



Study Material

For Capital Market Examination-2 (CME-2)

of

Compliance, Anti-Money Laundering and Counter-Terrorist Financing

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CME-2 Module

Compliance, Anti-Money Laundering and Counter-Terrorist Financing Module

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A Learning Map which contains the full syllabus appears at the end of this workbook. Please note that the examination is based upon the syllabus.

PREFACE

The Compliance, Anti-Money Laundering and Counter-Terrorist Financing Module (CME-2) module is one of the specialized modules in the CMA's Certification Examination series. This module is specifically developed to cater for the authorized persons' personnel who are directly involved in performing the compliance function as well as those involved in supervising the compliance function. This study manual has been developed to assist candidates to acquire the necessary knowledge regarding the compliance function in the securities business, and to prepare themselves to sit for the Compliance, Anti-Money Laundering and Counter-Terrorist Financing Module (CME-2) examination. This study manual is also meant to serve as a good and solid basis for any advanced compliance training program.

For ease of use, the study manual is divided into two sections:

- Section 1 covers the concepts, organization and processes of compliance in the securities business. This section consists of five chapters, as follows:

- Chapter 1: Fundamentals of Compliance
- Chapter 2: Compliance Roles and Responsibilities
- Chapter 3: Establishing and Monitoring Compliance
- Chapter 4: Risk Management and Compliance
- Chapter 5: Anti-Money Laundering and Counter-Terrorist Financing

- Section 2 covers the compliance regulations. This section deals with specific CMA rules and regulations that are directly related to the compliance function of the authorized persons. This section consists of the following chapters:

- Chapter 6: Authorized Persons Regulations – Authorization Process
- Chapter 7: Authorized Persons Regulations – Conduct of Business
- Chapter 8: Authorized Persons Regulations – Systems and Controls
- Chapter 9: Market Conduct Regulations
- Chapter 10: Anti-Money-Laundering and Counter-Terrorist Financing Rules

It should be noted that Section 2 of this study manual is meant to provide focused explanations to the Capital Market Law and its Implementing Regulations, relating directly to the compliance function. Candidates are advised to refer to the original legislations for complete rules and regulations governing authorized persons' activities.

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SECTION 1:
COMPLIANCE:
CONCEPTS, ORGANIZATIONS AND
PROCESSES

FUNDAMENTALS OF COMPLIANCE

1

LEARNING OBJECTIVES

The syllabus for this examination is broken down into a series of learning objectives and is included in the Syllabus Learning Map at the back of this workbook. Each time a learning objective is covered, it appears in a text box preceding the text.

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INTRODUCTION

In an ever-changing capital market environment, and with a stricter regulatory and supervisory framework as well as numerous regulatory requirements which must be adhered to all the time, it is crucial for capital market intermediaries to operate their businesses with a high degree of professionalism and compliance. Compliance with the rules and regulations of the capital market industry, as promulgated and administered by the Capital Market Authority (CMA or Authority) in Saudi Arabia is a basic and essential requirement for authorized persons¹, to ensure continued efficiency of the securities market industry. The compliance function is a mandatory requirement in many capital market jurisdictions around the globe, including the Kingdom of Saudi Arabia. CMA, which regulates and oversees the Saudi Arabian capital market, implements and enforces the Capital Market Law and its Implementing Regulations to create an appropriate investment environment, promote investors' confidence, and reinforce transparency and disclosure standards among all market intermediaries and other market participants.

This chapter introduces the fundamental elements necessary for understanding the concept of compliance. The first section discusses the definition and scope of compliance function. This is followed by a discussion of the principles of compliance based on the principles adopted by the International Organization of Securities Commissions (IOSCO) as applied to market intermediaries, and adapted to the local authorized persons. The chapter also discusses the importance of combining the compliance and control functions in the authorized person organizations as the two are complimentary to each other. The chapter then outlines the steps and guidelines of establishing compliance culture in an organization, and as well as the cost and benefits of having a compliance function in the authorized person.

1.1 DEFINITION, CONCEPT AND SCOPE

Learning Objective 1.1 – *Know* and be able to describe the meaning of compliance, its concept, scope and importance in an organization.

1.1.1 DEFINITION OF COMPLIANCE

According to Cambridge Advanced Learner's Dictionary, 'to comply' means to act according to an order, set of rules or request. In general, compliance means conforming to laws, regulations, rules, policies and standards.

In the context of securities market, compliance may be defined as the function

¹ The term authorized person used throughout this text refers to a firm which is authorized by the Capital Market Authority to carry on securities business in the Kingdom of Saudi Arabia.

that identifies, assesses, advises on, monitors on a continuous basis on a market intermediary's compliance with securities regulatory requirements, including whether there are appropriate supervisory procedures in place within the market intermediary.

When applied in the context of Saudi Arabia's capital market, compliance refers to carrying out licensed and authorized securities business activities in accordance with Capital Market Law and its Implementing Regulations relevant to authorized persons' business operations.

1.1.2 CONCEPT AND SCOPE OF COMPLIANCE

Compliance is about continuous adherence to the prescribed laws and implementing regulations issued by the Authority. In ensuring continuous compliance, authorized persons are required to ensure that they have complete understanding of the laws and the prescribed implementing regulations, keep themselves abreast of all subsequent updates and amendments to the law and regulations, translate these laws and regulations into a set of policies, standards and procedures. They are also required to develop effective compliance monitoring programs across all organization's business functions and activities, ensure full compliance with the above set of policies, standards and procedures and have effective mechanism for reporting any non-compliance to the board of directors, or relevant committees established within the organization or to the CMA directly.

1.2 PRINCIPLES OF COMPLIANCE

Learning Objective 1.2 - *Understand* the basic principles that define the purpose and the implementation of the compliance function.

Compliance is a crucial element in the proper functioning of market intermediaries and the securities market in general. The market intermediaries, must have the necessary systems and processes in place to ensure that they are complying with the applicable laws, rules and regulations of the Authority. Compliance is also important to ensure proper market conducts, which is to protect investors' interests and preserving market integrity.

The establishment of an effective compliance function within a market intermediary is consistent with IOSCO's Principle 23 of the Objectives and Principles of Securities Regulation for market intermediaries that states:

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

for these matters.”²

IOSCO (2006) outlines several principles to be observed by market intermediaries towards implementing an effective compliance function. These principles include the following: ³

1. *Establishment of a Compliance Function.* Each market intermediary should establish and maintain a compliance function, in the form of an appointment of a senior officer as a Compliance Officer and if appropriate, the establishment of a Compliance Department. The role of the compliance function is to identify, assess, advise on, monitor and report on the firm’s compliance with the rules and regulations of the regulatory authority on continuous basis. The scope of the compliance function should be appropriate to the nature, scale and complexity of the market intermediaries business. In implementing the compliance function, market intermediaries needs to observe the following:
 - a) The provision of the necessary authority to commensurate with the responsibilities of the compliance function (Compliance Officer and/or Compliance Department) and the provision of adequate resources (staff, facilities, technology, etc.)
 - b) The size of the compliance function should be suitable to the scope, nature and complexity of the organization. The compliance function typically would be performing the following tasks:
 - Fully understand the regulatory requirements imposed by the Authority
 - Establish, communicate, enforce and monitor the necessary policies and procedures to comply with the regulatory requirements
 - Provide guidance, supervision and training to staff in relation to compliance
 - Provide periodic report to the board or governing body on compliance issues relating to the regulatory requirements and to internal policies and procedures
 - Prepare compliance report to the regulatory Authority in a timely manner as required.
 - c) The roles and responsibilities of the compliance function must be clearly stated and located in the organization structure.
 - d) The mandate of the Compliance Officer must be clearly communicated to all staff in the organization; and the staff must be encourage to consult with the Compliance Officer on compliance matters.

² IOSCO (2006), page 5. <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD214.pdf>

³ Ibid.

2. *Role of Senior Management and the Governing Body.* Although a Compliance Officer may have been appointed, the ultimate responsibility on the market intermediaries compliance with the Capital Market Law and its Implementing Regulations falls on the board of directors or the governing body of the market intermediaries. Placing the board or the governing body on the highest level of compliance management enables accountability and promotes a compliance culture that permeates through the entire organization. In regard to the roles of senior management and the governing body to the compliance function, the following aspects need to be observed:
- a) Appointing a senior officer, who has the appropriate competence to be the firm's Compliance Officer, whose roles include advising the firm's employees on compliance matters, assessing effectiveness of the compliance function and making continuous improvement, and solving compliance issues.
 - b) Senior management should directly oversee the scope, structure and activities of the compliance function to ensure that the compliance function is carrying out its mandate.
 - c) The compliance function needs to be regularly assessed and appraised by senior management, independent of the Compliance Officer to ensure its objectivity of the appraisal.
 - d) Senior management must encourage all employees to have consultation with the compliance function with respect to the business of their respective operational areas.
 - e) Units and departments within the market intermediaries have to play their roles with respect to compliance by adhering to applicable controls, policies and procedures, in order to conduct their operations in accordance with regulatory requirements.
 - f) Owing to differences in the size and complexity of the market intermediaries , flexibility should be allowed for the market intermediaries to employ different structures to implement an effective compliance function.
3. *Independence and Ability to Act.* The compliance function should be able to operate on its own initiative, without undue interference from other parts of the business, and should have access to and should report to the CEO and the board or the governing body. The independence of the compliance function is important to ensure that the board or the governing body receive accurate and unbiased reports from the Compliance Officer. The Compliance Officer should also be given protection from undue influence by other parties who attempt to coerce, manipulate, mislead or fraudulently influence the Compliance Officer. However, complete independence may be

difficult to observe in smaller market intermediaries whose senior officers may have overlapping functions and responsibilities. In such situation, procedures are required to prevent conflicts of interest regarding the performance of compliance functions. In order to achieve independence in compliance function, the following are some ways that could be adopted by the market intermediaries..

- a) The budget for the compliance function and compensation for compliance personnel should not be directly dependent on the financial performance or revenues generated by a specific business line, but rather are dependent on the performance or revenues of the firm as a whole.
 - b) The compliance budget should receive sufficient resources to enable compliance personnel to carry out their responsibilities effectively.
 - c) Compliance personnel should have the ability on their own initiative to communicate with any employees and to obtain access to records or other information necessary to carry out their responsibilities, including the ability to conduct investigations of possible breaches of securities regulatory requirements or the internal compliance policies and procedures.
 - d) Compliance personnel should have access to senior management and, as appropriate, to the governing body to discuss significant compliance matters.
4. *Qualification of Compliance Personnel.* The employees who carry out the compliance responsibilities should have integrity and the necessary qualifications, industry experience, professionalism and personal qualities to enable them to carry out their duties and responsibilities effectively. The nature of the compliance function dictates that it be performed by highly capable individuals. The Compliance Officer must be ‘competent and knowledgeable’ concerning the securities laws and all implementing regulations, and possess the necessary qualifications and experience. In this respect, the market intermediaries must consider the following in appointing a Compliance Officer:
- a) completion of relevant courses and/or training
 - b) successful completion of prescribed qualifying examinations
 - c) continuing education requirements, and
 - d) relevant work and industry experience.
5. *Assessment of the Compliance Function Effectiveness.* The effectiveness of compliance functions should be regularly and periodically assessed, internally by the market intermediaries’s governing body, or externally by independent third parties such as external auditors or consultants. Internal and external parties play complementary roles to ensure effective assessment on compliance policies, procedures and controls. The periodic

assessment should include at least the following aspects:

- a) Adequacy of internal policies and procedures to address the compliance need with the Authority's rules and regulations.
- b) Adequacy in the assignment of duties and authorities to the Compliance Officer and the compliance function in general. Such assessment is even more important particularly when responsibilities for compliance functions are dispersed through an organization.
- c) The effectiveness of the compliance function, by paying particular attention not only to the success but also the deficiencies in the function, as these needs to be promptly addressed.
- d) Communication of the assessment report to the governing body. The report should contain the assessment results, highlighting of the deficiencies and recommendations for improvement. Where appropriate, additional training should be recommended to compliance personnel.

1.3 COMPLIANCE AND CONTROL FUNCTIONS

Learning Objective 1.3 – *Understand* the interdependence between compliance and control systems in an organization.

Compliance and internal control are complimentary to each other. A compliance program within the organization consists of the formal measures taken by the management to ensure that it meets the requirements of the laws and regulations, and acts as mitigating factor against breach of these rules. 'Internal control' refers to a set of standards, policies and procedures that define the conduct of the organization, managers and employees. These standards and policies are established in accordance with the relevant laws and regulations. Hence complying within the company's standard operating procedures ensures compliance with the CMA's rules and regulations.

Authorized persons are required to establish internal control mechanisms which are developed in tandem with standards for internal organization and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk. A compliance and control program should have the following objectives:

- to prevent breach of the laws, rules and regulations, code of conduct, and internal policies
- to be able to quickly identify any deviations or breaches of the rules and regulations
- to be able to implement an effective corrective action in cases of deviations and breaches

- to promote a culture of compliance and good ethics within the organization.

To be effective in carrying out the functions of compliance and control, the authorized person's Compliance Officer has to be mindful of the constant and rapid changes in the environment that influence and affect securities business which include:

- the use of information and communication technology
- liberalization and globalization of the market
- online trading, electronic banking, cross-border trading and listing, and
- evolving needs of investors and increased sophistication of their trading.

To establish an effective internal control system, the following steps have to be taken into consideration:

1. *Establish an appropriate organization structure.* This sets out the hierarchical structure, division of functions and managerial levels within the organization. The organization structure should clearly indicate which department is responsible for each business function and the lines of authority and accountability, and responsibility and reporting.
2. *Segregation of duties.* To ensure that the activities of an organization are carried out in a proper manner to prevent occurrence of fraudulent activities, task allocation among employees should be made in such a way that one employee's tasks act as a 'check and balance' over another employee's tasks. Common examples of segregation of duties would include segregation between: procurement of client and credit analysis; trading activities and settlement; daily maintenance of general ledger balance and validation of general ledger balance; and maintenance of accounts and custody of collaterals.
3. *Authorization and approval.* All transactions should be appropriately reviewed and approved by designated authorized official as per the company's authority manual. Such review and approval should be properly documented for compliance and audit review.
4. *Accounting control.* This is necessary for checking the accuracy of information contained in the accounting records and books of the company on a daily basis. The accuracy of entries, calculations, account balances, trial balances and others must be checked.
5. *Security and safe-keeping.* This relates to the custody and safeguarding of physical assets, accounting records, data, and restricting access to business premises and security areas within the premises.

1.4 COMPLIANCE CULTURE

Learning Objective 1.4 – *Know* the most common methods of establishing a compliance culture within the organization.

A compliance culture refers to an environment where the authorized person's governing body, management and employees are aware of, understand and comply with the prescribed laws and regulations governing the organization business activities, the authorized person's established policies and procedures, internal standards, codes and guidelines. When this philosophy is nurtured within the day-to-day conduct of the authorized person's activities, it becomes part of the work culture of the organization.

While many of the internal procedures need the full commitment of the Compliance Officer for their implementation, the ultimate responsibility for establishing a compliance culture rests with the authorized person's governing body and senior management. A good strategy for achieving this is through a mission statement that incorporates the ethics and compliance elements.

The following may be considered as general guidelines for the establishment of an effective compliance culture in an organization:

- Incorporate ethics and compliance in the mission statement of the authorized person.
- Have a well-documented operations manual incorporating practices that ensure compliance.
- Include in the operations manual practical procedures and explain the reasons behind each requirement and the consequences of non-compliance.
- Explain individual responsibilities for each function.
- Have a proper system for record-keeping that serves as good evidence of compliance.
- Provide effective channel of communication to ensure employee awareness of the internal policies and procedures relating to their duties and responsibilities.
- Provide adequate training, especially to new staff, that emphasizes ethical behavior and compliance with the policies and procedures.
- Include work ethics and compliance as part of performance evaluation of staff.
- Facilitate effective reporting mechanism by the Compliance Officer to the authorized person's governing body for compliance-related issues.

1.5 COSTS AND BENEFITS OF COMPLIANCE

Learning Objective 1.5 – *Understand* the costs and benefits associated with having and implementing the compliance function in the organization.

Since the concept of compliance was initially introduced to the market, the costs and benefits of having compliance functions within organization have always been a matter of debate. Some would argue that the cost generally outweighs the benefits it brings to the organization; while others argue otherwise. As capital market intermediaries and other financial services providers are becoming more strictly regulated with new sets of regulatory requirements and standards that must be adhered to at all times, the roles of compliance are becoming more significant and many organizations are willing to invest a significant amount of money in setting up comprehensive and effective compliance functions.

Further, the establishment of an effective compliance function within an authorized person is in line with the IOSCO's Principle 23 of the Objectives and Principles of Securities Regulation for market intermediaries. These require market intermediaries to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.

1.5.1 THE COSTS OF COMPLIANCE

Employing a specialized person as a Compliance Officer for the authorized person means additional costs in terms of remuneration and facilities. For a bigger organization, a full Compliance Department needs to be set up, complete with the required personnel and facilities. This would require a larger budget for the authorized person. A good compliance set up requires resources in terms of well-qualified compliance professionals as well as good compliance monitoring systems. The authorized person's compliance department shall be adequately resourced depending on the size, locality and complexity of the authorized person's business.

The staff development budget will also increase as the Compliance Officer and other employees in the Compliance Department need to be trained with specialized compliance-related courses in order to keep them abreast of recent developments in the market, changes in regulatory requirements issued by the Authority from time to time as well as keeping up with latest international best business practices relevant to the organization's business.

Costs may also be incurred in the form of administrative expenses related to the

compliance function, such as paperwork, generating reports, training and awareness seminars/workshops, fees and fines, etc. In addition there are hidden costs in relation to compliance functions. These include, human resources devoted to meetings, reviewing performance and reporting.

1.5.2 THE BENEFITS OF COMPLIANCE

An effective compliance function mitigates an authorized person's regulatory risk of non-compliance with Capital Market Laws and its Implementing Regulations. Comprehensive policies and procedures, internal codes, standards and guidelines established in line with the requirements of the Law and CMA's Implementing Regulations, coupled with effective compliance monitoring programs as well as continuous training and developments of its resources on compliance, enhance an authorized person's organizational compliance culture.

Along with the existence of a compliance culture in organizations, risk management will also be in place. These include having appropriate standard operating procedures and systems, clear and non-overlapping roles of the functions and departments, clear demarcation of duties and responsibilities, preventing sensitive information flows between departments, etc.

Companies or organizations that demonstrate competent and professional conduct would lead to a reduction or elimination of customer complaints, hence saving time and resources. A good compliance system can also lead to early detection of any deviations from the required procedures. This would also save the organization from larger problems and losses because corrective actions can be implemented at early stages.

An additional benefit would be to improve and enhance the staff morale. The employees will feel proud being employed by an organization that is professionally managed and has a clean compliance record with the Authority.

On a bigger picture, compliance will bring the following benefits to the overall securities markets:

- transparency – existence of a clear process, standard and procedures that are understood by and apply to everyone
- investor confidence – a high degree of market compliance among the market players will lead to investor confidence in the market
- Market stability - Contribute to an orderly market that is conducive to market development that leads to an efficient allocation of resources in the economy.

1.5.3 COSTS OF NON-COMPLIANCE

There are direct and indirect costs of non-compliance. The direct costs are losses and expenses made or spent owing to non-compliance or breach of laws and regulations. These include:

- company failure – incurring losses, fines and penalties
- fines and hidden costs resulting from inspection, litigation and legal proceedings
- bankruptcy of individuals and companies
- systemic failures in the market, which can be regional or global.

The indirect costs of non-compliance include loss of good standing and good reputation in the market. This may lead to low morale among employees and resignation of good staff. Customers and clients may also divert their business to other companies.

To understand the importance of compliance, one need only read the many market calamities that become news headlines from time to time, in various markets around the globe. The collapse of many giant financial institutions such as Barings Securities, Lehman Brothers and conglomerates such as World.com, Enron, etc. in the past may usually be traced to some form of non-compliance and weak supervisory controls within the firm's operations.

References:

1. International Organization of Securities Commissions (IOSCO) (2006), Compliance Function at Market Intermediaries, <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD214.pdf> Accessed: June 2011.
2. Richards, L. (2005), Compliance: Some Core Principles, US Securities and Exchange Commission, <http://www.sec.gov/news/speech/spch042005lr.htm>). Accessed: June 2011.
3. Securities Industry Development Centre (2008), Malaysia Capital Market: Examination Study Guide: Module 11: Compliance, Securities Commission of Malaysia.

Review Questions

1. What is the meaning of compliance in the context of an authorized person in the securities business?
2. Why is compliance important to the authorized persons and to the securities market as a whole?
3. What are the principles of compliance according to the IOSCO Report? How are they applied to the authorized persons?
4. Explain the relationship between compliance and internal control.
5. What are the steps necessary to establish an internal control system?
6. What is meant by a compliance culture? What are the suggested guidelines in establishing a compliance culture in an organization?
7. What are the direct and indirect costs of compliance?
8. What are the benefits of compliance?

Sample Multiple Choice Questions

1. Which of the following is least related to securities market compliance?
 - A. Conducting securities business in accordance with the laws, rules and regulations.
 - B. Maximizing the welfare of employees and complying with the objectives of stakeholders.
 - C. Making sure that employees understand their authorities and responsibilities and so that they do not breach rules and regulations.
 - D. Carrying out business in the most professional manner and observing good business ethics.
2. Why is 'compliance' important in securities business?
 - (i) It creates transparency in the market.
 - (ii) It results in investor confidence.
 - (iii) It reduces market volatility.
 - (iv) It avoids costly mistakes.
 - A. (i), and (ii) only
 - B. (i), (ii) and (iii) only
 - C. (i), (ii) and (iv) only
 - D. All of the above

3. To create an effective internal controls system, the authorized persons may take the following steps, with the exception of?
- A. Establishing an appropriate organization structure.
 - B. Segregating duties so that there are 'checks and balances'.
 - C. Authorization and approval should be vested in the same individual to avoid delays.
 - D. Ensuring the effectiveness of the accounting control.
4. The following are among the requirements that must be included in the process of establishing an effective compliance culture in an organization:
- (i) a well-documented operation manuals incorporating practices that ensure compliance.
 - (ii) a proper system for record-keeping to demonstrate and prove compliance.
 - (iii) incorporation of ethics and compliance in the authorized person's mission statement.
 - (iv) the board or governing body needs to comply with business policies and practices.
- A. (i), (ii) and (iii) only
 - B. (i), (iii) and (iv) only
 - C. (ii), (iii) and (iv) only
 - D. All of the above

COMPLIANCE ROLES AND RESPONSIBILITIES

2

LEARNING OBJECTIVES

The syllabus for this examination is broken down into a series of learning objectives and is included in the Syllabus Learning Map at the back of this workbook. Each time a learning objective is covered, it appears in a text box preceding the text.

INTRODUCTION

2.1 BOARD OF DIRECTORS

2.2 MANAGEMENT

2.3 THE COMPLIANCE OFFICER

2.3.1 DUTIES OF THE COMPLIANCE OFFICER

2.4 THE COMPLIANCE COMMITTEE

2.5 THE AUDIT COMMITTEE

2.6 INTERNAL AUDIT

INTRODUCTION

Compliance is not just the responsibility of the authorized person's Compliance Officer, but also the board of directors, senior managers, and other managerial personnel at all levels. In fact, compliance is the responsibility of the entire organization, from top management, to middle management to officers and staff, including board committees and other related special purpose committees. Each organizational level and each individual needs to have a compliance mindset in conducting his/her activities. Although this chapter provides detailed discussion on the specific responsibilities of key functions or persons in the organization in relation to compliance, each and every individual employee within an authorized person, regardless of their hierarchy and roles, is responsible for complying with the Capital Market Law, applicable CMA's Implementing Regulations, and directives, as well as the authorized person's internal policies, procedures, guidelines, codes and standards. Each individual employee has to play his part to support and comply with the system and not just rely on the Compliance Officer, Compliance Department or Compliance Committee.

This chapter begins with a discussion on the roles and responsibilities of the board of directors or the governing body of the authorized person towards ensuring the establishment and effective implementation of the compliance function. This is followed by a discussion on the roles and functions of the management as a team. The managers at all levels play key supporting roles to the Compliance Department and the Compliance Officer. The subsequent sections of the chapter present an extensive discussion on the roles and responsibilities of the Compliance Officer, whose roles, functions and responsibilities are listed in specific and clear terms to provide useful guidelines. This chapter also contains brief discussions on the functions of the Compliance Committee, Audit Committee and Internal Audit that play auxiliary roles to the compliance function.

2.1 BOARD OF DIRECTORS (GOVERNING BODY)

Learning Objectives 2.1 - *Know* the specific roles and responsibilities of the board of directors with respect to compliance function.

Article 54(b) of the Authorized Persons Regulations (APR) issued by the Capital Market Authority (CMA) provides that the 'governing body' of the authorized person is primarily responsible for compliance with the Capital Market Law and its Implementing Regulations and all other applicable regulatory requirements.

The board of directors (or the governing body of the authorized person) is the highest authority in the organization. It determines the long-term and short-term goals and strategies of the organization. It is also responsible for the proper implementation of these strategies in order to achieve the goals. In terms of compliance, the board or governing body is responsible for instituting the proper compliance culture in the organization and ensuring that company policies and

procedures are in accordance with the Capital Market Law and the implementing regulations prescribed by CMA from time to time. The board or governing body must also ensure that business activities are carried out in full compliance with the company policies and procedures and other relevant laws and regulations.

Although there is a Compliance Officer in the organization, this does not relieve the board or governing body of its responsibilities. The formulation of supervisory or compliance function may be within the Compliance Officer's job function, but the effective implementation of the program lies with the organization and its board or governing body. Any failure in the supervisory and compliance system will be deemed as the failure of the organization and its board of directors or the governing body.

The board or governing body of the authorized person has the following responsibilities.

- Ensuring that the appropriate policies and procedures are in place to enable the authorized person to comply with the Capital Market Law, the Implementing Regulations and all other applicable regulatory requirements issued by CMA from time to time.
- The establishment of a sound internal control to safeguard the stakeholders of the authorized person. Internal control measures should cover operational and financial controls as well as compliance and risk management functions.
- The establishment of a Compliance Department, appointment of a Compliance Officer and ensuring that the department is appropriately staffed and resourced and has access to all records.
- The establishment, implementation, enforcement and maintenance of the compliance manual and the compliance monitoring program.
- Establishing and ensuring compliance with the organization's code of conduct.
- Putting proper procedures in place to anticipate likely changes in the regulatory compliance requirements.
- Ensuring that there are periodic discussions between the board or governing body and the management concerning the effectiveness of internal control and risk management functions.
- The preparation of reports and notifications to be filed with the CMA.

2.2 MANAGEMENT

Learning Objectives 2.2 – *Know* the specific roles and responsibilities of the management with respect to the compliance function.

Management, which comprises a group of individual managers, is also responsible for supporting and promoting the compliance culture within an authorized person. It plays essential role in ensuring that all operational aspects of the business activities are carried out as per the requirement of the Capital Market Law and its Implementing Regulations as well as in compliance with the established policies and procedures.

To enhance compliance culture within the organization, the authorized person's management should provide its support and cooperation to the Compliance Officer in discharging its supervisory duties over each individual department's business operations. There should be open and continuous communications between the Compliance Officer and the management. Management should be receptive to comments and suggestions to improve the compliance standards within each manager's respective department.

2.3 THE COMPLIANCE OFFICER

Learning Objective 2.3 – *Understand* the specific roles, responsibilities and duties of the Compliance Officer.

Article 57 (a) of the Authorized Persons Regulation issued by the CMA requires an authorized person to appoint a senior officer as the Compliance Officer. The Compliance Officer is mandated to ensure the achievement of the authorized person's compliance objectives. In carrying out his duties independently and effectively without conflict of interest, the Compliance Officer must be independent of the front and back offices' operational functions, and not directly involved in trading, settlement, funding, processing or reconciliation activities, or other activities that would put him in a compromising position. He should only be engaged in the compliance function and be adequately empowered to provide regular reporting on any non-compliance issues to the authorized person's senior management, board of directors and the CMA, if necessary.

This does not apply to authorized person whose licensed business activity is limited to managing non-real estate investment funds or managing the portfolios of sophisticated investors, arranging or advising, as such an AP may outsource the function of compliance and AMLRO.

2.3.1 DUTIES OF THE COMPLIANCE OFFICER

Generally, the duties and responsibilities of the Compliance Officer are as follows.

- To ensure the authorized person's compliance with the Capital Market Law and its implementing regulations, and the CMA's prescribed directives and guidelines issued from time to time as well as the authorized person's compliance with its established policies and procedures, internal guidelines, codes and standards.
- To advise the authorized person on compliance matters. In carrying out this function, the Compliance Officer should:
 - understand all the laws, rules and regulations relevant to the authorized person
 - advise all personnel on how these requirements should be translated into authorized person's policies, procedures and practices
 - ensure that authorized person has the necessary policies and procedures to govern all key activities.
- To review, monitor and supervise the adequacy of supervisory measures within the organization to ensure compliance. It is the duty of the supervisors and heads of departments to supervise the activities of their staff and to enforce and ensure compliance. The Compliance Officer will carry out reviews to determine whether the supervision is effective and adequate to ensure staff compliance. If adequacy is established, it has to be continuously monitored and supervised to ensure its continued effectiveness.

The following are examples of processes and procedures that need to be reviewed by the Compliance Officer, to ensure that they comply with the related rules and regulations.

- The approval and opening of clients' accounts
- Order taking and execution (for buy and sell orders) of securities trading
- Trade settlement: payment and securities ownership transfer processes
- Clients' deposits and withdrawals
- Daily accounting entries of securities transactions
- Reconciliation activities of the back office
- Ensuring proper segregation of clients' funds
- Review of client accounts – proprietary and discretionary
- Review of position limits of clients
- Review of margin trading: credit assessment, margin limits, collateral,

margin calls, margin maintenance, etc.

- Review of staff trading to ensure that such trades are authorized, executed and recorded according to procedures
 - Review of clients' complaints: general causes, handling of the complaints, time taken to resolve the complaints
 - Review of company advertisements, reports, recommendations and other related information to ensure its accuracy and compliance
 - Follow-up on audit findings to ensure that issues raised by relevant authorities are properly addressed and rectified.
- To assist in training and educating staff members of the company on compliance matters. It is expected that all staff would be given the necessary training in order for them to carry out their functions effectively and efficiently. However, they also need to be given specific training on work ethics and compliance, focusing on the processes and procedures, rules and regulations, importance of compliance and consequences of non-compliance. The training may be formal or informal.
- To report compliance matters to the CEO on regular basis. As a rule of thumb, the reporting should be done on a monthly basis at least. The Compliance Officer should immediately report to the CEO on any compliance matters that require urgent attention of the board, such as breaches of laws and regulations, changes in risk position of the company, etc. As a guide, a report should contain details of:
 - company's credit exposure: breach in limits, over-due payments, non-payments, etc.;
 - company's liquidity positions: assets, liabilities and equity position, cash position, assessment of company's liquidity;
 - client risk exposures: assessment of credit policies, credit standards, major clients, risky clients, over-exposed clients, etc.;
 - other compliance related matters, such as:
 - errors in trade, if any: giving details on the reasons, amounts involved, profits and losses and corrective actions
 - any failures to segregate clients' assets
 - audit findings by the internal and regulatory auditors and the actions taken
 - amendments to laws, rules and regulations relevant to the company
 - conflict of interests.
- To liaise with the CMA and other regulatory agencies on compliance matters.

The Compliance Officer should manage the relationship between the authorized person and the relevant authorities to create a strong professional relationship and good rapport. This will facilitate information sharing and clarification of rules and regulations. Among other procedures, the Compliance Officer should:

- submit financial statements to the CMA on a timely basis as required;
- inform the CMA about any non-compliance that has taken place, and the corrective actions taken by the company;
- inform the CMA about any changes that have taken place in the company that affect the terms and conditions for the authorized persons and registered persons (RPs);
- notify the CMA in accordance with the notification requirements of Annex 3.2 of the Authorized Persons Regulations;
- inform the authorities immediately about any circumstances affecting the company's solvency or conditions that would impair its ability to perform its activities effectively;
- produce the necessary information and documentation as and when requested by the CMA and provide answers to their queries in a timely and satisfactory manner;
- cooperate and facilitate official inspection visits by the authorities and play central role in processing the reports of such inspections.

2.4 THE COMPLIANCE COMMITTEE

Learning Objectives 2.4 – *Understand* the specific roles and responsibilities of the compliance committee with respect to compliance function.

The establishment of the compliance committee in the authorized person is prescribed by Article 58 of the Authorized Persons Regulations. Whether this is required will depend on the nature, scale and complexity of the authorized person's business. The CMA may require an authorized person to establish such committee if it deems it necessary in view of the nature, scale and complexity of the authorized person's business.

The members of the compliance committee should include, but are not limited to: the CEO, the Compliance Officer, the Money Laundering Reporting Officer (MLRO), and a senior representative from Internal Audit (if any). If such committee is established, it is a requirement for it to meet at least quarterly.

2.5 THE AUDIT COMMITTEE

Learning Objectives 2.5 – *Understand* the specific roles and responsibilities of the audit committee with respect to compliance function.

The establishment of an audit committee is prescribed by Article 60 of the Authorized Persons Regulations. Such establishment is also based on the nature, scale and complexity of the authorized person's business. The CMA may require an authorized person to establish an audit committee if it deems it necessary in view of the nature, scale and complexity of the authorized person's business. The audit committee is independent of other governing boards established within an organization in order to ensure a fair and unbiased audit review. Both internal and external auditors report their findings to the audit committee.

Generally, the audit committee has the following functions:

- selecting the audit firm
- providing guidance to auditors
- reviewing the audit report, and
- informing the board of directors of the results of the audit.

2.6 INTERNAL AUDIT

Learning Objective 2.6 - *Understand* the specific roles and responsibilities of internal audit with respect to compliance function.

Internal audit is defined by Chartered Institute of Internal Auditors, UK as follows:

“Internal audit is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization to accomplish its objectives by bringing a systematic, disciplined approach to evaluating and improving the effectiveness of risk management, control and governance processes.”⁴

Article 61 of the Authorized Persons Regulations provides that, depending on the nature, scale and complexity of its business, an authorized person may delegate part of the task of monitoring the appropriateness and effectiveness of its systems and safeguards to an internal audit function. An internal audit function should have:

- clear responsibilities and reporting line to the audit committee or the appropriate senior manager

⁴ http://www.iaa.org.uk/en/Knowledge_Centre/Resource_Library/internal-audit.cfm

- be adequately resourced and staffed by competent individuals
- be independent of the day-to-day activities, and
- have appropriate access to the authorized person's records.

Reference:

1. Chartered Institute of Internal Auditors,
http://www.iaa.org.uk/en/Knowledge_Centre/Resource_Library/internal-audit.cfm. Accessed:
June 2011.
2. Securities Industry Development Centre (2008), Malaysia Capital Market: Examination
Study Guide: Module 11: Compliance, Securities Commission of Malaysia.

Review Questions

1. Who are responsible for implementing the compliance function in an authorized person?
2. What are the respective roles of the following people in implementing an effective compliance function in an organization?
 - a. Board of directors (or the governing body)
 - b. Managers (senior and junior)
 - c. Compliance Officer
 - d. Compliance committee
 - e. Audit committee
 - f. Internal Audit department
3. What are the specific duties of a Compliance Officer?
4. What are the areas or functions that need to be reviewed by a Compliance Officer?
5. How often should a compliance officer submit a compliance report to the board of directors? What is the typical content of such a report?
6. What are the specific roles of a Compliance Officer in relation to the CMA?

Sample Multiple Choice Questions

1. Compliance is not just the responsibility of the Compliance Officer, but also the _____.
 - (i) CEO
 - (ii) directors
 - (iii) employees
 - A. (i) only
 - B. (i) and (ii) only
 - C. (i) and (iii) only
 - D. All of the above.
2. Which of the following is NOT a responsibility of a Compliance Officer?
 - A. To advise the company on compliance matters.
 - B. To resolve customers' complaints.
 - C. To review the adequacy of internal control and risk management.

- D. To report compliance matters to the board of directors on regular basis.
3. The following are elements of internal control and risk management within an organization, EXCEPT:
- A. Proper use of the organization's resources
 - B. Management oversight of key activities
 - C. Risk assessment of the various functions
 - D. Control activities to ensure activities are within limits of the law.
4. Which of the following are examples of processes and procedures that need to be reviewed by the Compliance Officer:
- (i) Daily accounting entries of securities transactions
 - (ii) Reconciliation activities of the back office
 - (iii) Ensuring proper segregation of clients' funds
 - (iv) Ensuring that client accounts are generating income
- A. (i) and (ii) only
 - B. (ii) and (iii) only
 - C. (i), (ii) and (iii) only
 - D. All of the above
5. A Compliance Officer is responsible for communication with the Capital Market Authority (CMA) on various compliance matters, including:
- (i) Submission of financial statements on a timely basis
 - (ii) Cooperating and facilitating official inspection visits by the CMA
 - (iii) Informing the CMA on matters relating to solvency of the company
 - (iv) Submitting a summary market report on a daily basis.
- A. (i) and (ii) only
 - B. (i), (ii), and (iii) only
 - C. (i), (ii), and (iv) only
 - D. All of the above

ESTABLISHING AND MONITORING COMPLIANCE

3

LEARNING OBJECTIVES

The syllabus for this examination is broken down into a series of learning objectives and is included in the Syllabus Learning Map at the back of this workbook. Each time a learning objective is covered, it appears in a text box preceding the text.

INTRODUCTION

- 3.1 THE REGULATORY FRAMEWORK OF SAUDI CAPITAL MARKET
- 3.2 AN EFFECTIVE COMPLIANCE INFRASTRUCTURE
- 3.3 DEVELOPING A COMPREHENSIVE COMPLIANCE PROGRAM
- 3.4 CARRYING OUT AN EFFECTIVE COMPLIANCE MONITORING PROGRAM
- 3.5 SEGREGATION THROUGH CHINESE WALLS
 - 3.5.1 WHAT ARE 'CHINESE WALLS'?
 - 3.5.2 PURPOSE OF CHINESE WALLS
 - 3.5.3 ADVANTAGES OF CHINESE WALLS
 - 3.5.4 DISADVANTAGES OF CHINESE WALLS
 - 3.5.5 LIMITATIONS OF CHINESE WALLS
 - 3.5.6 WHAT CONSTITUTES AN EFFECTIVE CHINESE WALL?

INTRODUCTION

In order to implement an effective compliance function, appropriate compliance framework should be developed. Such framework should contain suitable and appropriate organizational structure that facilitates smooth running of the company's operations with the compliance function properly imbedded. Not only the organization chart needs to be properly designed and structured, but also the functions should be properly and clearly defined and delineated. In addition, proper segregation of functions needs to be observed at all times. Once this is in place, a comprehensive monitoring program needs to be established to ensure continuing effectiveness of the compliance function.

This chapter is about putting the concepts into practice. It focuses mainly on the establishment and monitoring of the compliance function within an authorized person. The chapter begins by providing an overview of the regulatory framework that governs the Saudi's securities market. This is followed by a discussion of the guidelines of establishing an effective compliance infrastructure, and establishing and implementing an effective compliance monitoring program. It is important for the authorized persons to manage sensitive and private information as this may lead to insider trading and conflicts of interests in the organization. Herein come the roles of Chinese walls which are discussed in the last section of the chapter.

3.1 THE REGULATORY FRAMEWORK OF THE SAUDI CAPITAL MARKET

Learning Objective 3.1 – *Know* various law and implementing regulations that govern the local capital market.

Article 4 of the Capital Market Law provides for the establishment of the Capital Market Authority (CMA) as the regulatory body of the Saudi capital market. Article 5 of the Capital Market Law mandated the CMA as the sole responsible entity for issuing regulations, rules and instructions, and for the enforcement of the Law. The Law and its Implementing Regulations that currently govern the Saudi capital market and enforced by the CMA are:

- Capital Market Law
- Authorized Persons Regulations (APR)
- Market Conduct Regulations (MCR)
- Securities Business Regulations (SBR)
- Investment Funds Regulations (IFR)
- Real Estate Investment Funds Regulations (REIFR)
- Anti-Money Laundering and Counter-Terrorist Financing Rules (AML/CTF)

- Corporate Governance Regulations (CGR)
- Offers of Securities Regulations (OSR)
- Merger and Acquisition Regulations (M&A)
- Listing Rules (LR).
- Instructions and Procedures Related to Listed Companies with Accumulated Losses Amounting to %20 or More of their Share Capital.
- Prudential Rules.
- The Resolution of securities Disputes Proceedings Regulations.
- Glossary of Defines Terms Used in the Regulations and Rules of the Capital Market Authority.
- Credit Rating Agencies Regulations.
- Investment Accounts Instructions.
- Rules of Qualified Foreign Financial institutions Investment in Listed Companies.
- Real Estate Investment Traded Funds Instructions.
- The Instructions of Book Building Process and Allocation Method in Initial Public Offerings.
- Regulatory Rules and Procedures Issued Pursuant to the Companies Law Relating to Listed Joint Stock.
- Parallel Market Listing Rules.

Authorized persons' conduct of business is governed by the above Laws and its Implementing Regulations. The extent of applicability of each regulation depends on the specific functions that the authorized person has been authorized to conduct by the CMA.

3.2 EFFECTIVE COMPLIANCE INFRASTRUCTURE

Learning Objective 3.2 – *Learn* how to develop an effective compliance infrastructure in an organization.

Establishing an effective compliance infrastructure is about developing an organizational structure that takes into account the proper implementation of the compliance function within the organization. There are two main aspects of compliance infrastructure:

1. the organization structure (or organization chart) and the lines of authority

and accountability, and

2. the description and delineation of roles and responsibilities of the individuals and departments.

The first involves the identification of the authorized person's functions that are related to compliance. The organization must first identify the various functions or departments or units that are directly and indirectly related to the compliance function, or those whose actions would have repercussions on the compliance aspects of the organization.

The second involves identification of the management levels and personnel related to compliance. Within the above functions, the individuals that are directly or indirectly related to the compliance function must be identified and their specific roles and responsibilities related to the compliance function must be specified.

There must be a clear description of relationships, in terms of delegation and accountability from the board of directors to the CEO to the compliance committee and the Compliance Officer, and those identified in the compliance program.

The organization structure must clearly state the hierarchy and clearly delineate the roles and responsibilities of each department, and the reporting structure.

3.3 DEVELOPING A COMPREHENSIVE COMPLIANCE PROGRAM

Learning Objective 3.3 – *Learn* how to design and develop a comprehensive compliance program in an organization.

In ensuring that the Capital Market Law, its Implementing Regulations, CMA directives, guidelines as well as the authorized person's standard policies and procedures are adhered to at all times, the authorized person must develop a comprehensive compliance program. The establishment of a comprehensive compliance program will assist the Compliance Officer to discharge his supervisory duties more effectively.

The general steps in designing a comprehensive compliance monitoring program are listed below.

- **Form a task-force**

The first step is to set up a committee which is representative of all business units or departments within the authorized person. The committee which is fully represented provides versatility and comprehensiveness to the compliance program.

- **Choose a management mechanism**

Decide on the appropriate management mechanism to implement the program, for example: line management. In a line management system, there will be clear lines of authority, responsibility and accountability. In this way, supervision and monitoring can take place in an effective manner.

▪ **Determine the functions**

Decide on the various individual functions and tasks to be included in the compliance program. A compliance manual needs to be prepared for each function and task. The manual will lay out in a simple language, step-by-step the process that must be observed by the individual performing each job. The manual will also include the code of conduct and things to be avoided in performing each task.

▪ **Communication and training of staff**

The manual that contains processes and procedures needs to be communicated to the relevant staff who will be performing the job, and to other related persons. Proper training needs to be provided to the relevant staff so that they understand the tasks and the processes and procedures thoroughly. A good training program could cover the following areas:

- the regulatory framework – the laws and implementing regulations;
- internal policies and practices, compliance standards and compliance manual;
- code of business conduct and professional ethics;
- methods of supervision and monitoring;
- benefits of compliance and costs of non-compliance;
- consequences of non-compliance.

▪ **Supervision and monitoring**

Supervision is a continuous process that includes coaching and mentoring, to ensure that each task is performed satisfactorily and in compliance with the required procedures. Supervision is to ensure compliance and to prevent mistakes and/or non-compliance. Monitoring, on the other hand, is a periodic exercise to examine whether activities are performed in a satisfactory manner, and to take remedial action if deviations have occurred.

- **Reporting**

The written reports resulting from the review and monitoring exercises must be submitted to the Compliance Department, and/or to the board.

The content of the compliance programs needs to be regularly updated to accommodate any changes in the regulations or changes which take place within each business unit. The successful implementation of the compliance program is dependent on every individual in the organization. It is therefore extremely important that the board or the governing body of the authorized person seeks to instill good governance and a compliance culture within the authorized person.

3.4 CARRYING OUT AN EFFECTIVE COMPLIANCE MONITORING PROGRAM

Learning Objective 3.4 – *Understand* the importance of carrying out an effective compliance monitoring program.

Developing compliance monitoring program is essential, but the real challenge is the effective implementation of such monitoring programs. Many organizations spend great efforts in establishing a comprehensive compliance monitoring program, but fail to have them implemented. The followings are common pitfalls when implementing compliance monitoring programs:

- lack of acceptance and support from the board and top management
- the Compliance Department is poorly staffed and inadequately resourced
- the Compliance Officer lacks in seniority, qualifications or experience, or is not assigned on a full-time basis to compliance matters
- complete reliance is placed on the Compliance Officer and Compliance Department to carry out the monitoring program
- lack of independence on the part of the Compliance Officer in discharging his duties
- failure to identify and manage conflicts of interest.

In order to ensure effective implementation of such programs, the authorized person must ensure that the above common pitfalls are addressed.

3.5 SEGREGATION THROUGH CHINESE WALLS

3.5.1 WHAT ARE 'CHINESE WALLS' ?

Learning Objective 3.5.1 – *Know* the meaning of Chinese walls and how it was initially used.

In the context of a financial intermediary, a Chinese wall may be defined as an informational barrier consisting of systematic procedures and structural arrangements that are designed to prevent unauthorized flow of confidential and price-sensitive information between different departments. For example, by virtue of their functions, an authorized person may be in possession of corporate information that has not been disclosed to the market. If this private information gets to the trading personnel, they will have an unfair advantage over the public in securities dealings. Chinese walls are meant to prevent this and other inter-departmental information flow that may result in misuse of the information.

The approval of the Compliance Officer is needed for the confidential information to be communicated between units/departments. In granting or denying the flow of information, the Compliance Officer shall take into consideration the material nature of information, the timing, elements of conflicts of interest or unfairness to the market and whether it will become public information in the near future.

The original aim of Chinese walls is to prevent insider trading in a market intermediary, as demonstrated by the following abstract:

“Chinese walls first came into existence in 1968 as part of a settlement between the Securities & Exchange Commission in the U.S and Merrill Lynch. Merrill Lynch was the lead underwriter for a potential public offering of debentures by the Douglas Aircraft Company. Merrill Lynch learned that the company was about to issue a revised estimate of its earnings with substantially lower figures. Merrill Lynch's underwriters gave this information to the sales department, who in turn told several mutual funds and other large institutional clients. During the three-day period before Douglas publicly disclosed this information, Merrill Lynch and its clients sold the stock to avoid substantial losses. As part of the settlement Merrill Lynch reached with the SEC, the firm adopted a statement of policy that “prohibits disclosure by any member of the Underwriting Division of material information obtained from a corporation ... and not disclosed to the investing public.” In effect, this statement of policy established the first Chinese wall. After the Merrill Lynch settlement, other brokerage firms voluntarily implemented Chinese walls to prevent the SEC from targeting them in insider trading investigations.”⁵

Subsequently, Chinese walls are also used to avoid situations of inter-departmental conflicts of interests. Nowadays, Chinese walls have also become an important risk management tool, in which case they are used as a means to segregate functions.

⁵ Gorman (2004), page 483.

These are explained in more detail in the following sections.

3.5.2 PURPOSE OF CHINESE WALLS

Learning Objective 3.5.2(a) –*Know* the purpose of Chinese walls in an organization.

Learning Objective 3.5.2(b) –*Know* the concept of Chinese walls in relation to insider trading activities.

Learning Objective 3.5.2(c) – *Know* the concept of Chinese walls in relation to conflicts of interest situations.

Learning Objective 3.5.2(d) – *Know* the concept of Chinese walls in relation to segregation of functions.

In modern organizations, Chinese walls may be used in three major applications:

- Prevention of insider trading
- Prevention of conflicts of interests
- Segregation of duties.

Prevention of Insider Trading

Insider trading is the illegal trading of a security based on nonpublic information. In a multi-service authorized person, the investment banking department usually obtains private information through its relationship and dealings with corporate clients. If the investment banker shares this information with the firm's trading and funds management personnel, it may lead to insider trading.

For example, the investment banker may be advising a corporate client on making a tender offer to take over another company. This is private information before it is disclosed to the public. If the investment banker discloses this information to trading staff within the authorized person, they may use this private information to trade for themselves or to advise their clients. This is of course a clear example of insider trading, which is prohibited by the law.

In order to prevent or avoid insider trading of this nature, private information, especially those that are price-sensitive, must be prevented from leaking from the investment banker department to other departments. A 'Chinese wall' surrounding the investment banker department must therefore be 'erected'.

Prevention of Conflict of Interest

A large authorized person may engage itself in many different activities, which

include retail and institutional brokerage, trading for the firm's own account, research, fund management, underwriting and investment banking that includes advising and arranging deals for corporate clients. With these multiple activities, an authorized person can face numerous situations of conflicts of interest.

For example, the Chinese wall may help to maintain analyst independence by separating the research and investment banking departments, so that analysts are not subject to pressure by the investment bankers. If research operates independently, analysts could express their true views on stocks without fear of constraining the activities of investment banking department.

Other situations of conflicts of interest may arise when, for example, the research department within an authorized person makes certain recommendations on certain stocks. This information is private information until it is disseminated to the clients and to the market. If Chinese walls do not exist, the managing function of the authorized person may come to know about this information before it goes public. The manager will be in a position of conflict of interest as he/she may be able to act to maximize his own wealth instead of maximizing the clients' wealth.

Segregation of Functions

Chinese walls not only refer to 'walls' that prevent movement of private information, but also include proper segregation of duties. Segregation of duties and functions is an important element of operational risk management. Operational risks may result in losses due to weakness or faulty work processes and procedures. If one person is allowed to handle the multitude processes, it may open doors for abuse of the system.

Segregation of duties means separating tasks in the work process by assigning the tasks to different employees. In this way there exists a 'check and balance' in the system. Examples of duties that can be logically segregated are: trading and settlement functions; front-office and back-office operations; and ledger maintenance and ledger approval.

3.5.3 ADVANTAGES OF CHINESE WALLS

Learning Objective 3.5.3 – *Know* the advantages of having proper Chinese walls arrangement in an organization.

With the presence of Chinese walls, information is contained within the respective departments that are authorized to receive such information. This situation allows other departments to act freely in performing their functions without fear of influencing or being influenced by other departments. For example, the research

department may analyze a stock based on its own merits, regardless of any deals being made by the investment bank department. The traders will also be able to trade freely without fear of being implicated for insider trading.

Chinese walls help to promote fairness and confidence in the securities markets by ensuring that those who are in possession of private information will not be able to use it for personal or private gains at the expense of unknowing investors. Prevalence of insider trading, especially within the authorized persons, reflects lack of honesty and fair play, and will result in the loss of investors' confidence in the market.

One of the functions of investment banks is to advise corporate clients on business deals, such as in mergers and take-overs; and in such situation a corporate client would entrust the investment banker with sensitive information. Without Chinese walls, the investment banker may share this information with other departments within the organization that are possibly in need of this information. In this sense, Chinese walls help to protect the interest of corporate clients.

3.5.4 DISADVANTAGES OF CHINESE WALLS

Learning Objective 3.5.4 – *Understand* the disadvantages of Chinese wall arrangement in an organization.

Effective Chinese walls may prevent an authorized person from fulfilling its duty of loyalty to its clients. According to this fiduciary duty, an authorized person must disclose to its customers all material facts within its knowledge that may affect a transaction. But Chinese walls prevent the authorized person from using private information obtained from investment bankers to satisfy this duty of the firm's retail traders.

Looking from a different angle, Chinese walls may create internal departmental conflicts. An authorized person has a duty of confidentiality to its corporate clients, while at the same time it has a duty to its retail customers to disclose relevant information on a stock. This puts the authorized person in a conflicting situation - to obey the confidentiality duty to its corporate clients at the 'expense' of its retail clients, or to obey the disclosure duty to its retail clients but violating the confidentiality requirement.

Another related disadvantage is the inability of the authorized person to share information among its different departments. If information and resources can be shared freely, it would lead to better decisions, cost savings, opportunities for collective thinking and other synergies of combining and integrating various

departments. For example, the investment bank department may have relevant information for the research department, while the research department may in turn have relevant information that may benefit the fund managers and trading department. With Chinese walls intact, the sharing of information and resources will not be possible.

3.5.5 LIMITATIONS OF CHINESE WALLS

Learning Objective 3.5.5 – *Understand* the limitation of Chinese walls arrangement in an organization.

Having Chinese walls is not a guarantee that the flow of inside and private information will stop, thereby preventing insider trading and analysts' conflicts of interest. Chinese walls may be successful in preventing unauthorized and accidental flow of inside information, but may not be able to prevent deliberate efforts to share inside information.

The prevention of insider trading through using Chinese walls is in the context of a market intermediary or an authorized person situation. Chinese walls therefore will not be relevant to prevent insider trading outside the context of a market intermediary.

3.5.6 WHAT CONSTITUTES AN EFFECTIVE CHINESE WALL?

Learning Objective 3.5.6 – *Know* the elements that make up effective Chinese wall arrangements.

Effective Chinese walls imply that they achieved their main objective of preventing insider trading, and the broader objectives of preventing conflicts of interests and facilitating segregation of duties. Implementing Chinese walls may seem simple, but making it work needs a lot more effort and commitment from the management. In reality, problems arising from unauthorized information flow are hard to contain. In the workplace, for example, people meet and mix. Also, with the modern information and communication technology, it seems impossible to contain information. Therefore, in addition to establishing the Chinese walls, organizations must be staffed by people with high integrity and work ethics, who will observe not only the letter of the law but also its spirit. In addition, the firm should also have an efficient management of sensitive information, for example, by

limiting the number of personnel involved in a corporate deal.

From the management perspective, there are initiatives that may be taken to improve the effectiveness of Chinese walls; these may include the following:

- *Mode of separation.* Although having physical walls may contribute to its effectiveness, Chinese walls need not be always physical structures. Other considerations include procedures and processes, management of information flow, organization structure (lines of responsibility and accountability, reporting and supervision), etc.
- *Monitoring and review.* Mode of separation must be complimented by having a systematic monitoring and review program of Chinese walls, which may be assigned to the Compliance Officer as one of his key responsibilities.
- *Educational programs.* The management must also embark on continuous educational programs on compliance and ethics for the entire staff, more so for those involved in activities that need information and those safeguarding information.
- *Porous walls procedures.* Penetrating the walls should be considered as a serious violation of company rules. The firm must have in place proper procedures for dealing with such violations.

References:

1. Gorman, C. M. (2003), Are Chinese Walls the Best Solution to the Problems of Insider Trading and Conflicts of Interest in Broker-Dealers?, *Fordham Journal of Corporate and Financial Law*, Vol. IX, pp. 475-99. ([http://ir.lawnet.fordham.edu/cgi/viewcontent.cgi?article=1169&context=jcfl&sei-redir=1#search="merril+lynch+and+chinese+walls"](http://ir.lawnet.fordham.edu/cgi/viewcontent.cgi?article=1169&context=jcfl&sei-redir=1#search=\))
2. Securities Industry Development Centre (2008), Malaysia Capital Market: Examination Study Guide: Module 11: Compliance, Securities Commission of Malaysia.

Review Questions

1. List the Implementing Regulations that have been issued by the Capital Market Authority. What are the most important regulations related to the compliance function?
2. What are the main aspects of a compliance infrastructure?
3. What are the elements that need to be considered in developing a compliance infrastructure?
4. What are the typical steps in establishing a compliance program in an organization?
5. Training of staff is one of the components of a compliance program. What should be the focus of such training programs?
6. What are the common pitfalls of a compliance program?
7. Explain clearly the meaning of Chinese walls.
8. How is the concept of Chinese walls being made use of in the securities markets?
9. What are the main purposes of Chinese walls in a market intermediary (authorized person)?
10. What are the advantages of Chinese walls?
11. What are the disadvantages of Chinese walls?
12. What are the limitations of Chinese walls?
13. How can the effectiveness of Chinese walls be improved?

Sample Multiple Choice Questions

1. Which statement is FALSE regarding the roles of Complaints Department in relation to a compliance program?
 - A. It provides important linkages between the authorized person and its customers and clients.
 - B. It provided important feedback on customer preferences.

- C. It should process each complaint according to the stated procedures.
 - D. It can highlight problems that the authorized person needs to focus on in a proactive manner.
2. Despite having a good compliance program in an organization, failures can still occur in its implementation, such as:
- A. Failure to identify and manage conflicts of interests
 - B. Failure to reduce the number of rules required
 - C. Failure to attract new clients with good standing
 - D. Failure to delegate responsibilities and authorities
3. A Chinese wall may be defined as an informational barrier consisting of systematic procedural and structural arrangements designed to stem the flow of information, in particular, _____ and _____ sensitive information between different departments with conflicting interests and obligations.
- A. Public; price
 - B. Public; volume
 - C. Private; price
 - D. Private; volume
4. Although Chinese walls do not guarantee success, its effectiveness may be enhanced by having the following characteristics:
- (i) physical separation of departments to insulate them from each other
 - (ii) a continuous education program to emphasize the organization's productivity
 - (iii) a well-defined procedure for dealing with situations where it is thought the wall has been crossed
 - (iv) constant monitoring by the Compliance Officer.
- A. (i), (ii) and (iii) only
 - B. (i), (iii) and (iv) only
 - C. (ii), (iii) and (iv) only
 - D. All of the above

RISK MANAGEMENT AND COMPLIANCE

4

LEARNING OBJECTIVES

The syllabus for this examination is broken down into a series of learning objectives and is included in the Syllabus Learning Map at the back of this workbook. Each time a learning objective is covered, it appears in a text box preceding the text.

INTRODUCTION

- 4.1 RISK AND RISK MANAGEMENT
- 4.2 PRINCIPLES OF RISK MANAGEMENT
- 4.3 RISK AND COMPLIANCE FRAMEWORK
- 4.4 RISK MANAGEMENT INFRASTRUCTURE
- 4.5 TYPES OF RISK
- 4.6 TOOLS FOR RISK MANAGEMENT
- 4.7 RISK MONITORING AND REVIEW

INTRODUCTION

In the real world, nothing is certain. There is no guarantee that the best plan will run according to what has been planned. Therefore, in addition to having good plans, effective organization must also manage risks and uncertainties so that possibilities of failure can be managed in an organization, minimized or avoided. In this context, risk management and compliance function complement each other to avoid calamities and disasters.

This chapter discusses various aspects of risk management and its relationship and interdependence with the compliance function. The first section discusses the meaning of risk and risk management, and this is followed by discussions of principles of risk management. The chapter also covers the risk and compliance framework and the important elements that support a strong risk management infrastructure, and some of the risk management tools that may be used to manage organizational risks. The chapter ends with a comprehensive discussion on various types of risk.

4.1 RISK AND RISK MANAGEMENT

Learning Objective 4.1 – *Know* the meaning of risk and risk management and understand why we need risk management.

Risk may be defined as the uncertainty of attaining objectives. Risks emanates from uncertainties in capital markets, project failures, legal liabilities, credit risk, accidents, natural causes and disasters as well as deliberate attacks from an adversary.

Risk management is a systematic approach to minimizing an organization's exposure to risk. A risk management system includes various policies, procedures and practices that work together to identify, analyze, evaluate, address and monitor risk. The strategies to manage risk include transferring the risk to another party, avoiding the risk, reducing the negative effects of risk, and accepting some or all of the consequences of a particular type of risk. In our everyday life, examples of risk management tools include purchasing of insurance, installing security systems, maintaining cash reserves and investment diversification. In short, risk management is the process of analyzing exposure to risk and determining how best to handle such exposure.

The implementation of strong and effective risk management and controls within financial institutions promotes stability throughout the entire financial system. Specifically, internal risk management controls provide four important functions:

1. to protect an organization against market, credit, liquidity, operational, and legal risks
2. to protect the capital market industry from systemic risk
3. to protect an organization's customers from large non-market related losses (e.g., organizational failure, misappropriation, fraud, etc.), and
4. to protect an organization against adverse reputational risk.

Sound and effective risk management and controls promote the stability of both securities firms and industry which, in turn, inspires confidence among the investing public and counterparties. Securities firms have economic and commercial incentives to employ strong risk management internal control systems. Without such controls, a firm is vulnerable to risk.

4.2 PRINCIPLES OF RISK MANAGEMENT

Learning Objective 4.2 – *Know* the general principles of risk management.

Organizations that are planning to establish risk management programs must adhere to certain principles that guide them towards a successful and effective implementation. Overall, risk management principles are based on common sense and what is relevant to an organization and its industry. In the context of the securities market industry the following principles of risk management are deemed relevant.

1. *Principle of value added.* An effective risk management program should add value to the organization through improved efficiency in various functions, such as human resource, operations, finance and marketing. Risk management should lead to a more focused activities and more efficient use of companies' resources.
2. *Principle of integrated process.* Risk management should not be treated as a stand-alone initiative; rather it should be integrated with the whole organization process as well as with all projects and change management processes.
3. *Principle of integrated decision making.* Organizations' decision making at all levels should explicitly address risks and uncertainties, particularly when considering alternative courses of action. The best available information should be used to evaluate risks, keeping in mind its limitation, shortcomings and possible pitfalls.
4. *Principle of systematic application.* Risk management should be approached and managed in a structured and systematic manner in order to bring about consistency in achieving results.
5. *Principle of suitability.* Risk management program should be developed and adapted to suit the needs of the organization and the environment in which it operates. The environment includes internal and external cultural factors that

may be unique to the organization.

6. *Principle of inclusivity.* It is important that all stakeholders understand and support the organization's risk management programs. To achieve this, appropriate amount of involvement of stakeholders is necessary, followed by maintaining the necessary transparency and regular communications with all relevant parties. The management must be mindful that the stakeholders may influence the achievement of organization's objectives.
7. *Principle of adaptability.* Organizations and their environments are subject to continuous changes. Some of these changes would be affecting the organization's activities and programs. As such, risk management programs must be ready at all times to promptly recognize and adapt to these changes.
8. *Principle of continuous improvement.* To make it relevant and effective at all times, risk management programs must evolve and be subject to constant and continuous reviews and improvements.

4.3 RISK AND COMPLIANCE FRAMEWORK

Learning Objective 4.3 – *Understand* the general overview of the risk management and compliance framework and the general processes involve in this area.

A growing regulatory environment, higher business complexity and increased focus on accountability have led organizations to pursue a broader range of risk and compliance initiatives across all departments. Nonetheless, these initiatives are often uncoordinated in an era when risks are interdependent and controls are shared. As a result, these initiatives get planned and managed in silos, which potentially increases the overall business risk for the organization. In addition, parallel compliance and risk initiatives lead to duplication of efforts and can cause costs to spiral out of control. An effective risk management and compliance process with control, definition, enforcement, and monitoring has the ability to coordinate and integrate these initiatives.

The span of a risk management and compliance process includes the following elements.

- **Risk management** enables an organization to evaluate all relevant business and regulatory risks and controls and monitor mitigation actions in a structured manner. The process includes:
 - identifying and categorizing the risk
 - assessing risk
 - mitigating risk
 - reporting on containment of risk.

- **Compliance** ensures that an organization has the processes and internal controls to meet the requirements imposed by regulators via various laws and implementing regulations, guidelines, best business practices, internal policies and procedures. The process include:
 - documenting process and risks;
 - defining and documenting controls;
 - assessing effectiveness of controls;
 - disclosure and certification of compliance process;
 - remediating issues.

4.4 RISK MANAGEMENT INFRASTRUCTURE

Learning Objective 4.4 – *Know* the important elements that support a strong risk management infrastructure.

To achieve effective risk management, there has to be an appropriate risk management infrastructure with the following characteristics.

4.4.1 Separation of duties/functions

The main principle of a risk management infrastructure is the separation of duties or functions, for example, the separation of authority, duties and functions within dealing and back office operations. The need to separate and segregate duties has been discussed earlier in Sections 1.3 and 3.5.2 of this Manual.

4.4.2 System adequacy

There has to be an adequate system to record transaction data, to be used for monitoring and managing risk. With modern information technology, all relevant information for each transaction and for each trader and investor is automatically captured as each passes through the clearing system. The data may be arranged and processed for monitoring and evaluation. For example, data processing should be able to evaluate if an account falls short of the maintenance margin, and is therefore due for a margin call. At the end of each trade, a report may be generated to evaluate the balances of all clients, so that those that over-trade or go out of line with accepted trading practices may be brought back to good standing.

4.4.3 Limit structure

One of the safety measures taken in risk management is setting the various limits applicable to authorized persons. For example, there are capital adequacy requirements with which the authorized person must comply. The limits ensure the

authorized persons do not engage in activities that exceed their ability to absorb risk.

4.4.4 Reporting as a risk management tool

Reports generated by internal and external auditors maybe used as tools for risk management, where the Risk Manager may bring to the attention of the Compliance Officer and senior management a possible default in the system. Efficient processes such as having a clearly defined line of delegation and accountability for each unit, department and the organization as a whole must be established.

4.5 TYPES OF RISK⁶

Learning Objective 4.5 – *Understand* various type of risk and some relevant case studies to illustrate such risks.

4.5.1 MARKET RISK

Market risk refers to uncertainties of market price movements resulting from country-wide factors or industry factors. In securities markets, market risk affects many or all securities, not just one or few securities. A change in government's economic policies or drastic change in weather that affects agricultural products are examples of market risk. The authorized person must be aware of this risk and convey its assessment to clients. The authorized person must also recognize its ability to withstand market risk so as not to be over-exposed.

Market risk is always present in all investments and investors need to be aware that they may not get the returns expected. For example, there may be a recession, or a change in consumer demand that results in change in market prices, etc. In the securities market, an increase in interest rates will usually result in a general decline in share prices, and this may result in losses to investors.

An example of dangers posed by market risk is demonstrated in the bankruptcy case of Orange County. Orange County's Treasurer used the Orange County Investment Pool's resources to invest in a significant amount of derivative securities, namely 'structured notes' and 'inverse floaters'. When interest rates rose, the rates on these derivatives securities declined along with the market value of those notes, since they were at rates below those generally available in the market. This resulted in a \$1.7 billion loss to the Orange County Investment Pool.

⁶ This section draws heavily from IOSCO (1998), including the description and examples for each type of risk.

4.5.2 LIQUIDITY RISK

Liquidity risk refers to inability to execute an order due to the lack of market liquidity or the lack of buying and selling activities in the security. Liquidity may be defined as the ability of a trader to sell or buy at or reasonably close to the desired price. When a security does not have or lacks in liquidity, it becomes difficult for investors to buy or sell the security. Investors or firms and their clients may find themselves stuck with securities and unable to sell them at reasonable prices. The authorized person must be aware of this risk when dealing with illiquid securities as it can be difficult to make the transaction, or even obtain a quotation. Liquidity risk also includes the risk that a firm will not be able to close their open positions or unable to hedge a position.

An example of liquidity risk is illustrated by the March 1994 \$600 million loss of Askin Management. Askin specialized in mortgage-backed debt instruments known on Wall Street as 'toxic waste' because they carried the highest credit and interest rate risk. When interest rates rose sharply, trading in these debt instruments ceased. No market participant would quote Askin a price on his positions anywhere near what he had paid for them. Kidder, Peabody & Co. lost \$25.5 million loaned to Askin to leverage these positions.

4.5.3 CREDIT RISK

Credit risk is the possibility that a trade cannot be settled due to inability of a client to obtain credit in time and therefore cannot perform the contracted obligation. In securities trading, if a buyer fails to pay within a specified period of time, the securities will be forced-sold to the market to settle payment, and the broker has to make up for any short-fall of the amount needed to close the transaction. Therefore, the broker must assess the credit risk of the client prior to entering into a transaction.

Securities firms are faced with credit risk whenever they enter into a loan agreement or extend credit to their clients as they may suffer losses if the clients default. Credit risk can be minimized by risk management and controls and procedures, for example, by requiring clients to maintain adequate collateral, make margin payments, and have contractual provisions for netting.

An example of credit risk is the impact of the 1997-98 Asian financial crisis on some of the US banks which reported in January 1998 that their latest quarterly results were hurt by the crisis. For example, J.P. Morgan reclassified approximately \$600 million of its loans as 'non-performing' due to the turmoil in Asia. Its fourth quarter profits fell to \$1.33 a share from \$2.04 a year earlier (35% lower than last year), which were below market expectations of \$1.57 a share.

4.5.4 DEFAULT RISK

In securities transactions, default risk is the risk that a counterparty does not deliver a security or cash payment as per agreement when the security was traded after the

other counterparty or counterparties have already delivered security or cash payment as per agreement. For example, Mr. A bought some shares of company ABC through his broker and he is given two days to deliver the cash after the shares are delivered. After two days Mr. A did not pay for the shares. This means he defaulted on the transaction. The security will be sold to the market and the broker has to cover any loss incurred. One way to overcome this kind of default risk is to affect the transfer of funds and the title of the securities simultaneously.

In loan contracts, default risks may be addressed by adjusting the costs of loan, or the interest charged to customers. The higher the risk, the higher will be the interest charged. In securities investment, for example in bond investment, investors will adjust the required rate of return to commensurate with the risks involved, including default risk of the bond issuer.

4.5.5 OPERATIONAL RISK

An operational risk may be defined as a risk arising from a faulty execution of a company's business function that results in losses incurred by the company. Another definition is that operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. This risk may also arise due to deficiencies in the firm's accuracy of information system or internal control. Operational risk is therefore a very broad concept which focuses on the risks arising from the people, systems and processes through which a company operates.

Applied to a market intermediary, operational risk is the risk of incurring losses due to improper trade processing, such as unidentified limit excesses, unauthorized trading, trading fraud, weakness in back office functions including inadequate books and records and a lack of basic internal accounting controls, inexperienced personnel, and unstable and easily accessed computer systems. To manage operational risk, care must be taken to ensure a proper systems and controls in the firm and that all transactions are authorized and there exists appropriate segregation of functions.

The importance of operational risk management and controls may be highlighted by the collapse of Barings in February of 1995. Britain's Board of Banking Supervision concluded that Barings' failure was due to immense losses from unauthorized and hidden derivatives trading of an employee of Barings Futures Pte. Limited in Singapore, that went virtually undetected by management. The trader had been left unsupervised in his dual role as head of futures trading and settlements and Barings' failure to independently monitor the trader's activities, as well as its failure to separate front and back office functions, created operational risk which resulted in large losses and, ultimately, the total collapse of the firm.

Similar poor management led to even larger losses at Japan's Daiwa Bank Ltd. in the bond market. In 1995, it was discovered that a bond trader at Daiwa was able to conceal approximately \$1 billion in trading losses because of his access to Daiwa's accounting books. As with Barings, the Daiwa trader was in control of accounts as

well as trading activities. Separation of trading and support functions, a fundamental risk management practice, was violated in both. Had proper management oversight, as well as the fundamental risk management and control practice of separating backroom and trading functions, been in place, the losses at Barings and Daiwa could perhaps have been avoided, or at the very least, minimized.

4.5.6 REPUTATIONAL RISK

This risk refers to the possibility of jeopardizing the good name or reputation of the company in the eyes of the market. Reputation risk may result in the decline in business resulting from the integrity of the company being called into question. Company's reputation may be affected by an isolated action of one employee, or may be a concerted action by several people within the firm or outside the firm. It is important to recognize that adverse publicity, whether true or not, will result in rapid decline in the company's business and earnings. The effect may start off with a decline in transactions handled by the company, pulling out of existing customers, reluctance of new customers to engage the company, and this goes on to result in reduction in revenues, resignation of good employees, etc.

4.5.7 LEGAL RISK

Legal risk is the risk of losses arising from the possibility that an entity may not be able to enforce a contract against another party. Legal risk involves the potential illegality of the contract, as well as the possibility that one or both parties entering into the contract without proper authority. Such contracts are called *ultra vires*. An *ultra vires* act is defined as any act performed without legal authority because such act is beyond the scope of powers granted to a corporation, state or municipality.

For example, the U.K. decision in *Hazell v. Hammersmith & Fulham L.B.C.*, 2 W.L.R. 372 (1991), ruled that swaps transactions entered into by local government authorities were *ultra vires*, and therefore legally unenforceable contracts. This ruling cost banks approximately \$1 billion in defaulted swap payments. The need for legal clarity is highlighted by the fact that legal counsel in *Hazell* had made continuous assurances that the swaps contracts were legal and enforceable

In 1998, Merrill Lynch settled with Orange County, California, for a massive \$400 million to settle accusations that it sold inappropriate and risky investments to Orange County. The county lost \$1.69 billion, which forced it to file for bankruptcy in December 1994. Orange County has asserted an *ultra vires* claim in its suit against Merrill Lynch claiming that Merrill Lynch should have known that the contract violated several provisions of the California Constitution, hence rendering the contracts unenforceable. Gaddi H. Vasquez, chairman of the County Board of Supervisors, stated: "Merrill Lynch abused the trust and the confidence of the people of the county by permitting and encouraging the investment of public funds in volatile financial instruments that were neither authorized by law nor suitable for the investment of taxpayers' dollars."⁷

⁷ <http://www.nytimes.com/1995/01/13/business/orange-county-in-suit-against-merrill-lynch.html>

4.5.8 SYSTEMIC RISK

Systemic risk refers to market failure that involves many institutions in the industry. Systemic risk may also be due to a 'crisis of confidence' among investors, creating illiquid conditions in the marketplace. Systemic risk is prone in situations where financial and securities activities are concentrated in a small number of institutions. Due to interconnection of financial transactions among the institutions, a failure of one institution may create the potential for a domino effect of failures that becomes a systemic risk. The situation is clearly demonstrated by the collapse of many giant institutions in the financial industry due to the subprime financial crisis in 2008. Systemic risk is perhaps the greatest challenge to market intermediaries and regulators. A uniform, flexible framework of risk management and controls, coupled with adequate capital standards is essential to the continued orderly operation of financial markets.

4.6 TOOLS FOR RISK MANAGEMENT

Learning Objective 4.6 – *Know* some of the risk management tools used to manage organizational risk.

There are various strategies, tools and methods that can be used by an organization to manage risk; the choice of these depends largely on the complexity and size of the organization.

4.6.1 Organizational strategy

Risk management, just like compliance, is the responsibility of the entire organization. It is important to involve the different functions or departments in the organization in monitoring and controlling risks as we are moving into an increasingly sophisticated world of securities business. Most firms institute certain groups to be responsible for monitoring and controlling risks, such as the Compliance department, Risk Management department, Credit department and Internal Audit department.

4.6.2 Risk reviews

These are periodic reviews of activities and functions within the firm to make sure they are conducted in accordance to stated guidance, policies and procedures. For example accounts reviews may indicate a concentration of business in certain clients or certain types of security. These findings may warrant further investigations if the accounts are suspiciously out of ordinary. Another example would be reviewing margin accounts to make sure all accounts are in good standing, and not going over the margin limit. Additionally, review may also be made of the trading pattern of certain traders or investors, as an unusual trading pattern may well have been deliberately designed to make profits in an illegal manner. Periodic reviews also help to reduce the likelihood of mistakes and serve as early detection of deviations

and problems; hence corrective actions may be taken at an early stage, thereby avoiding large losses.

4.6.3 Market risk management

There are many elements of market risk, such as interest rate risk, exchange rate risk, equity risks, liquidity risks, and systemic risks. There are various tools that may be used depending on the risk priorities of the firm. Some of the tools are quite simple, intuitive and subjective, while others can be quite sophisticated mathematical models. Mathematical models may include: range tests, standard deviations, moving averages and value-at-risk (VAR).

4.6.4 Liquidity risk management

Constant market monitoring of market activities is one way to monitor and control liquidity risks. If there is a lack of activity in certain securities that happen to be overweight in the firm's investment portfolio, a 'risk treatment' should be implemented.

4.6.5 Credit risk management

Credit risk is related to credit exposure. It refers to uncertainty about the ability of a counterparty to close or make settlement on a transaction. One way to manage this risk is to determine a limit when offering credit to clients. In fact, it should start when determining the credit policy of the company. This means determining whether credit should be extended to a particular client, and determining the limit (amount of credit) that would be extended to that particular client. Another tool for managing or reducing credit risk is the use of collateral, in which case decisions need to be made on collateral policies: determining the type of assets acceptable as collateral, and determining their value, liquidity and custodian. It should be remembered; however, that collateral may not be able to solve the entire credit risk. Other warning systems may also be used to provide alerts whenever certain control parameters exceed the stated limits. These parameters may include: credit concentration among clients or products, single client exposure, single security exposure, margin limits, etc.

4.6.6 Operational risk management

The Basel Committee on Risk Management Guidelines for Derivatives (1994) identifies operational risk, legal risk and liquidity risk as the main components of an internal compliance and control program.

Tools for managing operational risk include:

- segregation of operational duties
- reconciliation of front and back office accounts
- documentation confirmation
- periodic review of procedures.

One type of operational risk occurs when the firm does not have enough liquid assets for its operating or working capital. The capital adequacy rule is aimed at addressing this type of operational risk.

4.6.7 Legal risk management

This refers to the possibility of conducting transactions that are deemed illegal under the existing laws, rules and regulations. Managing such risk necessitates key questions such as the following.

- Do the parties have the necessary authority to engage in a transaction or a contract?
- Are the terms of the contract sound (in a legal sense)?
- Are the terms and conditions in compliance with all rules and procedures?
- Is there proper documentation for each transaction?

4.6.8 Ethics and risk management

Securities business operates in a risky and uncertain environment. Firms make profits by taking risks. Conservative firms (risk avoiders) prefer to have a big safety net in the form of less risky or risk-free assets, while aggressive firms (risk seekers) prefer to invest most of their resources in risky assets. One of the ways these firms manage risk and uncertainties is by legal means, that is, by using terms and conditions and disclaimers. A code of conduct can also be an important tool for managing risks. Firms that operate with a high degree of integrity will not engage in unethical means to make profits.

Firms may also transfer risks to other parties, such as their customers or to the markets. For example, firms may deliberately push securities prices up for their own interest, only to dump them for a hefty profit. This is a market manipulation and clearly illegal in all market jurisdictions. But at the global level, these activities may be difficult to monitor – hence good business ethics are required to check such temptations.

4.7 RISK MONITORING AND REVIEW

Learning Objective 4.7 – *Know* the importance of risk monitoring and review.

An important element of a risk management process is making sure of its continued effectiveness. This is done through a planned risk monitoring and review process. The purpose of monitoring and review is to ensure its relevance and effectiveness and to update information that becomes important feedback for organization's decision making. Risk monitoring also helps to identify new or changing risks.

Monitoring and review may involve regular checking or surveillance of what is already in place. The results of monitoring and review should be properly documented and used as an input to the review of the risk management framework. In the risk management process, records provide the foundation for improvement of methods and tools as well as of the overall process.

Reference:

1. International Organization of Securities Commissions (IOSCO), (1998), Risk Management and Control Guidance for Securities Firms and Their Supervisors, <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD78.pdf> (Accessed: June 2011)
2. New York Times, January 13, 1995, Orange County in Suit against Merrill Lynch. <http://www.nytimes.com/1995/01/13/business/orange-county-in-suit-against-merrill-lynch.html> (Accessed: June 2011)
3. Securities Industry Development Centre (2008), Malaysia Capital Market: Examination Study Guide: Module 11: Compliance, Securities Commission of Malaysia.

Review Questions

1. What is the meaning of risk and risk management? Why do organizations need risk management?
2. List out the principles of risk management that may be applicable to your organization.
3. What is the purpose of having a risk management framework? What are its suggested contents?
4. How are risk management and compliance related?
5. What are the components of the risk management infrastructure?
6. Explain the nature of the following risks in relation to an authorized person:
 - a. Market risk
 - b. Liquidity risk
 - c. Credit risk
 - d. Operational risk
 - e. Systemic risk
 - f. Reputational risk
 - g. Legal risk
 - h. Default risk
7. Describe how the above risks may be managed.
8. How are risk monitoring and review conducted?

Sample Multiple Choice Questions

1. The internal risk management controls provide the following important functions, EXCEPT:
 - A. To protect the firm against market, credit, liquidity, operational, and legal risks
 - B. To protect the financial industry from systematic risk
 - C. To protect the firm's customers from non-market-related losses (e.g. firm failure, fraud)
 - D. To protect the firm from suffering adversely from reputational risk.
2. Orange County's Treasurer used the Orange County Investment Pool's resources to invest in a significant amount of derivative securities, namely 'structured notes' and 'inverse floaters'. Then interest rates rose, the rates on these derivatives securities declined along with the market value of those notes (since they were at rates below those generally available in the market). This

resulted in a \$1.7 billion loss to the Orange County Investment Pool. This is an illustration of _____.

- A. Market risk
- B. Credit risk
- C. Liquidity risk
- D. Political risk

3. Which of the following is FALSE regarding credit risk?

- A. The possibility that a client cannot obtain credit before the transaction.
- B. The authorized person must assess the credit risk after entering into a transaction with a particular customer.
- C. Credit risk arises when a buyer fails to pay before a specified period of time.
- D. Securities firms are faced with credit risk whenever they enter into a loan agreement or extend credit.

4. Which of the following statements regarding default risk is FALSE?

- A. Default risk is the risk that a counter party does not deliver a security or its value in cash as per agreement.
- B. Default risk may be the result of credit risks and/or liquidity risk.
- C. Default risk is when a buyer of a foreign currency paid for the currency, but the foreign currency is not delivered for some unforeseen reasons.
- D. One way to overcome default risk is to make the transfer of funds after delivery of securities.

5. Which of the following statement is LEAST related to 'legal risk'?

- A. Legal risk is the possibility that an entity may not be able to enforce a contract against another party.
- B. Legal risk is the potential illegality of a contract.
- C. Legal risk arises when a contract is made by a party who has no authority to do so.
- D. If a contract is against the spirit of the law, it is legally unenforceable.

ANTI - MONEY LAUNDERING AND COUNTER TERRORIST FINANCING

5

LEARNING OBJECTIVES

The syllabus for this examination is broken down into a series of learning objectives and is included in the Syllabus Learning Map at the back of this workbook. Each time a learning objective is covered, it appears in a text box preceding the text.

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5.1 DESCRIPTION OF MONEY LAUNDERING PROCESSES

5.1.1 PLACEMENT, LAYERING, INTEGRATION

5.2 THE REGULATORY FRAMEWORK GOVERNING ANTI-MONEY LAUNDERING (AML)/COUNTER-TERRORISM FINANCING (CTF) IN SAUDI ARABIA

5.3 THE FINANCIAL ACTION TASK FORCE (FATF)

5.3.1 HISTORY OF FATF

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- 5.4.3 SUSPICIOUS TRANSACTIONS ASSOCIATED WITH TERRORIST FINANCING

5.5 THE ROLES OF AUTHORIZED PERSONS AND THE MONEY LAUNDERING REPORTING OFFICER (MLRO) IN AML/CTF INITIATIVES

- 5.5.1 KNOW YOUR CUSTOMER (KYC)
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- 5.5.3 CDD – RISK-BASED APPROACH

5.6 AML/CTF COMPLIANCE AND TRAINING

- 5.6.1 INTERNAL PROGRAMS, POLICIES AND PROCEDURES
- 5.6.2 TRAINING

APPENDIX 5.1: FATF 40 RECOMMENDATIONS ON MONEY LAUNDERING

APPENDIX 5.2: FATF SPECIAL RECOMMENDATIONS ON TERRORIST FINANCING

INTRODUCTION

Financial markets may be a fertile ground for money-laundering activities. Money that originates from illegal activities needs to be cleaned in order to remove traces of its origins. The origins are usually illegal activities such as drug trafficking, human trafficking, illegal arms sales, smuggling, and white collar crimes such as computer fraud, insider trading, embezzlement and bribery. The criminals must find a way to spend the money in a way that people, especially the authorities, will not be suspicious of the origin of the money. They do this by bulk-breaking the money and making lots of movements and transfers and deliberate transactions before finally putting the money into the normal financial system as if the money comes from legitimate sources. There is also an added twist to the money laundering process; after the September 11, 2001 attacks on New York. It has also become a major concern that money-laundering proceeds are conveniently channeled to finance terrorism.

This chapter begins by a description of the three stages of the money-laundering process, followed by explanations of the legal framework of combating money-laundering in the Kingdom of Saudi Arabia. The chapter also discusses the international initiatives in combating money-laundering and terrorist-financing in the formation of the Financial Action Task Force (FATF). Being in the front line, authorized persons in the Saudi capital market play crucial roles in combating money-laundering and terrorist-financing. They have to make every effort to detect and report suspicious transactions that take place in their firms. In fact the effort starts before a person is accepted as a client, the authorized person must perform the “know-your-customer” and “customer due diligence” processes.

5.1 DESCRIPTION OF MONEY LAUNDERING PROCESSES

5.1.1 PLACEMENT, LAYERING, INTEGRATION

Learning Objective 5.1.1 – *Know* what are the phases of the money laundering process.

Just like we clean dirty clothes in a laundering process, criminals clean ‘dirty money’ or illegal money in the money laundering process. Money laundering may be defined as the process of disguising illegal source of money so that the money looks like it came from legal sources. Typically, the money laundering process consists of three stages.

(i) Placement

The first phase is where the illicit money, often in cash, is put into the financial system for the first time. Since carrying bags of money to the bank may be conspicuous, the money is often broken into several small amounts and placed in different ways into the financial markets – several bank accounts in different banks and some may even go into securities markets or precious metals. Since regulations in most securities markets prohibit dealings in cash money, the use of securities market at this stage is somewhat limited.

(ii) Layering

The second phase, layering, is where the main machinery works. The role of the layering stage is to separate the money from their source by creating layers of financial transactions designed to disguise the audit trail. There may be a lot of buying and selling of securities, without really adhering to any systematic investment rules. Gains and losses are not of major concerns; rather the interest is just to move the money around in a seemingly legitimate way. In this sense, securities markets provide fertile soils for the layering process of the illegal money. Money from one country, may also be distributed to a series of accounts in other places and countries scattered around the globe. With the modern electronic banking facility, transferring money from one location to another is relatively easy and quick, and presents a convenient way that facilitate the process. Countries that do not subscribe to international cooperation for combating money laundering and terrorist financing become favorite places to receive the money-laundering proceeds.

(iii) Integration

The third phase is the process that gives an apparent legitimacy to the money that has gone through the layering process. In this stage, the laundered funds are placed back, or integrated, into the normal economic activities. The money may re-enter the financial markets for proper investments activities, or the real estate sector. The criminals may also spend the money into extravagant living, luxury assets, and lavish hobbies. The money may also be used to finance legitimate businesses.

5.2 THE REGULATORY FRAMEWORK GOVERNING AML/CTF IN KINGDOM OF SAUDI ARABIA

Learning Objective 5.2 – Know the regulatory framework governing AML/CTF in the Kingdom of Saudi Arabia and the respective governing authority.

Currently, there are two sets of legislations that govern an authorized person in relation to fighting money laundering and terrorist financing activities in Saudi capital market. These legislations are:

1. Anti-Money Laundering Law (Enf. by Royal Decree No. M/39 dated 25/6/1424H corresponding to 23/8/2003) and its Implementing

Regulations; and

2. Anti-Money Laundering and Counter-Terrorist Financing Rules issued by the Capital Market Authority issued pursuant to resolution no: 1-39-2008 dated 3/12/1429H corresponding to 1/12/2008.

The first legislation is implemented by the Ministry of Interior, while the second is implemented by the Capital Market Authority.

5.3 THE FINANCIAL ACTION TASK FORCE (FATF)

5.3.1 HISTORY OF FATF

Learning Objective 5.3.1 – *Know* the origin of the Financial Action Task Force (FATF) and its 40 + 9 recommendations.

The Financial Action Task Force on Money Laundering (FATF) was established by the G-7 Summit that was held in Paris in 1989. The Task Force was given the responsibility of examining money laundering techniques and trends, reviewing the action that had already been taken at a national or international level, and setting out the measures that still needed to be taken to combat money laundering. In April 1990, the FATF issued a report containing a set of 40 Recommendations, which provides a comprehensive plan of action needed to fight against money laundering. In 2001, the development of standards in the fight against terrorist financing was added to the mission of the FATF.

The continued evolution of money laundering techniques led the FATF to revise the FATF standards comprehensively and in October 2004 the FATF published comprehensive (40+9) Recommendations, further strengthening the agreed international standards for combating money laundering and terrorist financing. The 40+9 refers to the earlier 40 recommendations focusing on anti-money laundering activities while the 9 recommendations were subsequently added to focus on anti-terrorist financing activities. The full list of the 40+9 Recommendations is contained in Appendix 5.1 and 5.2 of this chapter.

Kingdom of Saudi Arabia has fully complied with all FATF's 40+9 Recommendations on AML and CTF when the local Anti-Money Laundering Law was enacted in 2003 and the implementing regulations were enforced in 2008.

5.3.2 FATF ON ANTI-MONEY LAUNDERING

Learning Objective 5.3.2 – *Know* the general areas covered under the FATF 40 Recommendations on Anti-Money Laundering.

Money laundering methods and techniques change in response to developing counter-measures. In recent years, the Financial Action Task Force (FATF) has noted increasingly sophisticated combinations of techniques, such as the increased use of legal persons to disguise the true ownership and control of illegal proceeds, and an increased use of professionals to provide advice and assistance in laundering criminal funds. The FATF calls upon all countries to take the necessary steps to bring their national systems for combating money laundering and terrorist financing into compliance with the FATF recommendations, and to implement these measures effectively.

The FATF recognizes that countries have diverse legal and financial systems and so all cannot take identical measures to achieve the common objectives. The Recommendations therefore set minimum standards for action, allowing countries to implement the details according to their particular circumstances and constitutional frameworks. The Recommendations cover all the measures that national systems should have in place within their criminal justice and regulatory systems; the preventive measures to be taken by financial institutions and certain other businesses and professions; and international cooperation.

Basically, the Recommendations cover the following major areas:

- The incorporation of money-laundering as a criminal act in the legal system
- Confiscation of assets
- Financial institutions' measures to fight money-laundering and terrorist financing, such as: performing customer due diligence, record keeping, reporting of suspicious transactions
- Institutional arrangements to combat AML and CTF
- International cooperation on related matters.

The full text of the FATF 40 Recommendations on Anti-Money Laundering is available in the Appendix at the end of this chapter.

5.3.3 FATF ON TERRORIST FINANCING

Learning Objective 5.3.3 – *Know* the general areas covered under the FATF 9 Special Recommendations on Counter-Terrorist Financing.

Terrorist financing became a serious issue after the September 11, 2001 events. The US passed the USA PATRIOT Act that aims at combating the financing of terrorism and money laundering, making sure these were given adequate focus,

among the US financial institutions.

Subsequently the FATF incorporates additional 9 Recommendations that specifically outline efforts to combat terrorist financing, in addition to the 40 Recommendations that focus on anti-money laundering. These 9 Recommendations have become the global standards for CTF and their effectiveness is almost always assessed in conjunction with AML. Often linked in legislation and regulation, terrorist financing and money laundering are conceptual opposites. Money laundering is the process whereby cash raised from criminal activities is made to look legitimate for re-integration into the financial system, whereas terrorist financing cares little about the source of the funds, but it is what the funds are to be used for that defines its scope.

Terrorists typically use low-value but high-volume illegal activities to fund their operations. Bulk cash smuggling and placement through cash-intensive businesses is one typology. They also move funds through the new online payment systems. They also use trade-linked schemes to launder money. Non-profit organizations and charities also continue to be used in countries where controls are not so stringent.

Since the 9 Recommendations are specifically focused on terrorist financing and were added on to the earlier 40 Recommendations on money-laundering, much of the details are not included. Specifically, the 9 Recommendations touch on the following, in relation to terrorist financing:

- criminalization of terrorist financing
- confiscation of terrorist assets
- reporting of suspicious transactions
- international cooperation
- mechanics of transferring funds, and
- use of non-profit organizations.

The full text of the FATF 9 Special Recommendation on Counter Terrorist Financing is available at the end of this chapter.

5.4 SUSPICIOUS TRANSACTION MONITORING

5.4.1 NATURE OF SUSPICIOUS TRANSACTIONS

Learning Objective 5.4.1 – *Know* the general nature of suspicious transactions and the required reporting requirements for them.

Each authorized person must clarify the economic background and purpose of any transaction or business relationship if its form or amount appears unusual in relation to the client, or if the economic purpose or legality of the transaction is not immediately clear. Special attention should also be paid to all complex and unusual

patterns of transactions.

Suspicious transactions are likely to involve a number of factors which together raise a suspicion that they may be connected with certain unlawful activities. As a general principle, a suspicious transaction is a transaction which causes any licensed representative or an employee of an authorized person to have a feeling of apprehension or mistrust about the transaction considering:

- a) the nature of, or unusual circumstances, surrounding the transaction
- b) the known business background of the person conducting the transaction
- c) the production of seemingly false identification in connection with any transaction, the use of aliases and a variety of similar but different addresses
- d) the behavior of the person or persons conducting the transactions (e.g. unusual nervousness); and
- e) the person or group of persons with whom the representative or employee is dealing.

If in bringing together all relevant factors, a licensed representative of an authorized person or an employee, has reasonable grounds to suspect that the transaction may be connected with certain unlawful activities, such transactions should be reported immediately to the appointed Money Laundering Reporting Officer (MLRO), who will make an official 'suspicious trading report (STR)' to the Financial Intelligence Unit (FIU⁸) with a copy to the CMA. If the MLRO decides that there are no reasonable grounds for suspicion, the reasons for this should be fully documented. The MLRO must also ensure that his decision is supported by the relevant documents. The authorized person must ensure that the MLRO maintains a complete file on all internal suspicious transaction reports received by him from the authorized persons' employees and any supportive documentary evidence, irrespective of whether such reports have been submitted to the FIU. The fact that a report may have been filed with the FIU previously should not preclude the making of a fresh report if new suspicions are aroused.

The AML/CTF regulations require reporting of a suspicious transaction as soon as possible after forming the suspicion. The suspicion, may, in some cases, be formed a considerable time after the date of the transaction as a result of additional information coming to light. The obligation to report is on the individual who becomes suspicious of a money laundering transaction. A licensed representative or an employee of an authorized person who deals with customers should be made aware of the statutory obligation to report suspicious transactions.

Each authorized person is required to have in place strong reporting mechanisms

⁸ The Saudi Arabian Financial Intelligence Unit (FIU) was established under Article 11 of the Anti-Money Laundering Law, as enacted by Royal Decree No. M/39 dated 25/6/14124 H/24/8/2003 (Anti-Money Laundering Law). The FIU is responsible for receiving and analyzing reports and the preparation of reports on all suspicious transactions and operations from all Financial and Non-Financial Institutions, such as lawyers. The Saudi Arabian FIU is a member of the Middle East and North Africa Financial Action Task Force (MENAFATF).

for suspicious transactions. For example, the AML/CTF Rules require that an authorized person appoint a registered person to be the Money Laundering Reporting Officer (MLRO). It is usual, but not necessarily the case, that the MLRO also functions as the Compliance Officer of the authorized person. The MLRO is primarily responsible for reporting any suspicious transactions to the FIU. The MLRO should act as a central reference point within the organization to facilitate reporting to the FIU. The role of the MLRO is not simply that of a passive recipient of reports of suspicious transactions, instead, he plays an active role in the identification and reporting of suspicious transactions. The MLRO should be involved in the regular review of large or irregular transactions generated by the authorized persons' internal system as well as receiving ad hoc reports made by front-line staff on suspicious transactions.

5.4.2 INDICATORS OF SUSPICIOUS TRANSACTIONS FOR MONEY-LAUNDERING AND TERRORIST FINANCING

Learning Objective 5.4.2 – *Understand* some possible indicators which may be linked to money laundering or terrorist financing.

Annex 1 of the AML/CTF Rules provides the following list as an example of indicators that a transaction or activity may be linked to money laundering or terrorist financing.

- The client exhibits unusual concern regarding the firm's compliance with AML/CTF requirements, particularly with respect to his identity and type of business.
- The client refuses to identify himself or to indicate legitimate sources for his funds and other assets.
- The client wishes to engage in transactions that have no apparent legal or economic purpose or are inconsistent with the declared investment strategy.
- The client tries to provide the authorized person with incorrect or misleading information regarding his identity and/or source of funds.
- The authorized person knows that the client has been involved in money laundering or terrorist financing activities, or in other criminal offences or regulatory violations.
- The client exhibits a lack of concern about risks, commissions, or other transaction costs.
- An authorized person suspects that the client appears to be acting as an agent on behalf of an undisclosed principal, but declines or is reluctant, without legitimate commercial reasons, to provide information about that person or entity.
- The client has difficulty describing the nature of his business or lacks general

knowledge of his own activities.

- The client holds multiple accounts under a single name or multiple names, with a large number of inter-account or third-party transfers with no apparent reason for that activity.
- The client makes multiple wire transfers to his investment account followed by an immediate request that the money be wired out to a third party without any apparent business purpose.
- The client makes a long-term investment followed shortly thereafter by a request to liquidate the position, and transfers the proceeds out of the account.
- The client's activities vary substantially from normal practices.
- A client refuses to provide the authorized person with basic information for a mutual fund to verify the client's identity.
- The client requests that the authorized person uses wire transfers in such a manner that originator information is not transferred from the sending to the receiving destination.
- The client seeks to change or cancel a transaction after being informed of the information verification or record keeping requirements by the authorized person.
- The client requests that a transaction be processed in such a manner as to avoid more documentation.
- The client's account shows an unexplained high level of wire transfers with very low levels of securities transactions.
- The authorized person knows that funds or property is proceeds that come from illegal sources.
- The source of funds changes repeatedly.

5.4.3 SUSPICIOUS TRANSACTIONS ASSOCIATED WITH TERRORIST FINANCING

Learning Objective 5.4.3 – *Know* some illustrative patterns of collection and movement of funds that could be associated with terrorist financing.

A US multi-agency task force named Operation Green Quest⁹, set up in October 2001 to combat terrorist financing, has developed a checklist of suspicious

⁹ Operation Green Quest was a United States Customs Service- sponsored inter-agency investigative unit formed in October 2001 after the 11 September attacks, and concerned with the surveillance and interdiction of terrorist financing sources.

activities. The following patterns of activity indicate collection and movement of funds that could be associated with terrorist financing.¹⁰

- Account transactions that are inconsistent with past deposits or withdrawals such as cash, checks, and wire transfers.
- Transactions involving a high volume of incoming or outgoing wire transfers, with no logical or apparent purpose, which come from, go to, or transit through locations of concern, such as sanctioned countries, non-cooperative nations and sympathizer nations.
- Unexplainable clearing or negotiation of third-party checks and their deposits in foreign bank accounts.
- Structuring at multiple branches or the same branch with multiple activities.
- Corporate layering, transfers between bank accounts of related entities or charities for no apparent reason.
- Wire transfers by charitable organizations to companies located in countries known to be bank or tax havens.
- Lack of apparent fund-raising activity, for example a lack of small checks or typical donations associated with charitable bank deposits.
- Using multiple accounts to collect funds that are then transferred to the same foreign beneficiaries.
- Transactions with no logical economic purpose, that is, no link between the activity of the organization and other parties involved in the transaction.
- Overlapping corporate officers, bank signatories, or other identifiable similarities associated with addresses, references and financial activities.
- Cash debiting schemes in which deposits in the US correlate directly with ATM withdrawals in countries of concern. Reverse transactions of this nature are also suspicious.
- Issuing checks, money orders or other financial instruments, often numbered sequentially, to the same person or business, or to persons or businesses whose names are spelled similarly.

It would be difficult to determine by the activity alone whether the particular act was related to terrorism or to organized crime. For this reason, these activities must be examined in context with other factors in order to determine a terrorist financing connection.

¹⁰ Wikipedia: http://en.wikipedia.org/wiki/Terrorism_Financing

5.5 THE ROLES OF AUTHORIZED PERSONS AND THE MONEY LAUNDERING REPORTING OFFICER (MLRO) IN AML/CTF INITIATIVES

This topic is advised to be read in conjunction with the relevant provisions in the Authorized Persons Regulations and the Anti-Money Laundering and Counter-Terrorist Financing Rules issued by the Capital Market Authority. As required by the regulation, an authorized person shall, among others, carry out the following review.

5.5.1 KNOW YOUR CUSTOMER (KYC)

Learning Objective 5.5.1 – *Know* the required ‘Know Your Customer’ (KYC) reviews to be carried out by the authorized persons and the respective MLROs.

An authorized person is expected to obtain satisfactory evidence of the identity and legal existence of persons applying to do business with it. Such evidence shall be substantiated by reliable documents or other means. Authorized persons should not keep anonymous accounts or accounts in fictitious names. Authorized persons are required to identify clients by using official or other reliable identifying documents, and to record the identity of their clients when establishing business relations or conducting transactions. In this respect, authorized persons shall verify, by reliable means, the identity, representative capacity, domicile, legal capacity, occupation or business purpose of any person, as well as other identifying information on that person, whether he be an occasional or usual client, through the use of documents such as identity card, passport, birth certificate, driver's license and constituent document, or any other official or private document, when establishing or conducting business relations, particularly when opening new accounts, entering into any fiduciary transaction, or performing any cash transaction exceeding a certain fixed amount.

Clients who fail to provide evidence of their identity should not be allowed to engage in business transactions. Additional measures should be undertaken to determine whether to proceed with the business where initial checks fail to identify the client or give rise to suspicions that the information provided is false.

Every authorized person must implement and maintain appropriate guidelines for its representatives and employees to assist them in learning essential facts about their clients' backgrounds. In determining the risk profile of a particular customer or type of customer, the authorized person should take into account, among others, the following factors:

- the background or profile of the customer
- the nature of the customer's business

- the origin of the customer (for example place of birth, residence)
- the customers' investment objectives
- the customers knowledge and experience in dealing in securities and derivatives
- the customer's financial background and where possible to be able to judge whether the amount of cash or other financial instruments going through accounts are consistent with the line of business or occupation being undertaken by the customer
- for corporate customers, whether there is an unduly complex structure of ownership for no good reason
- the means of payment as well as type of payment mode
- risks associated with non-face-to-face business relationships, and
- any other information that may suggest that the customer is of higher risk (e.g. knowledge that the customer has been refused a business relationship by another financial institution).

5.5.2 CUSTOMER DUE DILIGENCE (CDD)

Learning Objective 5.5.2 – *Know* the requirement for an authorized person to conduct due diligence and scrutiny of each customer's identity and his investment objectives.

Customer Due Diligence (CDD) is the process of performing a reasonable investigation into the facts and circumstances of a customer and his business to ensure a full and complete understanding of both.

Authorized persons should conduct due diligence and scrutiny of each customer's identity and his investment objectives. Due diligence should also be done in a continuous manner throughout the course of the business relationship to ensure that the transactions being conducted are consistent with the authorized person's knowledge of the customer, its business and its risk profile.

For clients in the 'suspicious' category, additional caution must be exercised when transacting with them; it is recommended that their activities be monitored on a regular basis and more closely. One method may be to 'flag' such accounts on the authorized person's computer. This would assist employees carrying out future transactions to take note of the 'flag' and pay extra attention to the transactions conducted on the account. While extra care should be exercised in such cases, it is not a requirement that the authorized person should refuse to do any business with such customers or automatically classify them as high risk and subject them to an enhanced customer due diligence process. Rather, authorized persons should weigh

all the circumstances of the particular situation and assess whether there is a higher than normal risk of money laundering or financing of terrorism activities.

An authorized person should consider reclassifying a customer as higher risk if, following initial acceptance of the customer, the pattern of account activity of the customer does not fit in with the authorized persons knowledge of the customer.

An authorized person should not commence business relation or perform any transaction, or in the case of existing business relation, should terminate such business relation if the customer fails to comply with the customer due diligence requirements.

5.5.3 CDD - RISK-BASED APPROACH

Learning Objective 5.5.3 – *Know* the extent to which an authorized person should apply each of the CDD measures on a risk sensitive basis.

The general rule is that customers are subject to the full range of customer due diligence (CDD) measures. Authorized persons should however determine the extent to which they apply each of the CDD measures on a risk sensitive basis.

The basic principle of a risk-based approach is that authorized persons adopt an enhanced CDD process for higher risk categories of customers, business relationships or transactions. Similarly, simplified CDD process is adopted for lower risk categories of customers, business relationships or transactions. The relevant enhanced or simplified CDD process may vary from case to case depending on customers' background, transaction types and specific circumstances, etc. Authorized persons should exercise their own judgment and adopt a flexible approach when applying the specific enhanced or simplified CDD measures to customers of particular high or low risk categories.

Authorized persons should establish clearly in their customer acceptance policies the risk factors for determining what types of customers and activities are to be considered as low or high risk, while recognizing that no policy can be exhaustive in setting out all risk factors that should be considered in every possible situation

The following are examples of high risk customers that a authorized person should consider exercising greater caution when approving the opening of account and when conducting transactions for these categories of customers.

- Non-resident customers
- Customers from locations known for its high crime rate (e.g. drug producing, trafficking, smuggling)
- Customers from or in countries or jurisdictions which do not or insufficiently apply the FATF Recommendations (such as jurisdictions designated as Non-Cooperative Countries and Territories (NCCT) by the FATF or those known to

- the authorized person to have inadequate AML/CTF laws and regulations)
- Politically exposed persons (PEPs) as well as persons or companies clearly related to them
 - complex legal arrangements such as unregistered or unregulated investment vehicles, or
 - companies that have nominee shareholders.

Upon determining that a customer is ‘high-risk’, the authorized person should undertake enhanced CDD processes on the customer. These should include:

- enquiring on the purpose for opening an account;
- enquiring the level and nature of trading activities intended;
- enquiring on the ultimate beneficial owners;
- enquiring on the source of funds;
- obtaining senior management’s approval for opening an account; and
- conducting enhanced ongoing monitoring of the business relationship.

In assessing whether or not a country sufficiently applies FATF standards in combating money laundering and terrorist financing, authorized persons should follow the correct procedures.

Authorized person should carry out their own country assessment of the standards of prevention of money laundering and terrorist financing. This could be based on the firm’s knowledge and experience of the country concerned or from market intelligence. The higher the risk, the greater the due diligence measures that should be applied when undertaking business with a customer from the country concerned.

In addition, the authorized person should pay particular attention to assessments that have been undertaken by standard-setting bodies such as the FATF and by international financial institutions such as the International Monetary Fund (IMF). In addition to the mutual evaluations carried out by the FATF and FATF-style regional bodies, as part of their financial stability assessments of countries and territories, the IMF and the World Bank have carried out country assessments in relation to compliance with prevention of money laundering and terrorist financing standards based on the FATF Recommendations.

5.6 AML/CTF COMPLIANCE AND TRAINING

5.6.1 INTERNAL PROGRAMS, POLICIES AND PROCEDURES

Learning Objective 5.6.1 – *Know* the requirements for an authorized person to adopt, develop and implement internal programs, policies, procedures and controls to guard against and detect any offence under the AML/CTF.

Pursuant to the AML/CTF Rules, an authorized person shall adopt, develop and implement internal programs, policies, procedures and controls to guard against and detect any offence under the rules. These programs must include:

- the establishment of procedures to ensure high standards of integrity of its employees or persons acting on their behalf and a screening system to evaluate the personal, employment and financial history of these employees
- continuous employee training programs, such as ‘Know Your Customer’ programs, and instructing employees or persons acting on their behalf with regard to the responsibilities specified under AML/CTF particularly in relation to reporting of suspicious transactions to the Authority, centralization of information, identification of clients and retention of records
- an independent audit function to check compliance with such programs, and
- a sound internal control system.

5.6.2 TRAINING

Learning Objective 5.6.2 – *Know* the requirement for an authorized person to conduct regular training programs for its employees on AML/CTF.

Employee training programs should be conducted on a regular basis, for example, once a year, in order to ensure that employees are kept up-to-date with the latest developments in this area and also as a mean of ensuring that employees are reminded of their responsibilities.

Notwithstanding the duties of the MLRO, the ultimate responsibility for proper supervision, reporting and compliance pursuant to AML/CTF Rules shall rest with the authorized person and the board of directors.

References:

1. FATF (2004), FATF 40 Recommendations. *www.fatf-gafi.org/dataoecd/7/40/34849567.PDF* (Accessed: June 2011)
2. FATF (2008), FATF IX Special Recommendations, *www.fatf-gafi.org/dataoecd/8/17/34849466.pdf* (Accessed June 2011)
3. Securities Industry Development Centre (2008), Malaysia Capital Market: Examination Study Guide: Module 11: Compliance, Securities Commission of Malaysia.
4. Wikipedia: Terrorism Financing, http://en.wikipedia.org/wiki/Terrorism_Financing. (Accessed: June 2011)

Review Questions

1. What is meant by money laundering? What is meant by financing of terrorism?
2. What are the typical steps of a money laundering process?
3. Explain the processes of 'know your customer' and 'customer due diligence'. How are they related?
4. What is meant by risk-based customer due diligence?
5. What are some of the typical characteristics of a high-risk customer?
6. What is meant by a 'suspicious transaction'?
7. What are some of the typical characteristics of a suspicious transaction in relation to money laundering?
8. What are some of the typical characteristics of a suspicious transaction in relation to financing of terrorism?
9. What must a MLRO do when he receives a suspicious transaction report from the employees of the authorized person?
10. What is FATF? What are the roles of FATF in relation to AML/CTF?
11. What are the general contents of the FATF 40 Recommendations on AML?
12. What are the general contents of the FATF 9 Special Recommendations on CTF?
13. Why is there a need for continuous training on AML/CTF?

Sample Multiple Choice Questions

1. The following are stages of a typical money laundering process. What is the right sequence of the process?
 - i. Conducting layers of financial transactions.
 - ii. Breaking up large amounts of cash into smaller sums and placing them into the financial system.
 - iii. Placing the money into the economic system as if it comes from legitimate sources.

- A. (i), (ii), (iii)
B. (i), (iii), (ii)
C. (ii), (i), (iii)
D. (iii), (i), (ii)
2. Which of the following statements is LEAST related to money laundering?
- A. Criminals and criminal activities exist in almost all countries for the purpose of making huge profits.
B. Illegal arms sales, smuggling, and activities of organized crime, such as drug trafficking, can generate huge amounts of proceeds.
C. Embezzlement, insider trading, bribery and computer fraud schemes can produce large profits.
D. The need to move the illegal money through various financial transactions in order to disguise the origin of the money.
3. Which of the following is NOT one of the reasons for performing the 'know your customer' process?
- A. To ensure the proper existence of the customer.
B. To assess the risk profile of the customer.
C. To ensure the customer is not a politically exposed person.
D. To understand the nature of customer's business.
4. Authorized persons should conduct ongoing due diligence on its customers in order to:
- i. Ensure that the transactions being conducted are consistent with the authorized persons knowledge of the customer.
ii. Cease trading for clients that are in "suspicious" category, pending further investigations.
iii. Take good care of customers who consistently provide income to the authorized person.
- A. (i) only
B. (i) and (ii) only
C. (i) and (iii) only
D. All of the above
5. If there is enough justification for a transaction to be categorized as a 'suspicious transaction', the MLRO of the authorized person shall make a formal report to the _____.
- A. Capital Market Authority (CMA)
B. Financial Intelligence Unit (FIU)
C. Saudi Arabian Monetary Agency (SAMA)
D. Ministry of Interior (MOI)
6. The 40+9 Recommendations of the Financial Action Task Force (FATF) refer to suggestions for combating:

- i. money laundering
- ii. international crimes
- iii. financing of terrorism

- A. (i) only
- B. (i) and (ii) only
- C. (i) and (iii) only
- D. All of the above

APPENDIX 5.1: FATF 40 RECOMMENDATIONS ON MONEY LAUNDERING

A. GENERAL FRAMEWORK OF THE RECOMMENDATIONS

1. Each country should take immediate steps to ratify and to implement fully, the 1988 United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances (the Vienna Convention).
2. Financial institution secrecy laws should be conceived so as not to inhibit implementation of these recommendations.
3. An effective money laundering enforcement program should include increased multilateral co-operation and mutual legal assistance in money laundering investigations and prosecutions and extradition in money laundering cases, where possible.

B. ROLE OF NATIONAL LEGAL SYSTEMS IN COMBATING MONEY LAUNDERING

Scope of the Criminal Offence of Money Laundering

4. Each country should take such measures as may be necessary, including legislative ones, to enable it to criminalize money laundering as set forth in the Vienna Convention. Each country should extend the offence of drug money laundering to one based on serious offences. Each country would determine which serious crimes would be designated as money laundering predicate offences.
5. As provided in the Vienna Convention, the offence of money laundering should apply at least to knowing money laundering activity, including the concept that knowledge may be inferred from objective factual circumstances.
6. Where possible, corporations themselves - not only their employees - should be subject to criminal liability.

Provisional Measures and Confiscation

7. Countries should adopt measures similar to those set forth in the Vienna Convention, as may be necessary, including legislative ones, to enable their competent authorities to confiscate property laundered, proceeds from, instrumentalities used in or intended for use in the commission of any money laundering offence, or property of corresponding value, without prejudicing the rights of bona fide third parties.

Such measures should include the authority to: 1) identify, trace and evaluate property which is subject to confiscation; 2) carry out provisional measures,

such as freezing and seizing, to prevent any dealing, transfer or disposal of such property; and 3) take any appropriate investigative measures.

In addition to confiscation and criminal sanctions, countries also should consider monetary and civil penalties, and/or proceedings including civil proceedings, to void contracts entered into by parties, where parties knew or should have known that as a result of the contract, the State would be prejudiced in its ability to recover financial claims, e.g. through confiscation or collection of fines and penalties.

C. ROLE OF THE FINANCIAL SYSTEM IN COMBATING MONEY LAUNDERING

8. Recommendations 10 to 29 should apply not only to banks, but also to non-bank financial institutions. Even for those non-bank financial institutions which are not subject to a formal prudential supervisory regime in all countries, for example bureaux de change, governments should ensure that these institutions are subject to the same anti-money laundering laws or regulations as all other financial institutions and that these laws or regulations are implemented effectively.
9. The appropriate national authorities should consider applying Recommendations 10 to 21 and 23 to the conduct of financial activities as a commercial undertaking by businesses or professions which are not financial institutions, where such conduct is allowed or not prohibited. Financial activities include, but are not limited to, those listed in the attached annex. It is left to each country to decide whether special situations should be defined where the application of anti-money laundering measures is not necessary, for example, when a financial activity is carried out on an occasional or limited basis.

Customer Identification and Record-keeping Rules

10. Financial institutions should not keep anonymous accounts or accounts in obviously fictitious names: they should be required (by law, by regulations, by agreements between supervisory authorities and financial institutions or by self-regulatory agreements among financial institutions) to identify, on the basis of an official or other reliable identifying document, and record the identity of their clients, either occasional or usual, when establishing business relations or conducting transactions (in particular opening of accounts or passbooks, entering into fiduciary transactions, renting of safe deposit boxes, performing large cash transactions).

In order to fulfill identification requirements concerning legal entities, financial institutions should, when necessary, take measures:

- (i) to verify the legal existence and structure of the customer by obtaining either from a public register or from the customer or both, proof of

incorporation, including information concerning the customer's name, legal form, address, directors and provisions regulating the power to bind the entity.

(ii) to verify that any person purporting to act on behalf of the customer is so authorized and identify that person.

11. Financial institutions should take reasonable measures to obtain information about the true identity of the persons on whose behalf an account is opened or a transaction conducted if there are any doubts as to whether these clients or customers are acting on their own behalf, for example, in the case of domiciliary companies (i.e. institutions, corporations, foundations, trusts, etc. that do not conduct any commercial or manufacturing business or any other form of commercial operation in the country where their registered office is located).
12. Financial institutions should maintain, for at least five years, all necessary records on transactions, both domestic or international, to enable them to comply swiftly with information requests from the competent authorities. Such records must be sufficient to permit reconstruction of individual transactions (including the amounts and types of currency involved if any) so as to provide, if necessary, evidence for prosecution of criminal behaviour.

Financial institutions should keep records on customer identification (e.g. copies or records of official identification documents like passports, identity cards, driving licenses or similar documents), account files and business correspondence for at least five years after the account is closed.

These documents should be available to domestic competent authorities in the context of relevant criminal prosecutions and investigations.

13. Countries should pay special attention to money laundering threats inherent in new or developing technologies that might favour anonymity, and take measures, if needed, to prevent their use in money laundering schemes.

Increased Diligence of Financial Institutions

14. Financial institutions should pay special attention to all complex, unusual large transactions, and all unusual patterns of transactions, which have no apparent economic or visible lawful purpose. The background and purpose of such transactions should, as far as possible, be examined, the findings established in writing, and be available to help supervisors, auditors and law enforcement agencies.
15. If financial institutions suspect that funds stem from a criminal activity, they should be required to report promptly their suspicions to the competent authorities.

16. Financial institutions, their directors, officers and employees should be protected by legal provisions from criminal or civil liability for breach of any restriction on disclosure of information imposed by contract or by any legislative, regulatory or administrative provision, if they report their suspicions in good faith to the competent authorities, even if they did not know precisely what the underlying criminal activity was, and regardless of whether illegal activity actually occurred.
17. Financial institutions, their directors, officers and employees, should not, or, where appropriate, should not be allowed to, warn their customers when information relating to them is being reported to the competent authorities.
18. Financial institutions reporting their suspicions should comply with instructions from the competent authorities.
19. Financial institutions should develop programs against money laundering. These programs should include, as a minimum:
 - 1) the development of internal policies, procedures and controls, including the designation of compliance officers at management level, and adequate screening procedures to ensure high standards when hiring employees;
 - 2) an ongoing employee training programme;
 - 3) an audit function to test the system.

Measures to Cope with the Problem of Countries with No or Insufficient Anti-Money Laundering Measures

20. Financial institutions should ensure that the principles mentioned above are also applied to branches and majority owned subsidiaries located abroad, especially in countries which do not or insufficiently apply these Recommendations, to the extent that local applicable laws and regulations permit. When local applicable laws and regulations prohibit this implementation, competent authorities in the country of the mother institution should be informed by the financial institutions that they cannot apply these Recommendations.
21. Financial institutions should give special attention to business relations and transactions with persons, including companies and financial institutions, from countries which do not or insufficiently apply these Recommendations. Whenever these transactions have no apparent economic or visible lawful purpose, their background and purpose should, as far as possible, be examined, the findings established in writing, and be available to help supervisors, auditors and law enforcement agencies.

Other Measures to Avoid Money Laundering

22. Countries should consider implementing feasible measures to detect or monitor the physical cross-border transportation of cash and bearer negotiable

- instruments, subject to strict safeguards to ensure proper use of information and without impeding in any way the freedom of capital movements.
23. Countries should consider the feasibility and utility of a system where banks and other financial institutions and intermediaries would report all domestic and international currency transactions above a fixed amount, to a national central agency with a computerised data base, available to competent authorities for use in money laundering cases, subject to strict safeguards to ensure proper use of the information.
 24. Countries should further encourage in general the development of modern and secure techniques of money management, including increased use of checks, payment cards, direct deposit of salary checks, and book entry recording of securities, as a means to encourage the replacement of cash transfers.
 25. Countries should take notice of the potential for abuse of shell corporations by money launderers and should consider whether additional measures are required to prevent unlawful use of such entities.

Implementation, and Role of Regulatory and other Administrative Authorities

26. The competent authorities supervising banks or other financial institutions or intermediaries, or other competent authorities, should ensure that the supervised institutions have adequate programs to guard against money laundering. These authorities should co-operate and lend expertise spontaneously or on request with other domestic judicial or law enforcement authorities in money laundering investigations and prosecutions.
27. Competent authorities should be designated to ensure an effective implementation of all these Recommendations, through administrative supervision and regulation, in other professions dealing with cash as defined by each country.
28. The competent authorities should establish guidelines which will assist financial institutions in detecting suspicious patterns of behaviour by their customers. It is understood that such guidelines must develop over time, and will never be exhaustive. It is further understood that such guidelines will primarily serve as an educational tool for financial institutions' personnel.
29. The competent authorities regulating or supervising financial institutions should take the necessary legal or regulatory measures to guard against control or acquisition of a significant participation in financial institutions by criminals or their confederates.

D. STRENGTHENING OF INTERNATIONAL CO-OPERATION

Administrative Co-operation

Exchange of general information

30. National administrations should consider recording, at least in the aggregate, international flows of cash in whatever currency, so that estimates can be made of cash flows and reflows from various sources abroad, when this is combined with central bank information. Such information should be made available to the International Monetary Fund and the Bank for International Settlements to facilitate international studies.
31. International competent authorities, perhaps Interpol and the World Customs Organization, should be given responsibility for gathering and disseminating information to competent authorities about the latest developments in money laundering and money laundering techniques. Central banks and bank regulators could do the same on their network. National authorities in various spheres, in consultation with trade associations, could then disseminate this to financial institutions in individual countries.

Exchange of information relating to suspicious transactions

32. Each country should make efforts to improve a spontaneous or "upon request" international information exchange relating to suspicious transactions, persons and corporations involved in those transactions between competent authorities. Strict safeguards should be established to ensure that this exchange of information is consistent with national and international provisions on privacy and data protection.

Other forms of Co-operation

Basis and means for co-operation in confiscation, mutual assistance and extradition

33. Countries should try to ensure, on a bilateral or multilateral basis, that different knowledge standards in national definitions - i.e. different standards concerning the intentional element of the infraction - do not affect the ability or willingness of countries to provide each other with mutual legal assistance.
34. International co-operation should be supported by a network of bilateral and multilateral agreements and arrangements based on generally shared legal concepts with the aim of providing practical measures to affect the widest possible range of mutual assistance.
35. Countries should be encouraged to ratify and implement relevant international conventions on money laundering such as the 1990 Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds

from Crime.

Focus of improved mutual assistance on money laundering issues

36. Co-operative investigations among countries' appropriate competent authorities should be encouraged. One valid and effective investigative technique in this respect is controlled delivery related to assets known or suspected to be the proceeds of crime. Countries are encouraged to support this technique, where possible.
37. There should be procedures for mutual assistance in criminal matters regarding the use of compulsory measures including the production of records by financial institutions and other persons, the search of persons and premises, seizure and obtaining of evidence for use in money laundering investigations and prosecutions and in related actions in foreign jurisdictions.
38. There should be authority to take expeditious action in response to requests by foreign countries to identify, freeze, seize and confiscate proceeds or other property of corresponding value to such proceeds, based on money laundering or the crimes underlying the laundering activity. There should also be arrangements for coordinating seizure and confiscation proceedings which may include the sharing of confiscated assets.
39. To avoid conflicts of jurisdiction, consideration should be given to devising and applying mechanisms for determining the best venue for prosecution of defendants in the interests of justice in cases that are subject to prosecution in more than one country. Similarly, there should be arrangements for coordinating seizure and confiscation proceedings which may include the sharing of confiscated assets.
40. Countries should have procedures in place to extradite, where possible, individuals charged with money laundering offence or related offences. With respect to its national legal system, each country should recognize money laundering as an extraditable offence. Subject to their legal frameworks, countries may consider simplifying extradition by allowing direct transmission of extradition requests between appropriate ministries, extraditing persons based only on warrants of arrests or judgments, extraditing their nationals, and/or introducing a simplified extradition of consenting persons who waive formal extradition proceedings.

APPENDIX 5.2: FATF SPECIAL RECOMMENDATIONS ON TERRORIST FINANCING

Recognizing the vital importance of taking action to combat the financing of terrorism, the FATF has agreed these Recommendations, which, when combined with the FATF Forty Recommendations on money laundering, set out the basic framework to detect, prevent and suppress the financing of terrorism and terrorist acts.

I. Ratification and implementation of UN instruments

Each country should take immediate steps to ratify and to implement fully the 1999 United Nations International Convention for the Suppression of the Financing of Terrorism.

Countries should also immediately implement the United Nations resolutions relating to the prevention and suppression of the financing of terrorist acts, particularly United Nations Security Council Resolution 1373.

II. Criminalizing the financing of terrorism and associated money laundering

Each country should criminalize the financing of terrorism, terrorist acts and terrorist organizations. Countries should ensure that such offences are designated as money laundering predicate offences.

III. Freezing and confiscating terrorist assets

Each country should implement measures to freeze without delay funds or other assets of terrorists, those who finance terrorism and terrorist organizations in accordance with the United Nations resolutions relating to the prevention and suppression of the financing of terrorist acts.

Each country should also adopt and implement measures, including legislative ones, which would enable the competent authorities to seize and confiscate property that is the proceeds of, or used in, or intended or allocated for use in, the financing of terrorism, terrorist acts or terrorist organizations.

IV. Reporting suspicious transactions related to terrorism

If financial institutions, or other businesses or entities subject to anti-money laundering obligations, suspect or have reasonable grounds to suspect that funds are linked or related to, or are to be used for terrorism, terrorist acts or by terrorist organizations, they should be required to report promptly their suspicions to the competent authorities.

V. International Co-operation

Each country should afford another country, on the basis of a treaty, arrangement or other mechanism for mutual legal assistance or information exchange, the greatest possible measure of assistance in connection with criminal, civil enforcement, and administrative investigations, inquiries and proceedings relating to the financing of terrorism, terrorist acts and terrorist organizations.

Countries should also take all possible measures to ensure that they do not provide safe havens for individuals charged with the financing of terrorism, terrorist acts or terrorist organizations, and should have procedures in place to extradite, where possible, such individuals.

VI. Alternative Remittance

Each country should take measures to ensure that persons or legal entities, including agents, that provide a service for the transmission of money or value, including transmission through an informal money or value transfer system or network, should be licensed or registered and subject to all the FATF.

Recommendations that apply to banks and non-bank financial institutions. Each country should ensure that persons or legal entities that carry out this service illegally are subject to administrative, civil or criminal sanctions.

VII. Wire transfers

Countries should take measures to require financial institutions, including money remitters, to include accurate and meaningful originator information (name, address and account number) on funds transfers and related messages that are sent, and the information should remain with the transfer or related message through the payment chain.

Countries should take measures to ensure that financial institutions, including money remitters, conduct enhanced scrutiny of and monitor for suspicious activity funds transfers which do not contain complete originator information (name, address and account number).

VIII. Non-profit organizations

Countries should review the adequacy of laws and regulations that relate to entities that can be abused for the financing of terrorism. Non-profit organizations are particularly vulnerable, and countries should ensure that they cannot be misused:

- (i) by terrorist organizations posing as legitimate entities;
- (ii) to exploit legitimate entities as conduits for terrorist financing, including for the purpose of escaping asset freezing measures; and
- (iii) to conceal or obscure the clandestine diversion of funds intended for legitimate purposes to terrorist organizations.

IX. Cash Couriers

Countries should have measures in place to detect the physical cross-border transportation of currency and bearer negotiable instruments, including a declaration system or other disclosure obligation.

Countries should ensure that their competent authorities have the legal authority to stop or restrain currency or bearer negotiable instruments that are suspected to be related to terrorist financing or money laundering, or that are falsely declared or disclosed.

Countries should ensure that effective, proportionate and dissuasive sanctions are available to deal with persons who make false declaration(s) or disclosure(s). In cases where the currency or bearer negotiable instruments are related to terrorist financing or money laundering, countries should also adopt measures, including legislative ones consistent with Recommendation 3 and Special Recommendation III, which would enable the confiscation of such currency or instruments.

SECTION 2: COMPLIANCE: REGULATIONS

AUTHORIZED PERSONS REGULATIONS: AUTHORIZATION PROCESS

6

LEARNING OBJECTIVES

The syllabus for this examination is broken down into a series of learning objectives and is included in the Syllabus Learning Map at the back of this workbook. Each time a learning objective is covered, it appears in a text box preceding the text.

INTRODUCTION

6.1 THE PRINCIPLES

6.1.1 THE ELEVEN PRINCIPLES

6.2 AUTHORISATION

6.2.1 REQUIREMENT FOR AUTHORIZATION

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6.3 REGISTERED PERSONS

6.3.1 REGISTERABLE FUNCTIONS

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6.3.3 CANCELLATION OF REGISTRATION

INTRODUCTION

Authorized Persons Regulations were issued by the Board of the Capital Market Authority pursuant to its Resolution Number 1-83-2005 dated 21/05/1426H corresponding to 28/06/2005G based on the Capital Market Law issued by Royal Decree No. M/30 dated 2/6/1424H.¹¹

Due to the length of the Regulations, it is divided into three chapters for ease of presentation. The chapters are as the follows:

- Chapter 6: Authorized Persons Regulations – Authorization Process.
- Chapter 7: Authorized Persons Regulations – Conduct of Business.
- Chapter 8: Authorized Persons Regulations – Systems and Controls.

This chapter is the first of the three chapters that discusses the Authorized Persons Regulation, covering Parts 1 to 4. The focus of the chapter is mainly on the process of application and the requirements for maintaining authorization. The chapter begins with the listing of 11 principles that govern authorized persons in conducting securities business. The chapter then discusses the various requirements for application for authorization followed by the necessary conditions that must be fulfilled to maintain the authorization. The last section describes the key functions that must be performed by registered persons within the authorized persons and the requirements for the registered persons.

6.1 THE PRINCIPLES

6.1.1 THE ELEVEN PRINCIPLES

Learning Objective 6.1.1 - *Know* the 11 principles governing the general conduct of the authorized persons (Part 2, Article 5).

The Authorized Persons Regulations issued by the Capital Market Authority outline 11 principles that provide a general statement of the fundamental obligations of authorized persons. They are intended to form a universal statement of the standards of conduct expected of the authorized persons. The 11 principles are that the authorized person should maintain:

1. **Integrity:** by conducting business with integrity

¹¹ In reading these regulations, any reference to the 'Capital Market Law' shall mean the Capital Market Law issued by Royal Decree No. M/30 dated 2/6/1424H; and any expressions and terms in this manual shall carry the meaning which they bear in the Capital Market Law and in the 'Glossary of Defined Terms used in the Regulations and Rules of the Capital Market Authority', unless otherwise is explicitly stated.

2. ***Skill, care and diligence:*** by conducting business with skill, care and diligence
3. ***Efficiency of management and control:*** by taking reasonable care to organize its affairs responsibly and effectively, with adequate risk management policies and systems
4. ***Financial prudence:*** by maintaining adequate financial resources in accordance with the rules set by CMA
5. ***Proper market conduct:*** by observing proper standards of market conduct
6. ***Protection of client's assets:*** by giving adequate protection to clients' assets
7. ***Cooperation with Regulators:*** including disclosing to the Authority any material event or change in the authorized person's business operations or organization
8. ***Communication with clients:*** by providing clear, fair and not misleading information to clients
9. ***Paying due regards to customers' interest:*** by giving fair treatment to all clients and giving due regards to their interests
10. ***No conflict of interests:*** by managing conflicts of interest in a fair manner, between authorized person and clients, and among clients
11. ***Customers' suitability:*** authorized person must make sure that their dealings and advice to customers are suitable given nature of the customers to whom the services are provided.

6.2 AUTHORIZATION

▪ REQUIREMENT FOR AUTHORIZATION

Learning Objective 6.2.1- *Know* the detail requirements for authorization (Part 3, Article 6 and Annex 3.1).

Article 6 of the Authorized Persons Regulations provides for the various requirements for application for authorization to become an authorized person. These authorization requirements set out below apply to all types of securities business and the application of each requirement will differ depending on the nature, scope and complexity of the activities. Applicants whom the type of their activities will be limited to managing private non-real estate investment funds, managing sophisticated investor portfolios, arranging and advising will be excluded from submitting some of those requirements (See Annex 3.1 from

Authorised Persons Regulations).

- List of controllers with details on the identity, ownership, integrity, regulatory status, business record and financial position.
- List of persons who are ‘close links’ with details on the identity, ownership, integrity, regulatory status, business record and financial position.
- A resolution of the governing body approving the application and certifying the accuracy of the required information.
- The profile of the proposed business with details on the securities activities and services to be provided. For authorization purposes, the regulations recognize five securities activities: *Dealing, Custody, Managing, Arranging and Advising*.
- A business plan providing details on the activities to be conducted for a 12-month period following authorization, description of the proposed clients, list of exchanges, clearing houses or depositories to be used.
- An audited financial statement of the company showing the current financial position and the projected position 12 months after authorization with the supporting evidence on the capitalization and resources as well as the clearly stated assumptions.
- List of persons to be registered as registered persons giving details of their qualifications and experiences.
- Documents relating to systems and controls on areas such as Risk Management, Anti-Money Laundering and Anti-Terrorism Financing, Compliance and Compliance Monitoring Programs and Code of Conduct.
- Operations manual, providing details on operating procedures on all its business activities.
- Proposed terms of business with clients.
- Proposed fees, commissions, charges and other expenses payables by clients.
- Agreements, arrangements and understandings with any third parties in relations to its proposed business operations.
- Professional indemnity insurance.
- Incorporation documents such as Articles of Association or by-laws

- Ownership structure chart, including each controller and close-links
- Organization chart outlining the reporting lines of each department within the business.
- Business continuity plan.

As a condition for authorization, an applicant must also demonstrate to the Authority that it:

- Is ‘fit and proper’ to conduct the securities business (see Section 6.2.2 below).
- Has adequate expertise and resources.
- Has the managerial expertise, financial systems, risk management policies and systems, technological resources and operational procedures and systems.
- His directors, officers, employees and agents also have the necessary qualification, skills, experience and integrity to conduct the proposed securities business.

As for the legal form of the authorized persons, in order to run the securities business, an authorized person must be established in the Kingdom, and also must be:

- A subsidiary of a local bank, or
- A joint stock company, or
- A subsidiary of a Saudi joint stock company that is engaged in financial services business, or
- A subsidiary of a foreign financial institution that is licensed under the Banking Control Law issued by Royal Decree No. M/5, dated 22/2/1386H.

The regulations also address the adequacy of financial resources of the authorized persons. To be qualified to become an authorized person, the paid-up capital must not be less than the following:

- Dealing and Custody :SR 50 million;
- Managing: SR 20 million for managing investment fund and client portfolios; and SR 5 million for managing private non-real-estate investment funds and sophisticated investor portfolios;
- Arranging: SR 2 million; and
- Advising: SR400, 000.

After meeting all the above requirements, the Authority may perform any of the followings:

- Carry out any enquiries it considers appropriate
- Require the applicant or his representative to be present to answer questions related to the application

- Ask for additional information, in which case the applicant must provide within 30 days of the request.
- Verify any information furnished by the applicant.

If the applicant is unable to provide the required information, or failed to provide the information within the stipulated time, the Authority may refuse to consider the application. However, when all information and required documents are received, the Authority shall notify the applicant in writing accordingly. The authority shall take any of the following decisions within 30 days of the date of the notice:

- Approve the application in whole or in part; or
- Approve the application subject to certain conditions and limitations; or
- Refuse the application; giving reasons.

If the Authority approves the application, this will be informed in writing, stating its permitted business profile, including any limitations, that the Authority may consider appropriate. If the Authority refuses the application, this will also be informed in writing, stating reasons for the refusal. In the meantime, an applicant is not permitted to conduct any securities business until approval from the Authority is obtained. An applicant may appeal to the Committee in respect of any decision taken by the Authority.

▪ FIT AND PROPER CRITERIA

Learning Objective 6.2.2 - *Know* the specific criteria which an authorized person's employees, officers and agents will be assessed in determining whether it is fit and proper to carry out securities business for which it is authorized (Part 3, Article 9).

In maintaining authorization, an authorized person must continue to be “fit and proper” to carry out the securities business. Assessment on the ‘fit and proper’ condition is made on the authorized person and its employees on the skills, competence, experience and integrity, based on the criteria that they must:

- possess adequate qualifications and professional experience;
- have probity or honesty and soundness of judgments;
- fulfill their responsibilities with diligence;
- not committed an offence involving fraud or dishonesty; and
- not have contravened or broken any laws and regulation governing the securities business or aimed at protecting investors.

The authorized person can only carry out business activities that have been authorized by the Authority, and not carrying out activities that are not within its permitted business profile. The authorized person must obtain approval from the Authority for any amendments to its permitted business profile as originally submitted during authorization. These include a change or modification to its

business profile; for example, adding new services, acquiring or establishing new subsidiaries, etc.

▪ WITHDRAWAL AND CANCELLATION OF AUTHORIZED PERSON

Learning Objective 6.2.3 - *Know* the conditions for the withdrawal and cancellation of license (Part 3, Article 12).

An authorized person who plans to cease its securities business must notify the Authority in writing at least 45 days in advance by providing the planned date on which the business will cease, and the reasons for the decision. If the advance notice is not possible because the business has to be stopped due to external reasons that the authorized person is unaware of, the decision must be immediately notified to the Authority.

When an authorized person decides to cease its business, it has to make sure that any outstanding business is properly completed or is transferred to another authorized person and provide reasonable notice to its clients on the cessation of the business. The written request to the Authority should be made not less than three months prior to the date of the proposed cancellation with proper justification. Depending on the circumstances, the Authority may approve the cancellation, or postpone the date of cancellation, or require other measures considered necessary for the protection of the authorized person's clients.

The Authority may refuse a request to cancel an authorization if it is considered necessary to maintain the authorization for the purpose of investigating matters affecting the authorized person or to protect the authorized person's clients. Cancellation may also be refused in order to impose a prohibition or requirements under the Capital Market Law or its Implementing Regulations.

The Authority may suspend the authorization if the authorized person does not carry on any securities business for a period of 12 months, or 6 months after notification to the Authority.

An authorized person shall continue to be subject to the jurisdiction of the Authority in respect of any act or omission that occurred before the cancellation of the authorization for two years thereafter. If at any time during this period, the Authority commences any enforcement investigation or proceedings, the authorized person shall continue to be subject to the jurisdiction of the Authority until the end of the enforcement investigation or proceedings.

6.2.1 CONTROLLERS AND CLOSE LINKS

Learning Objective 6.2.4 - *Know* the notification requirements relating to controllers and closed links (Part 3, Article 13 and 14).

The authorized person must obtain approval from the Authority that a person intends to become or ceases to be a controller of the authorized person. Application for a change in the controller or for a new person to become a controller of the authorized person must be notified to the Authority 30 days prior to the proposed effective date. In addition, the person who intends to become the controller must also notify and obtain approval from the Authority.

Any person must not establish close links with an authorized person before obtaining approval of the Authority. Such application for close links must be made 30 days prior to the effective date.

6.2.2 NOTIFICATION REQUIREMENTS AND POWERS OF AUTHORITY

Learning Objective 6.2.5 - *Know* the notification requirement that an authorized person must comply with in making various notifications on events or changes affecting the authorized person to the Authority (Part 3, Article 15 and Annex 3.2).

There are three types of notification, each of which requires different notification period to the Authority. Firstly, for changes related to the nature of business which require a 30-day notification; secondly, changes related to the registered person and organization restructuring which require a 7-day notification; and thirdly, changes related to business performance and factors that have immediate effect on day-to-day business which require an immediate notification to the Authority.

An authorized person must notify the Authority in writing not less than 30 days before any change in:

- The name of the authorized person or the registered name of the company
- The name of the business
- The address of the head office of the authorized person.

An authorized person must notify the Authority in writing within 7 days of the occurrence of:

- Any changes in the material information provided to the Authority on the application for registration form relating to the registered person's name, good reputation or character.
- If the authorized person is a company, the formation, acquisition, disposal or dissolution of a subsidiary, specifying the subsidiary's name and its principal business.

- If the authorized person is not a company, when it buys or sells more than half in nominal value of the capital of accompany, or an unincorporated body, specifying the name of the company and its business.
- Any changes in the information originally submitted under the following headings:
 - Branches of the authorized person
 - Insurance arrangements
 - Foreign countries in which the authorized person has securities business
 - The contracts or arrangements to clear and settle transactions, or for custody of client money and assets.

An authorized person must notify the Authority immediately on the occurrence of the following:

- The presentation of a petition for winding up of the authorized person
- An insolvency event
- The imposition of disciplinary measures or sanctions
- The conviction of the authorized person for any offence relating to banking or other financial services, companies, insolvency, or for any offence of fraud or any act involving a lack in of integrity or dishonesty, or the imposition of penalties for zakat or tax evasion.
- A general partner in the authorized person becoming a limited partner.
- The granting or refusal of any application for, or revocation of, authorization to carry on securities, banking or insurance business in a foreign country.
- The withdrawal or refusal of an application for, or revocation of, membership of an exchange or a clearing house.
- The appointment of inspectors by an official or a regulatory authority to investigate the affairs of the authorized person;
- A significant act of misconduct by the authorized person or its RPs;
- The resignation or dismissal of any of the following persons:
 - CEO or managing director;
 - Finance officer;
 - Director or partner;
 - Senior officer or manager;
 - Compliance officer;
 - MLRO

In the case of dismissal, full details of reasons for dismissal must be provided.

- Any matter affecting the authorized person and his personnel to remain fit and

- proper in accordance with these Regulations;
- Any other matter which would be material to the Authority's supervision of the authorized person and the registered persons; or
 - Any material changes to the information previously provided by the authorized person in application for registration of his registered persons.

Concerning the scope of an authorized person's business and operations, the authorized person must inform the Authority immediately in writing of any material event or change in its business or operations. Further, an authorized person must give the Authority prior written notice, or where the event has occurred, written notice as soon as it become aware of:

- A proposed reorganization or business expansion or other changes that could have material impact on the authorized person's business, risk profile or resources, including but not limited to the following:
 - Setting up a new business within an authorized person group or establishing a new branch;
 - Providing cross border services;
 - Providing a new product or services;
 - Sale or transfer of its material assets;
 - Ceasing to undertake a securities business transaction, or significantly reducing the scope of any activity.
- Entering into, or significantly changing, a material outsourcing arrangement of a function of an authorized person of sufficient importance, such that, if the function fails, it would jeopardize the authorized person's ability to comply with these Regulations.
- Any significant failure in the authorized person's systems or controls, including those reported to the authorized person by the authorized person's auditor; or
- Any event related to the authorized person that results in a material change in its capital adequacy, including:
 - Any action that would result in a material change in the authorized person's financial resources
 - The payment of a special or unusual dividend or the repayment of share capital or a subordinated loan;
 - For authorized person which are subject to the rules on consolidated financial supervision, any proposal under which a member of the authorized person's group may be considering an action such as those mentioned above; or
 - Any significant losses, whether recognized or unrecognized.

6.2.3 RECORD KEEPING

Learning Objective 6.2.6 - *Know* the record-keeping requirements that an authorized person must comply with (Part 3, Article 16).

The Authorized Persons Regulations also place great importance on the retention of records pertaining to conduct of authorized person's business. The regulations require an authorized person to record and retain sufficient information about its securities business. The records must be retained for a period of 10 years as prescribed by the Authorized Persons Regulations, unless the Authority specifies otherwise. The Authority may inspect the records directly or through a person appointed for that purpose. Records made by an authorized person may be recorded in any form, but must be capable of reproduction in printed form. When a client or former client requests any records kept during the regulatory record-keeping period, the authorized person must produce the record, within a reasonable period of time.

6.3 REGISTERED PERSON

6.3.1 REGISTRABLE FUNCTIONS

Learning Objective 6.3.1 - *Know* the key functions that must be registered with the CMA (Part 4, Article 19- Article 20).

The Authorized Persons Regulations specify key functions, called the registrable functions, which shall be registered with the Authority. Such functions are:

1. CEO or Managing Director
2. Finance manager
3. A director or partner
4. Senior officers or managers
5. Compliance officer
6. Money Laundering Reporting Officer (MLRO)
7. Client functions, including sales representatives, investment advisors, portfolio managers and corporate finance professionals as defined by the Authority.

The Authorized Persons Regulations also specify that only a registered person can perform registrable functions. Exceptions may be granted by the Authority under certain conditions. No person other than the registered person may perform a registrable function without the Authority's prior written consent.

It is also required that every authorized person must *at all times* have a registered person for each of the following functions:

- CEO or Managing Director
- Finance manager

- Compliance officer
- Money Laundering Reporting Officer (MLRO).

This does not apply to authorized person whose licensed business activity is limited to managing non-real estate investment funds or managing the portfolios of sophisticated investors, arranging or advising, as such an AP may outsource the function of CFO, compliance and AMLRO.

In practice, the Authority will not take action against the authorized person for failure to comply with the above requirement provided it is a temporary situation, and the authorized person actively seeks an appropriate substitute and notifies the Authority of another registered person who will perform that particular function.

In addition, the regulations allow a registered person to perform more than one function with the following exceptions:

- The CEO, finance manager and compliance officer must be separate persons unless specifically approved by the Authority, and
- The compliance officer should not perform a client function.

6.3.2 REGISTRATION REQUIREMENT

Learning Objective 6.3.2 - *Know* the general registration requirements, procedures and powers of the CMA in handling the registration applications (Part 4, Article 21 and 22).

Authority from such requirement. The Authority will specify the examination requirements associated with the registrable functions, together with guidance on eligible qualifications and criteria for an exemption from the required examination.

In considering an application for registration, the Authority may take any of the following actions:

- carry out any enquiries which it considers appropriate;
- require the authorized person or the applicant for registration to appear before the Authority to answer any questions and explain any matter it considers relevant to the application;
- require that additional information be provided;
- verify the accuracy of any information furnished by the applicant for registration;

The Authority aims to process an application for registration within 30 days of receiving all information and documents that it considers pertinent. The Authority may, after considering the application, take any of the following actions:

- Approve the application for registration;

- Approve the application for registration subject to such conditions as it considers appropriate;
- Defer making a decision for such period as may be necessary to carry out further investigation or to allow for the provision of additional information; or
- Refuse the application for registration by giving reasons.

If the Authority decides to approve the application for registration, the Authority will add the applicant's name to the register of registered persons that the Authority shall maintain for this purpose and so inform the authorized person.

If the Authority decides to reject the application, the Authority shall notify the applicant for registration and the authorized person named in the application in writing. An applicant for registration must not perform the registrable function until he has been registered by the Authority.

6.3.3 CANCELLATION OF REGISTRATION

Learning Objective 6.3.3 - *Know* the provisions for cancellation of registration (Part 4, Article 25).

The Authority has the power to cancel the registration of a registered person, if the registered person fails to meet or maintain his registration status. If a registered person's registration is cancelled, the authorized person that employs him must ensure that the person immediately ceases to perform a registrable function.

Within seven days of a registered person ceasing to carry on a registrable function or ceasing to be employed or associated with an authorized person, the authorized person must notify the Authority of that fact on the appropriate form. Upon receipt of the notice, the registration will be suspended, and the suspension shall remain in force until the Authority:

- agrees to the termination of the registration
- consents to the employment of that person by an authorized person in a similar capacity, or
- removes the person from the register of registered persons.

A registered person who is cancelled from the register by the Authority has a right of appeal to the Committee. Nevertheless, a registered person whose registration has been cancelled will continue to be subject to the jurisdiction of the Authority in respect of any act or omission that occurred before the cancellation of his registration and for two years thereafter. If at any time during this period the

Authority commences any enforcement investigation or proceedings, the registered person shall continue to be subject to the jurisdiction of the Authority until the end of the enforcement investigation or proceedings.

Review Questions

1. Describe the eleven principles governing the general conduct of the authorized persons.
2. What are the requirements for authorization?
3. What is the information required for authorization application?
4. Explain the process of determining if an authorized person is 'fit and proper' to carry out securities business.
5. What are the conditions for the withdrawal and cancellation of authorization?
6. Describe various notification requirements that need to be complied with by an authorized person?
7. Explain the application process to become a 'registered person'.
8. What is meant by 'registrable functions'? What are the registrable functions in an authorized person organization?

Sample Multiple Choice Questions

1. According to the Authorized Persons Regulations, the securities functions that require authorization by the Authority are dealing, managing, custody, arranging and _____.
A. investing
B. advising
C. underwriting
D. research
2. An authorized person wants to obtain authorization to for only 'dealing', 'and 'custody' . What is the minimum capital he has to have?
A. SR 50 million
B. SR 2 million
C. SR 400,000
D. SR 52 million
3. Any cancellation of an authorized person authorization must obtain approval from the Authority. Which of the following statements is FALSE with respect to cancellation of an authorized person's authorization?

- A. The authorized person who wants to cancel his authorization must give a notice to the Authority not less than six months prior to the date of the proposed cancellation.
 - B. An authorized person shall continue to be subject to the jurisdiction of the Authority in respect of any act or omission that occurred before the cancellation of the authorization for two years thereafter.
 - C. The Authority may refuse a request to cancel an authorization if it is considered necessary to maintain the authorization for the purpose of investigating matters affecting the authorized person.
 - D. The Authority may approve the cancellation, or postpone the date of cancellation, or require other measures considered necessary for the protection of the authorized person's clients.
4. According to the notification requirement of the Authorized Persons Regulations, an authorized person must notify the Authority in writing not less than 30 days before making any change in:
- i. The name of the company
 - ii. The address of the head office
 - iii. Disposal of a subsidiary
 - iv. The company becoming insolvent
- A. (i) and (ii) only
 - B. (i), (ii) and (iii) only
 - C. (i), (ii) and (iv) only
 - D. All of the above
5. Which of the following is true regarding 'registrable functions'?
- A. A registered person can't perform two registrable function at once.
 - B. The CEO may also function as a finance manager.
 - C. Sales representatives and investment advisors are not registrable functions.
 - D. Compliance Officer and Money Laundering Reporting Officer (MLRO) can be performed by one person.

AUTHORIZED PERSONS REGULATIONS: CONDUCT OF BUSINESS

7

LEARNING OBJECTIVES

The syllabus for this examination is broken down into a series of learning objectives and is included in the Syllabus Learning Map at the back of this workbook. Each time a learning objective is covered, it appears in a text box preceding the text.

INTRODUCTION

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- 7.1.2 SPECIAL COMMISSION ARRANGEMENT
- 7.1.3 CONFIDENTIALITY
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APPENDIX 7.1: CONTENT REQUIREMENTS FOR SECURITIES ADVERTISEMENT

APPENDIX 7.2: TERMS OF BUSINESS REQUIREMENTS

APPENDIX 7.3: KNOW YOUR CUSTOMER FORM

APPENDIX 7.4: REQUIRED CONTENTS OF CONTRACT NOTES

APPENDIX 7.5: REQUIRED CONTENTS OF PERIODIC VALUATION STATEMENTS
FOR CLIENT PORTFOLIO

APPENDIX 7.6: PERSONAL ACCOUNT DEALING

INTRODUCTION

This is the second chapter on the Authorized Persons Regulations. The Authorized Persons Regulations were issued by the Board of the Capital Market Authority pursuant to its Resolution Number 1-83-2005 dated 21/05/1426H corresponding to 28/06/2005G based on the Capital Market Law issued by Royal Decree No. M/30 dated 2/6/1424H.¹²

This chapter discusses Part 5 of the Authorized Persons Regulations. This part of the Regulations is on the conduct of business of the authorized person and may be considered as the core of the regulations. It covers specific provisions on the conduct of business, the ‘know-your-customer’ process, providing services and managing client relations. The chapter also contains a long list of annexes of the Regulations that are placed as appendices at the end of the chapter.

7.1 CONDUCT OF BUSINESS

7.1.1 INDUCEMENTS

Learning Objective 7.1.1 – *Understand* the limitations on the giving and receipt of gifts or inducements (Part 5, Article 27).

Authorized persons are prohibited from giving or offering gifts or inducements to persuade the client to engage in a securities transaction. An authorized person is also prohibited from directing his affiliate or any other person to be involved in any form of client inducements.

It is also prohibited for an authorized person to accept any form of gifts or inducements from a client if this would lead to a conflict of interest between the authorized person and the client, to a material extent. Similarly, the authorized person is also prohibited from directing his affiliate or any other person to receive gifts from clients that would lead to a conflict of interest. Further, an authorized person must not participate or offer to participate in any losses made by a client.

¹² In reading these regulations, any reference to the ‘Capital Market Law’ shall mean the Capital Market Law issued by Royal Decree No. M/30 dated 2/6/1424H; and any expressions and terms in this manual shall carry the meaning which they bear in the Capital Market Law and in the ‘Glossary of Defined Terms used in the Regulations and Rules of the Capital Market Authority’, unless otherwise is explicitly stated.

7.1.2 SPECIAL COMMISSION ARRANGEMENTS

Learning Objective 7.1.2 – *Understand* the circumstances in which an Authorized Person may enter into a special commission arrangement (Part 5, Article 28).

The Regulations defines ‘special commission arrangement’ as an arrangement where an authorized person receives goods or services in addition to trade execution services from an intermediary in return for the commission paid on transactions directed through that intermediary.

In simpler language, an authorized person (called AP1) may request another authorized person (called AP2) to perform certain services for him (AP1), such as executing a trade for his clients (clients of AP1). In this arrangement, AP2 provides the ‘services’ to AP1 and AP1 pays ‘commissions’ to AP2 for the services rendered. This is called a “special commission arrangement” because it is not standardized and depends on negotiation between the two parties.

Such an arrangement may be made provided that the following conditions are met:

- 1) The intermediary (AP2) provides best execution to the authorized person (AP1)
- 2) The arrangement is in the best interest of the authorized person’s clients (the client of AP1)
- 3) The arrangement between the authorized person (AP1) and the intermediary (AP2) is disclosed to the authorized person’s clients (client of AP1)
- 4) The amount of any fees or commission paid to the intermediary (AP1 to AP2) is reasonable in the circumstances.

7.1.3 CONFIDENTIALITY

Learning Objective 7.1.3 – *Understand* the exceptions to the authorized person’s duty of confidentiality in respect of client information (Part 5, Article 29).

An authorized person must keep information obtained from clients confidential. However, there are four circumstances where disclosure can be made:

- 1) Where the client has consented to its disclosure;
- 2) Where the disclosure is required by the Capital Market Law or its Implementing Regulations or the applicable laws of the Kingdom;
- 3) Where disclosure is reasonably necessary to perform a particular service for

- the client; or
- 4) Where the information is no longer confidential.

7.1.4 CHINESE WALL ARRANGEMENTS

Learning Objective 7.1.4 – *Understand* the characteristics and uses of Chinese Walls arrangements (Part 5, Article 30).

‘Chinese wall arrangements’ means written policies and procedures established by an authorized person to safeguard confidential or inside information obtained by the authorized person in the course of carrying out securities business. Chinese walls are designed to ensure that the information is known only to employees of the authorized person who are authorized to receive it, and to ensure that the information is not disclosed to any other persons.

An authorized person that provides corporate finance services and also provides *dealing, advising* or *managing* services must establish Chinese wall arrangements. Corporate finance services falls under ‘*arranging*’ license and this function often receives private information from companies. This information if known to other functions such as *dealing, advising* or *managing* may lead to conflicts of interest and infringement of insider trading rules.

An authorized person is not in violation of the provisions on insider information and insider trading of the Market Conduct Regulations (*see Section 9.2.4 of Chapter 9*), if the authorized person deals or advises in a security related to inside information, while at the same time, another department of the authorized person is in possession of the inside information, if the following conditions are met:

- a) The authorized person has established, implemented and maintained appropriate Chinese wall arrangements in view of the nature and size of its securities business; and
- b) None of the individuals involved in the dealing or advising activity has knowledge of the inside information or has received advice on the dealing or advising activity from an individual who has knowledge of the inside information.

7.1.5 PREPARED SECURITIES ADVERTISEMENTS

Learning Objective 7.1.5 – *Understand* the requirements to which a prepared securities advertisement must adhere before it is communicated to any person (Part 5, Article 33 and Annex 5.1).

One of the methods of communication to existing and potential clients is through a prepared securities advertisement. A prepared securities advertisement means any securities advertisement that is prepared in advance by the authorized person and is

communicated in writing, electronically or otherwise to one or more persons.

Before making any prepared securities advertisement, or approving one to be made by another person, an authorized person must ensure that the advertisement complies with the requirements of the relevant regulations and approved by a designated officer, and the content of the advertisement is clear, fair and not misleading.

If the prepared securities advertisement relates to specific securities then it must contain sufficient information to enable a person to make an informed assessment of the securities or securities activity to which it relates.

If an authorized person becomes aware that a prepared securities advertisement does not comply with the regulations, it must withdraw the advertisement as soon as possible. Complete record of each prepared securities advertisement shall be maintained. Content requirements for prepared securities advertisement are in detailed in Appendix 7.1 of this chapter.

7.1.6 DIRECT COMMUNICATIONS

Learning Objective 7.1.6 – *Understand* the requirements and restrictions to which any individual making the direct communication and the authorized person must adhere before and during the communication. (Part 5, Article 34 and 35).

Direct communications means communication other than a prepared securities advertisement, and these include meetings with a customer or potential customer, telephone calls, presentations or any direct interactions with one or more persons. Before making any direct communication, an authorized person must ensure that the recipient has consented to receiving these communications or the recipient has an existing customer relationship with the authorized person and understands that these communications may be made within the scope of this relationship.

An authorized person must ensure that an individual who makes a direct communication on its behalf, including any registered person or other employees, does so in a way which is clear, fair and not misleading. The person should not make any false or misleading statements and clearly explain the purpose of the communication at the initial point of communication, and identifies himself and the authorized person who he represents. Further, he should not communicate with a person outside of business hours, unless the person has previously agreed to such a communication.

An authorized person must have a code of conduct that requires individuals seeking to obtain business on behalf of the authorized person to avoid using any undue pressure or making any misleading or deceptive statements, and to make clear their purpose and identity to customers or potential customers.

In addition, an authorized person needs to be cautious regarding advertisements on non-retail investment funds and derivatives. Because of the risk inherent within non-retail investment funds and derivatives, an authorized person must not communicate a securities advertisement to a customer relating to either of these

unless it has determined that the securities are suitable for the customer.

7.2 ACCEPTING CLIENTS

7.2.1 CLIENT CLASSIFICATION

Learning Objective 7.2.1 – *Know* the three different types of clients (Part 5, Article 36).

Before conducting securities business with or for any client, an authorized person must classify the client into one of the following categories:

- a) Customer - a client who is not counterparty, whether it is an individual or a juristic person for whom an authorized person executes securities transactions.
- b) Execution-only customer – customer for whom an authorized person only deals as agent in accordance with the customer’s instructions.
- c) Counterparty - a client who is an authorized person, an exempt person, an institution or a non-Saudi financial services firm, or other than in the Authorized Persons Regulations, a counterparty means a counterparty to a transaction.

An authorized person’s dealing with its client classified as an execution-only customer must be restricted to dealing as his agent in accordance with the instructions that it receives from the client, and the authorized person must not advise such client. An authorized person must make a record of the classification established for each client, including sufficient information to support that classification.

7.2.2 TERMS OF BUSINESS WITH CLIENTS

Learning Objective 7.2.2 – *Know* the requirement that an authorized person must provide a client with its terms of business; the basic purpose of doing so and its record keeping requirements (Part 5, Article 38 and Annex 5.2).

Before conducting any securities business transaction with its client, an authorized person must provide the client with “terms of business” that set out the basis on which such securities business is to be conducted. The terms of business must take the form of an agreement between the authorized person and the client containing relevant terms including:

- The customer’s investment objectives.
- Any restrictions on the types of securities in which the customer wishes to invest; and the markets on which the customer wishes transactions to be executed.

- The services which the authorized person will provide and the payments for these services.
- Special arrangements, if needed, such as securities lending, margin transactions, collateral arrangements, special commission arrangements and custody of customers' assets.
- Notification to customer whenever the authorized person intends to pool client's asset with that of one or more other clients and explain the meaning of pooling and warn the customer that.
- Written notification to client that there may be different settlement, legal and regulatory requirements in overseas jurisdictions from those applying in the Kingdom whenever an authorized person arranges for client assets to be held overseas.

Detailed terms of business requirement as prescribed under the regulations are enclosed in Appendix 7.2 of this chapter. An authorized person is required to retain a record of the terms of business it provides to a client, and any amendment to them.

7.2.3 KNOW YOUR CUSTOMER

Learning Objective 7.2.3 – *Know* the requirement of Know Your Customer and basic details of the information that should be retained from clients (Part 5, Article 39 and Annex 5.3).

Before an authorized person deals, advises, or manages for a customer, a customer investment profile must be developed. To develop the customer profile, the authorized person must obtain information from the customer concerning his financial situation, investment experience, investment objectives and risk profile relevant to the services to be provided. Such information must be obtained as a precondition to providing such services.

The information required from clients must at a minimum include information as prescribed in Appendix 7.3 of this chapter. The authorized person must request an update of such information from each customer at least once every three years. If the customer refuses to provide the information required, the authorized person may not deal, advice or manage for him. Record of all information obtained from the customer in this regards shall be retained.

7.3 CLIENTS RELATIONS

7.3.1 FIDUCIARY DUTIES

Learning Objective 7.3.1 – *Know* basic details of the fiduciary duties that an Authorized Persons owes to its customers (Part 5, Article 40 and Annex 5.4).

Fiduciary may be defined as a relationship 'relating to the responsibility to look

after someone else's money in a correct way' (Cambridge Advanced Learner's Dictionary). A fiduciary duty is a legal or ethical relationship of confidence or trust regarding the management of money or property between two or more parties, most commonly a *fiduciary* and a *principal*. In a fiduciary relation one person (the principal), in a position of vulnerability, justifiably reposes confidence, good faith, reliance and trust in another (the fiduciary) whose aid, advice or protection is sought. In such a relation good conscience requires one (the fiduciary) to act at all times for the sole benefit and interests of another (the principal), with loyalty to those interests.

In this context, an authorized person is a fiduciary and owes statutory fiduciary duties to its customers. The duties include:

1. ***Loyalty***: An authorized person must act in all cases in good faith and in the interests of the customer.
2. ***Conflict of interest***: An authorized person must manage conflicts of interest fairly between itself and its customers. (*See also Section 7.3.2*)
3. ***No secret profits***: An authorized person must not use the customer's property, information or opportunities for its own or anyone else's benefits unless the authorized person makes full disclosure of such usage to the customer and obtains his consent.
4. ***Care, skill and diligence***: An authorized person owes the customer a duty to exercise care, skill and diligence that would be expected of a person having the necessary knowledge and experience in the business.

7.3.2 CONFLICTS OF INTEREST

Learning Objective 7.3.2 – *Understand* an authorized person's responsibilities regarding any conflict of interest between itself and its customers (Part 5, Article 41).

Further to the statutory fiduciary duties outlined above, an authorized person must also ensure that it safeguards at all times the interests of its customer, and that no conflict of interest between its interest and the interest of its customer affects the transactions or the services that the authorized person carries out for its customer.

Where an authorized person who acts for a customer has an actual or a potential conflict of interest in relation to a transaction it shall disclose that conflict of interest to the customer in writing. But, an authorized person is not required to disclose a conflict of interest if this information is related to the provision of *inside information*. (*see Section 9.2.3 of Chapter 9*) In that instance an authorized person shall take reasonable steps to ensure fair treatment for the customer. (*see also Section 7.1.4*)

If there is a loss incurred due to the conflict of interest between an authorized

person and its customer in any transaction, the authorized person must pay to the customer the value of the loss incurred by the customer as a result of the conflict. However, the loss will not be borne by the authorized person if the authorized person has disclosed the conflict of interest to the customer and the customer has agreed in writing that the authorized person can proceed despite the conflict.

An authorized person must in all cases comply with the *Market Conduct Regulations* (see Chapter 9) on the best execution in any dealing as principal with a customer. This means that, when acting as a principal, an authorized person must in all cases execute a transaction at a better price for the client than it would have obtained if the transaction was executed in his role as an agent.

7.3.3 DEALINGS THAT INVOLVE RISK

Learning Objective 7.3.3 – *Understand* the restrictions placed on an authorized person's dealing with its customers when undertaking activities that involve risk (Part 5, Article 42).

An authorized person must not deal, advise or manage for a customer, or take collateral for its own account from a customer, unless it has taken reasonable steps to enable the customer to understand the nature of the risks involved in the type of transaction in which the customer would be engaging.

Taking into account the risk involved in certain types of securities, the regulations require that an authorized person must not deal, advise, or manage for a customer in derivatives securities, contingent liability securities or non-retail investment funds, unless it has informed the customer of the nature and extent of the risks involved in such securities. Furthermore, an authorized person must not deal, advice, or manage for a customer in illiquid or speculative securities, unless it has informed the customer of the nature and extent of the risks involved in such securities, including any difficulties in determining their value.

7.3.4 SUITABILITY

Learning Objective 7.3.4 – *Understand* the regulations regarding the suitability of advice or a transaction for a customer (Part 5, Article 43).

Since investors may come from different investment backgrounds, knowledge and experience, the regulation is explicit with respects to the type of advice and products that need to be recommended to various investors. In this respect, the regulations require an authorized person must not deal, advise or manage for a customer or take collateral for its own account from a customer, unless the advice or transaction is suitable for that customer based on the knowledge and investment profile of the customer. This requirement recognizes the fact that some customers have extensive knowledge on investments while others have limited knowledge. Hence, an authorized person should be wise enough to provide an advice that is

‘suitable’ to the customer, given his level of knowledge and experience.

In determining the suitability of advice or a transaction for a customer, an authorized person must take the following into consideration:

- the customer’s knowledge and understanding of the relevant securities and markets, and of the risks involved;
- the customer’s financial standing, including an assessment of his net worth or of the value of his portfolio based on the information disclosed by that customer;
- the length of time the customer has been active in the relevant markets, the frequency of business and the extent to which he relies on the advice of the authorized person;
- the size and nature of transactions that have been undertaken for the customer in the relevant markets; and
- The customer’s investment objectives.

However, if an authorized person has advised a customer that a transaction is not suitable for him, but the customer decides to proceed with the transaction anyway, the authorized person may accept an order to buy or sell the security from the customer, provided that a record of the advice given to the customer is retained. This, however, does not apply to dealing for an execution-only customer.

7.3.5 CUSTOMER BORROWING

Learning Objective 7.3.5 – *Understand* the circumstances under which an authorized person may lend money or extend credit to a customer (Part 5, Article 44).

Although the regulations do not prohibit an authorized person from dealing financially with their customers, they do put clear boundaries within which these dealings should take place. Specifically, the regulations require that an authorized person shall not, in relation to securities business, knowingly lend money or extend credit to a customer unless the authorized person has made and recorded an assessment of the customer’s financial standing and is satisfied that the amount and the arrangements for the loan or credit are suitable for the customer. In addition, it is required that the customer has given his prior written consent to the lending or credit facility, specifying the maximum amount of the loan or credit together with details of the amount and of any charges to be levied.

The restrictions on lending do not apply where an authorized person settles a transaction in the event of a default or late payment by the customer; or it pays an amount to cover a margin call made for a customer for a period no longer than five days.

7.3.6 MARGIN REQUIREMENTS

Learning Objective 7.3.6 – *Understand* the circumstances and conditions under which an authorized person may effect a margined transactions or the granting of a loan or credit to cover margin payments (Part 5, Article 45).

A margin transaction is a transaction where the client pays a certain percentage (margin) of the cost of the transaction, and the authorized person arranges for a loan to the client for the remainder of the cost of the transaction. Margin trading has an added element of financing risk over and above the usual market risks. Because of this, constant monitoring is required to manage the risk.

The regulations state that an authorized person may not effect a margin transaction with or for a client unless the client has entered into terms of business specifying the following:

- the circumstances under which the client may be required to provide margin;
- particulars of the form in which the margin may be provided;
- particulars of the steps which the authorized person may be entitled to take if the client fails to provide the required margin, including the communication method(s) by which the margin call will be made on the client;
- that failure by the client to meet a margin call may lead to the authorized person closing out the client's position after a time limit specified by the authorized person, and that the authorized person is entitled to close out the position in any event after a period of five days from such failure; and
- Any circumstances, other than failure to provide margin, which may lead to the client's position being closed without prior reference to him.

Meeting the above conditions, an authorized person may make a secured or unsecured loan or grant credit to a client for a period of more than five days for the purpose of making a deposit of the margin or the required margin payment if:

- a credit assessment is made of the client by an employee of the authorized person who is independent of the trading or marketing functions; and
- the client has given his prior written consent to the lending or credit facility, and such consent specifies the maximum amount of the loan or credit together with details of the amount and of any charges to be levied.

Specifically, an authorized person who effects a margin transaction with or for a client must:

- require the client to provide a minimum initial margin of 25% of the value of the transaction prior to effecting the transaction;
- take reasonable steps to satisfy itself that the client is aware of the risks of margin transactions; and
- Monitor the margin provided by the client on daily basis, and ensure that the

margin is maintained at a minimum level of 25% of the current value of each applicable security position.

The Authority may prescribe a higher rate of margin to be provided for transactions in any security or category of securities, and the authorized person must require a client to provide any such prescribed rate of margin. The Authority may also prohibit margined transactions in relation to any security or category of securities. Margin must be in the form of cash, fully-paid securities or other acceptable collateral.

7.4 REPORTING TO CLIENTS

7.4.1 CONTRACT NOTES

Learning Objective 7.4.1 – *Know* the requirements that an Authorized Person must send a contract note when it has affected a sale or purchase of a security for a customer and the required content of a cover note (Part 5, Article 47 and Annex 5.5).

An authorized person who affects a sale or purchase of a security with or for a client must provide a contract note to the client, unless the authorized person is acting as manager and the client has confirmed in writing that contract notes are not required. The purpose of requiring a contract note is to document a transaction for recording and audit purposes.

Contract notes sent to customers shall include the required content requirements as per Appendix 7.4 of this chapter.

7.4.2 PERIODIC REPORTING

Learning Objective 7.4.2 – *Know* the requirements that an authorized person who acts as manager for a client must send periodic valuations to that client and the required content of such periodic valuation statement (Part 5, Article 48 and Annex 5.6).

An authorized person who acts as a manager for a client must send a valuation report at least every three months in respect of securities or securities-related cash balances contained in the client's account.

Such valuation reports must contain:

- contents and value of portfolio held by clients
- basis of valuation
- transaction history and changes in client's portfolio
- charges and remuneration
- securities pledged or charged

- derivatives positions (if any)

Details on the required contents of periodic valuation statements for clients' portfolios are contained in Appendix 7.5 of this chapter.

7.4.3 CLIENT RECORDS

Learning Objective 7.4.3 – *Understand* the record keeping requirements in respect of transactions effected by an authorized person for its clients and its clients' accounts (Part 5, Article 49).

Clients' records form bases for reports, dispute resolutions and any future valuations of clients' financial positions with the authorized person. Hence, it is a requirement for an authorized person to keep and maintain proper records of each transaction it effects. Such records must be current at all times and sufficiently demonstrate compliance with these Regulations. Such records must:

- accurately record at all times the assets and liabilities of each individual client and of all clients collectively;
- contain such information as is necessary to enable the authorized person to prepare a statement of each client's assets and liabilities, and details of transactions effected for the client; and
- Identify all client money and client assets that the authorized person, or its custodian, is responsible for.

Furthermore, the records of the authorized person must also contain:

- details of all orders in a security entered by a client;
- details of all purchases and sales of a security made by the authorized person for a client, or by the authorized person for its own account;
- a record of all income and expenses for each client, explaining their nature;
- details of all receipts and payments of client money and client assets;
- a record of the cash and securities held in each client account; and
- a record of client money and client assets.

7.4.4 EMPLOYEES' PERSONAL DEALINGS

Learning Objective 7.4.4 – *Understand* the regulations regarding Employees' Personal Dealings as they affect the employee and the authorized person (Part 5, Article 50 and Annex 5.7).

The Authorized Persons Regulations place restrictions on employees of authorized persons dealing for their own account. An employee of an authorized person must not knowingly be a party to any transaction in a security where a client of the

authorized person is a party, or establish a trading account at another authorized person, except where the employee's authorized person does not offer the same service.

Employees engaged in personal dealings must disclose to the compliance officer all transactions in securities transacted at an authorized person other than his own. The compliance officer must establish procedures to monitor employees' personal dealings in securities to ensure compliance with the Capital Market Law and the Implementing Regulations.

It is required for an authorized person to provide every employee with a written notice (the personal dealing notice) and the employees must undertake that they will observe the requirements of the personal dealing notice by signing a copy of it and returning it to the authorized person. As a guide, the regulations provide a model of personal dealing notice that must be complied with by the authorized person. The main contents of the dealing notice are:

- Permissible securities
- Restrictions on Rights Issues, Takeovers
- Restrictions on Executors and Agents
- Restrictions on General Exemptions
- Restrictions on Selling to or Buying from a Client
- Reporting of Transactions
- Restrictions on Dealing Ahead of a Research Recommendation
- Restrictions on Dealing Contrary to a Client's Interest
- Personal Benefits Acceptance Conditions
- Counseling and Procuring
- Summary of Insider Trading Rules

An authorized person is free to impose more stringent requirements than those required above. Detailed dealing notice is enclosed in Appendix 7.6 of this chapter.

7.4.5 TELEPHONE RECORDINGS

Learning Objective 7.4.5 – *Know* an Authorized Person's obligations if it wishes to make or accept telephone communications to or from its clients in relation to securities business (Part 5, Article 51).

An authorized person must not make or accept telephone communications from clients or prospective clients in relation to securities business unless the authorized person records the telephone communications. An authorized person must disclose to its clients or prospective clients that telephone communications in relation to securities business will be recorded.

It is a requirement for an Authorized person to retain the records of telephone communications in relation to securities business for a period of three years following the date of the telephone communication. In the event a telephone

communication is relevant to a dispute with a client or a regulatory enquiry, the record must be retained until the dispute is fully resolved or the enquiry completed.

Review Questions

1. What is meant by special commission? What are the conditions which allow an authorized person to enter into a special commission arrangement with its clients?
2. What is meant by 'Chinese wall' arrangements?
3. What are the requirements for an authorized person to communicate any securities advertisement to the public?
4. What are the three different types of client's classification? What is meant by 'Counterparty'?
5. What are some of the relevant terms and conditions which should be incorporated into the agreement between the authorized person and its clients?
6. What are some of the basic information which should be requested from clients as part of 'Know Your Customer' process?
7. What is the meaning of 'fiduciary'? What are the four fiduciary duties that an authorized person owes to its customers?
8. Describe an authorized person's responsibilities regarding any conflict of interest between itself and its customers.
9. What are the factors to be considered by an authorized person in determining the suitability of advice or a transaction for a customer?
10. Under what conditions an authorized person is allowed to lend money or extend credit to its customer?
11. What are the terms that should be agreed upon between the authorized person and its clients prior to any margin transactions?
12. How often the portfolio valuation statements should be sent to customers? What are the required content of such statement?
13. What are the main rules regarding personal dealing of authorized person's employees?

Sample Multiple Choice Questions

1. According to the client classification rules of the Authorized Persons Regulations, which of the following is not considered as a 'counterparty'?
 - A. An authorized person
 - B. An exempt person
 - C. A registered person
 - D. A non-Saudi financial services firm

2. An authorized person must not deal, advise or manage for a customer unless the advice or transaction is "suitable" for that customer, depending on:
 - i. The extent of customer's knowledge on securities market
 - ii. Customer's experience in securities market investing
 - iii. The investment profile of the customer
 - A. (i) only
 - B. (i) and (ii) only
 - C. (i) and (iii) only
 - D. All of the above

3. Which of the following statements are true regarding margin transaction?
 - I. A margin transaction is where the client pays a certain percentage of the cost of the transaction, and the remainder is paid by a loan.
 - II. Margin trading has a lower risk than a normal transaction because investor pays only part of the purchase price.
 - III. The authorized person may prescribe a higher rate than the prevailing margin and the client must comply with the new margin.
 - A. I only
 - B. I and II only
 - C. I and III only
 - D. All of the above.

4. According to the Authorized Persons Regulations, which of the following rules pertaining to personal dealings of employees of an authorized person is INCORRECT?
 - A. An employee must disclose to the compliance officer all transactions made in his company
 - B. An employee must disclose to the compliance officer all transactions made at authorized persons other than his own
 - C. An employee must not trade in a security that is being traded by a client of the authorized person.
 - D. An employee must not establish a trading account at another authorized person if his company offers the same service.

APPENDIX 7.1: CONTENT REQUIREMENTS FOR SECURITIES ADVERTISEMENT

Content required for prepared securities advertisement:

1. That the purpose of the advertisement must be clear.
2. The nature or type of securities business of the authorized person and the type of securities being advertised must be clear.
3. Any statement, promise or forecast must be fair and not misleading. All assumptions must be clearly stated. An advertisement must not forecast the possible future price of securities.
4. The advertisement must not include false or misleading statements relating to the securities business, size or resources of the authorized person or type of securities.
5. The advertisement must state the name and address of the authorized person, and that the authorized person is authorized by the Authority.
6. The advertisement must not describe a security as guaranteed unless there is a legally enforceable arrangement with a third party who undertakes to meet in full an investor's claim under the guarantee. If so, the advertisement must give details about both the guarantor and the guarantee sufficient for an investor to make a fair assessment about the value of the guarantee.
7. Advertisements that compare different securities or services must:
 - a. be based either on facts verified by the authorized person or on assumptions stated within the advertisement;
 - b. be presented in a fair and balanced way; and
 - c. Not omit anything material to the comparison.
8. An authorized person must include a statement his or his affiliates holding in the security, and/or that he provides in the previous 12 months significant advice or securities business services to the issuer of the securities concerned.
9. Any information about the past performance of securities or of an authorized person that is included in an advertisement must:
 - a. be a fair representation of the past performance of the securities or authorized person;
 - b. not be selected so as to exaggerate the performance of the securities or authorized person;
 - c. state the source of the information;

- d. be based on verifiable information; and
 - e. Warn that past performance is not necessarily a guide to future performance.
10. If the advertisement contains any reference to the impact of zakat or taxation, it must state the assumed rate of zakat or taxation and any applicable relief, and state that such rates and relief may change over time.
 11. Any advertisement for securities to which cancellation rights apply must contain details of such rights, including the period within which they may be exercised.
 12. Where the securities can fluctuate in price or value, a statement must be made that prices, values or income may fall and, if applicable, a warning that the investor may get back less than he invested.
 13. Where the advertisement contains or refers to a recommendation about a specific security or securities service, a statement must be made to warn that it may not be suitable for all investors and that if they have any doubts, they should seek advice from their investment adviser.
 14. Where the advertisement relates to a security which is a geared security or a contingent liability security, it must state:
 - a. that the security may be subject to sudden and large falls in value which could cause a loss equal to the amount invested; and
 - b. that the investor's loss may not be limited to the amount originally invested or deposited, but may have to pay more.
 15. Where a security is described as being suitable for an income seeking investor, the investor must be warned that income from the security may fluctuate; and part of the capital invested may have to be used to pay the required income.
 16. Where a security is denominated in a foreign currency, the investor must be warned that changes in currency rates may have an adverse effect on the value, price or income of the security.
 17. An advertisement for an illiquid security must state that it may be difficult for the investor to sell or realize the value of the security; and to obtain reliable information about its value or the extent of the risks to which it is exposed.
 18. If an advertisement relates to a security on which deductions for charges and expenses are made at the time of the initial investment or on the sale of the investment, a warning that such charges apply must be included.
 19. If an advertisement relates to a security on which performance fees are charged, a warning that such charges apply must be included.

APPENDIX 7.2: TERMS OF BUSINESS WITH CLIENTS

An authorized person's terms of business to be entered into with or for a client should, where relevant, provide for the following:

- The date on which the terms of business come into force.
- The name and address of the authorized person and a statement that the authorized person is regulated by the Authority.
- The customer's investment objectives.
- Any restrictions on the types of securities in which the customer wishes to invest; and the markets on which the customer wishes transactions to be executed.
- The services which the authorized person will provide.
- Details of any payment for services payable by the customer to the authorized person, including the following:
 - a) structure and methods of the payments;
 - b) how it is to be paid and collected;
 - c) how frequently it is to be paid, and
 - d) Any other payment that is receivable by the authorized person (or by any of its affiliates) in connection with any transaction executed by the authorized person, with or for the customer, in addition to or in lieu of any fees.
- If the authorized person is to act as manager, the terms of business must include the following:
 - a) the arrangements for giving instructions to the authorized person and acknowledging those instructions;
 - b) the initial value of the managed portfolio;
 - c) the initial composition of the managed portfolio;
 - d) the period of account for which statements of the portfolio are to be provided;
 - e) the extent of the discretion to be exercised by the authorized person, including any restrictions on investments;
 - f) how performance will be measured;
 - g) How valuations will be made.
- The arrangements for accounting to the customer for any transaction

executed on his behalf.

- A description of any cancellation right to which the customer may be entitled.
- That the authorized person may act as principal in a transaction with the customer, if applicable.
- Any risk warning required under Part 5 of these Regulations (i.e. on conduct of business)
- Whether the authorized person may undertake security lending activity with or for the customer.
- How the terms of business may be terminated.
- How to complain to the authorized person.
- A description of any right of the authorized person to realize the assets of the customer (including any collateral) or to close out or liquidate positions on a default.
- A statement of the basis on which the customer will incur any contingent liability, including margin requirements, and the maximum limits placed on such funding.
- Details of any authority to borrow or raise money on the customer's behalf, or enter into transactions which will involve the customer having to borrow or raise money and the maximum borrowing limit must be clarified.
- A statement explaining the authorized person's policy regarding special commission arrangements.
- Arrangements for:
 - a) registration of client assets if these will not be registered in the customer's name;
 - b) claiming and receiving dividends, commission payments and other entitlements accruing to the customer;
 - c) exercising conversion and subscription rights;
 - d) dealing with takeovers, other offers or capital reorganizations;
 - e) exercising voting rights;
 - f) the authorized person's liability in the event of a default by an eligible custodian;
 - g) the giving and receiving of instructions by or on behalf of the client or other person accredited by the client, and any restrictions to that authority; and

- h) Any agreement to lien or pledge interests over the client asset taken by the authorized person or an eligible custodian except in respect of charges relating to the administration or custody of the client assets.
- An authorized person must notify a customer where it intends to pool his client asset with that of one or more other clients and explain the meaning of pooling and warn the customer that:
 - a) customer assets or entitlements may not be separately identifiable by certificates, other physical documents of title or electronic record; and
 - b) Customers may participate pro rata in any irreconcilable shortfall resulting from the default of a custodian.
- Where an authorized person in accordance with these Regulations arranges for client assets to be held overseas, it must notify a client in writing that there may be different settlement, legal and regulatory requirements in overseas jurisdictions from those applying in the Kingdom.
- An authorized person must notify a customer in writing of the arrangements for holding client money.

APPENDIX 7.3: KNOW YOUR CUSTOMER FORM

The information required from clients must at a *minimum* include the following information:-

INDIVIDUAL CUSTOMER

PERSONAL INFORMATION

Name:

Date of birth:

ID Number/passport No.:

Marital Status:

Number of dependants:

Citizenship:

Address for Correspondence:

Home Phone:

Mobile Number:

Approximate annual income (in SAR)?

- 25,000 or less
- 25,001 to 50,000
- 50,001 to 100,000
- 100,001 to 250,000
- 250,001 to 500,000
- 500,001 to 1,000,000
- Over 1,000,000

Approximate net worth (excluding residence) (in SAR)?

- 25,000 or less
- 25,001 to 100,000
- 100,001 to 500,000
- 500,001 to 1,000,000
- 1,000,001 to 5,000,000
- Over 5,000,000

EMPLOYER INFORMATION

- *Employer's Name:*
- *Employer's Address:*
- *Employer's Phone Number:*
- *Position / Title:*
- *How long employed:*

BANK INFORMATION

- *Bank's Name:*
- *Branch:*
- *Main Account Number*

GENERAL INFORMATION

Is the customer a director or officer of a publicly listed company? YES / NO

Any other financial information on the customer's financial situation?

Customer's ideal investment portfolio profile based on securities risk

Type of Financial Instruments to be invested	Low Risk (short-dated debt instruments mainstream investment funds) (%)	Medium Risk (long-dated debt instruments; large companies) (%)	High Risk (small and single product companies; leveraged and high yield products) (%)
Shares			
Debt instruments			
Investment funds			
Trade finance			
Commodities			
Options			
TOTAL	100.0%	100.0%	100.0%

SOLE PROPRIETORSHIP OR A COMPANY

GENERAL INFORMATION

Name:

Commercial Registration No:

Registered Address:

Country of Registration:

Date of incorporation or start of business:

Business Phone:

Business Fax:

Number of employees:

Paid-up capital:

Annual Turnover:

COMPANY CONTACT

Name of Contact:

Address for Correspondence:

Business Phone:

Business Fax:

Mobile Number:

BANK INFORMATION

Bank's Name:

Branch:

Main Account Number

OTHER INFORMATION

Any other financial information on the customer's financial situation?

CUSTODIAN DETAILS

Name

Address for correspondence

Account name

Account number

Indicate where the following should be forwarded

	Certificates	Dividends/ Other Income	Sale Proceeds
Customer			
Custodian			
Other: Specify details as instructed by client			

INVESTMENT INFORMATION

Breakdown of Current Investment Portfolio

Type of Financial Assets	Amount
Shares	
Debt instruments	
Foreign exchange	
Deposits	
Trade finance	
Investment funds	
Commodities	
Contracts for derivatives and options	
Real-estate	
Other: Please specify	
Total	

Investment knowledge and experience

	Please tick (/)
Limited	
Good	
Extensive	

INVESTMENT PROFILE

Customer's appetite for risk

High _____ Medium _____ Low _____

General investment objectives?

Protection of capital	<input type="checkbox"/>
Income	<input type="checkbox"/>
Balanced	<input type="checkbox"/>
Growth of capital	<input type="checkbox"/>

What are the customer's preferred investment assets [tick as many as required]:

Denominated in Saudi Riyals?.....	<input type="checkbox"/>
Denominated in other foreign currencies?	<input type="checkbox"/>
State the foreign currencies:	<input type="checkbox"/>

APPENDIX 7.4: REQUIRED CONTENTS OF CONTRACT NOTES

Information to be included in the contract notes:

1. The authorized person's name and a statement that it is authorized by the Authority.
2. The transaction date and time.
3. The client's name, account number, address or other identifier.
4. The name of the security, the size involved and the type of the transaction (sale or purchase), and the maturity and delivery or expiry date (if the security is a contractually based security). If the security is an option that has been exercised, the information required are the strike price of the option and whether the exercise of the option creates a sale or purchase in the underlying asset.
5. The price at which the transaction was executed, or averaged and the total consideration due from or to the client, and a statement if applicable, that the price is an averaged price.
6. The agreed settlement date.
7. The authorized person's charges to the client in connection with the transaction.
8. The amount of any front-end loading if the transaction is a purchase of a unit in an investment fund.
9. Whether the authorized person executed the transaction as principal, or with or through an affiliate.
10. Where any commission or other return which has accrued or will accrue on the relevant securities is accounted for separately from the transaction price, the amount of the commission or other return which the purchaser will receive or the number of days for which he will receive commission must be clarified.
11. A statement, if this being the case, of any accrued dividend, bonus or other right which has been declared, but which has not been paid, that will not be passed to the purchaser under the transaction.
12. The amount of any costs including transaction taxes which are incidental to the transaction and which will not be paid by the authorized person out of the charges mentioned in item (7) above.
13. If the transaction involved or will involve the purchase of one currency with another, the currency conversion rate involved or a statement that the rate will be supplied on request.

14. If the security to which the contract note relates closes out an open position in a derivatives contract, the contract note must set out:

- a) each derivatives contract that forms part of the open position;
- b) each derivatives contract that forms part of the closing of the position;
and
- c) the net profit or loss made by the client on closing out the position.

APPENDIX 7.5: REQUIRED CONTENTS OF PERIODIC VALUATION STATEMENTS FOR CLIENT PORTFOLIO

1. Contents and value of Portfolio

- a) Description of each security held in the portfolio, the number of shares, units or contracts held, and the current value of each security position;
- b) Amount of cash balances;
- c) Total value of the portfolio on the valuation date; and
- d) Change in the value of the portfolio since the last valuation statement.

2. Basis of valuation

- a) A statement of the basis on which the value of each security has been determined and an explanation of any change in the basis for valuing any securities since the previous valuation report.
- b) Where any securities are valued in a currency other than the currency used to value the portfolio, the relevant currency conversion rates as of the valuation date must be shown.

3. Transactions and changes in portfolio

- a) Particulars of each transaction entered into for the portfolio during the period;
- b) Total amount of money transferred into and paid out of the portfolio during the period;
- c) Details of any securities transferred into or out of the portfolio during the period; and
- d) Total amount of commissions, dividends and other returns received by the authorized person for the portfolio during the period.

4. Charges and remuneration

- a) Total amount of fees, charges and taxes paid out of the portfolio for purchases and sales of securities during the period;
- b) Total amount of fees and charges for managing the portfolio and any other services provided by the authorized person during the period; and
- c) Details of any remuneration received by the authorized person from a third party in respect of transactions entered into for the portfolio, or a statement that the basis or amount of any such remuneration has been separately disclosed in writing to the client.

5. Securities pledged or charged

- a) Particulars of any securities that have been pledged as collateral for or charged to secure borrowings on behalf of the portfolio, and the identity of the person the securities are pledged to; and
- b) Total amount of any commission or other payments made in respect of such borrowings during the period.

6. Derivatives positions

- a) Profit or loss on each transaction to close out a derivatives position during the period (including any commissions or other fees payable for the transaction); and
- b) Details of each open derivatives position on the valuation date, including:
 - i. the underlying securities, commodity, index or any other asset;
 - ii. the trade price and date of the opening transaction;
 - iii. the current market price of the derivatives contract;
 - iv. the current unrealised profit or loss on the position; and
 - v. the exercise price and expiry date of the contract.

APPENDIX 7.6: PERSONAL ACCOUNT DEALING

Model personal dealing notice:

1. *Permission to deal*

- a) It is permitted to buy and sell securities in these categories:
[An authorized person should insert here types of securities or transactions in which the employee can deal. An authorized person will also need to clarify its procedure for restricting or withdrawing its consent in relation to particular securities in special conflict of interest circumstances.]
- b) An employee may not buy or sell any other securities without having obtained consent from *[the compliance officer or his deputy]*.
- c) Note that where a general or specific consent is given for a transaction, the other requirements set out in this notice (e.g. reporting) still need to be complied with.

2. *Rights issues, takeovers*

- a) The restrictions in this notice extend to making any formal or informal offer to buy or sell, taking up rights on a rights issue and exercising conversion or subscription rights and exercising an option.
- b) The restrictions also extend to buying or selling securities under any offer, including a takeover or tender offer, which is made to the public or all (or substantially all) the holders of the security concerned.

3. *Executors and agents*

The restrictions extend to dealings by the employee:

- a. as an executor of a will in which the employee or a relative of the employee has a significant interest;
- b. as an executor of any other will, unless the employee is relying entirely on the advice of another person (such as another broker or lawyer); or
- c. For another person, unless the employee is dealing as an employee of the authorized person.

4. *General Exemptions*

The restrictions do not extend to any transaction in a managed or discretionary account if the transaction is entered into without consultation with the employee.

5. *Selling to or buying from a client*

The employee may not sell to or buy from any client of the authorized person for his own account.

6. *Reporting of transactions*

The employee must immediately report to the authorized person in writing any purchase or sale of a security which the employee enters into otherwise than

through [name of the authorized person] or [name of another group company that is an authorized person], including those transactions falling within item (1) above. If, however, the employee has made arrangements for the authorized person promptly to receive a copy of the contract note (or similar report) in respect of the transaction, the employee does not have to report it to the authorized person.

7. Dealing ahead of a research recommendation

This restriction applies when the employee knows that the authorized person intends to publish a research recommendation and the employee knows, or should know, that the recommendation is likely to cause a price change in the security to which it relates. In that situation, the employee must not deal until the recommendation has been published and the clients for whom it was principally intended have had a reasonable opportunity to react to it. Dealing before the research recommendation has become public may also breach insider trading rules.

8. Dealing contrary to a client's interest

The employee must not deal in a security where he knows that such dealing is likely to have a direct adverse effect on the particular interests of one of the authorized person's clients.

9. Personal benefits

- a) If the employee's functions involve giving securities advice, including the preparation of research material, or entering into transactions in securities for the authorized person's own account or the account of those for whom it deals, the employee must not accept any benefit or inducement which is likely to conflict with the employee's duties to the authorized person or any of the authorized person's clients.
- b) "Benefit or inducement" means credit or any other financial advantages, money, property or gift; any services, facilities, or any opportunity to make, receive or increase a gain or revenue or to avoid or reduce a loss or expense.
- c) If in any doubt the employee should consult with [the compliance officer or his deputy].

10. Counseling and procuring

If the employee is precluded by the above provisions from entering into any transaction, the employee cannot advise or cause another person to enter into such a transaction or communicate any information or opinion to any other person if the employee knows, or has reason to believe, that that other person will as a result enter into such a transaction or cause or advise someone else to do so. This does not apply to actions which the employee takes in the course of his employment with the authorized person.

11. Summary of insider trading rules

The employee may not act contrary to Capital Market Law and its Implementing Regulations, especially the insider trading rules. Inside information is price-sensitive information that is not publicly available. An insider defined as a person who obtains inside information from a family, business or contractual relationship. The employee is likely to be an insider as a result of the employment, as is anyone to whom the employee passes the inside information. An insider may not trade in any security related to the inside information or communicate it to another person for the purpose of trading in the security. Another person may not trade in a security after receiving inside information relating to it. If the employee breaches these rules, the employee may face compensation claims, fines or prison. (Please see also Articles 4, 5 and 6 of the Market Conduct Regulations)

It is required for an authorized person to provide every employee with a written notice (the personal dealing notice) and the employees must undertake that they will observe the requirements of the personal dealing notice by signing a copy of it and returning it to the authorized person. An authorized person is free to impose more stringent requirements than those required above.

AUTHORIZED PERSONS REGULATIONS: SYSTEMS AND CONTROLS

8

LEARNING OBJECTIVES

The syllabus for this examination is broken down into a series of learning objectives and is included in the Syllabus Learning Map at the back of this workbook. Each time a learning objective is covered, it appears in a text box preceding the text.

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INTRODUCTION

This is the third and the last chapter on the Authorized Persons Regulations. The Authorized Persons Regulations were issued by the Board of the Capital Market Authority pursuant to its Resolution Number 1-83-2005 dated 21/05/1426H corresponding to 28/06/2005G based on the Capital Market Law issued by Royal Decree No. M/30 dated 2/6/1424H.¹³

This chapter discusses Parts 6 and 7 of the Authorized Persons Regulations, focusing on system and controls, and the handling of client money and client assets. The chapter covers specific provisions on the systems and controls, touching on the specific requirements of the authorized persons in establishing the necessary compliance mechanism in their firms, and the requirement to appoint a Compliance Officer and Money Laundering Reporting Officer (MLRO). The chapter also explains the various provisions governing the management of client money and client assets.

8.1 SYSTEMS AND CONTROLS

8.1.1 DIVISION OF RESPONSIBILITIES

Learning Objective 8.1.1 – *Know* the appropriate measures that should be taken by an authorized person to maintain a clear and appropriate division of the principal responsibilities among its directors or partners and senior management (Part 6, Article 53).

An authorized person must take appropriate measures to maintain a clear and appropriate division of principal responsibilities among its directors or partners and senior management. Such measures are necessary so that it is clear who is responsible for each function and the business and affairs of the authorized person are adequately monitored and overseen by the directors or partners, relevant senior managers and governing body of the authorized person.

The CEO of the authorized person is responsible for overseeing the establishment and implementation of the authorized person's systems and controls. In other words, there should be a proper organization chart of the authorized person that clearly shows lines of authority and responsibility, and that important functions are headed by senior managers, partners or directors.

¹³ In reading these regulations, any reference to the 'Capital Market Law' shall mean the Capital Market Law issued by Royal Decree No. M/30 dated 2/6/1424H; and any expressions and terms in this manual shall carry the meaning which they bear in the Capital Market Law and in the 'Glossary of Defined Terms used in the Regulations and Rules of the Capital Market Authority', unless otherwise is explicitly stated.

8.1.2 ESTABLISHMENT AND MAINTENANCE OF SYSTEMS AND CONTROLS

Learning Objective 8.1.2 – *Know* the requirement for an authorized person to establish and maintain systems and controls that are appropriate to its business. (Part 6, Article 54 and 55).

The regulations require an authorized person to establish and maintain systems and controls that are appropriate to its business. The establishment of systems and controls shall be based on the nature, scale and complexity of the authorized person's business, diversity of operations, number and value of transactions and degree of risk associated with each area of operations.

Such systems and controls should cover, at a minimum, areas such as:

- the division of responsibilities and reporting lines within the organization;
- risk management policies and systems;
- anti-money laundering and terrorism financing;
- compliance and compliance monitoring programs;
- code of conduct;
- operational procedures manual; and
- Business continuity manuals and plans.

It needs to be reminded that compliance with the Capital Market Law and its Implementing Regulations and all other regulatory requirements applicable to the authorized person is primarily the responsibility of the authorized person's governing body.

8.1.3 REVIEW BY THE GOVERNING BODY

Learning Objective 8.1.3 – *Know* the requirement for the authorized person's governing body to carry out regular review of division of responsibilities, systems and controls (Part 6, Article 56).

Regular review of the division of responsibilities, systems and controls shall be carried out regularly by the authorized person's governing body. The review shall also include reviewing various documents related to divisions of responsibilities, systems and controls, and must be done at least annually.

Further, an authorized person's governing body must expeditiously monitor the actions arising as a result of the review. Each review conducted should be recorded and the records must be maintained for a period of ten years.

8.1.4 COMPLIANCE

Learning Objective 8.1.4 – *Know* the requirement for the establishment of compliance function within an authorized person (Part 6, Article 57).

To ensure the effectiveness of the compliance functions within an authorized person, the governing body of the authorized person is responsible for supervising the following:

- ensuring that appropriate policies and procedures are in place to enable the authorized person to comply with the Capital Market Law, the Implementing Regulations and all other applicable regulatory requirements;
- ensuring that the compliance officer and his department are appropriately resourced and have access to all of the authorized person's records;
- the establishment, implementation, enforcement and maintenance of the compliance manual and the compliance monitoring programme;
- the establishment of and ensuring compliance with the code of conduct;
- the preparation of reports and notifications to be filed with the Authority; and
- the procedures for reporting to the governing body on compliance matters.

It should be mentioned that the Authority may review the appropriateness of an authorized person's compliance arrangements at any time.

8.1.5 THE COMPLIANCE COMMITTEE

Learning Objective 8.1.5 – *Know* the requirement for the establishment of compliance committee within an authorized person to oversee the effectiveness of compliance functions (Part 6, Article 58).

Depending on the nature, scale and complexity of its business, an authorized person may establish a compliance committee to monitor its securities business and its compliance programs. Nevertheless, the Authority may require an authorized person to appoint a compliance committee if it considers one to be necessary based on the nature, scale and complexity of the business.

When a compliance committee is established, its members should include, but are not limited to, the CEO, the compliance officer, the MLRO and a senior officer from internal audit (if any). The compliance committee must meet at least quarterly. Meetings must be minuted and the minutes must be retained for a period of ten years.

8.1.6 OUTSOURCING

Learning Objective 8.1.6 – *Understand* the extent of functions which could be delegated by an authorized person to external party and the supervisory controls required over this outsourcing arrangement (Part 6, Article 59).

An authorized person is allowed to delegate specific compliance or other functions to an external party, provided that appropriate safeguards are put in place, including:

- a) an assessment of whether the delegate is suitable to carry out the delegated function or task, taking into account the degree of responsibility involved;
- b) clear documentation of the extent and limits of any delegation;
- c) suitable arrangements to supervise the delegation, and to monitor the discharge of the delegate's functions or tasks; and
- d) appropriate remedial action if any concern arises about the performance of the delegate's functions or tasks.

An authorized person must exercise due diligence in the selection of an external party to perform specific functions. The outsourcing of any function by the authorized person will not derogate from the authorized person's, compliance officer's or the compliance committee's regulatory obligations.

8.1.7 THE AUDIT COMMITTEE

Learning Objective 8.1.7 – *Know* the requirement for the establishment of Audit Committee within an authorized person, if it required (Part 6, Article 60).

Depending on the nature, scale and complexity of its business, an authorized person may appoint an audit committee if it deems necessary. Nevertheless, the Authority may require an authorized person to appoint an audit committee if it considers one to be necessary based on the nature, scale and complexity of the business. Similar to the compliance committee, the audit committee, if established, should have quarterly minuted meeting, where minutes have to be retained for a period of ten years.

8.1.8 INTERNAL AUDIT

Learning Objective 8.1.8 – *Know* the requirement for the establishment of an Internal Audit functions within an authorized person, if it required (Part 6, Article 61).

Depending on the nature, scale and complexity of its business, an authorized person is allowed to delegate part of the task of monitoring the appropriateness and effectiveness of its systems and safeguards to an internal audit function.

An internal audit function should have clear responsibilities and reporting lines to the audit committee or appropriate senior manager, be adequately resourced and staffed by competent individuals, be independent of the day-to-day activities of the authorized person and have appropriate access to an authorized person's records.

Meetings of the internal audit function must be minuted and the minutes retained for a period of ten years.

8.1.9 AUDIT AND INSPECTIONS

Learning Objective 8.1.9 – *Know* the requirements for regular review of authorized person's books, accounts and other records related to securities business (Part 6, Article 62).

An authorized person's internal and external auditors must review books, accounts and other records related to securities business at least annually. All accounts, records, terms of business and other agreements to which an authorized person is party must be retained for the required period of ten years and be made available to the internal and external auditors.

8.1.10 RESOLUTION OF COMPLAINTS

Learning Objective 8.1.10 – *Understand* the importance of proper customer's complaint handling process (Part 6, Article 63).

An authorized person must have written procedures to ensure timely and proper handling of complaints from clients, and promptly take the appropriate remedial action in respect of complaints. Where a complaint arises from the conduct of a third party employed or recommended by an authorized person, the authorized person shall intercede on behalf of the client, making best efforts to resolve the complaint.

The authorized person must design adequate procedures to resolve complaints to ensure that each employee working with clients is aware of them. A complaint should be investigated promptly and fully by an officer of the authorized person

who was not originally involved in the matter giving rise to the complaint. The authorized person should make records of the written complaints and any action taken on the complaint.

8.1.11 EMPLOYEES

Learning Objective 8.1.11 – *Know* the requirement for an authorized person to establish adequate procedures for the recruitment, training, supervision and discipline of its employees (Part 6, Article 65).

An authorized person must establish adequate procedures for recruitment, training, supervision and discipline of employees to ensure that it recruits employees who are honest and appropriately qualified for the job. As employees are the prime asset of the authorized person, the regulations place emphasis on its employees' well-being. An authorized person must also establish a program to ensure that employees are trained appropriately, including passing any examinations required.

An authorized person is required to maintain records of disciplinary actions that are taken in connection with any breach of the Capital Market Law or its Implementing Regulations or any other conduct which may affect the conduct of the authorized person's securities business. The records must also include particulars of the breach or conduct for which the employee was disciplined and the steps taken to discipline the employee.

An authorized person must train its employees periodically and such training must cover updates to the Capital Market Law, its Implementing Regulations and any other laws relevant to the business of the authorized person. Such training should occur at least annually.

It is also a requirement for an authorized person to retain appropriate records relating to its employees in connection with their recruitment procedure, experience and qualifications for a period of ten years from the date of recruitment of the employee.

8.1.12 BUSINESS CONTINUITY

Learning Objective 8.1.12 – *Know* the requirement for an authorized person to ensure that it can continue to operate and meet its regulatory obligations in the event of an unforeseen interruption to its activities (Part 6, Article 66).

The regulations place great importance on the continuity of the authorized person's business operations. An authorized person should have in place appropriate arrangements, having regard to the nature, scale and complexity of its business, to ensure that it can continue to operate and meet its regulatory obligations in the event of an unforeseen interruption to its activities. These arrangements should be documented and regularly updated and tested to ensure their effectiveness.

Appropriate records relating to the arrangements in connection with business continuity must be retained for a period of ten years after it ceases to be used or is amended.

8.1.13 RECORD RETRIEVAL

Learning Objective 8.1.13 – *Know* the importance of efficient record retrieval and ability to produce such document for Authority's inspection when requested (Part 6, Article 67)

All records required to be maintained by an authorized person under the Capital Market Law or its Implementing Regulations must be available for inspection by the Authority.

8.1.14 MANDATE OVER AN ACCOUNT IN THE CLIENT'S NAME

Learning Objective 8.1.14 – *Know* the requirement for an authorized person to establish and maintain adequate records and internal controls in respect of a mandate it has over an account in the client's own name (Part 6, Article 68).

An authorized person must establish and maintain adequate records and internal controls in respect of a mandate it has over an account in the client's own name. An authorized person must in particular ensure that all transactions entered into pursuant to a mandate are within the scope of the authority conferred by the mandate and establish procedures for the giving and receiving of instructions under the mandate.

8.2 CLIENT MONEY AND ASSET

8.2.1 SEGREGATION REQUIREMENTS

Learning Objective 8.2.1 – *Understand* the segregation requirements in respect of authorized person's own assets and those of its clients and the effect of segregation (Part 7, Article 69 and 70).

An authorized person must segregate its own money and assets from client money and client assets. In addition, client money and assets must only be used for the benefits of the authorized person's clients. Client money and client assets which are segregated are deemed to be held by the authorized person for its clients and are not deemed to be assets of the authorized person. Creditors of an authorized person do not have any claim or entitlement to segregated money or assets.

8.2.2 CLIENT MONEY

Learning Objective 8.2.2 – *Understand* what constitutes client money and when money is not client money (Part 7, Article 71 and 72).

Generally, all money, except those immediately due and payable to the authorized person for its own account (including, fees and commissions which are lawfully due to the authorized person), that an authorized person receives from or on behalf of a client in the course of carrying on securities business is considered as client money.

It is a requirement for client money to be segregated and held in a client account, separate from the assets of an authorized person. All money paid into a client account by an authorized person will be treated as client money.

Only client money should be held in a client account unless it is required to open or keep open the account or it is temporarily in the account. An authorized person may transfer client money to another person for the purpose of settling a securities transaction with or through that other person or to provide collateral for a client. Further, money is not considered client money if it is immediately due and payable to the authorized person for its own account such as, fees and commissions which are lawfully due to the authorized person.

8.2.3 CLIENT'S MONEY TO BE HELD WITH A BANK

Learning Objective 8.2.3 – *Know* the requirement that Client Money is held in a local bank and the regulations concerning risk assessment, overseas banks and specific acknowledgement from the bank (Part 7, Article 73 and 74).

An authorized person must hold client money in a client account with a local bank. Prior to opening of such client account, an authorized person must assess the risk of the local bank, and should also consider whether it is necessary to open client accounts with more than one bank. However, an authorized person may open a client account with a local bank in its own group, provided it notifies its client of its intention and the client have not objected.

Client money may be held with an overseas bank but only if this is necessary for the settlement of a transaction in securities outside the Kingdom. Dividends or other income received outside the Kingdom for an authorized person's client may be paid into an account with an overseas bank in the authorized person's name, provided that the funds in question are either transferred to a client account or paid to the client no later than three days after notification of receipt. An authorized person must notify its client of its intention to hold client money with a bank outside the Kingdom. The same conditions applicable to local banks are equally applicable to an account with overseas banks.

Further, an authorized person must within 20 days of opening a client account obtain a written acknowledgement from the local bank with which the client account has been opened stating that:

- the client account will only hold client money and not money belonging to the authorized person; and
- the local bank will not enforce any right or claim that it may have against the authorized person, against the funds held in the client account, and that the bank will not combine the client account with any other account.

If an authorized person does not receive the said acknowledgement from the bank within 20 days, the authorized person must withdraw all money in the account and deposit it into the client account with another local bank.

8.2.4 PAYING IN AND WITHDRAWING CLIENT MONEY

Learning Objective 8.2.4 – *Understand* the regulations concerning the paying in, withdrawing and maintenance of money in a Client Money Account (Part 7, Article 75).

Except as otherwise stated, when an authorized person receives client money, it must deposit the money into the client account no later than the next day after receipt of the money. If a remittance comprises part client money and part other money it must be paid in full into a client account. The part of the remittance that is not client money should then be transferred out of the client account as soon as possible.

Client money may be held in a client account in a different currency from that received by the authorized person. In such a case an authorized person must, on daily basis, ensure that the amount held in that different currency is at least equal to the amount of the original currency and must adjust the amount held in that different currency accordingly (if necessary by making up any deficit). In carrying out the currency conversion the authorized person should use the closing spot currency conversion rate on the business day preceeding the day on which the conversion calculation is carried out.

8.2.5 MONEY CEASING TO BE CLIENT MONEY

Learning Objective 8.2.5 – *Understand* when Client Money ceases to be Client Money (Part 7, Article 76).

Money ceases to be client money for which the authorized person is responsible for, if it is paid:

- a) to the client;
- b) to a third party on the instructions of the client;
- c) into a bank account in the name of the client; or
- d) to the authorized person itself, where it is lawfully due and payable to the him.

8.2.6 COMMISSION

Learning Objective 8.2.6 – *Know* that no commission is payable to a client in respect of client money held in a client account (Part 7, Article 77).

An Authorized Persons Regulations prohibit commission to be payable to a client in respect of client money held in a client account.

8.2.7 RECORDS AND AUDITOR'S REPORT

Learning Objective 8.2.7 – *Know* that an authorized person must keep records which are sufficient to demonstrate compliance with the Client Money Rules of this Regulation (Part 7, Article 78).

An authorized person must keep records which are sufficient to demonstrate compliance with the Client Money Rules of this Regulation. An authorized person's auditors shall annually review the authorized person's compliance with the Client Money Rules and shall report on this review as part of its audit of the authorized person.

8.2.8 CONFIRMATION ON CLIENT ACCOUNT BALANCES

Learning Objective 8.2.8 – *Understand* the authorized person's obligations concerning the confirmation of balances in its Client Accounts (Part 7, Article 79).

An authorized person must confirm on daily basis that the aggregate balance of all its client accounts as at the close of the preceding business day was at least equal to the 'client money requirement' calculated in the manner prescribed by the Authority. The authorized person must also ensure that any shortfall is paid into a client account by the close of business on the day the calculation is performed, and any excess is withdrawn within the same time period.

An authorized person should use the values contained in its accounting records, such as its cash book, rather than values contained on statements received from banks. Fees and commissions may be excluded from the calculation. When an authorized person is required to pay money into a client account as stated above, such money will be client money. The Authority should be notified immediately if the authorized person is unable to perform the calculation of client money requirement.

8.2.9 RECONCILIATIONS OF CLIENT ACCOUNTS

Learning Objective 8.2.9 – *Understand* the authorized person's obligations concerning the reconciliation of each client account against the balances held at the bank (Part 7, Article 80).

An authorized person must, at least once in every 7 days, reconcile:

- the balance on each client account as recorded by the authorized person with the balance on that account as recorded on the statement issued by the local bank;
- the balance on each client transaction account with exchanges, clearing houses, intermediate brokers, settlement agents and counterparties as recorded by the authorized person with the balance as recorded in the statement issued by the person with whom the account is held; and
- its records of collateral received from clients with the statement of collateral or other form of confirmation issued by the person with whom that collateral is located.

An authorized person must perform the above reconciliations within 10 days of the date to which the reconciliation relates. Where any difference arises on any of the said reconciliations, the authorized person must correct it as soon as possible and in any event within 3 days. Notification to the Authority should be made as soon as possible whenever an authorized person is unable to perform any of the above required reconciliations.

However, where an authorized person is unable to resolve a difference arising from a reconciliation, but the records examined by the authorized person during its reconciliation indicate that there might need to be a greater amount of money in the relevant client accounts or collateral than is in fact the case, the authorized person must assume, until the matter is finally resolved, that those records are accurate and pay the difference from its own money into a client account and the amount paid will be client money.

8.3 CLIENT ASSET RULES

8.3.1 CLIENT ASSETS AND SEGREGATION

Learning Objective 8.3.1 – *Understand* what constitutes Client Assets and the need for segregation (Part 7, Article 82 and 83).

Client assets are assets, other than money, that the Authorized Person holds on behalf of its clients. In a similar way to client money, client assets have to be segregated. An authorized person must not hold client assets unless it is authorized

by the Authority to provide *custody* services. All assets including securities, which are received by the authorized person in the course of carrying on securities business, shall be treated as client assets unless they consist of cash or collateral.

An authorized person must segregate the client assets that it holds from its own assets and must not use client assets for its own account or the account of another client unless it has obtained the prior consent of the client to whom the assets belong. Client assets shall include collateral taken by way of pledge to satisfy an obligation arising from that pledge until applied to satisfy that obligation.

8.3.2 CLIENT ASSET ACCOUNT TITLES

Learning Objective 8.3.2 – *Understand* the requirement that the titles of accounts used to record Client Assets make it clear that the assets belong to the client (Part 7, Article 84).

If a client asset is recorded in an account with an authorized person, the authorized person must ensure that the title to the account makes it clear that such assets belong to the client. The authorized person must also make sure that the client assets are segregated from its own asset. Where a client's asset is recorded in an account with a custodian, local or overseas, the authorized person must require the custodian to make it clear in the title of the account that the client's asset belongs to one or more clients of the authorized person and that the assets are segregated.

8.3.3 HOLDING AND REGISTRATION OF CLIENT ASSETS

Learning Objective 8.3.3 – *Understand* the regulations concerning the holding and registration of Client Assets (Part 7, Article 85)

Securities that are eligible for the Depositary Centre must be held in an account in the relevant client's name with the Depositary Centre. An authorized person must hold a document of title to a client asset in its physical possession, or with a custodian in an account designated for client assets.

Where an authorized person registers or records title to a client asset it must ensure that it is registered or recorded in the name of the client, unless the client is an authorized person acting on behalf of its own client, in which case the asset must be registered in the name of that client.

Where the asset concerned is a security acquired overseas, title to the asset may be registered or recorded in the name of an overseas custodian or in the name of the authorized person, provided that the authorized person has satisfied itself that it is not feasible for the asset to be registered or recorded in the client's name. An authorized person must obtain a prior written agreement from the client to its assets being recorded or registered in the name of an overseas custodian or in the name of the authorized person. The authorized person then must notify the client in writing of any adverse consequences of the assets being registered or recorded other than in its name.

8.3.4 LENDING OF CLIENT SECURITIES

Learning Objective 8.3.4 – *Understand* the circumstances under which an Authorized Person may lend a client's securities (Part 7, Article 86).

An authorized person must not lend securities belonging to a client or engage in such lending activities with a client except after obtaining the client's written consent. Any securities lending activity must be subject to appropriate terms and conditions as agreed in the 'terms of business' agreement between the authorized person and the client.

An authorized person must at all times during the period of a securities lending transaction:

- ensure that the borrower provides collateral to cover the realizable value of the securities being lent;
- monitor on daily basis to ensure the amount of the collateral is sufficient to cover the realizable value of the securities; and
- make up the level of collateral if the amount of the collateral is not sufficient to cover the realizable value of the securities, unless otherwise agreed in writing with the client.

Securities, which are registered or otherwise held together for more than one client, must not be used for the purpose of a securities lending transaction, unless all of the clients to whom the securities belong give their consent in writing. If only some of the clients consent, the authorized person must ensure that only securities belonging to clients who have given their consent are used for this purpose. An authorized person must ensure that all securities lending transactions are appropriately documented.

8.3.5 ASSESSMENT OF CUSTODIAN

Learning Objective 8.3.5 – *Understand* the requirement to perform assessment of custodian (Part 7, Article 87).

An authorized person owes a duty of care to a client in deciding or recommending where to hold the client assets. An authorized person must undertake a risk assessment prior to recommending or deciding to hold client assets with a custodian to ensure that the custodian has in place adequate arrangements to safeguard the assets, and is subject to appropriate standards of regulatory oversight. An authorized person must conduct a risk assessment of custodians holding client assets as frequently as required to be satisfied of the above matters on a continuing basis.

An authorized person must notify its client before holding that client's assets with a custodian in the authorized person's group and must not hold the relevant client's assets with a custodian in its group if the client objects. An authorized person must not hold client assets with or recommend an overseas custodian to a client unless the proposed arrangements with the overseas custodian are necessary for the purpose of the acquisition or holding of securities outside the Kingdom.

The above requirements are also applicable in relation to overseas custodians. In carrying out a risk assessment in relation to an overseas custodian, an authorized person must take into account the extent to which the overseas custodian is subject to regulatory obligations at least equivalent to those imposed on custodians under the Capital Market Law and the Implementing Regulations.

8.3.6 CLIENTS AGREEMENTS

Learning Objective 8.3.6 – *Understand* the requirement for an Authorized Person to have clients' agreements with its clients prior to providing any custodial services (Part 7, Article 88).

Before an authorized person provides *custody* services to a customer, it must agree in writing with that customer appropriate terms of business relating to these services. Similarly, prior to providing *custody* services to counterparty, the authorized person must send a written notice to the counterparty that provides detail conditions for such services.

The agreement or the notice must cover the following matters:

- the manner in which the client assets will be registered;
- arrangements for the receiving and giving of instructions by the client in respect of custody services;
- the authorized person's liability to the client;
- any lien or security interest taken over the client assets by the authorized person or other party;
- the circumstances in which the authorized person may realise client assets which are held as collateral, to meet the client's liabilities;
- how the authorized person will deal with the claiming and receipt of dividends, commissions and other income and entitlements accruing to the client;
- how the authorized person will deal with corporate actions, such as the voting of shares, capital reorganizations and takeovers;
- the information to be provided to the client in respect of client assets that the authorized person holds;
- the provision of statements to the client;
- the fees and charges to the client in respect of the custody services; and
- an explanation of whether the client's assets will be pooled with the assets of other clients and an explanation of the effect of that pooling.

8.3.7 CUSTODIAN AGREEMENT

Learning Objective 8.3.7 – *Understand* the requirement for an Authorized Person to agree in writing with the custodian appropriate terms of business prior to holding of client's asset (Part 7, Article 89).

Before an authorized person holds client assets with a custodian, it must agree in writing with the custodian appropriate terms of business, which must cover the following:

- that the title of the account in which any client assets will be held indicates that the assets credited to the account do not belong to the authorized person;
- that the custodian is not to permit withdrawal of any client assets from the account other than to the authorized person or to another person as the custodian may be instructed by the authorized person;
- that the custodian will hold or record a client asset belonging to the authorized person's client separate from any securities or other assets of the custodian, and that it will treat the assets in the account as client assets;
- that the custodian will deliver to the authorized person a statement as at a date or dates specified by the authorized person which details the description and amounts of all the securities credited to the account, and the statement must be delivered to the authorized person within 7 days of the date of the statement;
- that the custodian will not claim any lien, right of retention or sale, over the securities standing to the credit of any account which title indicates that the assets credited to the account do not belong to the authorized person.

The above requirements are also applicable to client assets which are lodged in an account with an overseas custodian.

8.3.8 RECONCILIATIONS FOR ASSETS HELD

Learning Objective 8.3.8 – *Understand* the authorized person's obligations concerning the reconciliation of clients' assets which it does not physically hold, which it physically holds as well as its obligations if any reconciliation reveals a discrepancy (Part 7, Article 90).

An authorized person must as often as necessary, but at least every 7 days, reconcile its record of client assets which it does not physically hold, with

statements obtained from the Depository Centre, custodians or overseas custodians. In the case of dematerialized securities not held with the Depository Centre or through a custodian or overseas custodian, reconciliation must be made with the statements obtained from the person who maintains the record of entitlement.

An authorized person must as often as necessary, but at least every 6 months, carry out a count of all client assets physically held by it, and reconcile the results of that count to its record and perform a reconciliation between the authorized person's record of client holdings, and its record of the location of client assets. The count and reconciliation in the above paragraph must cover all of the authorized person's books and records, and must be performed by counting and reconciling all securities and other client assets as at the same date. An authorized person must perform the reconciliations within 10 days of the date to which the reconciliation relates.

An authorized person must within 3 days, correct any discrepancy which is revealed by any reconciliation that it has carried out. If the authorized person discovers any discrepancy which amounts to a shortfall, it must within 3 days make good any shortfall and if the discrepancy is not resolved within 7 days, report the matter to the Authority.

8.3.9 CLIENT STATEMENTS

Learning Objective 8.3.9 – *Understand* the authorized person's obligations concerning the provision of statements to clients and the matters covered in those statements (Part 7, Article 91).

An authorized person must, as often as necessary, but not less frequently than annually, provide each client in writing with a statement of assets held. An authorized person is required to provide a statement to a client for whom a client asset, collateral or other asset has been held at any time during the authorized person's financial year even when there are no holdings at the statement date. However, there is no requirement to provide a statement where the client's account with the authorized person has been closed, and the authorized person has sent the client a closing statement which demonstrates that the authorized person no longer holds a client asset, collateral or other asset for the client.

Statements may be sent electronically with the client's prior written consent where the authorized person is capable of reproducing the statement and keeping a record of its dispatch. All statements produced by or on behalf of an authorized person must list all client assets, collateral and other assets owned by the client for which the authorized person is accountable and:

- identify any securities registered in the client's name, separately from those registered in another name;
- identify those securities and assets which are being used as collateral, or have been pledged to third parties, separately from any other securities and asset;
- show the market value of any collateral held, as at the date of the statement;

- and
- be based on information as of trade date or settlement date, and the basis must be notified to the client.

8.3.10 SAFEGUARDING OF COLLATERAL

Learning Objective 8.3.10 – *Understand* the authorized person's obligations concerning the safeguarding of collateral (Part 7, Article 93).

An authorized person must take reasonable steps to ensure that collateral is properly safeguarded. Where the authorized person has reasonable grounds to believe that the collateral will not be properly utilized or safeguarded by a third party, then it must withdraw the collateral from the third party unless the client has indicated otherwise in writing.

Collateral held by the authorized person must be separately identifiable from assets of the authorized person. The authorized person must be able to identify at all times the client providing the collateral.

Where an authorized person passes collateral of a customer which is client money or client assets to a counterparty in the Kingdom, the authorized person must take reasonable steps to ensure that the counterparty treats the collateral as client money or client assets, and it has obtained the consent of its customer in the terms of business not to treat the money or assets as client money or client assets.

An authorized person must not undertake a transaction for a client that involves client money or client assets being passed either as collateral to a counterparty or to a settlement agent outside the Kingdom before formally notifying the client that his money or assets may be passed to such person. The authorized person must also notify the client that the regulatory regime may be different from that of the Kingdom and the authorized person has taken reasonable steps to ensure that the counterparty or settlement agent will effectively segregate the collateral from its own assets under the law of the country in which the counterparty or settlement agent is located.

Further, an authorized person who transfers clients' collateral to an exchange or clearing house must notify the exchange or clearing house that the collateral is client money or client assets, and that the authorized person is under an obligation to keep clients' collateral separate from the authorized person's collateral. The authorized person should also instruct the exchange or clearing house to credit the value of that collateral passed by the authorized person to the authorized person's client transaction account with the exchange or clearing house, and treats the sale proceeds of that collateral in accordance with the requirements of that exchange or clearing house.

Before an authorized person deposits a client asset as collateral with, mortgages, pledges, charges or grants another encumbrance over any client asset to, a third party, it must properly consider the credit risk to its clients, notify the client that the collateral will not be registered in the client's name and obtain the client's prior

written consent to carry out such actions.

The authorized person must have prior written consent from its client if it proposes to return to the client collateral other than the original collateral, or original type of collateral, or money.

An authorized person must notify the Authority as soon as it is aware of the insolvency of a person to whom it has passed collateral. The authorized person must notify the Authority as soon as reasonably practicable, of its intentions regarding making good any shortfall in client money or client assets that has arisen or may arise, stating the amounts involved.

8.3.11 OTHER COLLATERAL

Learning Objective 8.3.11 – *Understand* the terms under which an authorized person may treat collateral as ‘other collateral’ and the significance of holding collateral in this way (Part 7, Article 94).

Other collateral is collateral that an authorized person is entitled to treat as its own provided the authorized person is obliged to return equivalent assets to the client upon conclusion of a transaction or satisfaction of an obligation.

An authorized person must not receive or hold other collateral in the case of collateral of a customer before it has determined that the taking of collateral is suitable for the customer, and has taken reasonable steps to ensure that the customer understands the nature of the risks involved in his providing other collateral to the authorized person.

The authorized person must also disclose to the customer in the terms of business that his collateral will not be subject to the protections under the Client Asset Rules and as a consequence, his collateral will not be separated from the assets of the authorized person and will be used by the authorized person in the course of the authorized person's business, and he will therefore rank as a general creditor of the authorized person. Further, the authorized person also needs to ensure that it maintains adequate records to enable it to meet any prospective obligations including the return of equivalent assets to the customer.

Review Questions

1. Why is a clear and appropriate division of the principal responsibilities among an authorized person's directors, partners and senior management is important?
2. What are the minimum areas which should be covered when an authorized person establish system and controls?
3. What are the responsibilities of an authorized person's governing body relating to compliance?

4. Who should be the members of an authorized person's compliance committee? How often the committee should meet?
5. How often an authorized person's books, accounts and other records related to its securities business should be reviewed by its internal and external auditors?
6. What are the steps to be taken by an authorized person in handling customers' complaints?
7. What is 'Client Money' and what is not 'Client Money'?
8. Explain the process of conducting a client account reconciliation statement. What is the timeframe allowed to perform reconciliations of a client account?
9. What are clients' assets?
10. What are the appropriate terms and conditions to be incorporated in the 'terms of business' for a securities lending activity?

Sample Multiple Choice Questions

1. Which of the following statements about 'compliance committee' is NOT true?
 - A. An authorized person may, at its discretion, establish a compliance committee to monitor its securities business and its compliance program.
 - B. The compliance committee must meet at least once a year.
 - C. The Authority may require an authorized person to appoint a compliance committee if it considers necessary.
 - D. Minutes of the compliance committee meetings must be retained for a period of ten years.
2. An authorized person must prepare reconciliation statements of client money at least on weekly basis. Which of the following is FALSE regarding reconciliation requirements?
 - A. The balance on each client account as recorded by the authorized person must be reconciled with the balance on that account as recorded by the client.
 - B. Where differences arise on the reconciliations, the authorized person must correct it within 3 days.
 - C. An authorized person must notify the Authority as soon as possible if it is unable to perform the required reconciliations.
 - D. If there is a difference arising from a reconciliation that cannot be resolved, the authorized person must pay the difference from its own money into the client's account.

3. An authorized person must, as often as necessary, but at least _____, provide each client in writing with a statement assets of client's account.
- A. monthly
 - B. quarterly
 - C. semi-annually
 - D. annually

MARKET CONDUCT REGULATIONS

9

LEARNING OBJECTIVES

The syllabus for this examination is broken down into a series of learning objectives and is included in the Syllabus Learning Map at the back of this workbook. Each time a learning objective is covered, it appears in a text box preceding the text.

INTRODUCTION

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- 9.4.4 LIABILITY FOR ACTS OF OTHERS

INTRODUCTION

This chapter discusses the Market Conduct Regulations, that were issued by the Board of the Capital Market Authority Pursuant to its Resolution Number 1-11-2004 dated 20/8/1425H corresponding to 4/10/2004G based on the Capital Market Law issued by Royal Decree No. M/30 dated 2/6/1424H.¹⁴

The Market Conduct Regulations, which contain six parts, address issues such as the prohibition of market manipulation, prohibition of insider trading, prohibition of making untrue statements and authorized persons' conduct with respect to market manipulation and insider trading.

9.1 PROHIBITION OF MARKET MANIPULATION

9.1.1 PROHIBITION OF MANIPULATIVE AND DECEPTIVE ACTS OR PRACTICES

Learning Objective 9.1.1 - *Understand* that market manipulation and deceptive acts are prohibited (Part 2, Article 2).

The regulations prohibit any person to engage in or participate in any manipulative or deceptive acts or practices in connection with an order or transaction in a security, if the person knows or has reasonable grounds to know the nature of the act or practice.

It is also prohibited for any person to, directly or indirectly, enter an order or execute a trade in a security for the purpose of creating any of the following:

- a false or misleading impression of trading activity or interest in the purchase or sale of the security; or
- an artificial bid price, ask price or trade price for the security or any related security.

9.1.2 MANIPULATIVE AND DECEPTIVE ACTS OR PRACTICES

Learning Objective 9.1.2 - *Know* what actions are considered 'manipulative and deceptive' acts and practices (Part 2, Article 3).

The following actions are considered as manipulative or deceptive acts or practices:

¹⁴ In reading these regulations, any reference to the 'Capital Market Law' shall mean the Capital Market Law issued by Royal Decree No. M/30 dated 2/6/1424H; and any expressions and terms in this manual shall carry the meaning which they bear in the Capital Market Law and in the 'Glossary of Defined Terms used in the Regulations and Rules of the Capital Market Authority', unless otherwise is explicitly stated.

- making a fictitious trade, or
- affecting a trade in a security that involves no change in its beneficial ownership.

The following acts are among those considered as manipulative or deceptive acts or practices when committed for the purpose of creating a false or misleading impression of trading activity in a security or interest in the purchase or sale of the security, or for the purpose of creating an artificial bid price, ask price or trade price for a security:

- Entering a buy order with prior knowledge that a sell order has been (or will be) made at the same time with the same quantity and price, to give an artificial impression that there are interest, activities and liquidity in the security.
- Entering a sell order with prior knowledge that a buy order has been (or will be) made at the same time with the same quantity and price, to give an artificial impression that there are interest, activities and liquidity in the security.
- Making buy offers at successively higher prices or in a pattern of successively higher prices, thereby artificially pushing up the price.
- Making sell offers at successively lower prices or in a pattern of successively lower prices, thereby artificially pushing down the price.
- Entering orders to buy or sell securities in order to:
 - Establish a predetermined sale price, ask price or bid price.
 - Affect a high or low closing sale price, ask price or bid price.
 - Maintain the sale price, ask price or bid price, within a predetermined range.
 - Entering orders or series of orders for security that are not intended to be executed.

9.2 INSIDER TRADING

9.2.1 DISCLOSURE OF INSIDE INFORMATION

Learning Objective 9.2.1 – *Understand* the concept of trading in a security as it applies to the regulations concerning Insider Trading (Part 3, Article 4a).

The Market Conduct Regulations provide details on the offence of insider trading outlined in the Capital market Law. To be classified as an insider trading, the security must be a traded security and there must be inside information that would affect the price or value of that security, if the information were made available or disclosed to the general public.

It is an offence for a person to trade, either directly or indirectly, in that security based on his possession of the inside information.

Direct trading includes executing a trade for any account in which the person has an interest, and the person making a bid or offer for the security on the Exchange. Indirect trading includes any one of the three situations:

- 1) The person executing the trade as agent for another.
- 2) Arranging a trade to which a relative or person with whom he has a business or contractual relationship is party.
- 3) Arranging for his agent, or any other person acting on his behalf or his direction, to trade in the relevant security.

9.2.2 THE 'INSIDER'

Learning Objective 9.2.2 - *Know* what is the definition of 'insider' and what information constitutes as 'inside information' (Part 3, Article 4b).

A person is deemed an 'insider' in any of the following circumstances:

- A director, senior executive or employee of the company related to the inside information;
- A person who obtains inside information through a family relationship, including from any person related to the person who obtains the information;
- a person who obtains inside information through a business relationship, including obtaining the information from the issuer of a security related to inside information or from any person who has a business relationship with the person who obtains the information or from any person who is a business associate of the person who obtains the information; and
- a person who obtains inside information through a contractual relationship, including obtaining the information from the issuer of a security related to inside information or from any person who has a contractual relationship with the person who obtains the information.

9.2.3 INSIDE INFORMATION

Learning Objective 9.2.3 - *Know* what information constitutes an 'inside information' (Part 3, Article 4c).

'Inside information' means an information which fulfills the following criteria:

- information that relates to a security;
- it has not been disclosed to the general public; and that is not otherwise available to the general public; and
- a normal person would realize that, in view of the nature and content of the information, disclosing it or making it available to the public would have a material effect on the price or value of the security.

9.2.4 PROHIBITION OF DISCLOSURE OF INSIDE INFORMATION AND INSIDER TRADING

Learning Objective 9.2.4 - *Know* the regulations prohibiting the disclosure of inside information and insider trading (Part 3, Article 5 and 6).

The law not only prohibits trading based insider information, but it also prohibits dissemination of insider information. Anyone in possession of an inside information is prohibited from disclosing it to any other person.

The regulations prohibit an insider from disclosing any inside information to any other person when he knows or should have known that it is possible that such other person may trade in the security related to the inside information. A person who is not an insider is prohibited from disclosing to any other person any inside information obtained from an insider, when he knows or should have known that it is possible that such other person to whom the disclosure has been made may trade in the security related to the inside information.

Further, an insider is also prohibited from engaging in insider trading. A person who is not insider is prohibited from engaging in insider trading if he obtains the inside information from another person and he knows or should have known, that the information is inside information.

9.3 UNTRUE STATEMENTS

9.3.1 PROHIBITION OF UNTRUE STATEMENTS

Learning Objective 9.3.1- *Know* the prohibition of making untrue statement (Part 4, Article 7).

A person is prohibited from making an untrue statement of material fact verbally or in writing for the purpose of influencing the price of a security, or for inducing another person to buy or sell a security or inducing him not to buy or sell the security. A person is also prohibited from failing to make a statement that is required to be made under the relevant rules and regulation for the purpose of influencing the price of a security, or inducing another person to buy or sell a security, or inducing him not to buy or sell the security.

9.3.2 RUMORS

Learning Objective 9.3.2 - *Know* the prohibition of spreading rumours (Part 4, Article 8).

It is prohibited from anyone to circulate rumors, that is, an untrue statement of material fact or a statement of opinion, from himself or from someone else, for the purpose of influencing the price.

9.3.3 UNTRUE STATEMENTS DEFINED

Learning Objective 9.3.3 - *Know* the circumstances in which a person may make an untrue statement (Part 4, Article 9).

The regulations provide specific circumstances that are considered to be untrue statements. This prohibition applies to the statements of material fact that would have a significant impact on the transacted security prices. A person is said to be making untrue statements under the following circumstance:

- Making false or inaccurate statement of material fact;
- Getting another person to make a false or inaccurate statement;
- Making a statement containing a misrepresentation of a material fact;
- Getting another person to make a statement containing a misrepresentation of a material fact; or
- Omitting a material fact when making a statement

9.3.4 RESPONSIBILITY FOR UNTRUE STATEMENTS

Learning Objective 9.3.4 – *Understand* the circumstances under which a person may be liable for damages in respect of the making of untrue statements (Part 4, Article 10).

There are two circumstances that may result in a person being held liable for damages to a claimant for untrue statements. The first is where a person made an untrue statement of material fact and the statement is made for profit (or commercial benefit) and in relation to the purchase or sale of security. The claimant must establish that he was not aware that the statement was untrue, and that he would have acted differently if he had been aware of the untrue nature of the statement, and that the person who made the statement knew (or there was a substantial likelihood that he knew), that the statement was untrue in relation to a

material fact.

The second is where a person fails to make a statement where required by the Capital Market Law, the implementing regulations, or the rules of the Exchange or the Depository Center. As long as what had been omitted relates to a material fact, and the damages claim is in relation to the purchase or sale of a security, a damages claim could be made. The claimant must establish that he was not aware of the failure to make the statement, and that he would have purchased or sold the security in question (at all or at the same price) had he known that the statement was omitted.

9.4 AUTHORIZED PERSONS' CONDUCT

9.4.1 CONDUCT IN CASE OF MARKET MANIPULATION AND INSIDER TRADING BY CLIENT

Learning Objective 9.4.1 – *Know* what action should be taken by an authorized person or registered person if they suspect that their client is involved in market manipulation or insider trading (Part 5, Article 11).

Learning Objective 9.4.2 – *Know* the authorized person or registered person's responsibilities in respect of clients' priority, timely execution, best execution, timely allocation and churning (Part 5, Article 12 - 16).

The regulations require an authorized person or a registered person not to accept or execute a client order if any of them has reasonable grounds to believe that the client:

- is engaging in market manipulation or insider trading;
- would be engaging in market manipulation or insider trading in another market if these Regulations applied to that market; or
- would be considered in breach of the law, regulations or rules applicable in the relevant market.

Where an authorized person or registered person has decided not to accept or execute an order for the said client, the authorized person must document the circumstances of and reasons for its decision in writing and notify the Authority of the decision within three days. All record in relation to any decision shall be retained for a period of ten years from the date of the decision.

The Market Conduct Regulations further describe the authorized person or registered person's responsibilities in respect of clients' priority, timely execution, best execution, timely allocation and churning. These can be outlined as follows:

- ***Clients' priority:*** An authorized person or a registered person must execute

client orders for a security before executing any order for his own account.

- **Timely execution:** If an authorized person accepts a client order or decides in its discretion to execute a client order, it must execute the order as soon as is practical in the circumstances.
- **Best execution:** Where an authorized person deals with or for a client, it must provide best execution. An authorized person is considered to provide best execution when acting as agent, it ensures that the order is executed at the best prevailing price in the relevant market or markets for the size of the order; and when acting as principal, it executes the transaction at a better price for the client than it would have obtained if it executed the order in accordance with the preceding paragraph.
- **Timely allocation:** An authorized person who executes a transaction based on a client order must ensure that the transaction is promptly allocated to the account of that client. An authorized person who executes a discretionary transaction must ensure that the transaction is promptly allocated to the account of the client for whom the authorized person decided to transact.
- **Churning:** An authorized person must not advise or solicit a client to deal or deal or arrange a deal in the course of managing for a client if the dealing would reasonably be regarded as contrary to the interest of the client, based on the number and frequency of trades relative to the client's investment objectives, financial situation and the size and character of his account.

9.4.2 AGGREGATION OF CLIENT ORDERS

Learning Objective 9.4.3 – *Know* that aggregation of account is not allowed for Saudi market, but allowed with certain conditions for non-Saudi market (Part 5, Article 17).

Aggregation of orders is the amalgamation of one client's order with orders of other clients, or including those of the authorized person itself. Such combined order is then executed as a single block transaction.

The regulations prohibit the aggregation of orders for securities traded on the Saudi Stock Exchange. Aggregation of orders for securities that are not traded on the Saudi Stock Exchange are only permitted under the following conditions:

- the authorized person has provided a written explanation to the client of the advantages and disadvantages of aggregation and obtained written consent from the client to aggregate orders;
- the authorized person ensures that no client will be disadvantaged by aggregation of his orders; and

- all clients' orders that are aggregated receive the average price of execution for all of the orders that are executed.

In addition, an authorized person must establish a written policy setting out its method of allocating trades to client and principal orders.

9.4.3 DEALING AHEAD OF RESEARCH AND DEALING CONTRARY TO A RECOMMENDATION

Learning Objective 9.4.4 – *Know* that trading for own account ahead of research is not allowed (Part 5, Article 18).

Learning Objective 9.4.5 – *Know* that making a trade contrary to a research recommendation is prohibited (Part 5, Article 19).

Authorized persons often issue recommendations for particular securities, and there is a danger that such firms *front running* their own recommendations by buying (or selling) securities in advance of the publication of a positive (or negative) recommendation and consequently profiting at the expense of the clients. In securities business, *front-running* refers to unethical practice of a stock broker trading an equity based on information from the research department before the information is made available to its clients. (www.investopedia.com)

The regulations provide that an authorized person must not trade in a security for his own account if he knows that a research report is about to be issued to a client regarding the said security, until the client to whom the research is intended has had a reasonable opportunity to react to it. However, an authorized person may trade in the security for his own account if the research report is not expected to affect the price of the said security.

The regulations further prohibit an authorized person from advising or making a trade on a security for a client that is contrary to the recommendation of a report issued by the authorized person or any of its affiliates on the particular security, unless the recommendation and its potential conflict of interest between the authorized person and the client is disclosed to the client prior to making the trade.

An authorized person is prohibited from making a trade on a security for his own account that is contradictory to the recommendation unless reasonable grounds exist to make the trade.

9.4.4 LIABILITY FOR ACTS OF OTHERS

Learning Objective 9.4.6 – *Understand* the extent to which a person may be liable when acting at the direction of another person (Part 5, Article 20).

When an authorized person is found to have violated the provisions of the Capital

Market Law or the Implementing Regulations on market manipulation, insider trading or untrue statements while acting on behalf of another person (client) and at the direction of that person (client), that person (client) is liable and is subject to any sanctions to which the person (authorized person) carrying out the relevant acts is subject, unless the person (client) on whose behalf the act is carried out took reasonable steps to prevent the violations of the law and regulations, and did not authorize the acts in question.

In simpler language, when a person violates the law while acting as an agent, the principal is liable and subject to any sanctions in similar fashion as the agent unless the principal took reasonable steps to prevent the agent from violating the Law and its Implementing Regulations and did not authorize the act. In the context of securities trading, when an authorized person carries out a transaction as directed by a client, and the action happened to be in violation of the Law and its Implementing Regulations, the client will be subjected to similar sanction as the authorized person unless the client took the necessary steps to prevent the violation and not authorizing the transaction.

Review Questions

1. How does the Market Conduct Regulations define 'deceptive and manipulative' acts or practices?
2. Why do you think deceptive and manipulative acts or practices are prohibited?
3. Give some examples of deceptive and manipulative acts or practices.
4. How do the Regulations define 'inside information', 'insider' and 'insider trading'?
5. Why do you think the law prohibits insider trading?
6. What is the meaning of 'untrue statements' in the context of Market Conduct Regulations?
7. What are the responsibilities of authorized person in executing clients' orders?
8. Why is it prohibited to trade ahead of research and to trade contrary to research recommendations?

Sample Multiple Choice Questions

1. Which of the following actions may NOT be considered manipulative and deceptive according to the Market Conduct Regulations?
 - A. Entering a buy order with prior knowledge that a sell order will be made.
 - B. Entering a sell order with prior knowledge that another order has been made.
 - C. Making a series of buy offers in a way to deliberately pushing up prices.
 - D. Making sell offers in a way to deliberately pushing down prices.
2. Which of the following is MOST likely to be considered as an insider trading?
 - A. Trading in a security based on information that are not known to the public
 - B. Trading in a security based on a price-sensitive information
 - C. Trading in a security based on material information that is not yet announced to the public.
 - D. Trading in a security based on recommendation of a private research.
3. Which of the following statements are true regarding the prohibition of making an untrue statement as stipulated in the Market Conduct Regulations?
 - I. The statement is of material fact.
 - II. The statement is made for the purpose of influencing the trading activities of a security.
 - III. The statement is made with the intention to induce people to buy or sell a security.
 - IV. The statement is made with the intention to induce people not to buy or sell the security.

- A. I, II and III only
 - B. I, III and IV only
 - C. II, III and IV only
 - D. All of the above
4. The following actions are considered as ‘churning’ and prohibited by the Market Conduct Regulations:
- I. buying and selling a client's security at a frequency that is above normal for the client.
 - II. influencing a client to trade, who would otherwise prefer not to trade.
 - III. influencing a client not to trade, who would otherwise prefer to trade.
 - IV. The dealing may be reasonably regarded as going against the interest of the client
- A. I, II and III only
 - B. I, II and IV only
 - C. II, III and IV only
 - D. All of the above
5. The Market Conduct Regulation rules that an authorized person cannot make a trade on a security contradictory to the recommendation of a report issued by its Research Unit to a client, except under certain conditions. In this respect, which of the following is FALSE?
- A. authorized person can make a contradictory trade for the client provided that there is no conflict of interest between the Authorized Person and the client.
 - B. authorized person can make a contradictory trade for the client provided that its potential conflict of interest between the Authorized Person and the client is disclosed.
 - C. authorized person can make a contradictory trade for his own account if reasonable grounds exist to make the trade.
 - D. authorized person may make a contradictory trade in the security if the research report is not expected to affect the price of the said security.

ANTI-MONEY LAUNDERING AND COUNTER-TERRORIST FINANCING (AML/CTF) RULES

10

LEARNING OBJECTIVES

The syllabus for this examination is broken down into a series of learning objectives and is included in the Syllabus Learning Map at the back of this workbook. Each time a learning objective is covered, it appears in a text box preceding the text.

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INTRODUCTION

This chapter explains the Anti-Money Laundering and Counter-Terrorist Financing Rules (AML/CTF Rules).¹⁵ Anti-Money Laundering and Counter-Terrorist Financing Rules were issued by the Board of the Capital Market Authority, pursuant to its Resolution Number 1-39-2008, dated 3/12/1429H corresponding to 1/12/2008, based on the Capital Market Law, issued by Royal Decree No. M/30 dated 2/6/1424H.¹⁶ The objectives of the AML/CTF Rules are to ensure that:

- a) The authorized persons fully apply the Anti-Money Laundering Law issued by Royal Decree No. M /39 dated 25/06/1424H and its implementing Regulation, and apply the requirements of the FATF's 40 Recommendations and 9 Special Recommendations dealing with anti-money laundering and combating the financing of terrorism, the International Convention for Suppression and Financing of Terrorism (New York 1999), the United Nations Convention on Illicit Traffic in Narcotic Drugs and Psychotropic Substances (Vienna 1988) and the United Nations Convention (against transnational) on Organized Crime (Palermo 2000) and UN Security Council Resolutions 1267 and 1373 and successor resolutions related to combating terrorist financing.
- b) The credibility, integrity and reputation of the Saudi capital market are maintained.
- c) The authorized persons and their clients are protected from illegal transactions involving money laundering, terrorist financing or other criminal activities.

This chapter covers the following specific topics: the AML/CTF requirements, conducting the customer due diligence (CDD), record keeping requirements, provisions governing suspicious transactions, and internal policies, procedures and controls.

10.1. DEFINITION

Learning Objective 10.1- *Know* the meaning of money-laundering and terrorist financing as defined by the AML/CTF Rule. (Part1, Article 2).

Money Laundering refers to committing or attempting to commit any act for the

¹⁵ Often times, the abbreviations CTF and CFT are used inter-changeably. Literally, CTF means "Counter Terrorist Financing" while CFT means "Counteracting (or Combating) the Financing of Terrorism".

¹⁶ In reading these regulations, any reference to the 'Capital Market Law' shall mean the Capital Market Law issued by Royal Decree No. M/30 dated 2/6/1424H; and any expressions and terms in this manual shall carry the meaning which they bear in the Capital Market Law and in the 'Glossary of Defined Terms used in the Regulations and Rules of the Capital Market Authority', unless otherwise is explicitly stated.

purpose of concealing or disguising the true origin of funds acquired by means contrary to *Shari'ah* or law, thus making the funds appear as if they had come from a legitimate source. This definition has three components - first, the money normally comes from illegal or non-halal source, such as proceeds from criminal activities; second, there are actions taken to move the money in different ways and directions in order to lose track the origins of the money; third, the 'cleaned' money now appears to be coming from legitimate source and ready for use in legal economic activities.

Terrorist financing refers to the financing of terrorist acts, terrorists and terrorist organizations. Terrorist financing are associated with three aspects - first, financing of terrorists, that is, person or people that are associated with terrorist activities or terrorism; second, financing of terrorist organizations; third, financing of terrorist acts.

10.2. AML/CTF REQUIREMENTS

10.2.1. THE PRINCIPLES

Learning Objective 10.2.1 - *Understand* the general requirements and principles of implementing AML/CTF (Part2, Article 3)

Given the specific nature of securities business, organizational structure, type of clients and transactions, the authorized person must have in place appropriate policies and procedures to prevent money laundering and terrorist financing activities, and must ensure that these measures meet the requirements set out in the AML/CTF Rules.

The authorized person must be aware that Saudi Arabia has ratified and implemented the United Nations Convention on Illicit Traffic in Narcotic Drugs and Psychotropic Substances (Vienna 1988), the United Nations Convention on Organized Crime (Palermo 2000) and the International Convention for Suppression and Financing of Terrorism (New York 1999). These Conventions require the authorized person to establish systems, controls and procedures aimed at preventing money laundering and terrorist financing activities, including procedures for reporting suspected money laundering or terrorist financing transactions.

The senior management of the authorized person is responsible to effectively manage the risks of money laundering and terrorist financing activities. Senior management must be committed to establishing appropriate and effective policies and procedures for the prevention of money laundering and terrorist financing and to ensuring compliance with those policies as well as relevant legal and regulatory requirements. To ensure this, the authorized person must appoint a director or senior manager with direct responsibility for over-sighting compliance with the AML/CTF policies, procedures and relevant legal and regulatory requirements.

Further, it is also a requirement for an authorized person to:

- issue an effective statement of policies and procedures aimed at preventing money laundering and terrorist financing activities, and ensuring compliance with the current legal and regulatory requirements, including the maintenance of records and co-operation with the Financial Intelligence Unit (FIU) and other relevant law enforcement authorities in accordance with the relevant regulations and rules, including the timely disclosure of information;
- ensure that the content of AML/CTF Rules is understood by all officers and employees, and that they are all aware of the requirements and are vigilant in guarding the company against money laundering and terrorist financing activities;
- periodically review its policies and procedures on the prevention of money laundering and terrorist financing to ensure their effectiveness.
- adopt client's acceptance policies and procedures, and undertake to perform the required Customer Due Diligence (CDD) measures, including taking into account the risk of money laundering and terrorist financing depending on the type of clients, business relationships or transactions.

10.2.2. APPLICATION OF POLICIES AND PROCEDURES TO OVERSEAS BRANCHES AND SUBSIDIARIES

Learning Objective 10.2.2 – *Understand* the AML/CTF Rules affecting the authorized person's overseas branches and subsidiaries (Part 2, Article 4).

AML/CTF Rules also cover authorized person's overseas branches and its majority-owned subsidiaries. It is a requirement for an authorized person to ensure that its overseas branches and its majority-owned subsidiaries comply with the laws and regulations of Saudi Arabia concerning money laundering and terrorist financing, as well as the Financial Action Task Force (FATF) Recommendations. Special attentions shall be given to its branches and subsidiaries which are located in countries that do not or has not sufficiently implemented the FATF's Recommendations.

If the minimum AML/CTF requirements of Saudi Arabia and the host countries differ, the authorized person's branches and subsidiaries in the host countries shall apply the higher standard, to the extent that host country's laws and regulations permit.

Further, if the law of the host country conflicts with Saudi Arabian laws or regulations such that the overseas branch or subsidiary is unable to fully observe the higher standard, the authorized person shall report this to the Authority and comply with whatever advice given by the Authority. Similarly, where an authorized person's overseas branch or subsidiary is unable to observe group

standards because this is prohibited by host country laws, the authorized person shall inform the Authority immediately.

10.2.3. CASH PAYMENTS

Learning Objective 10.2.3 - *Know* the restriction on accepting cash (Part 2, Article 5).

The regulations prohibit acceptance of cash from clients, whether for investment purposes or as payment for services provided. All payments must be effected through a bank account.

10.3. CUSTOMER DUE DILIGENCE

Prior to accepting any clients, the authorized person must prepare a 'Know Your Customer' form containing the information required as prescribed under the Authorized Persons Regulations and the other information required by these Rules.

10.3.1. CLIENT ACCEPTANCE

Learning Objective 10.3.1 - *Know* the general procedure of accepting clients (Part 3, Article 7).

In order to identify the types of clients that are likely to pose a higher risk of money laundering and terrorist financing, an authorized person must develop client acceptance policies and procedures. For the identified higher risk clients, a more extensive customer due diligence (CDD) process must be adopted which includes clear internal policies on the approval of a business relationship with such clients.

The following are some factors that should be taken into consideration in determining whether a particular client or type of clients is of a higher risk:

- the background or profile of the client;
- the nature of the client's business, and the possibility of the business being associated with money laundering or terrorist financing activities;
- the place of establishment of the client's business and location of the counterparties with which the client does business, such as countries designated by the FATF or those known to the authorized person to have lack of proper standards in the prevention of money laundering or terrorist financing;
- unduly complex structure of ownership for no good reason;
- means of payment as well as the type of payment that could raise suspicion, such as payment is made by a third party check and the drawer of which has

- no apparent connection with the prospective client.
- any other information that may suggest that the client is of a higher risk (e.g. knowledge that the client has been refused a business relationship by another financial institution).

Although the risk category of a client is set in the beginning, the authorized person must reconsider the risk category when the pattern of account activity of the client does not fit in with the authorized person's knowledge of the client. Authorized person must also consider making a Suspicious Transaction Report (STR) to the Financial Intelligence Unit (FIU), Ministry of Interior, if necessary.

The regulations also prohibit an authorized person from accepting any client or opening an account for a client without meeting the client directly face-to-face unless the authorized person relies on other third parties for CDD process.

10.3.2. CUSTOMER DUE DILIGENCE (CDD)

Learning Objective 10.3.2 – *Understand* the steps involved in performing customer due diligence and the required verification process for each type of clients (Part 3, Article 8).

In general due diligence may be defined as the act of performing a reasonable investigation into the facts and circumstances of a transaction to ensure a full and complete understanding of the transaction.

In the context of the AML/CTF Rules, an authorized person is required to perform CDD to all its clients, with specific focus to assess the nature of their businesses and whether there is a possibility of linkage with money-laundering and terrorist financing activities.

Authorized person must take all steps necessary to be able to establish the true and full identity of each client, and of each client's financial situation and investment objectives. The opening of anonymous accounts, accounts using false or fictitious names, or accounts for prohibited persons notified by the Authority is strictly prohibited.

Further, the following steps shall be carried out on all clients:

- Identify the client and verify their identity using the valid original documents. This is also applicable to all persons with signatory authority over the account
- Identify and verify beneficial ownership and control using the valid original documents
- Obtain information on the purpose and intended nature of the business relationship – depending on the type of client, business relationship or transaction, authorized person must obtain sufficient information such that

ongoing due diligence on the client can be appropriately conducted, and

- Perform ongoing scrutiny of the transactions and account throughout the course of the business relationship to ensure that the transactions being conducted are consistent with the authorized person's knowledge of the client, the client's profile, taking into account, where necessary, the client's source of funds.

To verify the identity of clients and their respective beneficial owners, the following valid original documents shall be checked:

(a) Natural Persons

(i) *Saudi nationals*

- The client's National Identification Card or family record.
- The client's residential address and place of work and work address.

(ii) *Individual expatriates*

- A residence permit (Iqamah) or a five-year special residence permit or a passport for Gulf Cooperation Council (GCC) nationals or a diplomatic identification card for diplomats.
- The client's residential address and place of work and work address.

(b) *Legal persons*

For all clients that are legal persons, authorized person must obtain sufficient information about the nature of the business and its ownership and control structure so that it can identify the individual(s) that ultimately own(s) or control(s) the client. Specimen signatures shall be obtained for all account signatories.

(i) *Companies*

- A copy of Commercial register issued by the relevant authority.
- A copy of the articles of association, or the memorandum of association and their annexes, and amendments
- A copy of the identification card of the manager in charge.
- A copy of the issued resolution forming the Board of Directors.
- A copy of the board's resolution that approved of the opening of the account and authorized signatories;
- A list of the persons authorized to deal with the accounts, pursuant to what is provided for in the commercial register, and a copy of the identification card of each.
- A List of all company owners whose names are included in the memorandum of association and a copy of identification card of each.
- If the company has activities that require license from another government authority, a copy of that license is required.

(ii) Non-Profit Organizations and Entities

- A copy of the license issued by the relevant government authority.
- A copy of the board's resolution that approved the opening of the account.
- A copy of the articles of association.
- Board's authorization for the persons who would be responsible to open, deal and operate the accounts and a copy of the identification card of each.
- A copy of the Authority's approval for accepting the client and opening of the account.

(iii) Government entities

- A copy of all required documents in accordance with its law and regulation.
- A copy of the authority's approval of accepting the client and opening of the account.

For other type of clients not specified above, the approval of the Authority is required prior to opening of such accounts. For all clients, except where the authorized person is relying on a third party to perform the CDD process, the identity of a prospective client shall be verified face to face at an authorized person's premise before an account is opened or a business relationship is commenced. If there is doubt or difficulty in determining whether the document obtained to verify identity is genuine, authorized persons must not open the account, and shall consider whether they need to make a suspicious transaction report (STR) to the FIU. Copies of all documents used to verify the identity of the clients shall be retained.

Prior to establishing a business relationship, for the purpose of identifying the beneficial owner of an account, the authorized person must ask the said clients whether he is acting for his own account or for the account of another party.

Necessary information relating to clients must be obtained in order for the authorized persons to understand the purpose and nature of the business relationships with the clients. The following information may be needed to obtain a clearer understanding of the business relationship:

- record of changes of address;
- the expected source and origin of the funds to be used in the business;
- initial and ongoing source(s) of wealth or income;
- copies of the financial statements;
- the various relationships between signatories with underlying beneficial owners;
- The anticipated level and nature of the activity that is to be undertaken through the relationship.

10.3.3. RISK-BASED APPROACH – REDUCED AND ENHANCED CUSTOMER DUE DILIGENCE

Learning Objective 10.3.3 - *Know* how to implement the risk-based approach of customer due diligence – reduced and enhanced CDD. (Part 3, Article 9).

The general rule is that all clients shall be subjected to the full range of CDD measures. Depending on the risk level of the customer, an authorized person may perform reduced or enhanced customer due diligence.

Reduced CDD

The authorized person may perform a reduced CDD, for clients who are in a low risk category. Low risk clients for whom a reduced CDD applies are those whose information on their identity and beneficial owners is publicly available, such as, a company listed on the stock exchange of a country that sufficiently implement the FATF's Recommendations, or which is a subsidiary of such a listed company. In such a case, the authorized person need to identify the client and verify their identity using the valid original documents, obtain sufficient information on the purpose and intended nature of the business relationship and perform ongoing scrutiny of the client's transactions and account throughout the business relationship to ensure that the transactions being conducted are consistent with the authorized person's knowledge of the client.

However, where such a listed company is closely held, i.e. subject to the beneficial ownership/control of an individual or a small group of individuals, an authorized person shall carefully review the money laundering and terrorist financing risks and consider whether it is necessary to verify the identity of such individuals.

Enhanced CDD

The authorized person, on the other hand, must perform an enhanced CDD, for clients, business relationships or transactions that are in a high risk category. The relevant enhanced CDD process may vary from case to case depending on clients' backgrounds, transaction types and specific circumstances. Authorized person must exercise its own judgment and adopt a flexible approach when applying the specific enhanced CDD measures to clients of particular high risk types, but certainly the information gathered and the degree of scrutiny is greater than the normal clients.

The risk factors for determining what types of clients and activities which are considered as high risk must be clearly established in the authorized person's client acceptance policies. While it is recognized that no policy can be exhaustive in setting out all risk factors that must be considered in every possible situation, it is suggested that it must include at least client risk, country and geographical risk and product/service risk.

In assessing whether or not a country sufficiently applies the FATF recommendations and standards in combating money laundering and terrorist financing activities, an authorized person may resort to the following:

- Carry out a country assessment of the standards of prevention of money laundering and terrorist financing. This could be based on the authorized person's knowledge and experience of that country or from information acquired from relevant authorities;
- Use the compliance assessments reports produced by the FATF, FATF-style regional bodies, or the International Monetary Fund (IMF) and the World Bank; and
- Maintain an appropriate degree of ongoing vigilance concerning money laundering and terrorist financing risks and take into account information that is available on the standards of AML/CTF systems and controls that operate in the country.

Apart from the risk factors set out above in determining the risk profile of a client, the following are further factors that contribute to increased client risk:

- Complex legal arrangements that have no apparent legal or economic purpose;
- Persons from countries which do not or insufficiently apply the FATF's Recommendations, as designated as such by the FATF; and
- Politically exposed persons (PEPs)

10.3.4. POLITICALLY EXPOSED PERSONS (PEP)

Learning Objective 10.3.4 - *Know* what is Politically Exposed Persons (PEPs) and the required review process to be carried out relating to PEPs. (Part3, Article 10).

Politically Exposed Persons (PEPs) is defined under AML/CTF Rules as any individual who occupies, has recently occupied, is actively seeking or is being considered for, a senior position in a government, government agency, or government-owned company. The definition of PEP includes immediate family members (i.e. spouse, parent, sibling) and close associates (i.e. advisor, agent).

It is a requirement for an authorized person to have risk management systems in place to identify whether a client or a potential client, or a beneficial owner, is a 'politically-exposed person' (PEP). Any accounts identified as being held by such persons shall be considered higher risk and authorized person shall conduct enhanced ongoing monitoring of such accounts.

The opening or continued operation of an account for a PEP must be approved by

senior management of the authorized person. Authorized person shall also take measures to establish the source of wealth and source of funds of clients or beneficial owners who are PEPs.

10.3.5. NON-PROFIT ORGANIZATIONS AND ENTITIES

Learning Objective 10.3.5 - *Know* what are the non-profit organizations and the required review process (Part 3, Article 11).

Appropriate policies, procedures and controls shall be established in order to comply with the Authority's requirements regarding the opening and handling of accounts and transactions for non-profit organizations and entities.

The AML/CTF Rules define a non-profit organization and entity as an organization that primarily engages in raising/collecting donations and/or disbursing funds for non-profit purposes. The following requirements shall be observed when dealing with accounts of any such organizations:

- Non-profit organizations and entities must have an official registration/license issued by the relevant government authority, specifying the purposes and activities of the organization.
- Authorized person shall classify non-profit organizations and entities as high risk, and shall apply enhanced due diligence when dealing with such clients.

10.3.6. WHEN AUTHORIZED PERSON MUST PERFORM CDD

Learning Objective 10.3.6 - *Know* the situations when CDD shall be performed. (Part 3, Article 12).

An authorized person must carry out CDD measures when it:

- opens an account or establishes a business relationship with a client;
- suspects a client of money laundering or terrorist financing activities; or
- doubts the veracity of documents, data or information previously obtained for the purpose of identification or verification of the client.

In general, an authorized person must always perform CDD to verify the identity of the client or potential client and beneficial owner before or during the course of establishing the business relationship. When the authorized person is unable to perform the CDD process satisfactorily at the account opening stage, it must terminate such business relationship and shall not perform any transaction for the

said client, and must consider lodging a Suspicious Transaction Report (STR) with the Financial Intelligence Unit (FIU).

10.3.7. INVESTMENT FUNDS

Learning Objective 10.3.7 - *Know* the requirements for CDD on investment fund clients. (Part3, Article 13).

CDD is also required to be carried out for investment funds' clients. Where an authorized person acts for a client who is investing in an investment fund or a real estate investment fund, the authorized person must carry out CDD on the client and shall comply with the other requirements of these Rules.

However, if the client is a counterparty (i.e. a client who is an authorized person, an exempt person, an institution or a non-Saudi financial services firm), the authorized person needs not identify and verify the identity of the beneficial owners that are investing through the counterparty, provided that the following requirements are met:

- The counterparty is regulated, and licensed by the relevant government authority;
- The counterparty is based in a jurisdiction that adequately applies the FATF Recommendations;
- The counterparty is applying, as a minimum, requirements for AML/CTF (including measures for CDD and identification of beneficial owners) that are consistent with the requirements of these Rules and of the FATF Recommendations, and
- The counterparty has entered into an agreement with the authorized person agreeing, that upon the request of the authorized person or the Authority, the counterparty will provide any information requested regarding the beneficial owners.

10.3.8. RELIANCE ON OTHER THIRD PARTIES FOR CDD

Learning Objective 10.3.8 - *Know* the extent of reliance on third parties for CDD process and the required steps and documents for verifications. (Part 3, Article 14).

It needs to be stressed that an authorized person is fully responsible to conduct a proper CDD for all its clients. However in certain situation, when a client is introduced by a third party and CDD has been conducted, the authorized person may accept part of the CDD that has been conducted. A third party must either be a commercial bank or financial institution that engages in securities activities.

Authorized person, however, can only rely on third parties to perform the CDD if the client is located in a country other than Saudi Arabia.

Prior to accepting third party CDD, an authorized person must ensure that the third party applies the CDD measures as rigorous as those of the authorized person itself. Also, the authorized person must establish clear policies to determine whether the third party in question possesses an acceptable level of reliability in performing such CDD. When the authorized person wish to rely on the third party to perform the required CDD process, it must:

- Obtain copies of the CDD documentations and information, such as copy of the valid original documents used for verification and know your customer form;
- Take adequate steps, for example through a written agreement to ensure that copies of relevant documentation relating to the CDD requirements will be made available from the third party upon request in order to verify the CDD conducted by the third party; and
- Ensure the third party is regulated and supervised by a competent authority, and has measures in place to comply with CDD and record keeping requirements in line with these rules and the FATF recommendations.

Periodic reviews must be conducted to ensure that a third party that it relies on, continues to comply with the criteria set out above. This may involve review of their relevant policies and procedures and sample checks of due diligence conducted by them. Reliance on third parties that are based in country considered as high risk, such as countries that have no or inadequate AML/CTF systems, is prohibited.

10.3.9. ACQUISITION

Learning Objective 10.3.9 - *Know* the requirements of CDD for acquisition exercise. (Part 3, Article 15).

When an authorized person acquires, either in whole or in part, a financial institution in a foreign country, the authorized person shall ensure that the acquired financial institution has or will perform CDD measures consistent with the requirements in the AML/CTF Rules at the time of acquisition unless:

- the subsidiary it acquired holds the CDD records for all clients (including all relevant client identification information) and the authorized person has no doubt or concerns about the veracity or adequacy of the information so acquired, and
- the authorized person has conducted due diligence enquiries that have not raised any doubt on its part of as to the adequacy of AML/CTF procedures and controls previously adopted by the other financial institution.

10.3.10. NON-FACE-TO-FACE BUSINESS RELATIONSHIPS

Learning Objective 10.3.10 - *Know* the risk faced as a result of non-face-to-face business relationships and the required mitigating steps. (Part 3, Article 16).

Currently, the securities business is influenced in a very significant way by the development of information and communication technology, such as on-line banking and on-line securities trading. Face-to-face business relationships may become outdated. The modern non-face-to-face business relationship also opens opportunities for illegal activities that include money-laundering and terrorist financing.

Technology has large impact on the financing field. Accordingly, the regulations require an authorized person to be vigilant on the threats of technology on its business activities especially those related to money laundering and terrorist financing and must formulate its policies, procedures and controls, to prevent such threats. These policies, procedures and controls should be formulated in a way that addresses the specific risks associated with non-face-to-face business relationships and transactions. These specific risks must be addressed by specific and effective measures, both at the time the business relationship is established and as part of ongoing CDD.

10.3.11. ONGOING CDD AND UNUSUAL TRANSACTIONS

Learning Objective 10.3.11 - *Know* the requirements for ongoing CDD and unusual transactions monitoring. (Part 3, Article 17).

An authorized person must monitor on an ongoing basis the business relationships it has with clients. In doing so it must monitor the conduct of the client's account and scrutinize transactions undertaken to ensure that the transactions are consistent with the authorized person's knowledge of the client, its business and risk profile and the source of funds.

Furthermore, authorized person must pay attention to all complex, large transactions and all the unusual patterns of transactions which have no apparent economic or visible legal purpose. Special attention shall also be given to business relationships and transactions with clients or financial institutions from countries which do not or insufficiently apply the FATF's Recommendations. If the Authority advises the authorized person that such countries continue to not or insufficiently apply the FATF's Recommendations, authorized person shall treat all business relationships and transactions as higher risk and shall apply the enhanced CDD measures.

The background and purpose of all such transactions, including transactions that have no economic or visible legal purpose, must be examined, the findings

established in writing and those findings must be retained for a period of at least 10 years and be made available to the Authority, and internal and external auditors if requested.

10.3.12. REVIEW AND UPDATING OF RECORDS

Learning Objective 10.3.12 - *Know* the requirements for regular review and periodical update of clients' records. (Part 3, Article 18).

Identification data collected under the CDD process must be kept up-to-date, accurate and relevant. Authorized person must undertake annual or ad hoc reviews of existing records, particularly for high risk clients, when appropriate trigger events occur. Examples of trigger events that might prompt an authorized person to seek appropriate updated information include:

- An existing client applying to open a new account or establish a new relationship, or significantly alter the nature of an existing relationship;
- When there is a transaction that is unusual or not in line with the client's normal trading pattern based on the authorized person's knowledge of the client; or
- When the authorized person is not satisfied that it has sufficient information about the client or has doubts about the veracity or adequacy of previously obtained identification data.

10.4. RECORD KEEPING

10.4.1. RECORD KEEPING REQUIREMENTS

Learning Objective 10.4.1- *Know* the details of record keeping requirements contained in the rules and regulations of the Authority and the Saudi Stock Exchange (Tadawul). (Part 4, Article 19).

All authorized persons have to comply with the record keeping requirements contained in the rules and regulations of the Authority and the Saudi Stock Exchange (Tadawul). These records include all client identification data and other information and documents obtained from the CDD process, records of accounts and business correspondence, as well as all transaction records.

Authorized person is required to maintain sufficient records to permit reconstruction of individual transactions (including the amounts and types of currencies involved) so as to provide, if necessary, evidence for prosecution of criminal activity. In particular, authorized persons shall keep the following information regarding the accounts of its clients:

- details of the client and beneficial owner(s) (if any) of the account, and

other required CDD information;

- account details, including the volume of the funds flowing through the account; and
- for transactions: the origin of the funds, the form in which the funds were provided or withdrawn, such as, checks, transfer, identity of the person undertaking the transaction, destination of the funds, and the form of instruction and authorization.

Authorized person is required to ensure that all client and transaction records and information are available on a timely basis to the Authority. All records on transactions, both domestic and international, shall be maintained by the authorized person for at least ten years after the date of the transaction. Further, all CDD records, account files and business correspondence shall also be kept for a period of at least ten years after the account is closed. In situations where the records relate to on-going investigations or where records relate to transactions which have been the subject of a suspicious transaction report, they shall be retained until it is confirmed that the case has been closed even if it goes beyond the 10-year period.

The retention of such documents may be in the form of originals or copies, in paper or electronic form, provided that they are admissible as evidence in a court of law.

10.5. SUSPICIOUS TRANSACTION REPORT

10.5.1. SUSPICIOUS TRANSACTION REPORT (STR)

Learning Objective 10.5.1 - *Know* the process and procedures relating to suspicious transaction report (Part 5, Article 20 and Annex 1).

This article is very important as it represents the focus of authorized person efforts in fighting money-laundering and terrorist financing activities. It is important for the authorized person and its employees to be able to spot and detect a suspicious transaction or a client based on deviations from normality.

Consistent with the requirement of the AML Law and its implementing regulations, an authorized person must immediately file a suspicious transaction report (STR) to the FIU for any complex, huge or unusual transaction that raises doubt and suspicion concerning its nature and purpose, or it is suspected to be related to money-laundering and/or financing of terrorism activities. A copy of the STR shall be provided to the AML Unit of the CMA.

Within 10 days after filing the STR, the authorized person must submit to the FIU, a detailed report consisting all available data and information about the suspicious transactions and the parties involved. At the minimum the report shall include the following:

- Statement of account for a period of 6 months;
- Copies of all opening documents;
- All data related to the nature of the reported transactions; and
- The indications and justifications for the suspicion, along with all supporting documents.

An STR must be made regardless of whether they are also thought to involve other matters. The fact that a report may have already been filed to the FIU in relation to previous transactions of the client in question must not necessarily preclude the making of a fresh report, if new suspicion arises.

Authorized person is required appoint an appropriately senior employee as Money Laundering Reporting Officer (MLRO) to whom all staff are instructed to promptly refer all suspicious transactions for possible referral to the FIU. The MLRO must be a registered person with sufficient academic, scientific and practical experience in AML/CTF. Note that this does not apply to authorized person whose licensed business activity is limited to managing non-real estate investment funds or managing the portfolios of sophisticated investors, arranging or advising, as such an AP may outsource the function of compliance and AMLRO.

The MLRO shall act as a central reference point within the authorized person to facilitate onward reporting to the FIU. The MLRO must play an active role in the identification and reporting of suspicious transactions, and shall review reports of large or irregular transactions generated by the authorized person's internal systems on a regular basis. He has also to also review all ad hoc reports made by any employee of the authorized person.

Where authorized person employee brings a transaction to the attention of the MLRO, the circumstances of the case shall be reviewed at that level to determine whether the suspicion is justified, in which case a STR will be filed with the FIU. If a decision is made to not report the transaction to the FIU, the reasons for this shall be fully documented by the MLRO.

Records of all transactions referred to the MLRO by the employees together with all internal findings and analysis done in relation to them must be properly kept. A register must be maintained to record all STR made to the FIU. The register also should record all reports made by employees to the MLRO, regardless of whether the reports are filed to the FIU or not.

In making an STR, a standard form prescribed by the FIU for reporting shall be used. The reporting could be by fax, e-mail or any other means agreed by the FIU to ensure that the FIU receives the report promptly. If reports are initially made by telephone, the STR must be confirmed in writing within 24 hours. The authorized person must make sure that it receives an acknowledgement of receipt of STR from the FIU. Authorized person must continue to monitor the account and the client. In the case where a response is not received from the FIU regarding an STR, the authorized person must send a further STR if deemed appropriate.

A list of indicators of the types of potentially unusual or suspicious transactions or activities that could be a cause for further scrutiny is set out in Appendix 10.1 of this chapter. The list is not exhaustive and authorized person must remain vigilant to these and other forms of suspicions. Authorized persons are obliged to report any unusual or suspicious transactions or activity, whether these are of a type set out in the Appendix 10.1 or otherwise. The existence of one or more of the factors described in the list warrants some form of increased scrutiny of the transactions, but by itself does not necessarily mean that a transaction is suspicious.

In relation to terrorist financing, the FATF issued a paper in April 2002 on guidance for financial institutions in detecting terrorist financing, and a further report on terrorist financing typologies in March 2008. Authorized persons are required to ensure that their employees are familiar with these documents. (*Note: FATF 40 + 9 Recommendations are discussed in the technical part of this study guide*).

Where the FIU requires further information from an authorized person to follow up on an STR, the Authority will act as a conduit for the request and shall ask the authorized person to provide the information requested by the FIU.

In accordance with Article 25 of the AML Law, authorized persons and their directors, officers and employees (permanent and temporary) are protected by law from both criminal and civil liability for breach of any restriction on disclosure of information imposed by contract or by any legislative, regulatory or administrative provision, if they report unusual or suspicious transactions or activity in good faith to the FIU. This protection is available even if they did not know precisely what the underlying criminal activity was, and regardless of whether illegal activity actually occurred.

10.5.2. TIPPING OFF

Learning Objective 10.5.2 - *Know* the procedures relating to tipping off (Part 5, Article 21).

In all circumstances, an authorized person, its directors, officers and employees must ensure that clients or related parties are not alerted (informed or tipped off) to the fact that an STR related to the client has been made or being considered. An authorized person shall at all times keep its reporting of suspicious transactions highly confidential, and reports of suspicious transactions or reports that are to be reviewed by the MLRO for possible reporting shall be accessible only by specifically staff of the authorized person.

Where an STR has been made to the FIU and it becomes necessary to obtain further information, the FIU will communicate this to the Authority, who will contact the authorized person for the information. In this instance, great care must be taken to ensure that the client does not become aware that the STR has been made. The authorized person shall continue its business dealing with the reported

clients as usual, it must not warn its clients or other relevant parties of the suspicious transactions, and it shall await further instructions from the Authority.

10.5.3. DESIGNATED PERSONS – UNSCR RESOLUTIONS

Learning Objective 10.5.3 - *Know* the requirement to have effective procedures to promptly identify any clients or potential clients (including beneficial owners) that have been labeled as “designated persons” by the United Nations Committee under UNSCR 1267(1999) (“the 1267 Committee”); and successor resolutions. (Part 5, Article 22).

It is a requirement for an authorized person to have in place effective procedures to promptly identify any clients or potential clients (including beneficial owners) that have been labeled as “designated persons” by the United Nations Committee under UNSCR 1267(1999) (“the 1267 Committee”); and successor resolutions.

If an authorized person identifies a client or potential client as a designated person or a transaction where one of its parties is a designated person, it must immediately send an STR to the FIU. And in accordance with the AML Law and its implementing regulations must freeze any property that it holds for a designated person. Once an STR is made, the authorized person shall continue freezing the account and transactions of the client until it receives further instructions from the Authority.

Prior to opening any new account, authorized person must check the potential client’s name against the lists of designated persons. Authorized persons must, on a daily basis, check the names of all existing clients against the lists of names of designated persons by reviewing the UN website.

Whenever a person is ‘listed’ by a competent authority in Saudi Arabia under UNSCR 1373 (or a successor resolution), the Authority will notify all authorized persons of that listing and they must immediately freeze the property of such persons. When funds that have been frozen, are unfrozen because the designated person has been delisted, or because the person whose assets were frozen was incorrectly thought to be a designated person, or because authorization was made by the competent authority to release funds for legal or living expenses, then the Authority will notify the authorized person accordingly.

10.6. INTERNAL POLICIES, PROCEDURES AND CONTROLS

10.6.1. INTERNAL POLICIES AND COMPLIANCE

Learning Objective 10.6.1- *Know* the requirement to develop and implement internal policies, procedures and controls to help prevent money-laundering and terrorist financing and the required communication to employees.

Learning Objective 10.6.2- *Know* the duties that shall be performed by the MLRO. (Part 6, Article 23).

Authorized person is required to develop and implement internal policies, procedures and controls to help prevent money-laundering and terrorist financing and must communicate these to its employees. The compliance officer shall also ensure compliance with the AML/CTF policies, procedures and control. The policies, procedures and controls must include, among others, CDD measures, record retention, the detection of unusual and/or suspicious transactions and the obligation to make an STR.

An authorized person needs ensure that the MLRO and any of its staff (performing the compliance function) have timely access to all client and transaction records and other relevant information which they require to discharge their functions. In this regards, the MLRO shall undertake the following duties:

- Develop, update and implement the authorized person's system, procedures and controls on AML/CTF.
- Keep pace with developments in AML/CTF laws and regulations, trends, techniques, and update indicators or money-laundering or terrorist financing.
- Ensure that the authorized person complies with its policies and procedures.
- Receiving directly from staff any reports of suspicious transactions or activity. Analyze those reports and the decide whether to file an STR with the FIU.
- Prepare a report annually to the Board of the authorized person setting out all actions that have been taken to implement the internal policies, procedures and controls and proposals for increasing the effectiveness and efficiency of the procedures. Thereafter, the report shall be submitted to the Authority.

- Ensure that staff of the authorized person maintains all necessary records.
- Organize ongoing training for all staff of the authorized person.

10.6.2. INTERNAL AUDIT

Learning Objective 10.6.3 - *Know* the role of internal audit relating to AML/CTF (Part 6, Article 24).

The internal audit in the authorized person shall regularly assess the effectiveness of the authorized person's internal AML/CTF policies, procedures and controls and the authorized person's compliance with these Rules.

10.6.3. EDUCATION AND TRAINING

Learning Objective 10.6.4 - *Know* the requirement on AML/CTF regular and continuous education and training. (Part 6, Article 25).

Appropriate steps shall be taken to ensure that all authorized person's employees receive regular training on:

- AML/CTF laws and regulations, and in particular, CDD measures, detecting and reporting of suspicious transactions;
- prevailing techniques, methods and trends in money laundering and terrorist financing; and
- the authorized person's internal policies, procedures and controls on AML/CTF and the roles and responsibilities of staff in combating money laundering and terrorist financing.

An authorized person must have educational programs in place for training all new employees. Refresher training must also be provided at regular intervals to ensure that staff, in particular those who deal with the public directly and help clients open new accounts.

Review Questions

1. What do you understand by the terms ‘money laundering’ and ‘terrorist financing’?
2. What are the general requirements for an authorized person in combating money laundering and terrorist financing?
3. What is the meaning of customer due diligence (CDD) and why is this important in relation to AML/CTF?
4. What is meant by a ‘risk-based CDD’?
5. Describe the meaning of ‘politically-exposed person’ and its significance in relation to AML/CTF.
6. What is meant by a non-profit organization and its possible roles in AML/CTF?
7. Explain the meaning of suspicious transaction.
8. What are some of the indications that a transaction may be a suspicious transaction?
9. Explain the procedures that need to be followed by an authorized person in dealing with suspicious transactions.
10. Explain the process of making a suspicious transaction report to the Federal Intelligence Unit.

Sample Multiple Choice Questions

1. The AML/CTF Rules define ‘terrorist financing’ as the financing of:
 - I. terrorists
 - II. terrorist acts
 - III. terrorist organizations
 - IV. non-profit organizations in non-compliance countries.
 - A. I and II only
 - B. I, II and III only
 - C. II, III and IV only
 - D. All of the above

2. An authorized person is required to establish appropriate policies and procedures for the prevention of money laundering and terrorist financing. For this the authorized person is required to do all of the following, EXCEPT:
 - A. Issue an effective statement of policies and procedures aimed at preventing money laundering and terrorist financing.
 - B. Ensure the AML/CTF Rules are understood by all employees.
 - C. Ensure that employees are aware of their roles to detect money laundering and terrorist financing activities.
 - D. Take legal action against those involved in money laundering and terrorist financing activities.
3. The following are permissible methods of payment from clients of an authorized person to settle transactions according to the AML/CTF Rules:
 - I. Cash
 - II. Checks
 - III. Bank transfers
 - IV. Electronic transfers
 - A. I and II only
 - B. I, II and III only
 - C. II, III and IV only
 - D. All of the above
4. In the context of the AML/CTF Rules, the MAIN reason behind conducting a CDD process is:
 - A. To know the identity and personal background of client
 - B. To know the nature and objectives of client business
 - C. To assess business risk profile of the client
 - D. To assess the possibility of linkage with money-laundering and terrorist financing activities.
5. The AML/CTF Rules requires that a politically exposed person (PEP) is to be given a special treatment. Which of the following statement is FALSE regarding a PEP?
 - A. A PEP is someone who currently occupies, has recently occupied, is actively seeking or is being considered for a senior position in a political party.
 - B. A PEP is considered a high risk individual and enhanced CDD should be conducted on such a client.
 - C. The opening or continued operation of an account for a PEP must be approved by senior management of the Authorized Person.
 - D. Authorized Person shall take measures to establish the source of wealth and source of funds of PEPs.

APPENDIX 10.1: SECURITIES BUSINESS INDICATORS FOR MONEY LAUNDERING OR TERRORIST FINANCING

Examples of possible indicators that a transaction or activity may be linked to money laundering or terrorist financing are as follows:

1. The client exhibits unusual concern regarding the firm's compliance with AML/CTF requirements, particularly with respect to his identity and type of business.
2. Client refuses to identify himself or to indicate legitimate sources for his funds and other assets.
3. The client wishes to engage in transactions that have no apparent legal or economic purpose or are inconsistent with the declared investment strategy.
4. The client tries to provide the authorized person with incorrect or misleading information regarding his identity and/or source of funds.
5. The authorized person knows that the client was involved in money laundering or terrorist financing activities, or in other criminal offences or regulatory violations.
6. The client exhibits a lack of concern regarding risks, commissions, or other transaction costs.
7. An authorized person suspects that the client appears to be acting as an agent on behalf of an undisclosed principal, but declines or is reluctant, without legitimate commercial reasons, to provide information about that person or entity.
8. The client has difficulty describing the nature of his business or lacks general knowledge of his activities.
9. The client holds multiple accounts under a single name or multiple names, with a large number of inter-account or third-party transfers with no apparent reason for that activity.
10. The client makes multiple of wire transfers to his investment account followed by an immediate request that the money be wired out to a third party without any apparent business purpose.
11. The client makes a long-term investment followed shortly thereafter by a request to liquidate the position and transfers the proceeds out of the account.

12. The client's activities vary substantially from normal practices.
13. A client refuses to provide the authorized person with basic information for a mutual fund to verify the client's identity.
14. The client requests that the authorized person uses wire transfers in such a manner that originator information is not transferred from the sending to the receiving destination.
15. A client seeks to change or cancel a transaction after being informed of the information verification or record keeping requirements by the authorized person.
16. The client requests that a transaction be processed in such a manner to avoid more documentation.
17. The client's account shows an unexplained high level of wire transfers with very low levels of securities transactions.
18. The authorized person knows that funds or property is proceeds that come from illegal sources.
19. Change source of funds constantly

SYLLABUS LEARNING MAP CME 2: COMPLIANCE, ANTI-MONEY LAUNDERING AND COUNTER-TERRORIST FINANCING MODULE	
SECTION 1 – COMPLIANCE: CONCEPTS, ORGANIZATIONS AND PROCESSES	
CHAPTER 1: FUNDAMENTAL OF COMPLIANCE	CHAPTER/SECTION
On completion, the candidate should:	
1.1. <i>Know</i> and be able to describe the meaning of compliance, its concept, scope and the importance of compliance in an organization.	Ch 1, Section 1.1
1.2. <i>Understand</i> the basic principles that define the purpose and the implementation of the compliance function.	Ch 1, Section 1.2
1.3. <i>Understand</i> the inter-dependence between compliance and control systems in an organization.	Ch 1, Section 1.3
1.4. <i>Know</i> the most common methods to establish a compliance culture within the organization.	Ch 1, Section 1.4
1.5. <i>Understand</i> the costs and benefits associated with having and implementing the compliance function in the organization	Ch 1, Section 1.5
CHAPTER 2: COMPLIANCE ROLES AND RESPONSIBILITIES	CHAPTER/SECTION
On completion, the candidate should:	
2.1. <i>Know</i> the specific roles and responsibilities of the Board of Directors with respect to compliance function.	Ch 2, Section 2.1
2.2. <i>Know</i> the specific roles and responsibilities of the Management with respect to compliance function.	Ch 2, Section 2.2
2.3. <i>Understand</i> the specific roles, responsibilities and duties of the Compliance Officer	Ch 2, Section 2.3
2.4. <i>Understand</i> the specific roles and responsibilities of the Compliance Committee with respect to compliance function.	Ch 2, Section 2.4
2.5. <i>Understand</i> the specific roles and responsibilities of the Audit Committee with respect to compliance function.	Ch 2, Section 2.5
2.6. <i>Understand</i> the specific roles and responsibilities of the Internal Audit with respect to compliance function.	Ch 2, Section 2.6
CHAPTER 3: ESTABLISHING AND MONITORING COMPLIANCE	CHAPTER/SECTION
On completion, the candidate should:	
3.1. <i>Know</i> various law and implementing regulations that govern the local capital market.	Ch 3, Section 3.1
3.2. <i>Learn</i> how to develop an effective compliance infrastructure in an organization.	Ch 3, Section 3.2
3.3. <i>Learn</i> how to design and develop a comprehensive compliance program in an organization.	Ch 3, Section 3.3
3.4. <i>Understand</i> the importance of carrying out an effective compliance monitoring program.	Ch 3, Section 3.4
3.5.1 <i>Know</i> the meaning of Chinese Walls and how it was initially used.	Ch 3, Section 3.5.1
3.5.2 (a) <i>Understand</i> the purpose of Chinese walls in an organization.	Ch 3, Section 3.5.2

SYLLABUS LEARNING MAP CME 2: COMPLIANCE, ANTI-MONEY LAUNDERING AND COUNTER-TERRORIST FINANCING MODULE	
SECTION 1 – COMPLIANCE: CONCEPTS, ORGANIZATIONS AND PROCESSES	
<p>(b) <i>Understand</i> the concept of Chinese walls in relation to insider trading activities.</p> <p>(c) <i>Understand</i> the concept of Chinese walls in relation to conflicts of interest situations.</p> <p>(d) <i>Understand</i> the concept of Chinese walls in relation to segregation of functions.</p>	
3.5.3 <i>Know</i> the advantages of having proper Chinese walls arrangement in an organization.	Ch 3, Section 3.5.3
3.5.4 <i>Understand</i> the disadvantages of Chinese wall arrangement in an organization.	Ch 3, Section 3.5.4
3.5.5 <i>Understand</i> the limitation of Chinese walls arrangement in an organization.	Ch 3, Section 3.5.5
3.5.6 <i>Know</i> the elements that make up effective Chinese wall arrangements.	Ch 3, Section 3.5.6
CHAPTER 4: RISK MANAGEMENT AND COMPLIANCE	CHAPTER/SECTION
On completion, the candidate should:	
4.1. <i>Know</i> the meaning of risk and risk management and understand why we need risk management.	Ch 4, Section 4.1
4.2. <i>Know</i> the general principles of risk management	Ch 4, Section 4.2
4.3. <i>Understand</i> the general overview of risk management and compliance framework and the general process involve in this area.	Ch 4, Section 4.3
4.4. <i>Know</i> the important elements that support a strong risk management infrastructure.	Ch 4, Section 4.4
4.5. <i>Know</i> various type of risk and some relevant case studies to illustrate such risk.	Ch 4, Section 4.5
4.6. <i>Know</i> some of the risk management tools used to manage organizational risk.	Ch 4, Section 4.6
4.7. <i>Know</i> the importance of risk monitoring and review.	Ch 4, Section 4.7
CHAPTER 5: ANTI-MONEY LAUNDERING AND COUNTER TERRORIST FINANCING	CHAPTER/SECTION
On completion, the candidate should:	
4.1 Description of money laundering process	
4.1.1 <i>Know</i> what are the phases involved in money-laundering process	Ch 5, Section 5.1.1
4.2 Regulatory framework governing AML/CTF in Kingdom of Saudi Arabia	
4.2.1 <i>Know</i> the regulatory framework governing AML/CTF in the Kingdom of Saudi Arabia and the respective governing authority	Ch 5, Section 5.2.1
5.3. Financial Action Task Force (FATF)	

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SECTION 1 – COMPLIANCE: CONCEPTS, ORGANIZATIONS AND PROCESSES		
5.3.1	<i>Know</i> the origin of the Financial Action Task Force (FATF) and their 40 + 9 recommendations	Ch 5, Section 5.3.1
5.3.2	<i>Know</i> the general areas covered under FATF 40 recommendations on Anti-Money Laundering	Ch 5, Section 5.3.2
5.3.3	<i>Know</i> the general areas covered under FATF 9 Special Recommendations on Counter-Terrorist Financing	Ch 5, Section 5.3.3
5.4.	Suspicious transaction report	
5.4.1	<i>Know</i> the general nature of suspicious transactions and the required reporting requirements for suspicious transactions	Ch 5, Section 5.4.1
5.4.2	<i>Understand</i> some possible indicators which may be linked to money laundering or terrorist financing	Ch 5, Section 5.4.2
5.4.3	<i>Know</i> some illustrative patterns of collection and movement of funds that could be associated with terrorist financing	Ch 5, Section 5.4.3
5.5.	The roles of Authorized Persons and Money Laundering Reporting Officer (MLRO) in AML/CTF Initiatives	
5.5.1	<i>Know</i> the required “Know Your Customer” (KYC) reviews to be carried out by the Authorized Persons and the respective MLROs	Ch 5, Section 5.5.1
5.5.2	<i>Know</i> the requirement for an Authorized Person to conduct due diligence and scrutiny of customers’ identity and his investment objectives	Ch 5, Section 5.5.2
5.5.3	<i>Know</i> the extent to which an Authorized Person should apply each of the CDD measures on a risk sensitive basis	Ch 5, Section 5.5.3
5.6.	AML/CTF compliance and training	
5.6.1	<i>Know</i> the requirements for an Authorized Person to adopt, develop and implement internal programs, policies, procedures and controls to guard against and detect any offence under the AML/CTF	Ch 5, Section 5.6.1
5.6.2	<i>Know</i> the requirement for an Authorized Person to conduct regular training programs for its employees on AML/CTF	Ch 5, Section 5.6.2

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SECTION 2 – COMPLIANCE: REGULATIONS

CHAPTER 6: AUTHORIZED PERSONS REGULATIONS: THE AUTHORIZATION PROCESS		CHAPTER/SECTION
On completion, the candidate should:		
6.1 The Principles		
6.1.1	<i>Know</i> the eleven principles governing the general conduct of the Authorized Persons. (Part 2, Article 5)	Ch 6, Section 6.1.1
6.2 Authorization		
6.2.1	<i>Know</i> the detail requirements for authorization (Part 3, Article 6)	Ch 6, Section 6.2.1
6.2.2	<i>Know</i> the specific criteria which an authorized person's employees, officers and agents will be assessed in determining whether it is fit and proper to carry out securities business for which it is authorized (Part 3, Article 9)	Ch 6, Section 6.2.2
6.2.3	<i>Know</i> the conditions for the withdrawal and cancellation of license (Part 3, Article 12)	Ch 6, Section 6.2.3
6.2.4	<i>Know</i> the notification requirements relating to controllers and closed links (Part 3, Article 13 and 14)	Ch 6, Section 6.2.4
6.2.5	<i>Know</i> the notification requirement that an authorized person must comply with in making various notifications on events or changes affecting the authorized person to the Authority. (Part 3, Article 15 and Annex 3.2)	Ch 6, Section 6.2.5
6.2.6	<i>Know</i> the record-keeping requirements that an authorized person must comply with (Part 3, Article 16)	Ch 6, Section 6.2.6
6.3 Registered Person		
6.3.1	<i>Know</i> the key functions that must be registered with the Authority (Part 4, Article 19)	Ch 6, Section 6.3.1
6.3.2	<i>Know</i> the general registration requirements, procedures and powers of the Authority in handling the registration applications (Part 4, Article 21 and 22)	Ch 6, Section 6.3.2
6.3.3	<i>Know</i> the provisions for cancellation of registration (Part 4, Article 25)	Ch 6, Section 6.3.3
CHAPTER 7: AUTHORIZED PERSONS REGULATIONS: CONDUCT OF BUSINESS		CHAPTER/SECTION
On completion, the candidate should:		
7.1 Conduct of business		
7.1.1	<i>Understand</i> the limitations on the giving and receipt of gifts or inducements (Part 5, Article 27)	Ch 7, Section 7.1.1
7.1.2	<i>Understand</i> the circumstances in which an Authorized Person may enter into a special commission arrangement (Part 5, Article 28)	Ch 7, Section 7.1.2
7.1.3	<i>Understand</i> the exceptions to the Authorized Person's duty of confidentiality in respect of client information (Part 5, Article 29)	Ch 7, Section 7.1.3
7.1.4	<i>Understand</i> the characteristics and uses of Chinese Wall arrangements (Part 5, Article 30)	Ch 7, Section 7.1.4

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CME 2: COMPLIANCE, ANTI-MONEY LAUNDERING AND
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SECTION 2 – COMPLIANCE: REGULATIONS

7.1.5	<i>Understand</i> the requirements to which a prepared securities advertisement must adhere before it is communicated to any person (Part 5, Article 33 and Annex 5.1)	Ch 7, Section 7.1.5
7.1.6	<i>Understand</i> the requirements and restrictions to which any individual making the direct communication and the authorized person must adhere before and during the communication. (Part 5, Articles 34 and 35)	Ch 7, Section 7.1.6
7.2	Accepting Clients	
7.2.1	<i>Know</i> the three different types of clients (Part 5, Article 36)	Ch 7, Section 7.2.1
7.2.2	<i>Know</i> the requirement that an authorized person must provide a client with its terms of business; the basic purpose of doing so and its record keeping requirements (Part 5, Article 38 and Annex 5.2)	Ch 7, Section 7.2.2
7.2.3	<i>Know</i> the requirement of Know Your Customer and basic details of the information that should be retained from clients (Part 5, Article 39 and Annex 5.3)	Ch 7, Section 7.2.3
7.3	Clients Relations	
7.3.1	<i>Know</i> basic details of the fiduciary duties that an Authorized Persons owes to its customers (Part 5, Article 40 and Annex 5.4)	Ch 7, Section 7.3.1
7.3.2	<i>Understand</i> an Authorized Person's responsibilities regarding any conflict of interest between itself and its customers (Part 5, Article 41)	Ch 7, Section 7.3.2
7.3.3	<i>Understand</i> the restrictions placed on an Authorized Person's dealing with its customers when undertaking activities that involve risk (Part 5, Article 42)	Ch 7, Section 7.3.3
7.3.4	<i>Understand</i> the regulations regarding the suitability of advice or a transaction for a customer (Part 5, Article 43)	Ch 7, Section 7.3.4
7.3.5	<i>Understand</i> the circumstances under which an Authorized Person may lend money or extend credit to a customer (Part 5, Article 44)	Ch 7, Section 7.3.5
7.3.6	<i>Understand</i> the circumstances and conditions under which an Authorized Person may effect a margined transactions or the granting of a loan or credit to cover margin payments (Part 5, Article 45)	Ch 7, Section 7.3.6
7.4	Reporting to Clients	
7.4.1	<i>Know</i> the requirements that an Authorized Person must send a contract note when it has effected a sale or purchase of a security for a customer and the required content of a cover note (Part 5, Article 47 and Annex 5.5)	Ch 7, Section 7.4.1
7.4.2	<i>Know</i> the requirements that an Authorized Person who acts as manager for a client must send periodic valuations to that client and the required content of such periodic valuation statement (Part 5, Article 48 and Annex 5.6)	Ch 7, Section 7.4.2
7.4.3	<i>Understand</i> the record keeping requirements in respect of transactions effected by an Authorized Person for its clients and its clients' accounts (Part 5, Article 49)	Ch 7, Section 7.4.3

SYLLABUS LEARNING MAP CME 2: COMPLIANCE, ANTI-MONEY LAUNDERING AND COUNTER-TERRORIST FINANCING MODULE		
SECTION 2 – COMPLIANCE: REGULATIONS		
7.4.4	<i>Understand</i> the regulations regarding Employees’ Personal Dealings as they affect the employee and the Authorized Person (Part 5, Article 50 and Annex 5.7)	Ch 7, Section 7.4.4
7.4.5	<i>Know</i> an Authorized Person’s obligations if it wishes to make or accept telephone communications to or from its clients in relation to securities business (Part 5, Article 51)	Ch 7, Section 7.4.5
CHAPTER 8: AUTHORIZED PERSONS REGULATIONS: SYSTEMS AND CONTROLS		CHAPTER/SECTION
On completion, the candidate should:		
8.1	System and Controls	
8.1.1	<i>Know</i> the appropriate measures that should be taken by an Authorized Person to maintain a clear and appropriate division of the principal responsibilities among its directors or partners and senior management (Part 6, Article 53)	Ch 8, Section 8.1.1
8.1.2	<i>Know</i> the requirement for an Authorized person to establish and maintain systems and controls that are appropriate to its business. (Part 6, Article 54)	Ch 8, Section 8.1.2
8.1.3	<i>Know</i> the requirement for the Authorized person’s governing body to carry out regular review of division of responsibilities, systems and controls (Part 6, Article 56)	Ch 8, Section 8.1.3
8.1.4	<i>Know</i> the requirement for the establishment of compliance function within an Authorized Person (Part 6, Article 57)	Ch 8, Section 8.1.4
8.1.5	<i>Know</i> the requirement for the establishment of compliance committee within an Authorized Person to oversee the effectiveness of compliance functions (Part 6, Article 58)	Ch 8, Section 8.1.5
8.1.6	<i>Understand</i> the extent of functions which could be delegated by an Authorized Person to external party and the supervisory controls required over this outsourcing arrangement (Part 6, Article 59)	Ch 8, Section 8.1.6
8.1.7	<i>Know</i> the requirement for the establishment of Audit Committee within an Authorized Person, if it required (Part 6, Article 60)	Ch 8, Section 8.1.7
8.1.8	<i>Know</i> the requirement for the establishment of an Internal Audit functions within an Authorized Person, if it required (Part 6, Article 61)	Ch 8, Section 8.1.8
8.1.9	<i>Know</i> the requirements for regular review of Authorized Person’s books, accounts and other records related to securities business (Part 6, Article 62)	Ch 8, Section 8.1.9
8.1.10	<i>Understand</i> the importance of proper customer’s complaint handling process (Part 6, Article 63)	Ch 8, Section 8.1.10
8.1.11	<i>Know</i> the requirement for an Authorized Person to establish adequate procedures for the recruitment, training, supervision and discipline of its employees (Part 6, Article 65)	Ch 8, Section 8.1.11
8.1.12	<i>Know</i> the requirement for an Authorized Person to ensure that it can continue to operate and meet its regulatory obligations in the event of an unforeseen interruption to its activities (Part 6, Article 66)	Ch 8, Section 8.1.12

SYLLABUS LEARNING MAP
CME 2: COMPLIANCE, ANTI-MONEY LAUNDERING AND
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SECTION 2 – COMPLIANCE: REGULATIONS

8.1.13	<i>Know</i> the importance of efficient record retrieval and ability to produce such document for Authority's inspection when requested (Part 6, Article 67)	Ch 8, Section 8.1.13
8.1.14	<i>Know</i> the requirement for an authorized person to establish and maintain adequate records and internal controls in respect of a mandate it has over an account in the client's own name (Part 6, Article 68)	Ch 8, Section 8.1.14
8.2	Client Money and Asset	
8.2.1	<i>Understand</i> the segregation requirements in respect of authorized person's own assets and those of its clients and the effect of segregation (Part 7, Article 69 and 70)	Ch 8, Section 8.2.1
8.2.2	<i>Understand</i> what constitutes Client Money and when money is not Client Money (Part 7, Article 71 and 72)	Ch 8, Section 8.2.2
8.2.3	<i>Know</i> the requirement that Client Money is held in a local bank and the regulations concerning risk assessment, overseas banks and specific acknowledgement from the bank (Part 7, Article 73 and 74)	Ch 8, Section 8.2.3
8.2.4	<i>Understand</i> the regulations concerning the paying in, withdrawing and maintenance of money in a Client Money Account (Part 7, Article 75)	Ch 8, Section 8.2.4
8.2.5	<i>Understand</i> when Client Money ceases to be Client Money (Part 7, Article 76)	Ch 8, Section 8.2.5
8.2.6	<i>Know</i> that no commission is payable to a client in respect of client money held in a client account (Part 7, Article 77)	Ch 8, Section 8.2.6
8.2.7	<i>Know</i> that an Authorized person must keep records which are sufficient to demonstrate compliance with the Client Money Rules of this Regulation (Part 7, Article 78)	Ch 8, Section 8.2.7
8.2.8	<i>Understand</i> the Authorized Person's obligations concerning the confirmation of balances in its Client Accounts (Part 7, Article 79)	Ch 8, Section 8.2.8
8.2.9	<i>Understand</i> the Authorized Person's obligations concerning the reconciliation of each client account against the balances held at the bank (Part 7, Article 80)	Ch 8, Section 8.2.9
8.3	Client Asset Rules	
8.3.1	<i>Understand</i> what constitutes Client Assets and the need for segregation (Part 7, Article 82 and 83)	Ch 8, Section 8.3.1
8.3.2	<i>Understand</i> the requirement that the titles of accounts used to record Client Assets make it clear that the assets belong to the client (Part 7, Article 84)	Ch 8, Section 8.3.2
8.3.3	<i>Understand</i> the regulations concerning the holding and registration of Client Assets (Part 7, Article 85)	Ch 8, Section 8.3.3
8.3.4	<i>Understand</i> the circumstances under which an Authorized Person may lend a client's securities (Part 7, Article 86)	Ch 8, Section 8.3.4
8.3.5	<i>Understand</i> the requirement to perform assessment of custodian (Part 7, Article 87)	Ch 8, Section 8.3.5
8.3.6	<i>Understand</i> the requirement for an Authorized Person to have clients' agreements with its clients prior to providing any custodial services (Part 7, Article 88)	Ch 8, Section 8.3.6

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SECTION 2 – COMPLIANCE: REGULATIONS

8.3.7	<i>Understand</i> the requirement for an Authorized Person to agree in writing with the custodian appropriate terms of business prior to holding of client's asset (Part 7, Article 89)	Ch 8, Section 8.3.7
8.3.8	<i>Understand</i> the Authorized Person's obligations concerning the reconciliation of clients' assets which it does not physically hold, which it physically holds as well as its obligations if any reconciliation reveals a discrepancy (Part 7, Article 90)	Ch 8, Section 8.3.8
8.3.9	<i>Understand</i> the Authorized Person's obligations concerning the provision of statements to clients and the matters covered in those statements (Part 7, Article 91)	Ch 8, Section 8.3.9
8.3.10	<i>Understand</i> the Authorized Person's obligations concerning the safeguarding of collateral (Part 7, Article 93)	Ch 8, Section 8.3.10
8.3.11	<i>Understand</i> the terms under which an Authorized Person may treat collateral as "other collateral" and the significance of holding collateral in this way (Part 7, Article 94)	Ch 8, Section 8.3.11
CHAPTER 9: MARKET CONDUCT REGULATIONS		CHAPTER/SECTION
On completion, the candidate should:		
9.1	Prohibition of Market Manipulation	
9.1.1	<i>Understand</i> that market manipulation and deceptive acts are prohibited (Part 2, Article 2)	Ch 9, Section 9.1.1
9.1.2	<i>Know</i> what actions are considered "manipulative and deceptive" acts and practices (Part 2, Article 3)	Ch 9, Section 9.1.2
9.2	Insider Trading	
9.2.1	<i>Understand</i> the concept of trading in a security as it applies to the regulations concerning Insider Trading (Part 3, Article 4a)	Ch 9, Section 9.2.1
9.2.2	<i>Know</i> what is the definition of "insider" and what information constitutes as "inside information" (Part 3, Article 4b)	Ch 9, Section 9.2.2
9.2.3	<i>Know</i> what information constitutes an "inside information" (Part 3, Article 4c)	Ch 9, Section 9.2.3
9.2.4	<i>Know</i> the regulations prohibiting the disclosure of inside information and insider trading (Part 3, Article 5 and 6)	Ch 9, Section 9.2.4
9.3	Untrue Statements	
9.3.1	<i>Know</i> the prohibition of making untrue statement (Part 4, Article 7)	Ch 9, Section 9.3.1
9.3.2	<i>Know</i> the prohibition of spreading rumors (Part 4, Article 8)	Ch 9, Section 9.3.2
9.3.3	<i>Know</i> the circumstances in which a person may make an untrue statement (Part 4, Article 9)	Ch 9, Section 9.3.3
9.3.4	<i>Understand</i> the circumstances under which a person may be liable for damages in respect of the making of untrue statements (Part 4, Article 10)	Ch 9, Section 9.3.4
9.4	Authorized Persons' Conduct	

SYLLABUS LEARNING MAP CME 2: COMPLIANCE, ANTI-MONEY LAUNDERING AND COUNTER-TERRORIST FINANCING MODULE		
SECTION 2 – COMPLIANCE: REGULATIONS		
9.4.1	<i>Know</i> what action should be taken by an Authorized Person or Registered Person if they suspect that their client is involved in market manipulation or insider trading (Part 5, Article 11)	Ch 9, Section 9.4.1
9.4.2	<i>Know</i> the Authorized Person or Registered Person's responsibilities in respect of clients' priority, timely execution, best execution, timely allocation and churning (Part 5, Article 12 - 16)	
9.4.3	<i>Know</i> that aggregation of account is not allowed for Saudi market, but allowed with certain conditions for non-Saudi market (Part 5, Article 17)	Ch 9, Section 9.4.2
9.4.4	<i>Know</i> that trading for own account ahead of research is not allowed (Part 5, Article 18)	Ch 9, Section 9.4.3
9.4.5	<i>Know</i> that making a trade contrary to a research recommendation is prohibited (Part 5, Article 19)	Ch 9, Section 9.4.4
9.4.6	<i>Understand</i> the extent to which a person may be liable when acting at the direction of another person (Part 5, Article 20)	Ch 9, Section 9.4.5
CHAPTER 10: ANTI-MONEY LAUNDERING AND COUNTER-TERRORIST FINANCING RULES		CHAPTER/SECTION
On completion, the candidate should:		
10.1	<i>Know</i> the meaning of money-laundering and terrorist financing as defined by the AML/CTF Rule. (Part1, Article 2)	Ch 10, Section 10.1
10.2	AML/CTF Requirements	
10.2.1	<i>Understand</i> the general requirements and principles of implementing AML/CTF (Part2, Article 3)	Ch 10, Section 10.2.1
10.2.2	<i>Understand</i> the AML/CTF Rules affecting the authorized person's overseas branches and subsidiaries (Part 2, Article 4)	Ch 10, Section 10.2.2
10.2.3	<i>Know</i> the restriction on accepting cash (Part 2, Article 5)	Ch 10, Section 10.2.3
10.3	Customer Due Diligence	
10.3.1	<i>Know</i> the general procedure of accepting clients (Part 3, Article 7)	Ch 10, Section 10.3.1
10.3.2	<i>Understand</i> the steps involved in performing customer due diligence and the required verification process for each type of clients (Part 3, Article 8)	Ch 10, Section 10.3.2
10.3.3	<i>Know</i> how to implement the risk-based approach of costumer due diligence – reduced and enhanced CDD. (Part 3, Article 9)	Ch 10, Section 10.3.3
10.3.4	<i>Know</i> what is Politically Exposed Persons (PEPs) and the required review process to be carried out relating to PEPs. (Part3, Article 10)	Ch 10, Section 10.3.4
10.3.5	<i>Know</i> what are the Non-profit Organizations and the required review process (Part 3, Article 11)	Ch 10, Section 10.3.5
10.3.6	<i>Know</i> the situations when CDD shall be performed. (Part 3, Article 12)	Ch 10, Section 10.3.6
10.3.7	<i>Know</i> the requirements for CDD on investment fund clients. (Part3, Article 13)	Ch 10, Section 10.3.7

SYLLABUS LEARNING MAP
CME 2: COMPLIANCE, ANTI-MONEY LAUNDERING AND
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SECTION 2 – COMPLIANCE: REGULATIONS

10.3.8	<i>Know</i> the extent of reliance on third parties for CDD process and the required steps and documents for verifications. (Part 3, Article 14)	Ch 10, Section 10.3.8
10.3.9	<i>Know</i> the requirements of CDD for acquisition exercise. (Part 3, Article 15)	Ch 10, Section 10.3.9
10.3.10	<i>Know</i> the risk faced as a result of non-face-to-face business relationships and the required mitigating steps. (Part 3, Article 16)	Ch 10, Section 10.3.10
10.3.11	<i>Know</i> the requirements for ongoing CDD and unusual transactions monitoring. (Part 3, Article 17)	Ch 10, Section 10.3.11
10.3.12	<i>Know</i> the requirements for regular review and periodical update of clients' records. (Part 3, Article 18)	Ch 10, Section 10.3.12
10.4	Record Keeping	
10.4.1	<i>Know</i> the details of record keeping requirements contained in the rules and regulations of the Authority and the Saudi Stock Exchange (Tadawul). (Part 4, Article 19)	Ch 10, Section 10.4.1
10.5	Suspicious Transaction Report	
10.5.1	<i>Know</i> the process and procedures relating to suspicious transaction report (Part 5, Article 20 and Annex 1)	Ch 10, Section 10.5.1
10.5.2	<i>Know</i> the procedures relating to tipping off (Part 5, Article 21)	Ch 10, Section 10.5.2
10.5.3	<i>Know</i> the requirement to have effective procedures to promptly identify any clients or potential clients (including beneficial owners) that have been labeled as “designated persons” by the United Nations Committee under UNSCR 1267(1999) (“the 1267 Committee”); and successor resolutions. (Part 5, Article 22)	Ch 10, Section 10.5.3
10.6	Internal Policies, Procedures and Controls	
10.6.1	<i>Know</i> the requirement to develop and implement internal policies, procedures and controls to help prevent money-laundering and terrorist financing and the required communication to employees. (Part 6, Article 23)	Ch 10, Section 10.6.1
10.6.2	<i>Know</i> the duties that shall be performed by the MLRO. (Part 6, Article 23)	Ch 10, Section 10.6.1
10.6.3	<i>Know</i> the role of internal audit relating to AML/CTF (Part 6, Article 24)	Ch 10, Section 10.6.2
10.6.4	<i>Know</i> the requirement on AML/CTF regular and continuous education and training. (Part 6, Article 25)	Ch 10, Section 10.6.3

CME 2: COMPLIANCE, ANTI-MONEY LAUNDERING AND COUNTER-TERRORIST FINANCING MODULE

ANSWERS TO SAMPLE MULTIPLE CHOICE QUESTIONS

SECTION 1 – COMPLIANCE: CONCEPTS, ORGANIZATIONS AND PROCESSES

CHAPTER 1: FUNDAMENTAL OF COMPLIANCE

1. B
2. C
3. C
4. D

CHAPTER 2: COMPLIANCE ROLES AND RESPONSIBILITIES

1. D
2. B
3. A
4. C
5. B

CHAPTER 3: ESTABLISHING AND MONITORING COMPLIANCE

1. B
2. A
3. C
4. B

CHAPTER 4: RISK MANAGEMENT AND COMPLIANCE

1. B
2. A
3. B
4. D
5. D

CHAPTER 5: ANTI-MONEY LAUNDERING AND COUNTER TERRORIST FINANCING

1. C
2. A
3. C
4. A
5. B
6. C

CME 2: COMPLIANCE, ANTI-MONEY LAUNDERING AND COUNTER-TERRORIST FINANCING MODULE

ANSWERS TO SAMPLE MULTIPLE CHOICE QUESTIONS

SECTION 2 – COMPLIANCE: REGULATIONS

CHAPTER 6: AUTHORIZED PERSONS REGULATIONS: THE AUTHORIZATION APPLICATIONS

- 1 B
- 2 A
- 3 A
- 4 A
- 5 D

CHAPTER 7: AUTHORIZED PERSONS REGULATIONS: CONDUCT OF BUSINESS

- 1 C
- 2 D
- 3 A
- 4 A

CHAPTER 8: AUTHORIZED PERSONS REGULATIONS: SYSTEMS AND CONTROLS

- 1 B
- 2 A
- 3 D

CHAPTER 9: MARKET CONDUCT REGULATIONS

- 1 B
- 2 C
- 3 B
- 4 B
- 5 A

CHAPTER 10: ANTI-MONEY LAUNDERING AND COUNTER-TERRORIST FINANCING RULES

- 1 B
- 2 D
- 3 C
- 4 D
- 5 A