Turks and Caicos Islands Financial Services Commission

Guidelines for

Prudential Supervision of Investment Business

Contents

Preface

The purpose of these Guidelines is to provide guidance to investment businesses[1] on the Commission's expectations in respect to the conduct of their operations including their approach and implementation of international best practice. International best practices considers the application of the core principles established by the International Organization for Securities Commissions (IOSCO)[2] for securities regulation.

The Guidelines considered the Commission's risk based approach to the assessment of current and emerging risks to ensure the allocation of scarce resources to the sector, providers and products that pose the greatest risks to supervisory objectives.

The Turks and Caicos Islands Financial Services Commission (the Commission) is the sole regulator of investment businesses and as a member of IOSCO must ensure its supervisory objectives promulgate the IOSCO Core Principles.

The Guidelines were developed in accordance with the relevant laws of the Turks and Caicos Islands (TCI), namely:

- The Financial Services Commission Ordinance Cap 16.01 (FSCO)
- Investment Dealers (Licensing) Ordinance 2001 Cap. 16.13 (IDLO)
- Mutual Funds Ordinance as amended 2001 Cap. 16.07 (MFO)
- Proceeds of Crime Ordinance Cap. 3.15 (POCO)
- Anti Money Laundering and Prevention of Terrorist Financing Regulations 2010 (AML/PTF Regulations)
- Anti Money Laundering and Prevention of Terrorist Financing Code 2011 (AML/PTF Code)

1. Authority

1.1 These Guidelines are issued by the Turks and Caicos Islands Financial Services Commission (the Commission) pursuant to Section 43 of the FSCO.

1.2 Section 43 of the FSCO provides that "failure to follow the Guidelines may be taken into account by the Court or the Commission, as the case may be, in determining whether there has been a contravention of this Ordinance, or any Financial Services Ordinances or the Code."

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[1] Investment businesses are businesses requiring a licence pursuant to the Investment Dealers (Licensing) Ordinance and/or the Mutual Funds Ordinance.

[2] IOSCO is the international body that is recognized as the global standard setter for the securities sector. IOSCO develops, implements, and promotes adherence to internationally recognized standards for securities regulation.

2. Application

2.1 It is intended for all businesses licensed under the IDLO and the MFO.

2.2 Collectively, licensees engaged in investment dealing and mutual operation make up the investment business sector (hereafter referred to as "businesses" or "a business"). They are involved in the offer, sale, advice, management, or distribution of certain types of investment products.

2.3 The investment business sector in the TCI functions similarly to the securities sector as referenced by International Organization of Securities Commissions (IOSCO) and the Financial Action Task Force (FATF)[2].

3. Objective

3.1 The objective is to establish a framework for the prudential supervision of investment businesses, with particular emphasis on the requirement for businesses to implement and maintain effective systems to identify, measure, monitor, and control prudential risk as part of their overall risk management strategy. Section 4 (1) (a) of the FSCO vests in the Commission, responsibility for the supervision and regulation of licensees to their respective Ordinances; the intention is to advance the Commission's regulatory objectives of –

i) promoting market confidence;

ii) protecting investors; and

iii) reducing systemic risk.

3.2 The Guidelines consider certain key prudential risks, in particular: credit, market, liquidity and operational risks, any of which can reduce the adequacy of a business' financial resources and adversely affect confidence in the financial system or prejudice investors.

3.3 The Commission's regulatory objectives are consistent with the core **objectives** of **securities regulation** which are advocated by IOSCO as relevant standards in this area of business. The Commission is a signatory to IOCSO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation, and Exchange of Information (MMoU). The MMoU provides an efficient mechanism for the cooperation and exchange of information among signatories. As a member of IOSCO, the Commission is obligated to uphold sound prudential principles and practices for securities regulation. IOSCO principles are based on three basic objectives:

i) protecting investors;

[2] The objectives of the FATF are to set standards and promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system.

ii) ensuring that markets are fair, efficient, and transparent; and

iii) reducing of systemic risks.

These principles are established in 10 broad categories, and as the regulator of investment business, the Commission must adopt key requirements of the principles as they apply to the investment business sector.

3.4 The elements of the supervisory framework are: understanding of the significant activities of the business, inherent risks, quality of risk management, net risk, earnings, capital, liquidity and risk matrix and composite risk rating. The requirement for each element is expanded on below. It is envisaged that this exercise will inform legislative changes as it begins the process towards the implementation of prudential standards for the operation of investment businesses in the TCI.

4. Investment Business Sector

4.1 Legislation allows for the licensing of businesses engaged in investment dealing and the operation of mutual funds. Investment dealers and mutual funds operators are heavily reliant on external systems and markets. The risk to investment businesses is that a deficient framework of systems and controls increases vulnerability to risks, which may reduce the adequacy of a business' financial resources.

4.2 Each business' systems and controls must consider the risk of interlinkages and interdependencies, and the effects of the failure of an entity or cluster of entities on the business. As part of the supervisory process, businesses are required to: i) report any client or group of connected clients providing 10% or more of the business' fee income; ii) provide details of the number and value of related client/parties investments and the location of the investments; and iii) provide details on counterparties and intermediaries, and their relationship to the business and the value of investments held.

4.3 The systems and controls for the management of prudential risk will vary from business to business and must take into account the circumstances of the business. Implementation of risk management systems must reflect the operations of the business and should be appropriate to its size and risk profile, which include the type and complexity of the business, its structure, and nature of the business. These may be influenced by factors such as:

i) the diversity of its operations, including geographical diversity;

ii) the volume and size of its transactions; and

iii) the degree of risk associated with each area of its operation.

4.4. The guidance provided herein is not intended to be exhaustive and should be considered along with the Commission's Fit and Proper Guidelines, the Anti Money Laundering and Prevention of Terrorist Financing legislation and any other regulatory guidance, as may be issued by other sectors, such as banking and insurance, given the investment element of the products in these sectors.

5. Systems and controls in a prudential context

5.1 The investment business sector comprises participants of different business models, sizes, and complexity. These factors influence the degree of risk that each business poses to consumers and the market. The expectation is that each business must assess the adequacy of its financial resources as are appropriate to the risk of loss and the potential harm to its customers and market confidence. This requires the business to consider whether it has enough assets to cover its debts when they come due; whether it has a prudent approach to identifying and measuring its risks to ensure that appropriate systems and controls are implemented; and includes consideration for the human resources required to continually measure and monitor the risks faced by the business. Consistent application of these measures improves a business' access to capital and minimises the risk of loss of client's money and other assets for which it has custody.

5.2 The risk management function requires independent oversight of the management of risks inherent in the business' activities. Inherent risk is intrinsic to a particular activity and is assessed without regard to the size of the activity relative to the size of the business. The following are descriptions of inherent risk categories for assessment purposes:

(a) Credit Risk
Credit risk arises from a counterparty's inability or unwillingness to fully meet its contractual obligations.

(b) Market Risk
Market risk arises from changes in market rates or prices. Exposure to this risk can result from market-making, dealing, and position-taking activities in markets, such as interest rate, foreign exchange, equity, commodity and real estate markets.

(c) Liquidity Risk
Liquidity risk arises from a business' inability to convert different types of resources into available cash when needed and with minimum loss in value, particularly under stressed conditions.

(d) Operational Risk
Operational risk arises from problems in the performance of business functions or processes. Exposure to this risk can result from deficiencies or breakdowns in internal

controls or processes, technology failures, human errors or dishonesty and natural catastrophes.

(e) Legal and Regulatory Risk
Legal and regulatory risk arise from a business' non-compliance with laws, rules, regulations, prescribed practices, or ethical standards in any jurisdiction in which the business operates.

(f) Money Laundering and Terrorist Financing Risks
Money laundering risk is the risk that a business could be used to disguise the origins of illegally obtained money and/or the proceeds of criminal conduct; through the process of making such funds appear to have derived from a legitimate source.

Terrorist financing risk addresses the risk where a business is susceptible to be used as a conduit for financing or providing financial support to terrorists or terrorist groups.

(g) Strategic Risk
Strategic risk arises from a business' inability to implement appropriate business plans, strategies, decision making, resource allocation and its inability to adapt to changes in its business environment.

(h) Concentration Risk
Concentration risk can arise from uneven distribution of exposures to clients and/or third parties. Another type is sectoral concentration risk which can arise from uneven distribution of exposures to particular sectors, regions, industries, or products.

(i) Reputational Risk
The risk of potential losses arising from negative public opinion, whether based on facts or merely public perception, and the adverse impact this could have on an institution's revenues, liquidity, capital, operations, or customer base.

6. Oversight and management of prudential risks

6.1 Ultimate responsibility for the management of prudential risks rests with the board of directors; for non-corporate structures, the governing body of the business. The board may delegate certain functions to senior managers or key employees as part of its apportionment and oversight functions, which include:

i) maintaining **an up-to-date business plan** and **risk management strategy**;

ii) maintaining a well-defined **investment policy**;

iii) overseeing the development of **appropriate systems for the management of prudential risks**;

iv) establishing and maintaining adequate **internal controls**; and

v) ensuring the adequacy of **financial resources.**

6.2 Where functions are delegated, the business must ensure that appropriate systems and controls are in place to allow the board to participate in and control its prudential risk management activities. This requires a reporting relationship to the board based on adequate and timely information to facilitate monitoring of adherence to policy. The board should approve and periodically review these systems and controls to ensure that delegated duties are being satisfactorily performed. The business must be able to satisfy the Commission that individuals proposed to hold or who hold key functions possess sufficient competence and capability for the particular function.

7. Prudential risk management on a group basis

7.1 Some businesses while operating as a separate entity may form part of a group where management of the business' prudential risks may be entirely or largely subsumed within the whole group. This means that from time-to-time personnel elsewhere in the group may carry out these functions on behalf of the business.

7.2 The risk management arrangements remain the responsibility of the business and it must ensure that any prudential issues that are specific to it are:

i) identified and adequately addressed by those to whom it has delegated certain prudential risk management tasks; or

ii) dealt with by the business itself.

7.3 The board is responsible for the effectiveness of the risk management framework and for ensuring that it remains relevant.

8. Business planning and risk management

8.1 Upon application and throughout the duration of the licence, a business plan is required to be maintained. The business plan must include appropriate systems for the management of prudential risk.

8.2 Business planning and risk management are closely related activities. The investment business/strategic plans are forward-looking assessments of the business' financial resources/needs, and documents how certain investment strategies may affect the risks that the business faces. Business planning should involve the creation of specific risk policies which will normally outline a business' strategy and objectives for the management of its market, liquidity and operational risks, and the processes that it intends to adopt in order to achieve these objectives.

8.3 The business plan and prudential risk management systems of the business must provide:

i) an explanation of its overall business strategy, including its business objectives;

ii) a description of, as applicable, its policies towards market, liquidity and operational risk (its risk policies), ***including its appetite or tolerance for these risks and how it identifies, measures or assesses, monitors and controls these risks;***

iii) the systems and controls that it intends to use to ensure that its business plan and risk policies are satisfactorily implemented;

iv) a description of how the business accounts for assets and liabilities, including the circumstances under which items are netted, included or excluded from the business' balance sheet and the methods and assumptions for valuation;

v) appropriate financial projections and the results of any stress testing and scenario analysis; and

vi) details of, and the justification for, the methods and assumptions used in financial projections.

8.4 The prudential risk management system enables a business to:

i) identify the prudential risks that are inherent in its business plan, operating environment and objectives, and determine its appetite or tolerance for these risks;

ii) measure or assess its prudential risks;

iii) monitor its prudential risks; and

iv) control or mitigate its prudential risks.

8.5 A business should consider the relationship between its business plan, risk policies and the financial resources that it has available (or can readily access), recognising that decisions made in respect of one element may have consequences for the other two.

8.6 A business plan and risk management systems should be:

i) effectively communicated so that all employees and contractors understand and adhere to the procedures related to their individual responsibilities;

ii) regularly updated and revised, when there is significant new information or when actual practice or performance differs materially from the documented strategy, policy or systems.

iii) proportionate to the scale and complexity of its operations, and the nature and degree of risk that the business faces and be accessible, upon request, to the Commission.

9. Internal control

9.1 In a prudential context, internal controls are concerned with ensuring that a business plan and risk management systems are implemented as intended and operating as expected. As part of the internal control mechanism, a business must establish and maintain adequate internal controls. There should be an effective internal audit and compliance system.

9.2 Internal controls can vary from business to business; however, they must be structured to assist the board with effectively meeting the following objectives:

i) safeguarding the assets of its customers and the business, as well as identifying and managing liabilities;

ii) maintaining the efficiency and effectiveness of its operations;

iii) ensuring the reliability and completeness of all accounting, financial and management information; and

iv) ensuring compliance with its internal policies and procedures as well as all applicable laws and regulations.

9.3 The adequacy of the internal controls must be considered based on the business' risk/ vulnerabilities, which have the potential to hinder the achievement of the above objectives. The following risks should be considered and the extent to which they need to be controlled:

i) the delegation or contracting of functions or activities to employees, appointed representatives or other third parties (under outsourcing arrangements) and how they are to be monitored and controlled;

ii) the risk that a business' employees or contractors might accidentally or deliberately breach its policies and procedures;

iii) the need for adequate segregation of duties; and

iv) the need for internal audit and the establishment of an internal audit function.

10. Segregation of duties

10.1 Segregation of duties is an important internal control in the prudential context. It helps to ensure that no one individual is completely free to commit the business' assets or incur liabilities on its behalf. Segregation can also help to ensure that the board receives objective and accurate information on financial performance, the risks faced by the business and the adequacy of its systems. In this regard, a business should ensure that there is adequate segregation of duties between employees involved in:

i) taking on or controlling risk (which could include risk mitigation);

ii) risk assessment (which includes the identification and analysis of risk); and

iii) internal audit.

10.2 A business should ensure that no single individual has unrestricted authority to do all of the following:

i) initiate a transaction;

ii) bind the firm; and/or

iii) make payments and account for it.

10.3 Where a business outsources a function such as internal audit, it should take reasonable steps to ensure that every individual involved in the performance of this service is independent from the individuals who perform its external audit.

10.4 In circumstances where the size of the business allows for one or more risk management committee(s), adequate internal controls should be put in place to ensure that these committees are effective and that their actions are consistent with the objectives of the business. This should include consideration of the following:

i) appropriateness of the skill sets of the committee members, normally made up of relevant senior managers.

ii) clear terms of reference, reporting lines and responsibilities of the committee;

iii) setting limits on the committee's and members' authority;

iv) agreeing routine reporting and non-routine escalation procedures;

v) agreeing the minimum frequency of committee meetings and the documentation of meeting minutes; and

vi) reviewing the performance of these risk management committees.

11. Prudential risk assessment

11.1 A business' prudential risk assessment activities should normally include the following considerations:

- i) its total exposure to risk at the business level (across risk categories);
- ii) how exposures may be unwound, hedged, or otherwise mitigated, as appropriate;
- iii) capital allocation;
- iv) the correlations or potential correlations between the various risks. This should also include looking for risks to which the business plan is particularly sensitive, such as interest rate risk and dealings with counterparties;
- v) the adequacy of information in the investment prospectus. Prospectus must be current and, for mutual funds, include, at a minimum, prescribed information in relation to the fund's objectives, risks, performance, distribution policy, executive team, investment strategies and other relevant information.
- vi) the use of stress tests and scenario analysis;
- vii) whether there are risks inherent in the business that are not being addressed adequately;
- viii) the risk adjusted return that the business is achieving; and
- ix) the adequacy and timeliness of management information on market, credit, liquidity, operational and (where applicable) group risks from the business lines, including the utilisation of risk limits.

11.2 A summary of the results of the analysis undertaken by a business' risk assessment function (including, where necessary, an explanation of any assumptions that were adopted) should be reported to the board.

12. Management information

12.1 The role of management information should be to help the board and senior managers to understand risk at the business level. Information that should be available in a prudential context would help the business to:

- i) determine whether a business is prudently managed with adequate financial resources;
- ii) make decisions that fall within its ambit (for example, the high-level business plans, strategy and risk tolerances of the business); and
- iii) oversee the execution of tasks for which they are responsible.

12.2 Information to be made available to the board and senior managers include for example:

i) business level information such as the overall profitability and value of the business and its total exposure to risk;

ii) where applicable, reports from committees to which the board has delegated risk management tasks;

iii) reports from the business internal audit and risk assessment functions, if applicable, including exception reports, where risk limits and policies have been breached or systems circumvented;

iv) financial projections under expected and stressed conditions;

v) reconciliation of actual profit and loss to previous financial projections and an analysis of any significant variances;

vi) matters which require board decision, for example a significant variation to a business plan, amendments to risk limits, the creation of a new business line, etc;

vii) compliance with regulatory prudential standards;

viii) risk weighted returns; and

ix) liquidity and funding requirements.

12.3 Management is responsible for the integrity of the information and to ensure that it has appropriate processes to validate the integrity of its information. The information that is provided to the board should be:

i) timely, its frequency determined by factors such as:
   a) the volatility of the business (that is, the speed at which its risks can change);
   b) any time constraints on when action needs to be taken; and
   c) the level of risk that the business is exposed to, compared to its available financial resources and tolerance for risk;

ii) reliable; and

iii) relevant to issues on which the board should focus particular attention.

13. Record keeping

13.1 Investment businesses are subject to the record keeping requirements pursuant to Regulations 34 – 38 of the AML/PTF Code.

13.2 A business' record retention policy should ensure access to prudential data/information such as annual audited financial statements pursuant to the legal requirements under the IDLO and MFO, and other supplemental information as may be requested by the Commission on a routine or adhoc basis.

13.3 Proper record keeping:

i) facilitates the prudential supervision of a firm by ensuring that adequate information is available regarding its past and current financial situation and business activities (which includes the design and implementation of systems and controls); and

ii) evidences that the business is operating in accordance with the law with information available on its operation in order to test whether the business is operating in a prudent manner and is not prejudicing the interests of its customers or market confidence.

13.4 A business must have adequate systems and controls for maintaining the security of its records so that they are reasonably safeguarded against loss, unauthorised access, alteration, or destruction. The records must be kept in a format that can be reproduced in English.

14. Expectations of the Financial Services Commission

14.1 In formulating an approach to prudential supervision of investment businesses, the Commission will require each investment business to provide specific information through periodic reporting to commence by 31 July 2021. The information provided will enable the Commission to undertake a more detailed desk-based review of the business.

14.2 An important component of the reporting requirement is the submission of information and data that is based on the results of each business' ongoing prudential risk assessments. The aggregated data will be available for use by the Commission and the sector.

14.3 This new process complements the program of on-site examinations and provides an opportunity to enhance and maintain a good standard of regulatory oversight of the industry.

15. Policy Review

15.1 These Guidelines will be kept under review and updated as required.