



**PRINCIPLES OF CONDUCT
OF DERIVATIVES BUSINESS**

October 1995

Principles of conduct of derivatives business

1. The Commission has followed closely the current debate about the use of derivatives in financial markets and recognises the political pressure world-wide for regulatory action on derivatives business^{*}. Whilst derivatives may be a useful way of protecting against risk, the Commission is aware that, as complex and sophisticated instruments which equally enable operators to take risks, they can also be dangerous if inappropriately undertaken or inadequately controlled. This has been evidenced by the major losses experienced on derivatives transactions both in financial and other corporate institution environments and also in the extensive media coverage surrounding derivatives. In many instances the losses have resulted from failure to implement or operate basic controls. New regulation tends to emerge as a reaction to events. However, the Commission hopes that by careful planning, preparation and caution on the part of local institutions precipitate action does not become necessary.
2. The Commission" believes the level of derivatives business in the Bailiwick is not high but there is evidence that its use is growing. There has also been some suggestion that, as the large onshore markets become increasingly scrutinised and regulated, institutions may see offshore centres as an attractive location for their derivatives business. This is not a development the Commission would wish to encourage.

Against the background of increasing international scrutiny and supervision of finance

* Derivatives cover a wide range of contracts including, but not limited to, foreign exchange forward contracts, forward rate agreements, futures, options, structured note agreements, swaps, warrants and contracts for differences and instruments traded on exchanges and those traded over-the-counter, ie created between counterparties. Derivatives business covers the carrying on of any finance business involving derivatives or involving products comprised in part or wholly of derivatives.

business and the potential danger to the reputation of the Bailiwick, which the Commission is required to address under the Financial Services Commission (Bailiwick of Guernsey) Law 1987, the Commission considers it appropriate to set out a statement of Principles in order to encourage those financial institutions that conduct derivatives business to do so in a prudent manner with the necessary skills, systems and controls to handle the risks properly. It is the intention that this statement of Principles will be widely distributed to all those who might be participating in derivatives business within the local industry.

3. All those carrying on derivatives business or persons intending to use derivatives as part or all of their finance business in the Bailiwick, whether or not subject to statutory regulation by the Commission, are expected by the Commission to comply with the Principles set out in the attachment to this memorandum. While the Principles do not have the force of law, they are a statement of the standards expected in the context of the laws under which the Commission operates. Failure to comply with any of the Principles will be taken into consideration by the Commission when reviewing the fitness and properness of financial institutions and individuals responsible for them who are subject to, or who become subject to, statutory regulation and may thus lead in certain circumstances to the refusal, suspension or cancellation of a registration, authorisation or licence.
4. The Principles are relevant to all financial institutions carrying on any derivatives business including, but not limited to, accountants, administrators, advisers, banks,

brokers, building societies, credit unions, custodians/trustees, dealers, fiduciaries, friendly societies, collective investment schemes, industrial and provident societies, insurance companies/managers, intermediaries, investment managers, lawyers, market makers and promoters/sponsors. They apply both to directors and employees when engaged in any derivatives business on behalf of financial institutions.

5. The Principles are not exhaustive of the standards expected and conformity with them does not absolve a failure to observe other requirements for conducting derivative business and they are complementary to, rather than superseding, Principles of Conduct of Finance Business as set out in the Commission's Annual Report of 1990 and elsewhere.

THE PRINCIPLES

1. A financial institution entering into any derivatives business (either on its own behalf or on behalf of a client) must possess sufficient resources, experience and capabilities to conduct such business.

2. Know your customer^{*}

A financial institution should at all times make best endeavours to ascertain appropriate knowledge of any client's affairs for whom it is acting and ensure that all clients have adequate knowledge of the principles and risks of derivatives business.

3. Training and experience

Individuals responsible for a financial institution's controls must ensure that the individuals conducting and monitoring derivatives business (at all levels) are appropriately qualified and have sufficient and relevant levels of knowledge and experience.

Staff conducting derivatives business must undergo continuing education in the business.

4. Relevant legislation

A financial institution conducting derivatives business must have regard to, and comply with, all relevant legislation and regulatory requirements.

^{*} This is not a requirement to establish the identity of the customer (as in an anti-money laundering context) but a requirement to understand that customer's needs, circumstances and motives.

5. Controls

A financial institution carrying on derivatives business must:

- a) Establish a written policy on such business approved by the board or similar body. All staff conducting derivatives business should be made aware of this policy and be formally required to adhere to it.
- b) Have at least one member of the board (or similar body) who has a full knowledge and understanding of the derivatives business undertaken.
- c) Ensure that all derivatives business is conducted in a timely and efficient manner.
- d) Ensure that all derivatives business conducted for clients is segregated from its proprietary trading.
- e) Ensure that all proprietary derivatives business is fully recorded as soon as possible but not later than the end of the business day on which that business is conducted.

All non-proprietary derivatives business shall be fully recorded

not later than the end of the business day following the business day on which that business is conducted.

- f) Ensure that the dealing and settlement functions of its derivatives business are conducted by separate persons who act independently of each other.
- g) Ensure that only individuals specifically authorised by that institution may conduct derivatives business.
- h) Ensure that all derivatives business is reviewed at least on a daily basis and

senior management made aware of the results of the review. This review should ensure that any unusual profits, unusual losses, errors, omissions or breaches of policy will be detected. Such a review should be conducted by staff independent of those carrying on dealing and settlement functions.

- i) Ensure that any unusual profits, unusual losses, errors, omissions or breaches of policy arising from any derivatives business are reported as soon as possible to the board (or similar body).
- j) Ensure that its controls over intra-group derivatives business is not less than its controls over third party business.
- k) Conduct all derivatives business in accordance with best practice.

6. Reporting and monitoring

Senior management must continually monitor delegated activities to receive sufficient, timely reports for each activity undertaken to evaluate current and potential positions and performance. Sufficient information should also be available to readily apprise clients of their position. Valuation bases should be applied consistently.

Systems should be capable of providing head office with sufficient, timely information for each activity undertaken.

Should the management of a financial institution in the Bailiwick at any time become aware of any significant area of concern financial or otherwise in connection with derivatives business they must report it to the Commission without delay.

7. Information systems

A financial institution's information system must be capable of verifying source data and ascertaining details of all margin and settlement obligations and must monitor exposures at least by the end of each day but preferably instantaneously, for both client and proprietary trading.

8. Risk warnings

A financial institution should ensure that clients entering into derivatives business are provided with a clear warning of the risks involved. All derivatives business advertisements should be clear, should not exaggerate the available opportunities, and should include appropriate risk warnings.

9. Safeguarding client assets

Where a financial institution acts as trustee or custodian of derivatives or products comprised in part or wholly of derivatives it should ensure proper protection for such client assets.

10. Compliance

A financial institution should maintain documentation adequate to enable it to demonstrate compliance with the Principles.