

RULE 2600
INTERNAL CONTROL POLICY STATEMENTS
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INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA

INTERNAL CONTROL POLICY STATEMENT 1

GENERAL MATTERS

This policy statement is one in a series that prescribes requirements for and provides guidance on compliance with Rule 17.2A that states "every Dealer Member shall establish and maintain adequate internal controls in accordance with the internal control policy statements in Rule 2600."

Internal control is defined as follows:

"Internal control consists of the policies and procedures established and maintained by management to assist in achieving its objective of ensuring, as far as practical, the orderly and efficient conduct of the entity's business. The responsibility for ensuring adequate internal control is part of management's overall responsibility for the day-to-day activities of the entity". (CICA Handbook, 5200.03)

The effectiveness of specific policies and procedures is affected by many factors, such as management philosophy and operating style, the function of the board of directors (or equivalent) and its committees, organizational structure, methods of assigning authority and responsibility, management control methods, system development methodology, personnel policies and practices, management reaction to external influences, and internal audit. These and other aspects of internal control affect all parts of the Dealer Member's firm.

In addition to compliance with required policies and procedures set out in these Policy Statements, a Dealer Member must consider the following, to the extent that they suggest a higher standard than would otherwise be required:

- (i) Recommended provisions set out in these Policy Statements;
- (ii) Authoritative literature such as the Internal Control Guidelines published by Investment Industry Regulatory Organization of Canada and publications of the Canadian Institute of Chartered Accountants;
- (iii) Comments on internal control that may have been made by internal and external auditors and by industry regulators, and actions that the Dealer Member has taken as a result;
- (iv) The balance struck between preventive and detective internal controls. "Preventive controls are those which prevent, or minimize the chance of occurrence of, fraud and error. Detective controls do not prevent fraud and error but rather detect them, or maximize the chance of their detection, so that corrective action may be promptly taken. The known existence of detective controls may have a deterrent effect, and be preventive in that sense". (CICA Handbook, 5205.13)

The extent of preventive controls implemented by a Dealer Member will depend on management's view of the risk of loss and the cost-benefit relationship of controlling such risk. Where the inherent risk is high (e.g., cash, negotiable securities), the cost of effective preventive controls will usually be warranted and expected by industry regulators. On the other hand, where the inherent risk is very low (e.g., prepaid expenses, stock exchange seats), the cost of preventive controls would usually not be warranted nor expected by industry regulators. Further, in a circumstance where a preventive control is warranted, a detective control should not be considered to be a suitable alternative unless it will result in prompt detection of fraud and error and provide near certainty of recovery of the property that is the subject of the fraud or error.

For example, the safeguarding of customers' [segregated securities](#) warrants the implementation of highly effective preventive controls. Accordingly, Dealer Members safeguard such securities by placing them in recognized depositories whenever possible or storing them in bank and/or in-house vaults of an appropriate class suitable to insurers. It would not be appropriate to keep such securities in standard filing cabinets even if such securities were counted monthly since the risk of loss would be high and the possibility of recovery could be very low.

(v) Industry practice.

Determining whether internal control is adequate is a matter of judgement. However, internal control is not adequate if it does not reduce to a relatively low level the risk of failing to meet control objectives stated in this series of Policy Statements and, as a consequence, one or more of the following conditions has occurred or could reasonably be expected to do so:

- (i) A Dealer Member is inhibited from promptly completing securities transactions or promptly discharging the Dealer Member's responsibilities to clients, to other brokers, or to the industry;
- (ii) Material financial loss is suffered by the Dealer Member, clients or the industry;
- (iii) Material misstatements occur in the Dealer Member's financial statements;
- (iv) Violations of regulations occur to the extent that could reasonably be expected to result in the conditions described in (i) to (iii) above.

Other Policy Statements in this series set out control objectives, required and recommended firm policies and procedures and indications that internal control is not adequate. While recommended firm policies and procedures will be appropriate in many cases to meet the stated objectives, they constitute merely one of a number of methods which Dealer Members may utilize. It is recognized that Dealer Member firms may conduct their business in compliance with legal and regulatory requirements although they may employ procedures which differ from the recommended firm policies and procedures contained in the Policy Statements. The information is designed to provide guidance to Dealer Member firms in the preparation of procedures tailored to the specific needs of their individual environment in meeting the stated control objectives.

Dealer Members must maintain a detailed written record which as a minimum should include the specific policies and procedures approved by senior management to comply with these Internal Control Policy Statements. These policies and procedures must be reviewed and approved in writing by senior management at least annually, or more frequently as the situation arises, for their adequacy and suitability. One method of documentation is to note on a copy of this Statement the recommended policies and procedures which have been selected, and details of their performance such as who performs them, when, and how performance is evidenced. Other forms of documentation, such as procedures manuals, flow charts and narrative descriptions are recommended.

INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA
INTERNAL CONTROL POLICY STATEMENT 2
CAPITAL ADEQUACY

This policy statement is one in a series that prescribes requirements for and provides guidance on compliance with Rule 17.2A that states "*every Dealer Member shall establish and maintain adequate internal controls in accordance with the internal control policy statements in Rule 2600.*" It should be read in the context of Policy Statement 1 dealing with General Matters.

This Policy Statement focuses on the monitoring of a Dealer Member firm's capital position, principally through its system of management reporting. The effectiveness of such monitoring depends in large measure on the timeliness, completeness and accuracy of the accounting books and records from which those management reports are drawn. Establishing and maintaining policies and procedures to ensure such timeliness, completeness and accuracy is part of a Dealer Member's responsibility for internal control. However, these matters are outside the scope of Policy Statement 2.

Control Objective

To monitor and act upon information produced by the management reporting system so that Risk Adjusted Capital is maintained at all times in an amount at least equal to the minimum required by regulation.

Minimum Required Firm Policies and Procedures

1. The Chief Financial Officer is responsible for continuous monitoring of the capital position of the firm to ensure that at all times Risk Adjusted Capital is maintained as prescribed by Corporation regulation.
2. The firm's planning process recognizes the projected capital requirements resulting from current and planned business activities.
3. Activity limits for the major functional areas of the firm (such as capital markets, principal trading, borrowing/lending, etc.) are designed to ensure that the combined operations of the firm maintain at least the minimum required amount of risk adjusted capital.
4. Such activity limits are approved by senior management and communicated to the executives responsible for the various major functional areas. Actual performance is compared to such limits by the Chief Financial Officer or designated person assigned the task of monitoring the capital position, and breaches are reported promptly to senior management.
5. At least weekly, but more frequently if required (e.g. the firm is operating close to early warning levels or volatile market conditions exist), the Chief Financial Officer or designated person assigned the task for monitoring the capital position documents that he/she has:
 - (a) Received management reports produced by the accounting system showing information relevant to estimation of the capital position;
 - (b) Obtained other information concerning items that, while they may not yet be recorded in the accounting system, are likely to significantly affect the capital position (e.g. bad and doubtful debts, unreconciled positions, underwriting and inventory commitments and margin requirements);

- (c) Estimated the capital position, compared it to planned capital limits and the prior period and reported adverse trends or variances to senior management.
 - (d) Estimated the application to the Dealer Member of the liquidity and capital tests under the early warning calculations for Level 1 and/or Level 2 of Rule 30. In addition, at least monthly estimate the application of the profitability tests under the early warning calculations for Level 1 and/or Level 2 of Rule 30.
6. Senior management takes prompt action to avert or remedy any projected or actual capital deficiency and reports any deficiencies, when required, immediately to the appropriate regulators. In addition, senior management promptly reports to the appropriate regulators any conditions or circumstances that are, or should be, apparent from the actions required to be performed under this Statement that could require the Dealer Member to be designated in early warning Level 1 or Level 2 in accordance with Rule 30 because of the application of the liquidity, capital or profitability tests.
 7. The month-end estimate of required and risk adjusted capital is reconciled to the Monthly Financial Report submitted for regulatory filing. Material discrepancies are investigated and steps taken to preclude re-occurrence.
 8. At least annually there is a documented supervisory review of the firm's management reporting system related to capital, to identify and implement changes required to reflect developments in the business or in regulatory requirements.

Indications that Internal Control is not Adequate

- The accounting system produces information that is late or requires correction.
- Staff responsible for preparing risk adjusted capital reports lack an understanding of the regulatory requirements.
- Chief Financial Officer or person designated with the supervisory task of monitoring the capital position of the firm lacks an understanding of the business of the different functional areas of the firm and cannot properly evaluate their activities level and capital/risk implications for the firm.
- No steps are taken to establish the reliability of management reports utilized to monitor the capital position.
- Planning procedures fail to take into account the impact of planned activities on required capital.
- The firm is operating unexpectedly near its early warning levels.
- The firm experiences significant unexpected changes in its capital position.

INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA
INTERNAL CONTROL POLICY STATEMENT 3
INSURANCE

This policy statement is one in a series that prescribes requirements for and provides guidance on compliance with the requirement in Rule 17.2A that states "every Dealer Member shall establish and maintain adequate internal controls in accordance with the internal control policy statements in Rule 2600." It should be read in the context of Policy Statement 1 dealing with General Matters.

Control Objective

To ensure that:

- (a) The firm is in compliance with regulatory requirements for insurance;
- (b) Other insurance coverage is in accordance with business needs; and
- (c) Insurable losses are identified and claimed on a timely basis.

Minimum Required Firm Policies and Procedures

1. Insurance requirements and level of coverage are reviewed and approved at least annually by the Dealer Member's executive committee or board of directors.
2. A senior officer of the firm is designated by the Dealer Member's executive committee or board of directors as responsible for insurance matters.
3. The senior officer or designated person assigned the task reviews the terms of insurance policies regularly and ensures that the Dealer Member's operating procedures are designed to result in compliance with policy terms and regulations.
4. The senior officer or designated person assigned the task monitors business changes to evaluate the need for changes in coverage or operating procedures.
5. The senior officer or designated person assigned the task monitors business operations to ensure that insured losses are identified, insurer notified and claimed on a timely basis and their effect on aggregate limits are taken into account.
6. Senior management takes prompt action to avert or remedy any projected or actual insurance deficiency and reports any deficiencies, when required, immediately to the appropriate regulators.

Indications that Internal Control is not Adequate

- Staff responsible for insurance matters are ill informed of their duties or insufficiently trained.
- Material breaches of insurance policies which could result in denial of coverage are not detected on a timely basis.
- No steps are taken to establish the reliability of reports utilized for the monitoring of variables that may affect insurance coverage.
- Failure to report claims or failure to recover on claims thought to be covered.
- Deficiencies in coverage are indicated on regulatory capital filings.

INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA
INTERNAL CONTROL POLICY STATEMENT 4
SEGREGATION OF CLIENTS' SECURITIES

This policy statement is one in a series that prescribes requirements for and provides guidance on compliance with Rule 17.2A that states "every Dealer Member shall establish and maintain adequate internal controls in accordance with the internal control policy statements in Rule 2600." It should be read in the context of Policy Statement 1 dealing with General Matters.

Control Objective

To segregate clients' fully-paid and excess margin securities so that:

- (a) The firm is in compliance with regulatory and legal requirements for segregation;
- (b) Fully paid and excess margin securities are not improperly used.

Minimum Required Firm Policies and Procedures

1. At least twice weekly the information system produces a report of items requiring segregation (the "segregation report").
2. Items requiring segregation are placed in "acceptable securities locations" as defined by regulation on a timely basis.
3. Written custodial agreements with applicable regulatory provisions exist for securities held at acceptable securities locations.
4. Securities are moved into or out of segregation only by authorized personnel.
5. There is a daily supervisory review of compliance with segregation requirements for clients' securities according to the latest segregation report and of action taken to settle previously identified deficiencies.
6. If any segregation deficiency exists, the most appropriate action prescribed by regulation required to settle the deficiency is taken expeditiously.
7. There is supervisory review or other procedures in place to ensure the completeness and accuracy of segregation reports.
8. If any segregation deficiency is identified in such supervisory review, the most appropriate action required to settle the deficiency is taken expeditiously.
9. Management has set reasonable guidelines so that any material segregation deficiency is reported to senior management on a timely basis.
10. At least annually there is a documented supervisory review of firm policies and procedures to identify and correct any divergence from regulatory requirements.

Indications that Internal Control is not Adequate

- Insufficient attention is paid to preventing violations of legal and regulatory provisions concerning securities held in segregation, including preventing the hypothecation of fully paid and excess margin securities.
- Staff responsible for segregation procedures are ill informed of their duties or insufficiently trained.

- No steps are taken to establish the reliability of segregation reports utilized (e.g. by a service bureau).
- Segregation deficiencies persist for an extended period of time without proper management attention.
- Securities are held at locations that do not meet the criteria of an acceptable securities location and/or without a written custodial agreement.

INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA
INTERNAL CONTROL POLICY STATEMENT 5
SAFEKEEPING OF CLIENTS' SECURITIES

This policy statement is one in a series that prescribes requirements for and provides guidance on compliance with Rule 17.2A that states "every Dealer Member shall establish and maintain adequate internal controls in accordance with the internal control policy statements in Rule 2600." It should be read in the context of Policy Statement 1 dealing with General Matters.

Control Objective

To provide safekeeping services to clients so that:

- (a) The firm is in compliance with regulatory requirements for safekeeping;
- (b) Securities in safekeeping are not improperly used.

Minimum Required Firm Policies and Procedures

1. Securities held in safekeeping are held pursuant to a written safekeeping agreement with the client.
2. There are procedures in place to ensure that safekeeping securities are kept apart from all other securities.
3. Securities held in safekeeping are recorded as such in the firm's securities position records, client's ledger and statement of account.
4. Securities held in safekeeping are released only on instruction from the client.

Indications that Internal Control is not Adequate

- Insufficient attention is paid to preventing violations of legal and regulatory provisions concerning securities held in safekeeping, including those requiring them to be:
 - (i) Kept apart from all other securities held by the firm;
 - (ii) Not used to finance the operations of the firm;
 - (iii) Registered in the name of the client;
 - (iv) Not released solely because the client has become indebted to the firm.
- A client's power of attorney on hand for securities held in safekeeping is held by personnel having access to the securities.
- Physical access to securities held in safekeeping is not restricted to a minimum number of authorized persons.

INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA

INTERNAL CONTROL POLICY STATEMENT 6

SAFEGUARDING OF SECURITIES AND CASH

This Policy Statement is one in a series that prescribes requirements for and provides guidance on compliance with Rule 17.2A that states *"every Dealer Member shall establish and maintain adequate internal controls in accordance with internal control policy statements in Rule 2600."* It should be read in context of Policy Statement 1 dealing with General Matters.

Control Objective

To safeguard both firm and client securities and cash so that:

- (a) Securities and cash are protected against material loss; and
- (b) Potential losses are detected and reported (for regulatory, financial and insurance purposes) on a timely basis.

Minimum Required Firm Policies and Procedures

(It is recognized that Dealer Members with small operations may not be able to comply with the segregation of duties requirements due to the limitation inherent in the size of their firm and operations. To the extent that these minimum requirements are inappropriate in the operations of such Dealer Members, they would not be required to follow them and must implement compensating control procedures to meet the stated control objectives of this Policy Statement.)

1. Receipt and Delivery of Securities

- (a) Personnel responsible for the receipt and delivery of securities do not have access to the record keeping of such securities.
- (b) Securities handling is done in a restricted and secure area.
- (c) Receipts and deliveries are promptly and accurately recorded (certificate numbers, registrations, coupon numbers, etc.).
- (d) Negotiable certificates delivered through the mail are sent by means of registered mail.
- (e) Signed receipts are obtained from the client or agent for all securities delivered free.

2. Restricted Access to Securities

- (a) Only designated individuals are permitted to physically handle securities.
- (b) Physical handling of securities is carried out in a restricted and secure area.
- (c) Custody of securities is entrusted to individuals not involved in maintaining or balancing of stock records.
- (d) Vault facilities are physically appropriate to the value and negotiability of the securities they contain.

3. Clearing

- (a) Clearing reports containing the settlement activity from the previous day are compared and balanced to company records promptly.

- (b) The reconciliation of the clearing or settlement of accounts should be performed by firm personnel independent of trading.
- (c) Prompt action is taken to correct differences.
- (d) Aged "fails" to deliver and receive are reviewed regularly to determine reason(s) for delay in settlement.
- (e) Any fail that continues for an extended period of time is reported promptly to senior management.
- (f) Client securities are not used in settling short "pro" sales unless the client's written permission has been obtained, appropriate collateral is provided to the client, and the use of such securities is not contrary to any laws.
- (g) Clearing records are reconciled regularly to clearing house and depository records to ensure agreement of securities and cash on deposit.

4. Custody

- (a) A risk assessment is performed on any securities location which holds securities on behalf of the firm and its clients.
- (b) Limits are set on the value of securities or other assets (e.g. gold, letters of credit, dividends, interest, etc.) held at any securities location.
- (c) The firm has a proper written agreement with each acceptable securities location used to hold securities as required by SRO regulation.
- (d) Processing controls include an adequate division of duties over the recording of entries and over the initiation of transfers made on the records of the depositories (e.g. transfers between "free" and "seg").
- (e) Security and other asset positions as per the company's records are reconciled on a regular basis (at least monthly) to the positions as per the custodian's records. Differences are investigated and appropriate adjustment entries are made.

5. Security Records

- (a) Personnel responsible for maintaining and balancing stock records are not involved in custody of the physical securities.
- (b) Stock records are promptly updated to reflect changes in the location and ownership of all securities under the firm's control.
- (c) Journal entries made to stock records are clearly identified and adjustments are properly reviewed and approved before processing.

6. Security Counts

- (a) Segregated and safekeeping securities are counted at least once a year in addition to the count conducted during the annual external audit as required by SRO regulation.
- (b) Securities contained in current boxes are counted at least monthly.
- (c) Interim surprise counts are conducted by individuals other than those who have custody of securities.
- (d) Count procedures ensure that all physical securities are included and related positions such as transit and transfers are also verified simultaneously.

- (e) During a security count, both the descriptions of the security and quantity should be compared to the records of the firm. Any discrepancies should be investigated and corrected promptly. Positions not reconciled within a reasonable period are reported promptly to senior management and accounted for promptly.

7. Branch Transits

- (a) Separate transit accounts are used on the security position records to record the location of certificates in transit between each office of the firm. These accounts are reconciled on a monthly basis.
- (b) Entries are made to book out securities to or from the branch to the transit account, and then upon physical receipt the securities are booked from the transit account to the receiving branch.
- (c) The receiving branch checks securities received against the accompanying transit sheet.
- (d) Methods of transportation selected for securities in transit comply with insurance policy terms and take into account value, negotiability, urgency, and cost factors.

8. Transfers

- (a) A record is maintained showing all securities sent to and held by transfer agents.
- (b) Authority to request transfers into a name other than the firm's name is restricted to designated individuals outside the transfer department and is permitted only in respect of fully-paid securities (new issues excepted).
- (c) The transfer department executes transfers only upon receipt of a properly authorized request.
- (d) Securities out for transfer are recorded as such in the firm's security position record.
- (e) All positions for securities at transfer agents are supported by a receipt.
- (f) An ageing of all transfer positions is prepared weekly and reviewed by management to verify the validity of the positions and the reasons for any undue delay in receiving securities from transfer agents.
- (g) The duties of personnel handling transfers do not include other security cage functions such as deliveries, current box or segregation.

9. Re-Organization

- (a) A formal procedure exists to identify and document the timing and terms of all forthcoming rights, offers, etc.
- (b) There is a clear method of communicating forthcoming re-organization activity to the sales force, including deadlines for submitting special instructions in writing including any special handling procedures required around the key dates.
- (c) Responsibilities for organizing and handling each offer are clearly assigned to a single person or department.
- (d) Procedures to balance positions daily and to provide for the physical control of these securities are clearly defined.
- (e) Suspense accounts involving offers and splits are reconciled and reviewed regularly.

10. Dividends and Interest

- (a) A system is in place to record the total amounts of dividends and interest payable and receivable at due date.
- (b) Individuals in charge of record keeping do not handle cash or authorize payments.
- (c) Dividend and interest accounts are reconciled at least monthly and reviews performed of aged dividend receivables.
- (d) Write-offs are authorized by the department manager or other senior personnel only.
- (e) Journal entries to and from dividend and interest accounts are approved by the supervisor/manager.
- (f) Other than as part of an automatic settlement system dividend claims are not paid unless accompanied by supporting documents, proof of registration, etc. Such supporting documents are compared to internal records for validity and approved by a senior member of the department.
- (g) Non-resident tax is withheld where applicable by law.
- (h) A system is in place to ensure appropriate reporting of client income for income tax purposes, as required by law.

11. Internal Accounts

- (a) Internal accounts are reconciled at least monthly.
- (b) The reconciliation is subject to a supervisory review.

12. Cash

- (a) A senior official is responsible for reviewing and approving all bank reconciliations.
- (b) Bank accounts are reconciled, in writing, at least monthly, with identification and dating of all reconciling items.
- (c) Journal entries to clear reconciling items are made on a timely basis and approved by management.
- (d) The reconciliation of bank accounts is performed by someone without incompatible functions, including access to funds (both receipts and disbursements), access to securities and record keeping responsibilities, including the authority to write or approve journal entries.
- (e) Approval levels required to requisition a cheque are established by senior management.
- (f) Cheques are pre-numbered and numerical continuity is accounted for.
- (g) Cheques are signed by two authorized individuals.
- (h) Cheques are only signed when the appropriate supporting documentation is provided. The supporting documentation is cancelled after the cheque is signed.
- (i) Where facsimile signature is used, access to the machine is limited and supervised.

Recommended Firm Policies and Procedures

Messengers

- (a) Background checks are performed when messengers are hired to ensure their integrity and reliability.
- (b) Messengers receive adequate training.
- (c) Messengers perform an initial inspection of cheques and securities received for quantity, amount, description, negotiability, etc.
- (d) Messengers obtain a receipt or valid security of equivalent value upon delivery of cheques or securities.
- (e) Management sets carrying limits and monitors them to ensure compliance with insurance policy terms.

Indications that Internal Control is not Adequate

- There is a significant number and dollar value of unreconciled positions and balances.
- Significant differences in reconciliations are not resolved on a timely basis.
- A large number of staff is involved in reconciling positions.
- Material losses have occurred.

INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA

INTERNAL CONTROL POLICY STATEMENT 7

PRICING OF SECURITIES

This policy statement is one in a series that prescribes for and provides guidance on compliance with the requirement in Rule 17.2A that states "every Dealer Member shall establish and maintain adequate internal controls in accordance with the internal control policy statements in Rule 2600." It should be read in the context of Policy Statement 1 dealing with General Matters."

This policy statement specifically addresses the control environment in which a Dealer Member prices securities. For guidance on the valuation of securities or definition of "market value", refer to Corporation Form 1 - General Instructions and/or Regulation 96 made under the Ontario Securities Act.

CONTROL OBJECTIVE

To ensure that:

- a) There is independent and timely verification of security prices designed to detect errors or omissions in the pricing of securities;
- b) Security pricing discrepancies are identified and corrected on a timely basis and reviewed and approved by senior management.
- c) There is consistency of procedures in the pricing of all types of securities.
- d) There is accuracy and completeness of the pricing of securities and to ensure the reliability of prices.

MINIMUM REQUIRED FIRM POLICIES AND PROCEDURES

1. Information sources used for the Dealer Member's pricing records should be reputable and independently verifiable. The continued use of these pricing sources should be reviewed on an annual basis by senior management to ensure that they are still appropriate and meet the needs of the Dealer Member firm.
2. Verification of security prices must take into consideration documented member policies as to criteria in determining the market value of securities consistent with SRO Rules.
3. There should be documented procedures in place to ensure appropriate pricing for all security records of the member for purposes of preparing management reports used to monitor profit and loss, and the regulatory capital position of the member. These functions should be performed by a knowledgeable, authorized [individual](#) who is properly supervised.
4. Personnel involved with trading of securities do not have access to back office security price records and should not be involved in the pricing process, recording and storage of pricing data; and if they are involved there should be compensating controls, appropriate review and approval.
5. Independent security pricing verification must be carried out for each month-end at a minimum. The results of the verification procedures must include quantification of all differences (distinguished between adjusted and unadjusted differences) and follow-up of any material differences to the Dealer Member including a review and approval by senior management.

6. Supporting documentation must be maintained evidencing verification of securities pricing and adjustments.
7. Procedures are in place to ensure daily mark to market of a Dealer Member's security positions "owned and sold short" for profit and loss reporting in accordance with SRO requirements.
8. Dealer Members inventory profit and loss information must be reviewed by knowledgeable and authorized staff who are adequately supervised and are independent of the Dealer Member's trading function.

INDICATIONS THAT INTERNAL CONTROL IS NOT ADEQUATE

- Inconsistent methods used during the month to value and report client security portfolio (last sale price, last bid or ask price).
- No evidence of a review of "flagged" security price over-rides on EDP reports, or audit trail of price change.
- High error rate on margin calls and/or collateral re-pricing of financing transactions.
- Unexplained fluctuation in trader inventory profit and loss trading.
- Foreign exchange security denomination not considered in security pricing.
- Security price information provided by independent vendor service is effectively based on the price information supplied by the member itself due to its market share or trading as market maker in a specific security or group of securities.
- The existence of more than one price for the same security on management reports.
- Numerous back dated adjustments to correct security price information.
- No procedures for new product development initiation and rollout within the Dealer Member's organization and evidence of management review and approval.
- Lack of segregation of duties.

INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA
INTERNAL CONTROL POLICY STATEMENT 8
DERIVATIVE RISK MANAGEMENT

The policy statement is one in a series that prescribes requirements for and provides guidance on compliance with Rule 17.2A that states “every Dealer Member shall establish and maintain adequate internal controls in accordance with the internal control policy statement in Rule 2600.” It should be read in the context of Policy Statement 1 dealing with General Matters.

CONTROL OBJECTIVE

Derivatives are financial instruments whose values are derived from, and reflect changes in, the prices of the underlying products. They are designed to facilitate the transfer and isolation of risk and may be used for both risk transference and investment purposes. This policy statement includes all types of derivatives i.e. exchange traded and over-the-counter derivatives.

The control objective is to ensure that:

- a) There is a risk management process of identifying, measuring, managing and monitoring risks associated with the use of derivatives.
- b) Management demonstrates their understanding of the nature and risks of all derivative products being used in treasury, trading and sales.
- c) Written policies and procedures exist that clearly outline risk management guidance for derivatives activities.

MINIMUM REQUIRED FIRM POLICIES AND PROCEDURES

1. ROLE OF BOARD OF DIRECTORS

- (i.) Approve all significant risk management policies to ensure that they are consistent with the broader business strategies of the firm.
- (ii.) These policies must be reviewed and amended as business and market circumstances change.
- (iii.) Senior management must report at least annually to the board on risk exposures taken by the firm except for exchange traded options.

2. ROLE OF SENIOR MANAGEMENT

- (i.) Senior management must be responsible for ensuring that there are adequate written policies and procedures for conducting derivatives operations on both a long-range and day-to-day basis. This includes:

- A clear delineation of the lines of responsibility for managing risk
 - An adequate system for measuring risk
 - Appropriate risk position limits
 - An effective system of internal controls
 - A comprehensive reporting process
- (ii.) Ensure that if limits are exceeded, there must be a system in place so that such occurrences are made known to senior management and approved only by authorized personnel.
 - (iii.) Ensure that all appropriate approvals are obtained and that adequate operational procedures and risk control systems are in place.
 - (iv.) Ensure risk control systems appropriate for the product are in place to address market, credit, legal, operations and liquidity risk.
 - (v.) Ensure that their derivatives activities are undertaken by professionals in sufficient number and with the appropriate experience, skill levels, and degrees of specialization.
 - (vi.) Ensure that management designates the appropriate officer to commit their institutions to derivatives transactions.
 - (vii.) Ensure that there is a regular evaluation of the procedures in place to manage risk to ensure that those procedures are appropriate and sound.
 - (viii.) Ensure that all standard and non-standard derivative product programs are approved.
 - (ix.) Ensure that there is an accurate, complete, informative and timely management information system. The risk management function should monitor and report its measures of risks to appropriate levels of senior management and to the board of directors of the firm.

3. PRICING

- (i.) Refer to Internal Control Policy Statement 7, “Pricing of Securities.”
- (ii.) Derivatives positions should be marked to market on at least a daily basis.
- (iii.) All pricing models used must be independently validated, including those models that compute market data or model inputs by an independent risk management function must review and approve the pricing models and valuation systems used by front- and back-office personnel and the development of reconciliation procedures if different systems are used.
- (iv.) Valuations derived from models must be independently scrutinized at least monthly.

4. INDEPENDENT RISK MANAGEMENT

- (i.) Dealer Members must have a risk management function, with clear independence and authority to ensure the development of risk limit policies and monitoring of transactions and positions for adherence to these policies.

- (ii.) The financial accounting departments of Dealer Member firms are required to measure the components of revenue regularly and in sufficient detail to understand the sources of risk.

INDICATIONS THAT INTERNAL CONTROL IS NOT ADEQUATE

- The firm does not have a pervasive risk management cyclical process philosophy of identification, measurement, management and monitoring.
- The firm does not have written policies on the use and marketing of derivative instruments.
- The firm does not have a policy of preparing deal and booking memoranda which explain the business purpose and profitability of a transaction as well as how to record (from a financial and regulatory perspective) the transaction.
- If the firm utilizes models to mark instruments to market and that
- the models are not independently verified
- Periodically (at least monthly) the market input parameters, such as yields and volatility's have not been independently scrutinized.
- Financial reporting personnel have difficulty explaining major derivatives P&L changes or components of revenue or loss.
- Financial reporting personnel have difficulty preparing financial disclosures on a timely basis.
- The firm has no established off market pricing policies for independent assessment and approval.
- The firm does not have an independent risk management process reporting to the senior management or board of directors.
- The firm does not have master netting agreements and various credit enhancements, such as collateral or third-party guarantees, to reduce its counterparty credit risk, if available.
- The firm does not have any guidelines and processes in place to ensure the enforceability of counterparty agreements.

