ACH Clearing Rules
Guidance Note No. 4

KEY TOPICS

1. Supervisory Procedures
2. Benchmarks
3. Content of Written Supervisory Procedures
4. Outsourcing
5. Review of Supervisory Procedures

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Cross-reference

1. ACH Rule Procedure 3.5
2. PS 164
3. Ongoing compliance initial & continuing industry qualifications"
4. Ongoing Compliance & Supervision - initial and ongoing recognition for Participants

Guidance Note History

Introduced:

11 March 2004

Introduction of New Rule Book

MANAGEMENT REQUIREMENTS

Purpose

The purpose of this Guidance Note is to provide assistance to participants to establish appropriate management structures and appropriate supervisory policies and procedures. It outlines the standards ACH ("the Clearing House") expects of supervisory policies and procedures.

Background

The ACH Clearing Rules and Procedures ("Rules") require ACH Participants ("Participants") to have appropriate management structures in place at all times to ensure that its Responsible Executives have and effective control adequate level of supervision over all parts of the Participant's business wherever it is located. Participants are required to maintain accurate records of the management structure and allocation of responsibilities among their Responsible Executives. The Rules require these Participants to have appropriate supervisory policies and procedures and meet any standards prescribed by the Clearing House.

The Rules require Participants relying upon the Affiliate Director supervisory structure until the "Recognition End Date" (16 July 2004) to have appropriate management structures in place to ensure that its directors (or partners) and Affiliates have adequate supervision and effective control over all parts of the
Participant's business, wherever the business is located (and keep accurate records of its management structure and its allocation of responsibilities among its directors (or partners) and Affiliates).

Requirements for supervisory procedures

The Clearing House is of the view that establishing, maintaining and enforcing compliance and supervisory procedures is the cornerstone of self-regulation within the financial services industry. A distinction can be drawn between compliance procedures and supervisory procedures. Written compliance procedures generally cover the applicable rules and policies and describe prohibited practices. Written supervisory procedures document the supervisory system that has been established to ensure that the compliance procedures are being followed and to prevent and detect prohibited practices.

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A Participant should be able to evidence both its policies and procedures and the ongoing implementation of those policies and procedures.

The Clearing House believes the following principles are applicable in Australian markets:

- Participants must ensure that adequate compliance and supervisory procedures are in place and that sufficient resources, both personnel and systems, are devoted to the implementation of those procedures; and
- supervisory responsibilities must be periodically reassessed in light of changes in the nature and size of the Participant's business.

These principles are recognised in the Rules:

- It is also implicit in the definition of Unprofessional Conduct, which can include "unsatisfactory professional conduct, where the conduct is such that it involves a substantial or consistent failure to reach reasonable standards of competence and diligence".

The Clearing House expects all Participants to adopt and implement management structures and document supervisory procedures that are specifically tailored to the type and scale of the Participant's business. This should include documented supervisory procedures covering market, clearing and settlement operations. The Clearing House expects that Responsible Executives or Affiliate Directors will be responsible for the "ownership" of the management structures and supervisory procedures and will be held accountable as such by the Clearing House.

The Clearing House believes that management structures and supervisory policies and procedures should be in writing and be designed to reasonably supervise the business and each person in the business. The Clearing House also believes that evidence that these management structures and supervisory procedures have been implemented and carried out must be maintained and be available to the Clearing House upon request. The documentation of management structures should also identify any internal committee structures.

The adequacy of a Participant's management structures and supervisory procedures is a factor the Clearing House may take into account in considering disciplinary action. For example, the Clearing House may take the view that a Responsible Executive or Participant may be considered not to have "failed to supervise" another person if:

- It can be evidenced that there have been established procedures and a system for applying those procedures which would reasonably be expected to prevent and detect, insofar as practicable, the breach; and
- the Responsible Executive has discharged the duties and obligations incumbent upon them competently; and
- there was no reasonable cause to believe that there was non-compliance with the procedures and systems.

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The Clearing House considers a "failure to supervise" by a Responsible Executive, Affiliate or a Participant to be one of the most serious matters for which the Clearing House could take disciplinary action.

Benchmarks for appropriate supervisory procedures

When developing, implementing and reviewing compliance and supervision procedures, Participants should have regard to:

- ASX Market Rules & Procedures, ACH Clearing Rules and Procedures and ASTC Settlment Rules and Proceduers (where applicable)

Content of written supervisory procedures

At a minimum, the Clearing House believes the written supervisory procedures should be based upon the framework set out below.

Focus

Participants should develop supervisory procedures tailored to their business and designed to ensure that the Participant remains compliant with its legal and Rule obligations. In addition, Participants should scrutinize each business area for places where the interests of "Representatives"[1] might diverge from those of the Participant or its customers. Any place where a Representative might gain significant benefits in a way that would be inconsistent with the customer's or the Participant's best interests is a place that requires close control and monitoring. Participants should be especially vigilant in this regard in areas where their business is unique in some way. Innovative business practices often require innovative supervisory structures, but the compliance risks inherent in a new business policy or practice are not always apparent before problems arise.

Recitation

The written supervisory procedures should not be dependant upon recitals of the applicable laws and rules. That is the role of the compliance procedures. Written supervisory procedures should primarily document the supervisory system that will ensure compliance with those laws and rules (set out in the compliance procedures) is achieved and be supported by cross-reference to those laws and rules.

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[1] Unless defined otherwise in the Rules, for the purposes of this Guidance Note, "Representative" means a "representative" within the meaning of section 910A of the Corporations Act;

Delegation of supervisory responsibilities

The written supervisory procedures should include:

- The specific identification of the Responsible Executives responsible for supervision by name or by title and position. Also, an internal record should show both the appointment and cessation date of the person(s) holding these position(s).

- The supervisory steps and reviews to be taken by the appropriate Responsible Executive or Approved Representative, including the exception reports and/or other documents being reviewed and the substantive area being reviewed and any automated systems that are used as part of the firm's supervisory system.

- The frequency of supervisory reviews:
    - Describe as daily, weekly, monthly, quarterly or annually, depending upon the nature, type or level of firm activity in a particular area.
    - Allow for unscheduled reviews, particularly where there are indications of misconduct or potential misconduct.

- The documentation of supervisory reviews, in a manner sufficient to demonstrate to management and the Clearing House that a review has been conducted. The procedures should describe how the supervisory review will be documented and provide for the documentation of steps taken as a result of the review.

Once the required supervisory tasks have been identified, each task should be assigned to a specific Responsible Executive. Participants may find it prudent to make a single Responsible Executive responsible for each task, rather than assigning responsibility jointly. Joint assignments should be avoided as they create the possibility that when problems arise, each Responsible Executive may assume another has taken responsibility for resolving the problem. In addition, the Clearing House may initiate action against both Responsible Executives if they are jointly accountable.

The procedures should also specify which tasks Responsible Executives may delegate to administrative personnel or other persons taking into account any need for specific qualifications. Where a Responsible Executive delegates tasks to others, that delegation should be clearly documented.

Effective procedures place primary authority for most matters with a single supervisor. They also provide a way for the firm to check up on that supervisor's effectiveness. The procedures generally should place primary responsibility for oversight in the hands of individual senior supervisors.

The Clearing House expects that the assignment of tasks and delegations would also be reflected on the records of management structure and allocation of responsibilities required in relation to the Rules regarding Management Structure.

Designation of Responsible Executive

The written procedures should clearly identify who has supervisory responsibilities. Each type of business in which a Participants engages should have a designated Responsible Executive and they should have the authority to carry out the supervisory responsibilities of the Participant.

There is a necessity to exercise strict supervisory control over Branch Offices. The Clearing House expectations of the responsibilities for supervision and conduct of Branch Offices is expanded upon below. The Responsible Executives are not required to be located in the Branch Offices but are accountable for the activities of those Branch Offices.

The Clearing House expects that this would also be reflected on the records of management structure and allocation of responsibilities required under the Rules.

Assignment of Representatives

Participants should assign each Representative to one or more Responsible Executives who are qualified to supervise the activities of the Representatives. The assignment of a Representative to a Responsible Executive does not need to be a direct relationship. There may be an indirect relationship as a result of delegations and hierarchical management structures. In any event, the relationship must be identifiable.

Participants must continue to monitor the activities of Representatives and the qualifications of their Responsible Executives to ensure that the supervisors are properly qualified. The Clearing House expects that this would also be reflected on the records of management structure and allocation of responsibilities required under the Rules.

Qualifications of supervisory personnel

The written supervisory procedures should identify those qualifications the Participant has deemed important in determining whether a Responsible Executive can fulfil their assigned responsibilities, the procedures for determining whether the Responsible Executive possesses such qualifications, and the methods for monitoring the performance of the Responsible Executive.

All Responsible Executives should receive compliance training. Training should provide a clear description of the Participant's expectations.

Process for monitoring and control

The procedures should describe clearly what monitoring steps must be taken, and by whom.

Where possible, the procedures should be designed to prevent breaches in addition to monitoring for breaches after they occur. For example:

- It is the view of the Clearing House that it is inappropriate for advisers and other front office staff to have access to originals of confirmations or client account statements prior to their despatch to clients. This is a fundamental fraud prevention control.

- Where advisers wish to include other material (such as personalised notes) with confirmations or client account statements, that material should be provided to the back office for inclusion rather than providing the confirmation or client account statement to the adviser. Where the advisers wish to check confirmation details against their records of transactions, advisers should be provided with copies, not originals. Where confirmations are produced in Branch Offices for despatch to clients, unless Participants can demonstrate that advisers do not have access to them prior to despatch, that practice should be discontinued and confirmations should be produced centrally

- Bookings of executed transactions should be segregated from those persons executing the transactions;
- advisers and other front office staff should not:
    - have access to incoming or outgoing client cheques,
    - have access to unopened incoming mail,
    - be allowed to personally deliver confirmations, statements, cheques, etc to clients;
    - be allowed to personally collect cheques from clients;
    - have access to confirmations, statements or cheques which have been placed into envelopes but have not yet been mailed.

Independent checks on activity

Participants should not permit persons to supervise themselves. For example, a trading supervisor who also has day-to-day trading responsibilities cannot also be responsible for the supervisory review of their own trading activity. Participants should design policies and procedures to monitor Representatives' activity and detect potential breaches.

Automated systems

Participant's written supervisory procedures may incorporate the use of automated systems to assist in determining compliance with the applicable rules. However, the supervisory system must provide for a Participant's testing and monitoring of the automated systems to determine that they are operating properly. Additionally, any exception reports produced must be investigated and the results of the investigation documented. If a firm has an effective supervisory procedure reasonably designed to detect programming errors or software failures, it is unlikely that such problems would result in a charge of failure to supervise.

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Specialised procedures to deal with complex products

Participants should pay particular attention to procedures regarding the supervision of new and complex products. Such products may require additional specialised and enhanced procedures. Responsible Executives, Affiliates and Approved Representatives must understand the nature of the products and activities in which the Representatives under their supervision are engaged.

Outsourcing

The Rules oblige Participants to be accountable for third party service providers. Therefore written supervisory procedures should include procedures for ensuring the Participant can satisfy itself that the performance of, and compliance by, these parties is appropriate.

Responsibilities of Responsible Executives for Branch Offices

Branch Offices pose a special compliance challenge. Distance, time and a lack of a compliance culture of Branch Office staff can defeat supervisory procedures that have been adopted with the best of intentions. Compliance issues originating in Branch Offices represent a significant proportion of the disciplinary matters considered by the Clearing House.

It will not be necessary for there to be a Responsible Executive in each Branch Office. How control is best effected is up to the Participant to determine bearing in mind that Participants and their Responsible Executives are subject to potential disciplinary action for failure to supervise their Representatives.

Where there is no Responsible Executive located in a particular branch office, it follows that some level of centralised compliance control is essential. It is not enough for Responsible Executives to delegate responsibility for Branch Office operations and then not follow up on a regular basis whether that person carries out the assigned duties effectively. As an organisation grows more complex and as Branch Offices grow more numerous, dispersed and distant, so does the need for central control by Responsible Executives. However, centralised control does not imply that there is no compliance role for the Branch Office managers.

Responsible Executives are responsible and accountable for compliance in all Branch Offices and are viewed by the Clearing House as being directly responsible and accountable for the conduct of employees within a Branch Office. With appropriate controls, Branch Office managers can add substantial value to a Participant's overall compliance operations and support the Responsible Executives in satisfying their obligations.

In striking a balance between central compliance control and local responsibility, Responsible Executives should clearly delineate who will be responsible for specific duties and then establish follow-up and review procedures to make sure all duties have been successfully completed.

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Review of Supervisory Systems

Periodic Review of Supervisory System

The Board of each Participant should periodically review the supervisory systems and procedures to ensure they are reasonably designed to achieve the Participant's compliance with applicable laws, rules and regulations.

One method a Board may adopt to achieve this would be to designate and identify one or more Responsible Executives who are ultimately accountable for reviewing the supervisory system, procedures, and inspections implemented by the Participant. The designated Responsible Executives should be accountable for taking or recommending appropriate action reasonably designed to achieve the Participant's compliance with applicable laws, rules and regulations. Another method is to designate the compliance manager to review the supervisory system, procedures, and inspections implemented by the Participant and report on the effectiveness of implementation of them by the Responsible Executives.

Internal and Branch Office Inspections

On-site reviews are of critical importance. The review must be designed to assist in detecting and preventing breaches of, and achieving compliance with, applicable laws and rules. If carried out efficiently, with careful file reviews, they allow the Participant to obtain an accurate view of the Branch s supervisory procedures should also address the number of visits to be made to a Branch Office.

The personnel who make the visits should have the skills and experience to conduct reviews and be knowledgeable of the industry and the nature of the firm's business. Such personnel should be able to perform their work with an independent, objective perspective. People independent from the supervision, control or bottom line performance of the Branch Office should conduct reviews of the Branch Office operations and controls.

Whether or not problems were identified during the on-site visits, written reports should be prepared promptly and the findings discussed with the regional managers and senior management. Reports should be presented to the Compliance Committee, senior management and the Board (depending on the structure of the Participant). Deficiencies identified should be corrected and follow up reviews carried out (where relevant) and documented.

Appropriate documentation of the supervisory process

When a Participant's supervisory efforts in a particular matter are called into question, it is almost always to the Participant's advantage to have a written record of the supervisory efforts that were undertaken.

A written record will serve as helpful evidence that the supervisors considered the problem and made good faith judgments about the proper course of action. It is in the interests of the Participant, its Directors and Responsible Executives to be able to ensure these records are made.

For this reason, the procedures should specify that when significant compliance-related issues arise, the Responsible Executive should generate a written record of the steps they took, possibly in consultation with the Participant's Compliance Executive or legal advisers.

Updating of written supervisory procedures

When a rule change necessitates modification of a Participant's supervisory system and written supervisory procedures, the Participant should prepare and distribute an internal memorandum or other similar document describing the modification or amendment and provide a method for updating the relevant supervisory materials within a reasonable period of time.

Distribution of procedures and amendments

A copy of a Participant's written supervisory procedures must be kept and maintained (or be available at all times on a corporate intranet) in each Office and Branch Office. Participants should also consider making copies of the ASTC Settlement Rules and Procedures, the ACH Clearing Rules and Procedures and Corporations Act available on the same basis.

Role of compliance personnel in supervisory processes

A line supervisor is one who has the power to hire, fire, punish or reward a subordinate employee. The line supervisor of a Authorised Representative is generally the Branch Office manager. In larger Participants, the line supervisor of the Branch Office manager may be a district or regional manager. The ultimate line managers will be the Responsible Executives.

Compliance personnel generally are not line supervisors for business unit employees, although they may be line supervisors with respect to employees in the compliance department.

Generally, the role of compliance personnel with respect to the activities of employees is to inform line supervisors of compliance related issues and to monitor the effectiveness of line supervisors' compliance-related efforts. Compliance personnel may advise line supervisors about the hiring, firing and discipline of employees, but they generally do not make actual decisions in these areas.

The Clearing House is of the view that Compliance personnel should not be Responsible Executives.

Such a mixing of functions undermines the compliance officer's support and monitoring functions. The procedures should describe the compliance department's supporting functions (e.g. education, exception reporting, branch audits, conduct of compliance meetings) and line supervisors' responsibilities with respect to those functions (e.g., reviewing exceptions reports and responding to branch audit findings). However, the Clearing House will accept compliance executives being appointed as Responsible Executives for the sole purpose of being responsible for compliance with the Rules in relation to Capital Adequacy.

The Clearing House acknowledges that, for various reasons, a Participant may wish to appoint a compliance executive as a Responsible Executive. A compliance executive will generally not be held liable by the Clearing House for failure to supervise another unless they have the responsibility, ability and authority to affect the other person's conduct.

Content of Written Compliance Procedures

Participants should develop compliance procedures tailored to their business and reasonably designed to establish the compliance obligations to ensure that the Participant stays in compliance.

The Clearing House's observation is that "rules based" compliance manuals (lists of do's and don'ts or recitation of the law or rules) have a limited role and do not address the root causes of compliance failings or effectively promote responsible behaviour. "Integrity" and behaviour based compliance manuals better promote responsible behaviour, encourage improvements in conduct and better establish internal peer standards.

In principle, the Clearing House has no objection to externally sourced manuals and in many cases it is the most appropriate use of limited resources available. However, the limitations of their value need to be appreciated. Generic manuals are of limited use to a Participant, as they do not take account of the nuances and particular practices adopted by the Participant. They should be considered as a base document only, to be tailored to the type and scale of business being conducted. Generic, untailored manuals can be directly contradictory to the practices adopted.

Qualification

The Clearing House has published this note to promote commercial certainty and to assist Participants. Nothing in this note necessarily binds the Clearing House in the application of the Rules in a particular case. In issuing this note the Clearing House is not providing legal advice and market participants should obtain their own advice from a qualified professional person in respect of their obligations. The Clearing House may replace this Guidance Note at any time without further express notice to any particular person. Readers may contact the Clearing House to ensure they have the latest version.

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