCH Business Rules and circulars and the Exchange Control Notices issued by Bank Negara Malaysia~~

~~xiv.~~xiii. review proprietary account to ensure compliance with credit/position limits imposed and that over-limits are reported to management

~~xv.~~xiv. review discretionary accounts to ensure compliance with Exchange~~s~~'s business rules and that transaction are not in excess of clients' financial resources

~~xvi.~~xv. review of all proprietary account and discretionary accounts transactions, and ensure there is no conflict of interests during the execution of client trades and house trades

~~xvii.~~xvi. review clients' position limits to ensure compliance with Exchange imposed position limits and reportable position limit

~~xviii.~~xvii. review margin calls issued to clients to ensure collection of margins are within the stipulated time frame

~~xix.~~xviii. review of employee transactions to ensure that such transactions are authorised, executed and recorded in compliance with proper procedures

~~xx.~~xix. review of client's complaints, i.e. analyse trends in complaints, the general causes and the average length of time taken to respond to and resolve clients' complaints. The Compliance Officer should review the handling of complaints by a designated officer to ensure that the handing of complaints, including any subsequent investigation and action taken, are in compliance with proper procedures.

~~xxi.~~xx. review of all advertisements, sales literature and any other types of information pertaining to recommendations/business disseminated to the client/public to ensure accuracy and compliance with relevant laws, rules and regulations, ~~and that all these documents have been approved by the Exchanges~~ before being published and made accessible to the public

~~xxii.~~xxi. follow up on audit findings. The Compliance Officer should ensure that audit finds raised by internal, external and regulatory auditors are addressed and rectified promptly

The frequency of reviewing and monitoring should be determined by assessing the level of risk involved, and the frequency and nature changes occurring in the operating environment. The reviewing and monitoring programme may be carried out daily, weekly or monthly, or as issues-based reviews of particular risk issues identified from past reviewing and monitoring or issues raised by the auditors during periodic audits. Ongoing reviewing and monitoring activities can offer the advantage of quickly detecting and correcting deficiencies in the system. Examples of such ongoing activities include the review and monitoring programme effectively, the Compliance Officer should have some measures such as a checklist to confirm that the reviewing and monitoring process have been performed and to record any deficiencies found. The checklist could also be used as a reference when having discussions with staff and management. A sample of reviewing and monitoring checklist is shown in **Annex IV**.

When performing the reviewing and monitoring process, the Compliance Officer should focus on areas of risk. The Compliance Officer should assess the risk in financial terms if activities are not controlled properly or a critical control step is missing, examples:

i. risk of loss resulting from weaknesses in credit control and/or portfolio concentration-counterparty default on transactions in the process of being settled and where value had been delivered to the counterparty but not yet received in return

ii. risk of loss resulting from weaknesses in control of liquidity- failure to meet its payment obligations on settlement dates or in the event of margin calls

iii. risk of loss resulting from weaknesses in internal control- inaccurate financial information reported as a result of incorrect data used to value financial positions

iv. risk of loss resulting from weaknesses in legal control- contracts or collateral not legally enforceable and exercisable

In this regard, the Compliance Officer should also:

i. review the effectiveness of internal controls relevant to measuring, reporting and limiting risks

ii. review the credit approval process to ensure that the risks of specific products are adequately captured and the credit approval procedures are followed. As a matter of general policy, business with a counterparty should not commence until a credit line has been approved

iii. review risk exposure and concentration of risk, ensure that trading activities are within the limits approved by the Board and adequate capital is maintained to support derivative activities

iv. review to ensure that margin policy complies with the Exchange's rules on margin trading

v. review the legal documentation process and ensure guidelines and procedures are followed and consider the quality, marketability and enforceability of collateral pledged

The reviewing and monitoring process would only be effective if the Compliance Officer holds regular meetings with management and staff involved to review past findings. This is because regular meetings are helpful to review how procedures are working, to consider the weaknesses and any recommendations for change. This will help to establish an effective compliance culture.

Annex V describes in general some of the risks involved and risk management of exchange-traded derivatives. It serves as a reference for the Compliance Officer to enhance his/her compliance reviewing and monitoring process

d) to assist in training and educating staff members on compliance matters

All new recruits and existing staff members must be adequately trained and equipped with the necessary capabilities to carry out the responsibilities assigned to them. Training is critical to the successful implementation of a compliance culture. The Compliance Officer must assist in training and educating staff members on compliance related aspects of their jobs and should ensure that they are kept up-to-date with changes in regulatory requirements. Training can comprise both formal and on the job training. Some examples of on the job training that can be conducted by the Compliance Officer are:

i. informing staff of weakness found during the compliance review and monitoring process

ii. explaining regulatory requirements and the consequences if such requirements are not met

iii. disseminate information that the regulators have communicated through circulars, e.g. changes in regulatory requirements or disciplinary action taken by the regulators

e) to report to the Board of Directors

A timely information reporting system will foster an environment of compliant practices. It is duty of the Compliance Officer to inform and report to the Board on all matters pertaining to compliance at least once a month. However, the Compliance Officer should immediately report to the Board and the relevant Exchange(s) if a matter requires urgent attention, e.g. breaches of the laws, and matters pertaining to segregation of clients' assets and risk position of the broker.

The compliance report should report at the minimum, the following issues:

i. *credit exposure*
The Board should be informed of any breach in limits that has occurred and follow-up actions taken, any overdue payments and follow-up on non-payments

ii. *funding*
The Board should be apprised of the level of the organisation's Adjusted Net Capital and the impact of business activities on the organisation's overall liquidity position

iii. *collateral received*
The Board should be informed of the type and financial exposure of collateral pledged by clients and measures taken by the organisation to satisfy itself that the documentation has been appropriately reviewed

iv. *error trades*
The Board should be informed in detail on how the error trades occurred and the amount of profit/loss absorbed by the organisation

v. *segregation of clients' assets*
The Board should be informed of any deficiency in clients' segregated assets

vi. *audit findings by the internal, external and regulatory audits*
The Board should be informed of the audit finds raised by the internal. External and regulatory audits and the actions taken by management to address the issues highlighted

vii. *other compliance issues and amendments to laws, rules and regulations*
The Compliance Officer is responsible for ensuring that new compliance issues are properly addressed and reported to the Board, and compliance risks are brought to the Board's attention. The Compliance Officer must also report to the Board of Directors matters that had been brought to the attention of the Executive Director or other senior management personnel and the actions taken.

viii. *Other matters*
The Board should also be informed of situations of potential conflicts of interests.

f) to liaise with the regulatory bodies on compliance matters

Managing the organisation's relationship with the regulator is very important. The Compliance Officer is the most suitable personnel in the organisation to play the role of liaison officer between the futures broker and the regulators due to the independence of his/her functions. Report must be cultivated to facilitate information sharing, clarification of rules and regulations and requests for advice. Consequently the Compliance Officer should:

i. ensure monthly financial statements are submitted to the regulators within the stipulated time

ii. inform the regulators immediately of any non-compliance and the actions or remedy to be taken by the organisation

iii. inform the regulators of any constitutional changes in relation to the organisation's operations and any changes affecting the dealer's licence or licences issued to its dealer's representatives

iv. inform the regulators immediately of any circumstances affecting the organisation's solvency or any condition that would materially impair its ability to meet any of its obligations

v. be able to produce documents and information as and when requested by regulators and is answerable to any queries that the regulators may have in relation to his/her compliance duties and responsibilities

The Compliance Officer is encouraged to maintain routine contact with the regulators to discuss contentious issues and seek advice and suggestions to problems encountered. However, the regulators are not obliged to provide **solutions**, as this is the responsibility of the broker.

Finally, the Compliance Officer should understand the reason inspection visits by regulators are conducted and be aware of the frequency of such visits. The purpose of audit inspections conducted by regulators are as follows:

~~*i. Exchanges:*~~

That the futures brokers and clearing participants :

i. comply with the relevant laws, rules, regulations, directives, guidelines, policies and procedures

ii. maintain adequate internal controls in all areas

iii. protect clients' assets by maintaining proper segregation

iv. maintain proper records that support and explain its activities, e.g. trading, settlement records, etc.

~~*ii. MDCH*~~
~~That the clearing members:~~

v. maintain a proper and up-to-date Operations Manual

vi. have experienced management, qualified staff and an adequate back office system to carry out the business of dealing in derivatives

vii. safeguard the Company's and its clients' assets against unauthorised use or disposal by having proper controls in place

viii. maintain proper accounting records i.e. all transactions reported in the monthly financial reports are fairly stated, supported by relevant documents, and classified and disclosed in accordance with the Rules of Bursa Derivatives ~~of MDCH~~ and

ix. maintain adequate capital and financial resources to support its trading activities

Regulators assess internal controls and risk management as the focus is on detective and preventive measures. A reactive approach is not deemed appropriate in this industry due to the high risks involved due to the inherent leverage. Hence, during the inspection visit, the regulators expect, at the minimum the following, in order to conduct the audit in an efficient and effective manner:

i. availability of front office, back office and accounting records

ii. all records have been maintained properly, in compliance with rules and regulations and can be substantiated

iii. trading activities conducted comply with the rules and regulations

iv. accurate and full information to be given to all inquiries

v. co-operation from all levels of staff

The Compliance Officer therefore should build positive long-term relationships with the regulators and is encouraged to exchange ideas on good compliance principles and activities to further develop a positive compliance culture across the industry.

ANNEX II - ~~COMMON AREAS OF NON-COMPLIANCE~~

~~The following are some common areas of non-compliance with the Futures Industry Act 1993 and the Futures Industry Regulations 1995, MDCH, KLOFFE, COMMEX Business Rules and Circulars which the Compliance Officer should focus and give due consideration/~~

~~A. Futures Industry Act 1993(FIA) and Futures Industry Regulations 1995 (FIR):~~

1. ~~Floor representatives not licenses as FBR were receiving orders from clients.~~
   ~~*Refer section 18(1)(b)*~~

2. ~~Contract notes not sent promptly to the client~~
   ~~*Refer section 49(1) and FIR 13(1)*~~

3. ~~The clients' segregated bank account not designated as 'Clients' segregated' and the clients deposits are not banked into a clients' segregated account within **T+1.**~~
   ~~*Refer section 52A(1)*~~

4. ~~No written instruction from clients requesting for withdrawals.~~
   ~~*Refer section 52A(3)(a)*~~

5. ~~Clients' monies are invested other than in licensed banks~~
   ~~*Refer section 52A(3)(d) and 52A(5)(a)*~~

6. ~~No records kept as regard clients' deposits and withdrawals~~
   ~~*Refer section 52A(8)(b)*~~

7. ~~Clients not furnished with relevant documents~~
   ~~*Refer section 53 and FIR 15*~~

8. ~~Order tickets not containing the minimum information such as client name, client code, contract details, and no indication of the name of the FBR by whom clients' orders were received and by whom it was carried out. Furthermore, there is not time stamp on the order tickets.~~
   ~~*Refer section 54(8) and FIR12(2)*~~

~~B. MDCH Business Rules~~

1. ~~Failure to maintain Adjusted Net Capital at the higher of:~~
   i. ~~RM500,000; or~~
   ii. ~~10% or such other percentage as may from time to time be determined by MDCH~~ Clearing House ~~of the total amount paid by Member of MDCH~~ the Clearing House ~~and any third party including any other clearing house organisation in respect of margins~~
   ~~*Refer rule 208(a)*~~

2. ~~Failure to notify MDCH immediately when:~~
   i. ~~Its Adjusted Net Capital is reduced below the minimum level prescribed under the Rules 208(a); and/or~~
   ii. ~~the Member fails to meet any other financial requirements, which may from time to time be stipulated by MDCH~~
   ~~*Refer rule 500*~~

~~3. Failure to furnish a copy of Audited Accounts to MDCH within three months at the end of the Financial Year or within such longer period as may be permitted in writing by the CEO of MDCH~~
~~*Refer rule 502*~~

~~4. Failure to pay margin call on time to MDCH~~
~~*Refer rule 614(a) and 615*~~

~~5. Failure to submit monthly financial reports in accordance with the Financial Reporting Guide~~
~~*Refer Financial Reporting Guide*~~

~~The above are also applicable to KLOFFE and COMMEX business rules, with the exception of item 4.~~

~~C. KLOFFE and COMMEX Business Rules and Floor Procedures and Circulars~~

~~1. Opening of accounts:~~

~~i. Clients' information relating to investment objectives and financial situations not obtained. In addition, documents required for account opening such as salary slips and/or Form J were not obtained from the clients.~~
~~*refer KLOFFE Business Rules 603.1(a)(i)) & COMMEX Business Rules 308(a)*~~

~~ii. No evidence of approval of clients' accounts for trading either by the Compliance Officer, the ED or the Credit Committee. In the case of accounts approved by the Credit Committee or the ED, the approvals have not been made subject to review by the Compliance Officer.~~
~~*refer KLOFFE Business Rules 603.1(a(i)) & COMMEX Business Rules 308(b)*~~

~~iii. Background and financial information of clients not sent to the clients within 15 days from the date of approval for verification.~~
~~*refer KLOFFE Business Rules 603.1(a)(ii) & COMMEX Business Rules 308(g)*~~

~~iv. Failure to furnish the client with the documents as required by FIA such as the Risk Disclosure Statement~~
~~*refer to KLOFFE Business Rules 603.1(a)(iv)(A) & COMMEX Business Rules 308(c)*~~

~~v. Client's written acknowledgement that he/she has received the relevant document not obtained.~~
~~*refer KLOFFE Business Rules 603.1(a)(iv)(B)*~~

~~2. Order taking:~~

~~i. No order ticket raised for orders keyed into the trading system.~~
~~*refer KLOFFE Business Rules 603.3(a)*~~

~~ii. No time stamp on order tickets or orders executed before time stamping of order tickets.~~
~~*refer KLOFFE Business Rules 603.3(a) & COMMEX Floor Procedures 502(c)*~~

~~iii. Delays in execution of clients' orders~~
~~*refer KLOFFE Business Rules 603.3(a)*~~

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iv. ~~Order tickets did not contain the minimum information such as client name, client code and contact details.~~
~~*refer KLOFFE Business Rules 603.2(b)*~~

3. ~~Contract notes not sent to the clients by the next business day.~~
~~*refer KLOFFE Business Rules 603.4(a)*~~

4. ~~As regards to promotional materials, insufficient records maintained for the names of persons responsible for preparing, reviewing and approving the materials. In addition, no indication of the materials being approved by the Compliance Officer.~~
~~*refer KLOFFE Business Rules 603.5(c) & COMMEX Business Rules 304(b)*~~

5. ~~No supervision of employee trading by the Compliance Officer. In addition, employees have opened trading accounts without obtaining prior written consent from the BOD and there was no notification to the Exchanges.~~
~~*refer KLOFFE Business Rules 601.2(b)*~~

6. ~~Compliance Officer reporting to ED and not to the BOD~~
~~*refer KLOFFE Business Rules 610.1 & COMMEX Business Rules 303(c)*~~

7. ~~Non-permissible collateral accepted as a form of margin payment~~
~~*refer KLOFFE Business Rules 614.2, Guideline 2.7 to the KLOFFE Business Rules and Trading Member Circular 23/98*~~

8. ~~A proper client complaint log is not maintained~~
~~*refer KLOFFE Business Rules 615 & COMMEX Business Rules 314(b) & (c)*~~

9. ~~Payments for margin calls issued to clients received after the 48 hours time frame~~
~~*refer KLOFFE Trading Member Circular 3/96*~~

10. ~~Commission rate charged lower than the rate determined by the Exchange~~
~~*refer KLOFFE Trading Member Circular 6/97 & 21/96*~~

11. ~~Margin imposed on clients below the MDCH margin requirements. Beside this, clients have been allowed to trade despite outstanding margin call or net debit balance. In addition, margin calls have been made without taking into consideration the initial margin and variation margin.~~
~~*refer COMMEX Business Rules 311*~~

ANNEX III ~~COMMON INTERNAL CONTROL WEAKNESSES~~

~~The following are common internal control weaknesses found in futures broker members. These are also critical areas of internal controls, which the Compliance Officer needs to pay attention to.~~

~~*1. Segregation of duties*~~

~~Lack of segregation of duties between front office, back office and accounting departments.~~

~~*2. Independent review*~~

~~i. lack of proper checking of data input and output from the back office system before and after the processing leaving errors undetected. Subsequently adjustments had to be made to rectify errors~~

~~ii. no proper independent checked performed on the interest paid to clients~~

~~iii. wrong account or amounts posted in the general ledger~~

~~iv. no indication of review on the reconciliation performed and no follow up actions taken.~~

~~*3. Transaction processing controls*~~

~~i. weaknesses in the system of processing accounting vouchers:~~
- ~~accounting vouchers not available or missing~~
- ~~no supporting documents attached to accounting vouchers~~
- ~~invoices received not stamped “DATE RECEIVED”~~
- ~~supporting documents where payments have been made not stamped “PAID”~~
- ~~no initials to indicate who prepared, checked and approved the accounting vouchers~~
- ~~accounting vouchers outdated~~
- ~~particular of transactions such as cheque number, nature of accounting entries not properly filled in the accounting vouchers prepared~~
- ~~accounting vouchers not serially numbered~~
- ~~the person who makes the claim is also the person who approves the claim (e.g. the ED)~~

~~ii. weaknesses in the system of processing clients’ deposits:~~
- ~~no official receipt (OR) issued/missing ORs~~
- ~~inconsistency in the issuance of ORs/ORs not issued upon the receipt of the clients’ deposits~~
- ~~ORs undated~~
- ~~clients’ deposits updated into the back office system late~~
- ~~ORs not issued in chronological order~~

~~iii. Weaknesses in the system of processing clients’ withdrawals:~~
- ~~withdrawal request forms not stamped “DATE RECEIVED” or undated~~
- ~~no indication of proper verification of clients’ signatures, clients’ excess cash and other details before payments are approved~~
- ~~payment vouchers (PVs) not available/missing~~
- ~~clients’ withdrawals updated into the back office system late~~

~~iv. prepayments and accruals:~~

- ~~no proper prepayment schedule maintained~~
- ~~amortisation charge wrongly computed~~
- ~~accrual basis accounting not followed consistently~~
- ~~lack of proper monitoring of accruals (e.g. expenses accrued not reversed out subsequently when payment is made)~~

~~v. fixed assets:~~

- ~~no proper fixed asset register maintained~~
- ~~no capitalisation policy established~~

~~vi. poor collateral management:~~

- ~~expired bank guarantees not removed from the back office system~~
- ~~no proper register maintained to record collateral received~~
- ~~no authorisation letter (letter of consent) from clients for disposal of shares in the event of overloss or amount owing to member~~
- ~~no reconciliation performed between CDS records and the member's records for acceptance of scripless shares as collateral~~

~~vii. error trade report~~

- ~~no reference number~~
- ~~no indication of approval~~
- ~~error trade forms were not properly completed/lack of details~~
- ~~error trades not reported to the management on a timely basis~~
- ~~insufficient and incomplete narration~~
- ~~no written indication of the report being reviewed by the relevant personnel~~

ANNEX IV FUNCTIONAL CONTROL STANDARDS FOR FUTURES BROKING ACTIVITIES

The need for an effective system of internal control is more relevant and important to a business today. Technology and the growth of globalised institutions have not only speeded up execution and trading processes worldwide and the transmission of information across borders, but they have arguably also introduced a new dimension of systemic risk of a magnitude that regulators, analysts and economics are still grappling to quantify. A good set of systems and internal controls may not eliminate external systemic risk but they will help a firm to detect and quantify the risk faster, giving the firm added valuable time to plan and respond to risk. Apart from systemic risk, good internal controls will help to substantially minimise a firm's operations risk.

Great attention has been placed on the need for effective control in establishing the rules and other arrangements for the operation of the derivatives market itself. This section has set down the basic functional control standards that should be established across derivatives activities:

Managerial oversight and understanding

It is the responsibility of the Board of Directors to establish policies and procedures, and maintain a sound system of internal controls, which covers not only financial controls but operational and compliance controls, and risk management. It is the responsibility of senior management to effectively implement all policies and procedures set by the Board. However, the ultimate responsibility or control effectiveness in the organisation shall rest with the board of directors. Control is exercised through the issuance of internal control policy and procedures and regular performance monitoring by senior management.

It is fundamentally important that senior management fully understand and are familiar with all types of risk involved in derivatives activities. They must be aware of and understand the nature of profitable activity and whether profit expectations are commensurate with the risk level of the activity.

Segregation of duties

There must be a high degree of segregation of duties between front office, back office and accounting:

Front office

The following functions are not part of the day-to-day activities of dealers:

- confirmation of contract notes and monthly statements
- monitoring and prescribing of trading, position and credit limits, except for ensuring that clients operate within the limits imposed by the Credit Control Department/company
- authorization of increase in limits or breaches of controls
- opening of general ledger accounts. This control is intended to prevent dealers from setting up dummy or suspense accounts for storing unauthorised trades. The dealer's request to open an account and the justification for doing so is checked by another employee.
- accounting entries
- transfer of funds
- reconciliations relating to the organisation's trading position and financial statements

In addition to the day-to-day supervision of the dealer's trading practices by a senior personnel who is familiar with trading practices, there must also be a review by the Compliance Officer. The function of the supervisor is to monitor the following activities (where applicable) on a real-time basis:

- open positions of each dealer

- position limits and their status
- compliance with time requirements for placing trade orders and entering trades into the system
- sequence of placements of orders and trade entries
- trading practices
- ~~production of trading slips according to deal ticket documentation standards~~
- degree of error in placing or inputting trades ~~and production of trading slips~~
- application of internal and external business ethics and standards
- compliance with trading room policy
- intra-day market activities particularly market movements and their effect on the financial positions of the trades

~~There should be common standards for recording trade information, so that proper documentary records can be maintained and the records are in the form required for data processing. The procedures or controls to enforce these common standards at the front office are as follows:~~

- ~~the order tickets to be used by the dealers must be pre-numbered sequentially so that missing or unused tickets or missing records can be tracked easily~~
- ~~there must be an order ticket accompanying each transaction~~
- ~~the complete details of the transaction, as dictated by processing needs, should be recorded~~
- ~~the full name of the counterparty should be recorded~~
- ~~all order tickets must be signed and authorised by the dealer and /or the supervising officer~~
- ~~all trades must be recorded or booked on the date the trade is entered into. This prevents the "risk picture", i.e. positions, market movements cash and credit, from being distorted and the accounting records misstated~~
- ~~where trades are entered into manually, all order tickets must be time-stamped~~
- ~~all order tickets must be passed to the back office promptly and regularly~~
- ~~each dealer must maintain a record of all his trades in a notebook or jotter in physical or electronic form. The trades should be recorded in chronological order and the dealer must sign the notebook at the end of each trading day.~~
- ~~all spoilt or cancelled order tickets must be kept and their status verified and authorised by a senior officer. The order tickets should then be returned to the back office to enable them to maintain the records and the sequence of the pre-numbered order tickets.~~
- ~~all missing order tickets should be followed-up and investigated according to prescribed procedures~~
- ~~order tickets which are incomplete or contain errors should be recorded and compiled. The cause of the deficiency must be reviewed regularly and its solution should be implemented promptly. Where the deficiency arises from the dealer's practices, the matter should be resolved by the chief dealer~~
- ~~all dealers must comply with the standard procedures for reconfirmation of cancelled or amended trades with the client.~~

Dealing Room Security:

- access to the dealing room should be restricted to only properly authorized personnel
- entry to the dealing room should be restricted to, for example, card key access
- visitors to the dealing floor should be properly supervised

Client complaints should be monitored by the front office in conjunction with the back office customer service unit. Where client complaints indicate a systemic weakness in the underlying process, steps should be taken to resolve the matter internally and to communicate with the customer to reassure them that action is being taken.

Back Office

The back office must have a comprehensive policy and procedures manual. The policy and procedures manual must be up to date in all respects. Back office procedures must ensure the completeness and accuracy of:

- trade transactions posted to the back office system
- funds transfer processing
- trade adjustments, reversals and corrections
- other revenue posting (such as fees)

To ensure all trade positions are identified and reconciled:

- positions reconciliation must be completed independently from the dealing room and must be completed before the start of the next trading day
- all positions must be reconciled
- all reconciling items must be investigated promptly
- unreconciling items must be brought to the attention of the chief dealer
- a copy of the position reconciliation must be retained as evidence of work done

To ensure accuracy of back office records:

- a contract note should be sent to the customer for every trade
- a daily system audit trail must be produced which lists in detail all changes made to previously input data (regardless of the data field concerned)
- back office transactions must be completed in all respects and on a timely basis
- supervisory controls over funds transfer should be adequate to prevent unauthorized payments being made
- control procedures must be established and maintained over instructions received via phone, telex and fax.
- whenever possible, payment should be based on standing customer’s instruction
- any settlement instruction not in accordance with standing customer’s instruction should be authenticated and approved before payment is made, e.g. call customer for confirmation
- all phone calls to customers must be logged and where possible taped for security reasons
- procedures must establish for verification of customers’ payment instructions
- customer instructions must be checked against authorized signature lists
- procedures must exist to highlight and report any instruction which require payment to a non-standard or unusual account or address. Further approval and authentication should be required before any payment is made
- there should be proper controls over segregation of duties and review and authorisation for payment. The person initiating payment instructions should not for example be able to authorise payment or in charge of accounting entry
- the withdrawal amount should be checked prior to payment
- payment instructions must be stamped “PAID” after payment is made and be filed securely to prevent resubmission for duplicate payment
- controls should establish to ensure collection of margin or follow up action have been taken in the event margin was not paid on time
- all documents should be properly filed

Any errors in processing must be investigated and corrected without delay. An audit trail of processing errors should be maintained to help trace causes, trends and to monitor level of errors. Recurring error and other deficiencies must be brought to management's attention. A corrective action plan should be formulated and implemented as soon as practicable to correct the cause of systemic processing errors.

To ensure that appropriate collateral is received, monitored, safeguarded against loss and only released under the correct authority, the following controls over the receipt, recording and maintenance of collateral should be practised:

- policy and procedures on acceptance of collateral should be established before collateral is received
- the circumstances whereby collateral can be used to satisfy an outstanding customer obligation must be clearly stated and this will include an event of default, liquidation or bankruptcy of the counterparty
- a legal opinion should be obtained which expressly comments on the adequacy of the security arrangements that are contained in the underlying documentation such that the security is well founded and that off-set can be utilised according to contractual terms
- collateral once received, should be verified and details of the collateral should be loaded on the back office system
- recording of collateral must be in accordance with the FIA and must include the following:
  a) client name
  b) type of collateral received
  c) amount (in face value terms)
  d) quantity (number of bonds or shares)
  e) date of receipt
  f) date updated to back office system
  g) place of safekeeping
- collateral physically received into safekeeping must be placed in a secure place (e.g. fire proof vault)
- person who has no authority over the recording process must make receipt into custody of a vault
- collateral must be independently reconciled to third party records if relevant
- movement in the value of the collateral should be updated on the back office system. Shortfalls should be highlighted. Procedures must be established to ensure that operations identify shortfalls and make the necessary margin calls
- collateral should only be released in accordance with contract terms and on instructions from the customer and upon verification that customer obligations have been satisfied
- all release instructions must be checked against customer authorisation lists
- a final independent review must take place before collateral are released to ensure that:
  a) all authentication procedures have been performed
  b) sufficient documentation evidence

Accounting

Care should be taken to ensure that an appropriate level of segregation of duties exists in respect of the accounting function and that all entries are authorised before data is input to the general ledger. Independent check is a crucial management tool in ensuring accuracy and integrity of accounting information and records.

To ensure that accounting information are complete, accurate and process on a timely basis, the following accounting controls should be practices:

Reconciliation

- any accounting related reconciliation must be performed independently, evidence in writing, verified by independent officer and filed
- all reconciling items must be followed up and resolved promptly
- unknown difference should be investigated
- any write off of a difference must be approved at the appropriate level of management
- problems items in dispute, long dated outstanding items must be highlighted to management
- a build-up of reconciling items or unusually high levels must be brought to management's attention for remedial action

Inter-company balances

- inter-company receivable and payable balances must be reconciled periodically
- balances should be confirmed between parties through the exchange of a periodic statement of the balance
- reconciliation differences must be investigated and promptly resolved
- the reconciliation process must be documented and verified by an independent officer

Documentation and recording of transactions

There should be a system of well-designed accounting forms and documents to record all activities. The accounting vouchers should capture consistently and completely all the accounting entries with their corresponding account code, nature of the entries, date of the entry, persons who prepared, checked/authorised and posted the entries into the general ledger system. In addition, any supporting documents, e.g. invoices, debit/credit notes and any schedules/computation which support the amount posted into the general ledger should be attached together. All accounting vouchers should be serially numbered or pre-numbered so that it can be used as a reference for the related entries in the general ledger as well as a control to ensure transactions are not omitted from the general ledger. The implementation of a proper accounting voucher system would ensure existence of an audit trail and provide accountability to the accounting data captured in the system.

Cash

- all cash which should have been received was in fact received and recorded promptly and accurately
- cash receipts are deposited on a timely basis
- cash disbursements are properly recorded
- all disbursements are made by way of issuance of cheque or telegraphic transfer
- bank reconciliation be performed by staff not responsible for issuance of cheques or custody of cash
- cash balances are maintained at adequate levels
- do not permit any one employee to handle a transaction in its entirety

Fixed assets

A proper fixed asset register should be maintained as this will assist in monitoring each of the fixed assets owned (for example fully depreciated fixed assets). Any additions or disposals of fixed assets should be updated into the fixed asset register promptly and accurately. A system of authorisation requiring senior management approval of all acquisitions and disposal of fixed assets should be established. Depreciation charge per month should be computed based on the depreciation policy adopted, charged into the Profit and Loss Account and updated into the register. A proper capitalisation policy is encouraged in order to avoid assets of insignificant amount being included as fixed assets.

Prepayments and accruals

A prepayment and accruals schedule should be maintained as this could assist in monitoring of prepayments and accruals amounts

Others

- the potential impact on profit and loss resulting from any problem item should be identified and where necessary a reserve taken for potential expected loss
- adjusting entries must be passed to clear resolved items
- the creation and use of suspense, error or sundry accounts should be avoided

Safekeeping of important documents

For security purposes, all important documents and back up diskettes should be kept in fire proof safe or at a secure location.

Internal control over electronic data processing (EDP)

In a manual accounting system, an important element of internal control consists of division of duties among several persons in such a manner that the work of one employee is to verify that of another, to avoid one person handling a transaction in its entirety. If an electronic data processing system is installed, machines may do work formerly done by several employees. Despite the integration of several functions in an EDP system, the importance of internal control is not in the least diminished.

a) Control over input

Input controls are designed to provide assurance that data received for processing represent properly authorised transactions and are accurate and complete when read in the computer. Control over input begins with proper authorisation and initiation of the transactions to be processed. When transaction data are originally recorded on 'hard copy' source documents, the appropriate person initiating the document should indicate authorisation. In online systems transaction data may be entered directly into the computer from remote terminal device located in the departments initiating the transactions. In these cases, access to the terminals must be limited to those persons authorised to initiate transactions.

If transactions documents are collected into batches for processing in sequence as on batch, input controls are necessary in batch processing to determine that no data is lost or added to the batch. The sequence of serial numbers of source documents comprising each batch should be accounted for.

b) Control over processing

Processing controls are designed to assure the reliability and accuracy of data processing. A major method of achieving control over processing is the use of program controls, which are written into the computer programs such as item count, control total, validity, self-checking number etc.

c) Control over input

Output controls are designed to assure the reliability of computer output and to determine that output is distributed only to authorised personnel. Control over output begins with independent verification and follow up on exceptions and errors reported.

ANNEX V COMPLIANCE CHECKLIST (SAMPLE)

(This checklist is intended to provide guidance and is not exhaustive).
COMPLIANCE CHECKLIST as at __________ (date)

DAILY FUNCTIONS:	PERFORMED YES/NO	REMARKS
Beginning of day:		
a) Check with Back Office Department whether any margin call from ~~MDCH~~ Bursa Clearing (D) and appropriate action has been taken		
b) Check back office report to ensure follow up actions have been done on clients having margin call or breach position limits and ensure no breach of ~~Exchanges Business~~ Rules of Bursa Derivatives		
c) Check to ensure daily bank reconciliation, back office reconciliation and other reconciliations have been performed		
d) ~~Check whether the time on the "Time Stamping Machine" is same as the Exchanges trading time~~		
e) Check to ensure contract notes are printed and issued to clients as prescribed by the ~~Exchanges Business~~ Rules of Bursa Derivatives and ~~FIA~~CMSA		
f) ~~Check on the movement of funds from/to the designated external account~~		
g)		
h)		
Mid of day:		
a) Check and review all transactions executed		
b) Check and review clients opening position to ensure the positions do not exceed the limit determined by the Board		
~~c) Check to ensure reportable positions is reported to the Exchange~~		
d)		
e)		
End of day:		
a) Check whether all cash transactions related to clients accounts were updated into the back office system on a timely basis and all client deposits are banked into segregated bank by T+1		
b) Check whether all transactions relating to give up trades		

and position transfer were updated in the back office system on a timely basis		
c) Review error reports, if any and ensure error trades are closed out immediately, review all trade amendments		
d) Review the ANC to ensure its compliance with the minimum financial requirement		
e) ~~Review Dealer's trade blotter, trade chits and printed trade confirmations for time stamped, signed and initialled by dealers, trade blotter and chits matches. Review of other records.~~		
f)		
g)		

WEEKLY FUNCTIONS	PERFORMED YES/NO	REMARKS
a) Check accounting vouchers to ensure all vouchers are prepared during the week are properly prepared, checked and approved.		
b)		
c)		
MONTHLY FUNCTIONS:		
a) Check to ensure Back Office Department print and send the monthly statements to clients an ensure compliance with the ~~Business~~ Rules of ~~the Exchanges~~Bursa Derivatives and ~~FIA~~CMSA		
b) Check the monthly financial reports to ensure accuracy before submit to the relevant authorities		
c) Preparation of Compliance report		
d)		
e)		

AD HOC FUNCTIONS	PERFORMED YES/NO	REMARKS
a) Check to ensure annual subscription and fidelity fund contributions are paid on time to ~~the Exchanges~~Bursa Derivatives		
b) Check to ensure annual report is submitted to the ~~Exchanges and MDCH~~Bursa Derivatives within stipulated time		
c) Opening of new accounts: i. Check to ensure initial deposit received/cleared before commencement of trading (or as company's policy) ii. Check to ensure supporting documents required are available, approved by ED iii. Check to ensure that the client's background and financial information verification is carried out		
d) Advertisement i. Check to ensure that the material issued been reviewed and approved in advance (by CO ~~and Exchanges~~) ii. Check to ensure copies of all advertisements, sales literature and educational materials, the names of person approved the materials and the source of recommendation have been retained iii. ~~Check to ensure approval has been given by the Exchanges~~		
e) Check to ensure that the Operation Manual has been updated to reflect the current procedures practised by the staff		
f) Check to ensure audit findings raised in the audit reports have been followed-up and practised		
g) Check to ensure broker and FBR licenses have been renewed		
h) Disseminate information throughout the organisation upon receipt of circulars from Bursa Derivatives and other regulatory bodies		
i) Review internal controls when necessary e.g. reorganisation changes in size of the operations		
j) Review closing of accounts		
k)		

ANNEX VI TYPES OF RISK AND RISK MANAGEMENT OF EXCHANGE TRADE DERIVATIVES

The basic risk associated with exchange traded derivatives transactions are credit risk, market risk, liquidity risk, operations risk and legal risk.

Credit risk

Broadly defined, credit risk is the risk that the counterparty fails to perform an obligation to the broker. The broker should evaluate both settlement and pre-settlement credit risk at the counterparty level across the products. On settlement day, the exposure to counterparty default may equal the full value of any cash flows or securities the broker is to receive. Prior to settlement, credit risk is measured as the sum of the replacement cost of the position, plus an estimate of the broker's potential future exposure from the instrument as a result of market changes.

The first line of defence that is employed in countering the threat of counterparty default is internal controls that ensure credit risk is assessed prior to entering into transactions with a given counterparty. Assessment of credit risk posed by a potential counterparty must involve taking into consideration the capital adequacy of the party, its debt/equity ratio, its assets/liabilities ratio with particular emphasis on liquidity assets, its earning ratio and the types of assets held and liabilities incurred by that party.

Certain credit circumstances structure may be used to reduce the credit exposure dealing with counterparties. Such structure may include collateral or third party guarantees. In such cases, a broker's credit exposure should reflect these risk-reducing features only to the extent that the resource provisions are legally enforceable in all relevant jurisdictions. The broker should be able to demonstrate that it has exercised due diligence in evaluating the enforceability of these resource provisions ad provides adequate protection to the organisation.

Credit limits should be established for all counterparties with whom the broker conducts business. As a matter of policy, business with counterparty should not commence until a credit line has been approved. It is important that broker set up an independent credit risk management team responsibility for:

a) approving credit exposure measurement standards
b) setting credit limits and monitoring their use
c) reviewing credit and concentration of credit risk
d) reviewing and monitoring risk reduction arrangements.

Credit exposure should be monitored continuously and compared to the approved limits. Management should be informed of any breach that has occurred. Follow-up action on unresolved excess exposures should be updated and reported to management. For settlement risk, the settlement process should be monitored daily and overdue payments be reported to management daily. Follow-up action on non payment should be updated and reported to management.

Market risk

Market risk the risk to a broker's financial condition resulting from adverse movements in the level or volatility of market prices. The market risks created by futures contracts are exposure to changes in the price of the underlying cash instrument and changes in interest rates. There are three components to the management of market risk.

a) mark-to-market valuation

   The proper market risk management derivatives begins with their valuation. Inaccurate valuation leads to incorrect income recognition and inaccurate hedging strategies. Valuation on a mark-to-market basis will reflect the current value of cash-flows and provide information about market risk and appropriate hedging actions.

b) stress simulations

   Broker should subject their portfolio to stress simulations. The stress simulations should take into account extreme market movements. The results of the stress tests should be evaluated and contingency plans developed accordingly.

c) risk limits

   Broker should apply a consistent measure of the market risk of their derivative portfolios and compare them regularly with the predetermined market risk limits

Liquidity risk

A broker faces two types of liquidity risk in its derivatives activities:

a) Market liquidity- the risk that a broker cannot easily unwind or offset a particular position at or near the previous market price because of inadequate market depth or because of disruption in the market place.

b) Funding liquidity- the risk that the broker is unable to raise funds to meet its payment obligations on settlement date or in the event of margin calls.

Because neither type of liquidity risk is necessarily unique to derivatives activities, management should evaluate these risks in the broader context of the broker's overall liquidity. In controlling liquidity risk, a broker should:

a) be able to assess its liquidity demands over a particular period, and

b) be able to assess the amount it could raise in the markets for funding and managing its exposure

Operation risk

Operation risk is the risk of loss occurring as a result of inadequate systems and control, human error, or management failure.

The board of directors and management should ensure there is proper dedication of resources (financial and personnel) to support operations systems development and maintenance. System support and operational capacity should be adequate to accommodate the types of derivatives activities in which the broker engages in. This includes being able to:

a) capture all relevant details of transactions
b) provide for accurate and timely input
c) identify errors
d) efficiently process and settle all transactions accurately and in a timely manner
e) facilitate efficient reconciliation and
f) provide for proper risk exposure monitoring

Segregation of operational duties, exposure reporting and risk monitoring from dealing and marketing is critical to proper internal control. Proper internal control should be provided over the entry of transactions into the database, transaction numbering, date and time notation, confirmation and settlement process.

There should be a unit responsible for ensuring proper reconciliation of front and back office database on regular basis. This includes verification of position data, profit and loss figures and transaction by transaction detail.

Management should ensure that a mechanism exists whereby derivatives contract documentation is confirmed, maintained and safeguarded. There should be an approved policy that specifies documentation requirements and formal procedures for safeguarding of important documents that are consistent with legal requirements and internal policies.

Operations risk can be assessed through periodic reviews of procedures, documentation requirements, data processing systems and other operational practices. Such reviews may help to reduce the likelihood of errors and breakdowns in controls, improve the control of risk and the effectiveness of the limit system and prevent unsound marketing practices and the premature adoption of new products or lines of business.

Legal risk

Legal risk is the risk that contracts are not legally enforceable or documented correctly. Participants in the derivatives markets have experience significant losses because they were unable to recover losses from a defaulting counterparty when a court held that the counterparty had acted outside its authority in entering into such transactions. Hence prior to engaging in derivatives transactions, a broker should:

a) adequately evaluate the enforceability of its agreements. If the governing law of the agreement is specified to be located in a third country, the broker must ensure that judgment obtained can be enforced in the broker’s and counterparty’s jurisdictions

b) satisfy itself that the terms of any contract governing its derivatives activities with a counterparty are legally sound.

c) satisfy itself that its counterparties have the necessary authority to engage in the derivatives transactions.

d) ensure that its right with respect to any margin or collateral received from a counterparty is enforceable and exercisable.

In addition to the above, a broker should have approved policies that specify documentation requirements for derivatives activities and formal procedures for saving and safeguarding important documents. The broker should have knowledge of relevant tax laws and interpretations governing the use of derivatives instruments. It should also regularly review and update its legal opinion to ascertain that the legal position of its broking business has not changes with regard to the enforceability of the derivatives contract.