



May 2007

Statement of Guidance

Internal Controls for Trust Companies, Company Managers and Corporate Services Providers

1. Statement of Objectives

- 1.1 To provide guidance on the requirement imposed on licensees by the Rule on Internal Control.
- 1.2 To provide a standard of best practice to licensees for the implementation of an effective and sound Internal Control System.

2. Introduction

- 2.1 Internal controls are defined¹ as the systems, policies, procedures and processes effected by the organisation to:
 - ensure reliability and integrity of information;
 - ensure compliance with laws, regulations, policies, internal rules & procedures, etc;
 - safeguard assets;
 - promote the economical and efficient use of resources; and
 - accomplish goals and objectives.
- 2.2 Internal controls help management to measure performance, make decisions, evaluate processes, and decrease the risk of unexpected losses or damage to its reputation.
- 2.3 While internal audit is inter-related to internal controls, the distinction is that internal audit provides an independent and objective review of an organisation's activities and internal controls.

¹ The definition was adapted from the Institute of Internal Auditors.



May 2007

3. Management and Supervision

- 3.1 The board of directors should have full responsibility for the licensee's operations including the development, implementation and ongoing effectiveness of the licensee's internal controls and adherence thereto by all employees.
- 3.2 Regular and effective communication should occur within the organisation to ensure that management, including the board of directors, is at all times apprised of the status of the licensee's operations and financial position, including risks posed to or weaknesses detected, non-compliance with legal and regulatory requirements, and the overall adherence to business objectives.
- 3.3 Where business functions and/or internal control functions are delegated or outsourced, ultimate responsibility for effective internal controls remains with management. Accordingly, agreements on outsourcing internal controls should be approved by the board of directors. Furthermore, management should ensure that persons to whom business functions and/or internal control functions are delegated or outsourced to are fit and proper and have sufficient capacity to fulfil the task.
- 3.4 It is recognised that internal control functions can be varied and extensive and certain procedures may not have been specifically agreed to by the board of directors. However, such approval is required by the Rule on Internal Controls. Accordingly, the board should be regularly apprised by, or oversee, management who has delegated responsibility for the establishment of those procedures.
- 3.5 Reporting lines should be clearly identified with supervisory and reporting responsibilities assigned to appropriate staff members.
- 3.6 Detailed policies and procedures regarding authorisations and approvals, as well as the authority of key positions, should be clearly defined and communicated to and followed by staff.



May 2007

- 3.7 Management should ensure that management and supervisory functions are performed by qualified and experienced individuals.

4. Risk Management

- 4.1 Appropriate and effective risk management policies should be established and continually monitored. From an internal control perspective, a risk assessment should identify and evaluate the internal and external factors that could adversely affect the achievement of the organisation's performance, information and compliance objectives. This process should cover all risks faced by the licensee and operate at all levels within the organisation. It differs from the risk management process, which typically focuses more on the review of business strategies developed to maximise the risk/reward trade-off within the different areas of the organisation.
- 4.2 Effective risk assessment identifies and considers internal factors (such as the complexity of the organisation's structure, the nature of the licensee's activities, the quality of personnel, organisational changes and employee turnover) as well as external factors (such as fluctuating economic conditions, changes in the industry and technological advances) that could adversely affect the achievement of the licensee's goals.
- 4.3 The risk assessment process also includes evaluating the risks to determine which are controllable by the licensee and which are not. For those risks that are controllable, the licensee must assess whether to accept those risks or the extent to which it wishes to mitigate the risks through control procedures. For those risks that cannot be controlled, the licensee must decide whether to accept these risks or to withdraw from or reduce the level of business activity concerned.
- 4.4 In order for risk assessment, and therefore the system of internal control, to remain effective, senior management needs to continually evaluate the risks affecting the achievement of its goals and react to



May 2007

changing circumstances and conditions. Internal controls may need to be revised to appropriately address any new or previously uncontrolled risks.

- 4.5 The licensee should have a business continuity plan that outlines the likely scenarios involving interruptions and documented disaster recovery plan.

5. Operational Controls

- 5.1 Management should establish and maintain processes to obtain and confirm information regarding every client in relation to establishing the true identity of the client, the beneficial owner(s) and person(s) authorised to give instructions.
- 5.2 Policies and procedures should be established to minimise the potential existence of conflicts of interest between the licensee and its staff or its staff and clients. In circumstances where conflicts of interest cannot be avoided, clients should be fully informed of the nature and possible ramifications of such conflicts.
- 5.3 Senior management should request presentations and performance reports on a periodic basis in order to gauge the licensee's progress toward its goals. For example, management may want to review the acceptance of new accounts and account terminations on a monthly basis, while a detailed review of earnings can be done on a quarterly basis.
- 5.4 Physical controls should be established to restrict access to tangible assets, including cash and securities. Control activities include physical limitations, dual custody, and periodic inventories.
- 5.5 Important documents, such as original trust agreements and certificates



May 2007

of incorporation, should be kept in a safe and secure location. The licensee should also have a retention schedule for important documents.

- 5.6 A client's assets should be segregated from other clients' assets and from those of the licensee. Adequate systems, procedures and records should always be maintained so that these assets may be identified and accounted for at all times.
- 5.7 Appropriate and effective procedures should be established and followed to protect the licensee's and clients' assets from theft, fraud and other forms of misappropriation.
- 5.8 Adequate and reliable audit trails should be maintained to prevent, detect and investigate suspected improprieties. There should be regular reconciliation of the licensee's internal records with those of third parties such as banks, custodians, brokers, and counterparties.

6. Information Management

- 6.1 Management of information, both physically and electronically stored, should be assigned to qualified and experienced staff.
- 6.2 Management should ensure that the licensee's operating and information management systems meet the licensee's needs and operate in a secure and adequately controlled environment.
- 6.3 Information management reporting requirements should be clearly defined to ensure the adequacy, reliability, accessibility and timeliness of production of required internal and external reports, including those required by the Authority.
- 6.4 Key components of the information management system design and implementation programme should be adequately documented and regularly reviewed for effectiveness.



May 2007

- 6.5 Appropriate electronic data processing and data security policies should be put in place to prevent and detect the occurrence of errors, omissions or unauthorised insertion, alteration or deletion of, or intrusion into, the licensee's data processing system (electronic or otherwise) and data.
- 6.6 Management should establish and maintain effective record retention policies to ensure that all relevant legal and regulatory requirements are complied with, and which enable the licensee, the Authority, or any other regulatory body to carry out routine and ad-hoc reviews or investigations.

7. Monitoring Activities

- 7.1 The overall effectiveness of the licensee's internal controls should be monitored on an ongoing basis. Monitoring of key risks should be part of the daily activities of the licensee as well as periodic evaluations by the business lines and internal audit.
- 7.2 Monitoring the effectiveness of internal controls can be done by personnel from several different areas, including the business function itself, financial control and internal audit. For that reason, it is important that senior management makes clear which personnel are responsible for which monitoring functions. Monitoring should be part of the daily activities of the business but also include separate periodic evaluations of the overall internal control process. The frequency of monitoring different activities of a licensee should be determined by considering the risks involved and the frequency and nature of changes occurring in the operating environment.
- 7.3 Ongoing monitoring activities can offer the advantage of quickly detecting and correcting deficiencies in the system of internal control. Such monitoring is most effective when the system of internal control is integrated into the operating environment and produces regular reports for review. Examples of ongoing monitoring include the review and approval of journal entries, and management review and approval of



May 2007

exception reports.

- 7.4 It would be advantageous for an effective and comprehensive internal audit of the internal control system to be carried out by operationally independent, appropriately trained and competent person(s). The internal audit function, as part of the monitoring of the system of internal controls, should report directly to the board of directors or its audit committee, and to senior management.
- 7.5 Internal control deficiencies, whether identified by business line, internal audit, or other control personnel, should be reported in a timely manner to the appropriate management level and addressed promptly. Material internal control deficiencies should be reported to senior management and the board of directors.

8. Compliance

- 8.1 The Management should establish and maintain an appropriate and effective compliance function within the organisation that is appropriate to the size of the organisation and that is independent of all operational and business functions.
- 8.2 Management should ensure that persons performing the compliance function possess the necessary skills, qualifications and experience to enable them to effectively execute their duties.
- 8.3 In conjunction with management, persons performing the compliance functions should establish, maintain and enforce effective compliance procedures. These procedures should cover all legal and regulatory requirements, including those relating to anti money laundering and counter financing of terrorism (AML/CFT).
- 8.4 Management should maintain and enforce policies and procedures to



May 2007

ensure the proper handling of complaints from clients and that the appropriate remedial action is promptly taken. Complaints procedures should be in writing. Ideally, complaints should be investigated by persons who are not directly involved in the subject matter of the complaint.

9. Personnel and Training

- 9.1 Management should implement procedures to ensure that the licensee employs persons who are fit and proper to perform the duties for which they are employed.
- 9.2 All staff and others performing services on the licensee's behalf should be provided with adequate and up-to-date documentation regarding the licensee's policies and procedures, which should include those relating to internal controls.
- 9.3 Management should ensure that adequate training suitable for the specific duties that staff members perform is provided initially and on an ongoing basis, including training relating to AML/CFT. A licensee's training programme should ensure that staff possess or acquire appropriate and practical experience through "on-the-job" training and, where appropriate, structured courses.

10. Segregation of Duties

- 10.1 Key duties and functions should be appropriately segregated so as to minimise errors or detect fraud. Segregation and rotation of duties ensure that employees in sensitive positions do not have absolute control over key areas of the business. For example, it may be practical for the employee who originates a transaction not to be involved in the processing of that transaction.
- 10.2 The compliance program should be independent of management to



May 2007

enhance its effectiveness. Reviewing for compliance with customer due diligence guidelines and other laws and regulations is an essential part of a compliance program.

- 10.3 An effective independent audit function can provide assurance that the licensee's internal control structure is being maintained and operated adequately.
- 10.4 Approvals and authorisations – Requiring approvals and authorisations at the appropriate levels for transactions over certain limits ensure that management is aware of the transaction or situation, and helps to establish accountability.

11. General Guidance

These guidelines were drawn from Hong Kong's "Management, Supervision and Internal Control Guidelines for Persons Licensed by or Insured with the Securities and Futures Commission."