

Regulatory Monitor

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A closer look at the revised Investment Services Guidelines

Following the enactment of the amendments to the Investment Services Act (ISA) on October 1, 2002, the Malta Financial Services Authority (MFSA) has issued revised Investment Services Guidelines on December 4, 2002, which have now been further revised on May 16, 2003. The Guidelines constitute the Standard Licence Conditions (SLCs) of all investment services licence holders and are legally enforceable against them even by means of administrative penalties of up to Lm40,000 (approximately Euro 92,000).

Investor Compensation Scheme

The Investor Compensation Scheme Regulations 2003 were brought into force on January 3, 2003. They are based on the Investor Compensation Scheme Directive (Directive 97/9/EC) of the European Union. The Regulations provide for payments to investors of 90% of claims subject to a maximum of Lm8,500 in the case of licence holder's inability to repay money owed to or belonging to investors and held on their behalf in connection with licenced business or to return to investors any instruments belonging to them and held, administered or managed on their behalf or, where this is not possible, their monetary equivalent or value.

The Regulations provide for two types of contributions by licence holders. A Fixed Contribution of 2.5% of the minimum Net Tangible Assets Requirement is levied directly from licence holders by the Scheme's Management Committee, while a Variable Contribution of 0.1% of Total Revenue of the licence holder subject to a minimum of Lm300 per annum, based on previous year's audited figures, must be kept in an Investor Compensation Scheme Reserve and may be called up by the Management Committee in the case of need.

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EU Compliance Checklist

Measuring the amount of legislation which has gone into Acts of Parliament, Legal Notices and Guidelines over the past 18 months is by no means an easy task. For the financial services industry, much legislation has already been in force for some time now though other pieces of legislation will soon come out of hibernation. As might be expected, the vast majority of the new rules were required in view of Malta's accession to the EU. And as luck would have it, most of the legislation which is in force will surely be more vigorously enforced after the 1 May 2004 deadline. What should you be looking at over the next 12 months?

Your Contracts and Standard Business Terms

Amendments to the Consumer Affairs Act have been in force for a few months and require the abolition of any unfair term in all consumer contracts. So every contract which you use with your customer has to be revised. And not only. A cultural change is required, and some training will be necessary to do so.

Your customers' data

The Data Protection Act, which is expected to come into force during the summer, requires the collection of data for specific purposes which are to be disclosed, not to mention giving customers the possibility to opt-out from receiving direct marketing.

Your employees' health and safety

A number of regulations have redefined the concept of health and safety, giving employers more duties and employees more rights.

Other specific rules which could affect your business

Do you conduct direct marketing by electronic means? Or perhaps promote products over the phone? Have you ever received a request for information from the Financial Investigation Unit? There are rules covering all of this, and more of course.

Your opportunities

New legislation does not always mean new burdens. On the contrary there are always new opportunities. In fact some rules are catalysts for the improvement of business efficiency and customer satisfaction, while others will allow the creation of new products and services. Ultimately those businesses which will exploit these opportunities will outclass their competitors.❖

Authorised Staff and Product Training Requirements

A new SLC has been introduced to require the services of 'arranging deals', 'portfolio and fund management', 'investment advice' and 'stockbroking' to be provided only by Licence Holders' staff members who have been authorised by MFSA. In order to obtain such authorisation, Licence Holders will be required to satisfy the MFSA of such staff members' competence.

Over these past years the MFSA has emphasised the importance of training, particularly for staff of Licence Holders promoting particular investment products, primarily collective investment schemes and unit-linked products. A new SLC has been incorporated to clarify the nature of the Authority's product training requirements. Licence Holders are required to ensure that their staff have attended an acceptable course of training and the MFSA must have been made aware of the content of the course and the identity and experience of the trainer. The trainer is required to assess the candidates at the conclusion of the course and must confirm in writing to the MFSA that the candidate has achieved a standard of competence that indicates that s(he) is capable of arranging deals in relation to and/ or giving advice in respect of the product (as applicable).

Conduct of Business Rules

A new requirement has been introduced to the effect that when acting on an execution-only basis a note should be maintained in the client's file indicating that no advice was provided. This note should also be signed by the client. A standard requirement for the proper recording of investment advice provided has also been introduced.

The use of a Client Fact Find has become mandatory before providing any service involving the provision of advice or discretionary portfolio management for a customer. A Specimen Client Fact Find which may be used by Licence Holders has also been prepared and may be found in the Appendices to the Guidelines.

A new requirement has been introduced, requiring licence holders to obtain a confirmation – to be signed by the customer - to the effect that the risks associated with certain high risk instruments have been clearly explained prior to the undertaking of a transaction in relation to such instruments for or on behalf of a Private Customer.

The six monthly reporting to customers on the performance of their portfolio now applies only where the Licence Holder is providing portfolio management services and not where the Licence Holder merely provides investment advice.

Licence Holders are no longer required to send a contract note to customers with each deal when to do so would duplicate a confirmation or contract note containing the essential details of the

transaction (other than those that are specific to the Licence Holder) which is to be promptly dispatched by someone else, or where the Licence Holder is providing discretionary portfolio management services, and it has agreed with the customer that confirmations need not be supplied, either generally or in specified circumstances.

Staff who deal with prospective and actual Private Clients only engage in the practice of "cold calling" (which means visiting a person or contacting them by telephone – without being expressly invited to do so) on condition that they are civil and considerate, do not use undue pressure, deception or artificiality, make plain their identities and purpose, avoid contacts during unsocial hours (that is before 09:00hrs and after 20:00hrs), ensure that no deals are finalised on the sole basis of a telephone conversation unless there are prior arrangements with the client, and do not promote any high risk instruments by means of cold calling.

Staff Dealing

Staff must not be permitted to use its facilities to deal in shares quoted on any stock exchange except in the same way as any other client. Consent should be obtained, usually from the Compliance Officer, prior to staff initiating transactions. A record of each consent given must be maintained in each individual employee's file in addition to a copy of the contract note. Licence Holders are now required to place annual limits on dealings by officers and employees. The limit might (for example) be expressed in terms of value or number of deals or some other acceptable criterion. Internal rules in this respect should form part of the terms of an individual's contract of employment. All transactions undertaken by officers or employees on their own account should be at "arm's length" – but this does not preclude discounts being allowed to officers and employees. Staff members are prohibited from dealing if the dealing might impair his/her ability to service the licence holder's clients objectively and effectively or which might create a conflict between their own interest and that of their client.

Close Links

A number of Sections of the ISA, including sections 6(8) and 18(2), have been amended to cater for the concept of 'close links', which is derived from Article 3(3) of the EU Investment Services Directive. Where close links exist between an applicant and any other person, MFSA shall only grant a licence if it is of the opinion that those close links do not prevent it from exercising its supervisory functions effectively. The MFSA may also cancel or suspend licences if close links prevent it from exercising such functions. Moreover, notification requirements and provision to require information related to close links apply. The ISA also grants the MFSA the power to issue guidelines to define close links.

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In light of the above, the notification requirements under the Guidelines have now been extended (SLC 1.07(n) refers), to include the Licence Holder's obligation to notify the MFSA on a continuous basis of any changes or circumstances which give rise to the existence of close links between itself and any other person. The Guidelines also contain interpretation provisions relating to close links.

Related Company Loans and Loans to Directors

A requirement has been introduced for a licensee to notify MFSA in writing of the provision of a 'related company' loan. Such loans should be of a temporary nature, repayable on demand and not be such as to lead to deterioration in the financial status of the company in such a manner as to result in breaches of the licensee's financial resources requirements. Licence holders are furthermore prohibited from making a loan to a shareholder or director without prior, express approval from the MFSA. Ordinarily, such proposals will not be approved – but in the event that MFSA does not object to the loan, the term should be temporary, the balance should be repayable on demand and the loan must not lead to deterioration in the licensee's financial status such that it would fall short of its minimum financial resources requirements.

Collective Investment Schemes

A scheme now has a six month 'running in period' to comply with its investment policy and restrictions, notwithstanding that it may have already reached the Lm1 million mark. Following various requests for guidance and clarification by the industry, a procedure has been established for breaches of investment restrictions due to reasons beyond the control of the scheme or its Manager, such as in the case of market movements

The requirement that a majority of directors of a scheme must be independent from the Manager and Advisor has been removed. A corporate scheme constituted as a SICAV, may now appoint its Manager as sole corporate director.

The MFSA has announced that it will no longer be accepting applications for the licensing of Feeder Funds or any similar structures. However, the SLCs relating to Feeder Funds have been retained insofar as these remain applicable to the Feeder Funds which have already been granted a licence.

Private Schemes

One of the amendments (Legal Notices 351 and 353 of 2002 which amended Legal Notice 6 of 1995), concerns the removal of the exemption from licensing in respect of collective investment schemes deemed by the MFSA to be private in nature and purpose. Although such schemes will not require a collective investment scheme licence, they will require recognition from MFSA in terms of the Investment Services Act (Recognition of Private Collective Investment Schemes) Regulations, 2002 (Legal

Notice 353 of 2002). Such recognition will imply that the scheme will not be bound by all the standard licence conditions. However, private schemes would still be subject to certain conditions such as the submission of an auditor's report to the MFSA. The Guidelines also include an indication of the criteria to be taken into account in determining whether a collective investment scheme may be deemed to be private in nature and purpose.

Outsourcing

The MFSA has clarified its approach on outsourcing. A Licence Holder who delegates authority must retain responsibility for the activity which is outsourced. Accordingly, on an on-going basis, the Licence Holder must ensure that the outsourced function is carried out at a proper standard and that the integrity of the Licence Holder's own systems and controls is not prejudiced. The entity or person supplying the service ("the service provider") must be competent and financially sound. The Licence Holder must be able to demonstrate that it has taken proper steps to verify this and that it also has procedures in place for assessing the service provider's performance on an on-going basis. Additionally, the Licence Holder must be able to satisfy the MFSA – if called upon to do so – that the service provider is committed for the term of the contract to devoting appropriate resources to providing the service.

CDF Advocates' dedicated compliance team has already been outsourced compliance related services with the approval of the MFSA. ❖

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