



BANK OF JAMAICA

STANDARDS OF SOUND BUSINESS PRACTICES

MANAGEMENT OR INVESTMENT OF CUSTOMERS' FUND

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STANDARD OF BEST PRACTICE – MANAGEMENT OR INVESTMENT OF CUSTOMERS' FUNDS

This Standard of Best Practice is issued pursuant to Section 29G of the Banking Act which specifies, inter alia:

"A bank shall not manage or invest funds on behalf of its customers unless such investment is carried out under a Trust subject to regulations made under the Bank of Jamaica Act or the Standards of Best Practice issued from time to time by the Bank of Jamaica".

A PURPOSE

The Bank of Jamaica, in this Standard, requires that all managed fund activities (as defined below) conducted by a bank and all operations of funds and securities relating to the conduct of such activities, be transferred to a separate legal entity, thereby removing the direct risk of contagion such activities may have on the bank's deposit-taking operations. The purpose of this Standard is to:

- a) Specify requirements of Section 29G of the Banking Act and set out the permissible circumstances under which a bank may engage in the management or investment of funds on behalf of its customers;
- b) Provide best practice guidance as to the conditions under which such permissible investment or management activities may be carried out and ensure that any transactions between the bank's investment/management operations (if any) and the bank, its affiliates or other external parties are carried out on a prudent, arms-length and transparent basis.

The operational aspects of the transition process are dealt with in Section J to this Standard.

B OBJECTIVES

The objectives to be achieved under the referenced statutory amendment are as follows:

1. Ensure that the general public is clear as to the nature of the arrangements under which they are placing their funds with the bank;
2. Remove misperceptions of any implied guarantee on the part of a bank with respect to investment or other financial products which may be marketed through its network;

3. Ensure cessation and prevention of the current practice of banks commingling their deposit-taking operations with their investment management or managed funds activities. More particularly:
 - (i) the use of funds under management to fund an institution's liquidity needs in its banking operations,
 - (ii) the use of deposit liabilities and other funding from its banking operations to fund the short- and long-term obligations of funds under management,
 - (iii) the categorization of banks' assets and liabilities (relating to managed fund activities) as off-balance sheet items, notwithstanding that these items carry substantial direct and/or indirect risk to the bank,
 - (iv) the lack of transparency in relation to the use and operation of inter-company or intra-company accounts,
 - (v) the movement of assets between banking and investment management operations on an indiscriminate and less than arms-length basis;
 - (vi) the lack of credible documentation to distinguish clear legal ownership of banking assets from the assets of investment/funds management operations;
4. Prevent the conflict of interest that may arise as a result of a bank's management placing the interests of one group of customers ahead of the other, that is, investors versus depositors or vice versa;
5. Achieve separation of staff and operational arrangements relating to funds management activities from those relating to banking operations so as to ensure separate decision-making, rigid controls and focused attention as well as the development and enhancement of specialized skills necessary to carry out the respective responsibilities;
6. Ensure that the bank's capital requirements are matched with the activities in which it is engaged and remove the dependence or potential drain of managed funds activities on banking capital.

C DEFINITIONS

For the purpose of this Standard:

1. Managing or investing funds on behalf of customers or "Managed Funds" activities of a bank extends to all situations where a customer(s) provides to the bank a sum of money for the purpose of investing/dealing in investments (as defined below) or other assets in a specified manner as may be agreed between the parties; or in a pool of investments as defined below or any variation or combination of these.

A bank will be regarded as engaging in or conducting managed funds activities whether:

- (a.) the terms of that agreement or arrangement allow the bank full, partial or no discretion as regards the investment activity to be carried out on behalf of customers; or
- (b.) the funds are to be invested together with the funds of other customers/investors in a collective manner or are to be invested in a segregated manner; or
- (c.) such investment activities are undertaken directly by the bank or through the use of an intermediary. In this case, managed funds activities also include cases where a bank either gives advice or takes decisions regarding the investment of customers' funds even if the execution of such decisions are carried out by another institution or party.

2. **The term "Managed Funds" refers to the investments that are managed by a bank for a customer(s) who remain(s) the beneficial owner of the assets in question.**

3. "Investments" are investments of all types, including, but not limited to, government securities, equities (both ordinary and preferential), bonds, convertible securities, money market instruments, and derivatives of all these as well as participations in all types of income or non-income earning assets. Investments may be denominated in both domestic and foreign currencies, and may or may not be quoted on a recognized investment exchange. A salient characteristic is that their value fluctuates in response both to the underlying reality of their worth and to investors' perceptions of that worth.

A bank that is managing such funds on behalf of a customer is under no obligation to repay the sum originally made available for investment. Consequently, the sum returned to the customer (if any) may be more or less than the original amount invested, depending solely on the performance of the investments undertaken with such funds. This is distinct from "deposits" which are fixed sums of money held by a deposit-taking institution for a defined period and which are repaid at the end of the period, or on demand, in the same amount, plus interest at an agreed rate (if applicable), and which are covered by a statutory Deposit Insurance Scheme.

4. "Custodian of Assets" means where a bank holds assets on behalf of a customer for safekeeping purposes with the assets remaining at all times in the name of the customer. The bank is not in any way empowered to deal with the asset, save to deliver same to the customer or on the customer's order.

D PROHIBITION

1. A bank shall not engage or participate in activities that involve the management or investment of funds on behalf of its customers unless such activity falls within the permissible exception below.

2. In addition, a bank shall not in any case issue any express guarantee or offer any implicit guarantee or other undertaking to make payment to an investor, whether in the event of non-performance by the issuer or underlying asset; or in the event of fluctuations in the value of investment products or underlying assets; or otherwise.

E PERMISSIBLE EXCEPTION

A bank may invest or manage funds on behalf of another party in circumstances where it is doing so as a Trustee under Trust arrangements that meet both of the following conditions:

1. The Trust is established under a valid Trust Deed or Order of the Court or pursuant to a valid Will or other testamentary instrument; and
2. The Trust is established solely on behalf of or solely for the benefit of a minor/minors.

For the purpose of this Standard, a minor is an individual who has not yet attained the age of twenty-one (21) years.

A Trust may be defined as: A relation or association between one person or persons on one hand and another person or persons on the other based on confidence, by which property is vested in or held by the one person (the Trustee), on behalf of and for the benefit of another, under terms and conditions set out in a Trust deed or other legally, acceptable formal Trust instrument.

Nothing contained in this Standard will act to prevent a bank from acting merely as custodian of assets held on behalf of another party.

Where a bank is conducting permissible investment management business under a Trust as outlined above, it should ensure transparency of agreements. It should also ensure that the customer or other relevant party fully understands and accepts the bank's responsibilities under such Trust arrangements. All aspects of the Trust and other ancillary agreements must be fully documented and formally agreed to by both sides.

F PROPRIETARY TRADING

This Standard of Best Practice is not intended to affect a bank's proprietary trading operations.

Section 29G(2) of the Banking Act provides that a bank that engages in proprietary trading for its own account shall conform to the Standard of Best Practice issued from time to time by the Bank of Jamaica.

The Standard of Best Practice, which relates specifically to a bank's proprietary trading activities, will be issued by the Bank of Jamaica shortly.

G MANAGEMENT APPROACH/PRINCIPLES VIS A VIS PERMISSABLE INVESTMENT OR MANAGEMENT ACTIVITIES PURSUANT TO A TRUST

- I. The management and operational principles that should apply to this aspect of a bank's business should be considered under the following headings, viz:
- a) The relationship with and responsibilities of the bank vis a vis beneficiaries under a Trust;
 - b) The relationship between the bank in its capacity as Trustee and the other deposit-taking operational aspects;
 - c) The bank as Trustee and its relations to the entity undertaking investment management activities on behalf of the Trust, if any

The role of a bank under Trust arrangements is to act in the interest of beneficiaries under that Trust. In fulfillment of this fiduciary responsibility, a bank should ensure that under no circumstance should the bank's interest be placed ahead that of the Beneficiary. The main issues which must be addressed are the following:

- Segregation
- Records and information
- Transparency of agreements.

Segregation

A bank should implement appropriate policies to ensure that segregation is assured/achieved in a number of areas.

1. Trust assets must be clearly distinct and separated both from those of the bank and those of other Trusts. Even if Trust assets are held or invested in a collective investment vehicle, such as a Unit Trust, it must be easy to identify that proportion of the fund which constitutes the assets of a specific Trust.
2. Assets of a Trust must never be aggregated with those of the bank or of the related entities within a group of which the bank is a part. Neither should these assets be included in any of the bank's liquidity (or otherwise in its pool of funds) or other calculations. However, the bank must incorporate in its audited financials, appropriate disclosure of assets held in Trust, in accordance with generally accepted accounting principles.
3. Management of customers' Trust arrangements must be handled by a management team which is wholly independent from the other operational functions of the bank. This is in order to ensure that the Trustee, at all times, properly discharges its fiduciary responsibilities to the beneficiaries under each Trust arrangement, without conflicts of interest.

4. The bank should be remunerated by a transparent fee structure based on the terms of the Trust Deed or other Trust agreements, or otherwise on a basis that encourages it to perform well for the client, plus the refund of direct costs (such as dealing or external custody charges). If remuneration is linked to the value of Trust assets, the bank must ensure that the valuation basis is clear, consistent and acceptable (if not already outlined in the Trust document) and validated by independent auditors. Such valuation must be made available to all persons entitled to receive information on the performance of the Trust.

In every case where dictated by best practice (e.g. where investments are held in unquoted securities or real estate), the services of an independent professional valuator must be utilized. Where the value of any asset cannot be accurately determined, the lowest range of valuation possibilities should be taken so as to ensure, as far as possible, that the Trust's assets are not overstated, and the institution is not profiting unfairly in its remuneration.

Whatever policies are employed to effect proper segregation of assets, management and income, these should be robustly managed by the bank including the Compliance and Internal Audit functions.

Records and Information

This covers both the records that are maintained by the bank, and the information that is provided to any person(s) entitled to receive such information under the terms of the Trust. In every case, this should be consistent with the terms of the Trust documents but should, as a minimum, consist of:

- A complete list of all assets which are being handled on behalf of the Trust/beneficiary(ies). This should cover, inter alia:
 - Full identification and amount of asset/investment held,
 - Current valuation,
 - Where held (e.g. in the bank's nominee company or an overseas custodian, etc.),
 - Original purchase price(s);
- Full details of all transactions in each asset/investment for each Trust (dates and amounts of purchases and sales, prices, agents used, etc.);
- Details of all income received for each line of asset/investment for each Trust/beneficiary and how it was dealt with (re-invested or paid out, and, if the latter, where/to whom);
- Full dealing records so that auditors/examiners can readily ascertain that best practice dealing took place at all times (see further discussion below).

Based on these records, all persons required under each Trust deed/instrument to receive information should receive regular information on the activities undertaken in relation to that Trust from the bank. At minimum, this should include in relation to each Trust and beneficiary, where applicable:

- A list of all current holdings, together with their current values;
- Details of all dealings in relevant assets/investments done since the last report;
- Details of all income received since the last report, and its disposition;
- Details of any tax payments (e.g. withholding tax) or possible liabilities;
- Details of the basis of any valuations where this is not self-evident (e.g. unquoted or highly illiquid stocks);
- Report from the investment manager including performance of the relevant markets and investment activities since the last report and the investment manager's plans for the next period.

The frequency of reports should normally be specified by the Trust deed/instrument however best practice dictates that such a report package be issued at least quarterly and must be in writing even though written reports may be supplemented by discussions and ad hoc correspondence.

Transparency of Agreements

Each bank should ensure that the parties under a Trust arrangement fully understand and accept what the bank, as Trustee, is undertaking to do. All the terms of the Trust document must be fully understood by all parties.

Additionally, all agreements entered into with third parties pursuant to the Trust must be fully documented and formally agreed to by all the relevant parties. This includes agreements entered into with custodians of Trust assets and investment managers appointed, if different from the bank, based on the terms of the Trust. At minimum, each agreement should cover the terms of the Trust arrangements being addressed and include, where applicable, the following additional issues:

- What funds/assets are being entrusted to the bank and whether they represent the whole of the Trust's investment portfolio or only a part;
- What is the objective of the fund/assets to be managed (e.g. income, growth, or a mix of the two);
- The risk appetite to be satisfied;
- The investment strategy to be followed (types of instrument, sectors, countries, etc.);
- The hedging policy to be followed (e.g. for foreign exchange risk);
- The decision-making process to be adopted (discretionary, non-discretionary or partially discretionary);

- The way in which income should be handled (e.g. re-invested or paid out) including whether the policy adopted should be different for interest/dividend income as against realization income;
- The remuneration arrangements for the bank;
- Terms and conditions of custodial arrangements;
- The duration of the agreement and what cancellation notice has to be given;
- Provisions for review of the agreement(s) including timing and basis of reviews;
- The bases of measuring, valuing and accounting for assets/investments;
- Provisions for the resolution of disputes/differences;
- Details of the basis of any valuations where this is not self-evident (e.g. unquoted or highly illiquid stocks);
- Reports to be provided to other persons required under the Trust Deed to receive reports including reports on the market(s) in which Trust assets invested, details of investment activities since the last report, and the investment manager's plans for the next period;
- Exit procedures and the conditions and basis of compensation in the event of such eventuality.

The frequency of all reports from third parties, if not outlined in Trust documents, should be provided in writing at least quarterly as a best practice.

II. Relationship between Trustee Functions and other Operational Functions of the Bank

In addition to the requirements for segregation of activities, management, personnel and systems outlined above, the nature of a Trust places further responsibilities on Trustees, which require additional measures to achieve the Trust's objectives (i.e. to ensure that the interests of beneficiaries are protected). This involves ensuring that deals are executed strictly in accordance with best practice/conduct of business rules. More particularly, the Trustee should ensure that:

- Customer deals must be at the best possible price;
- No 'front running' is allowed (i.e. a dealer resolving his own position before dealing on behalf of third parties);
- Customers must be treated equally with the dealing institution;
- Customers must be treated equally vis-a-vis one another by the dealing institution;
- Separate accounting records from that of the dealing institution should be maintained.

The bank should ensure that dealings between the bank's Trust department and its other operations are carried out on an arms-length basis, fully documented and on the most advantageous terms to the Trust. Thus, the Trust department should be treated as a customer of the bank acting on behalf of others.

It is preferable that a separate accounting facility for Trust activities is maintained as the need to keep adequate records of Trusts' portfolios make specific and dedicated arrangements essential. However, where accounting for Trust activities is facilitated through the bank's normal accounting system(s), the bank should ensure that segregation of accounts, ledgers, etc. is appropriate to assure the level of independence required. This may require amendments to the bank's normal accounting system(s).

Where the Trust department obtains advice (as allowed under the Trust instrument) from other departments within the bank, impartiality must be clearly established so as to avoid any question of advice being issued, and followed, that is really intended to assist the bank in dealing with its own particular situation (e.g. disposal of an unwanted stock, and/or doing so at a more favourable price). This requires that the bank implement very firm rules regarding the behaviour of its investment analysts, as well as effective "Chinese walls" that conceal information on the bank's own positions from investment officers acting on behalf of Trusts.

H ROLE OF THE BOARD OF DIRECTORS

The role of the Board of Directors of a bank engaged in permissible investment management activities is based on the same principles as for any other area of the bank's activities. The Board has to decide whether it is appropriate for the bank to be engaged in this activity, having regard to its strategic objectives. Thereafter, it has to set policy covering the more detailed objectives which should be based on a full business plan submitted by management covering pertinent areas including the target market, organizational structure, resources needed and their availability as well as budgets.

The Board should fully apprise itself of the peculiarities of Trustee activities, which has a number of areas in which it is easy for unethical practices to flourish. For example, assets and income of the bank and its Trust clients can be conflated or one client's business can be mixed up with that of another.

The Board should clearly understand the reputational risk to the bank of any improper behaviour in this area, and ensure, through the Audit Committee, that there are robust compliance procedures and reviews to ensure consistent adherence to policies, procedures and standard of sound business practice.

I ROLE OF MANAGEMENT

The role of management of a bank engaged in permissible investment management activities is consistent with responsibilities in other aspects of the bank's operations. Senior management must ensure that the policies set by the board are effectively implemented, establish the detailed

organization and reporting lines, ensure that staff quality and systems are appropriate, and establish standard arrangements for management review of all aspects of the activities.

Management has more specific responsibilities. These are based on the number of peculiar issues that management needs to focus on. These include:

- That staff who take decisions on behalf of Trust clients are adequately qualified to do so, and that the information they use to make decisions is of appropriate quality and independence;
- That there are regular checks to ensure that investment practices of investment managers adhere strictly to customer agreements and are applied strictly on an arms-length basis;
- That valuations of Trusts' assets are applied on a clear, consistent and conservative basis, with independent assessments, where needed, and that income and other accruals are recorded and applied;
- The custody of Trust assets is secure;
- That records are impeccably kept and up to date, such that, the position of each Trust client's investment account(s) can always be immediately ascertained;
- That there are adequate checks to ensure that transactions with the other operational areas of the bank are recorded and applied according to policies and best practice of business rules and that custody records are regularly reconciled both to Trust/beneficiaries accounts and third party custodian statements, as well as, where appropriate, to physical securities;
- That sufficiently detailed records of activities are maintained so that there is at all times a clear audit trail for all activities;
- That Trust clients are kept fully informed on a regular basis of the position of their portfolios;
 - That in the absence of customer review (e.g. failure of a personal representative to undertake reviews on behalf of a minor), additional checks are in place to ensure that such accounts do not become a vehicle for in-house fraud (e.g. up-to-date statements of activities must be maintained);
- That the Compliance function is working effectively to ensure adherence to all the rules in this area;
- That Trust management activities are appropriately checked by Internal Audit;
- That this sphere of activity is separately audited by external auditors.

J INVESTMENT MANAGEMENT: THE TRANSITION TO THE NEW REGIME

Introduction

This section covers some of the issues that will arise from the transition as banks make the transition to the new regime for investment management. In summary, it deals with cases where either:

- (a.) All investment business carried out on behalf of customers (save and except for permitted Trust business) will be transferred to a separate company, probably within the same group, which will have its own capital, board of directors, management, staff, operational and accounting systems; or
- (b.) The bank takes the decision to run down or effect the transfer of this business to a third party, not being a member of the group.

Part 1. Preliminary Transitional Arrangements

The first item of business should be for banks to provide their advice to the Bank of Jamaica on the size and nature of their respective Managed Fund portfolios, if any. This preliminary advice should incorporate:

- (a.) The aggregate amount of Funds under Management;
- (b.) The nature of the different contracts between the bank and the investors, including sample agreements;
- (c.) The size and nature of the securities invested in or on behalf of clients;
- (d.) The extent to which any of these securities are encumbered and the nature of such encumbrance;
- (e.) The extent to which the bank has guaranteed the obligations of any issuers of these securities (whether explicitly or by practice); and the terms of such guarantees;
- (f.) The maturities of the securities invested in, vis a vis the maturities of investors' accounts or funds;
- (g.) The legal conditions for the termination or transfer of the contractual arrangements;
- (h.) The details of any Trust that the bank may be subject to, including details of the form of the Trust, the settlors, other Trustees, beneficiaries, Trust assets and the general powers of the bank under the Trust documents.

As it is critical that the Managed Funds activity should not constitute any drain on regulatory capital, banks are required to immediately cease the practice of guaranteeing (whether expressly or impliedly) any obligation on the part of an issuer of security to the bank's Managed Funds customers.

This preliminary advice should be received by the Bank of Jamaica within ten (10) working days of the receipt of this document.

Part 2. The Transition Process

The main step in the transition process is for each bank to determine the best method of bringing itself within the new legal regime. This requires the submission to the Bank of Jamaica, within **30 days** of the receipt of this Standard, of a Programme for the transfer or other disposal of the bank's Managed Funds business.

The programme should also advise the Bank of Jamaica of the contemplated arrangements for the Managed Funds portfolio.

At a minimum, the Programme should outline:

- (a) The bank's decision as to how it proposes to deal with its Managed Funds portfolio, whether by transfer or by winding down or other means of disposal. In any case where a bank intends to wind down its Managed Funds operations, this should be effected within 6 months, and in exceptional cases within a maximum of one year. **No extensions will be granted to this period.**
- (b) Pro-forma financial statements immediately post-separation, with projections of bank operations for the next two years, inclusive of detailed assumptions underpinning these projections.
- (c) Confirmation that the bank has immediately ceased the practice of issuing any Guarantees or other undertakings, which create an obligation for the bank to honour the commitments of any issuer of securities or to make payment notwithstanding the non-performance of the underlying assets.
- (d) The taking of all other necessary steps to take into account and unwind all transactions between the bank's Managed Funds operations and its deposit-taking operations.
- (e) The measures that will be implemented as regards any new Managed Funds business that the bank may garner during the transition period. The best method of treating with such situations is to refer such customers to the funds management institution in the group, where one already exists. Where the bank does not have a funds management institution within the group, the contracts with the customer should be appropriately worded to indicate that these contractual arrangements will be transferred to a new institution. If it is the intention of the institution to run down its Managed Funds business, then no new business should be accepted.
- (f) The details of any initiative to publicize the bank's restructuring, including the timing and content of such initiative.
- (g) The details of any transfer of management and staff to the institution that will conduct the Managed Funds operations, if this is the case. If a new institution is to be established, the transferring bank should provide the details of the institution's

business plan, the proposed directors and managers, as well as the structure and general systems of the new institution. Please note that whilst a new Managed Funds institution and a deposit-taking institution may share some common directors, it is imperative that there is no case of any manager having joint management responsibilities with both entities.

- (h) The timetables for making the transition. These should include concrete, monthly targets and objectives. The Bank of Jamaica will shortly advise of the information it will require of the bank on a monthly basis to keep the Central Bank abreast of the efforts towards transition. The timetables will also be discussed with the Financial Services Commission to ensure that these are feasible and that the efforts of the Supervisory Authorities can be co-ordinated in this process.

Part 3. Collateral Matters

The Bank of Jamaica wishes to advise as follows:

1. It is expected that once the transition is completed, banks will treat with Managed Funds entities in the group on the same basis as other customers, i.e. on a transparent and arms-length basis.
2. The Bank of Jamaica will enter into consultations with the Financial Services Commission to elicit the assistance of that agency in making the transition process as seamless as possible.
3. The Bank of Jamaica may request that a bank's external auditors provide verification of any transaction related to the transition process.
4. The Bank of Jamaica expects that whilst a bank may share the same overall physical facilities with a Managed Funds institution (e.g. using the same building), there must be full and obvious separation of physical facilities of the Managed Funds institution and those of the bank. There must be appropriate signage and the physical lay-out of the premises should be designed to ensure this separation is clear to customers.
5. Non-compliance with the terms thereof will amount to a breach of the Standard, carrying with it the statutory consequences.
6. It is expected that banks will be in a position to complete this transition process within six (6) months from the date of the issue of the Standard of Best Practice and that banks will bonafide work towards this target to ensure that the financial sector is not unduly dislocated.