



INVESTMENT  
DEALERS  
ASSOCIATION  
OF CANADA

# bulletin



ASSOCIATION  
CANADIENNE  
DES COURTIERS  
EN VALEURS MOBILIÈRES

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*For distribution to relevant parties within your firm*

**BULLETIN #2967**

March 1, 2002

## **By-Laws and Regulations**

### **Internal Control Policy Statements on Pricing of Securities and Derivatives Risk**

The Board of Directors of the Association has approved amendments to Policy No. 3 by the addition of Internal Control Policy Statement 7 - Pricing of Securities and Internal Control Policy Statement 8 - Derivatives Risk Management, to be effective March 1, 2002.

The purpose of the amendment is to provide industry standards with respect to internal controls over pricing and derivatives trading by member firms. ~~There are currently no specific internal control policy statements that address the pricing of securities and managing derivatives risk.~~

A copy of the amendment is attached.

Kenneth A. Nason

*Association Secretary*

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**INVESTMENT DEALERS ASSOCIATION OF CANADA  
POLICY AMENDMENT**

Policy No. 3 is amended by the addition of Internal Control Policy Statement 7 - "Pricing of Securities" and Internal Control Policy Statement 8 - "Derivative Risk Management" as follows:

**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 IDA By-Law 17.2A that states *"every Member shall establish and maintain adequate internal controls in accordance with the internal control policy statements in Policy No. 3."* 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 Member prices securities. For guidance on the valuation of securities or definition of "market value", refer to IDA 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 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 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 Regulations.
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 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 member's security positions "owned and sold short" for profit and loss reporting in accordance with SRO requirements.
8. Members inventory profit and loss information must be reviewed by knowledgeable and authorized staff who are adequately supervised and are independent of the 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 member's organization and evidence of management review and approval.
- Lack of segregation of duties.

## **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 IDA By-law 17.2A that states “every Member shall establish and maintain adequate internal controls in accordance with the internal control policy statement in Policy No. 3.” 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.) 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 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.

PASSED AND ENACTED BY THE Board of Directors this 14th day of April 1999, to be effective on a date to be determined by Association staff.