



FJÁRMÁLAEFTIRLITIÐ  
THE FINANCIAL SUPERVISORY AUTHORITY, ICELAND

## Guidelines No. 5/2011

Guidelines on the status and responsibilities of the  
compliance function of financial undertakings

Based on the second paragraph of Art. 8 of Act. No. 87/1998,  
on Official Supervision of Financial Activities

12 December 2011

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## 1. General

1. The Financial Supervisory Authority is now issuing Guidelines on the status and responsibilities of the compliance function of financial undertakings, based on the second paragraph of Art. 8 of Act No. 87/1998, on Official Supervision of Financial Activities.

2. In preparing these Guidelines, consideration was had for the principles and objectives set out, for instance, by the International Organisation of Securities Commissions (IOSCO)<sup>1</sup> and the Basel Committee on Banking Supervision.<sup>2</sup> The implementation of other states and their experience was also examined.

3. Financial undertakings are to be operated in a proper and sound manner, guided by the interests of their clients, shareholders, guarantee capital owners and the economy as whole, cf. the first paragraph of Art. 1 of Act No. 161/2002, on Financial Undertakings. In order to achieve the above objectives, financial undertakings must fulfil their obligations as provided for in laws and rules and follow proper and sound business practices in their operations. The management of financial undertakings are to see to it that employees can pursue their work with integrity, honesty and professionalism. It is important that management set a good example in this regard and ensure that such a corporate culture prevails within financial undertakings.

4. It is in the interests of the financial market, financial undertakings, shareholders, directors and their employees, as well as all investors, that the activities of compliance are effective, since this contributes to ensuring that undertakings operate in accordance with laws and rules and follow proper and sound business practices. All the employees and managers of financial undertakings need to consider the risk involved in not complying with laws, rules and internal criteria which apply to the activities of financial undertakings, such as application of sanctions by authorities, financial loss or reputational damage, and its impact on investor protection, i.e. compliance risk. In this connection, FME wishes to reiterate that a financial undertaking shall have a secure risk management system covering all its activities, as provided for in Art. 17 of the Act on Financial Undertakings.

5. Within a financial undertaking authorised to trade in securities there must be a compliance function, entrusted with the task of monitoring and regularly assessing the suitability and efficacy of specific measures taken by the financial undertaking. The compliance function also monitors and assesses actions undertaken by financial undertakings to rectify any failures to fulfil their obligations. Closely related to this supervisory function is the role of compliance in providing employees of a financial undertaking, who are responsible for concluding securities transactions, the necessary instruction, advice and assistance to enable them to fulfil the undertaking's obligations pursuant to the Act on Securities Transactions. It is also the role of compliance to receive notifications from employees due to suspicion of market abuse and insider misconduct and to notify FME of such suspicions. Furthermore, the Board of Directors of a financial undertaking may entrust compliance with additional duties, provided that such work is compatible with the responsibilities of compliance provided for in laws and rules and sufficient capacity exists to carry this out.

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<sup>1</sup> International Organization of Securities Commissions (IOSCO): *Compliance Function at Market Intermediaries, Final Report*. March 2006.

<sup>2</sup> Bank for International Settlements, Basel Committee on Banking Supervision: *Compliance and the compliance function in banks*. April 2005.

6. These Guidelines discuss, firstly, the status of compliance in financial undertakings and, secondly, its responsibilities. They comprise instructions to further clarify the minimum requirements of laws and rules concerning the status and scope of compliance within financial undertakings, together with instructions from FME as to how it considers parties should comply with them. This is not, however, an exhaustive list of explanations.

7. The status and scope of the compliance function in financial undertakings is provided for primarily in Art. 6 of Regulation No. 995/2007, on Investor Protection and the Business Conduct of Financial Undertakings, which was adopted with reference to Act No. 108/2007, on Securities Transactions (AST).

#### Art. 6

##### *Compliance*

A financial undertaking shall establish and maintain adequate policies and processes designed to detect any risk of failure by the undertaking in question to comply with its obligations under the Act on Securities Transactions, and to put in place procedures to minimise such risk and enable the Financial Supervisory Authority to exercise its powers effectively under this Regulation.

Measures taken by a financial undertaking for the purpose of satisfying the above requirements concerning compliance shall take into account the nature and scale of the undertaking's activities.

A financial undertaking shall establish and maintain an effective compliance function which operates independently of the other aspects of its activities and which has the following responsibilities:

- a) to monitor and, on a regular basis, to assess the adequacy and effectiveness of the measures provided for in the first paragraph and actions taken to address any deficiencies in the undertaking's compliance with its obligations;
- b) to provide employees of a financial undertaking, who are responsible for concluding securities transactions, the necessary instruction, advice and assistance to enable them to fulfil the undertaking's obligations pursuant to the Act on Securities Transactions.

A financial undertaking shall ensure that the following conditions regarding compliance are satisfied:

- a) those parties responsible for compliance must have the necessary authority, resources, expertise and access to all relevant information;
- b) a Compliance Officer shall be appointed who is responsible for the compliance function and all reporting to senior management required in the third paragraph of Art. 5;
- c) employees who work in compliance may not be involved in the performance of services or activities which they monitor;
- d) the method of determining the remuneration of employees of a financial undertaking who work in compliance may not be likely to compromise their objectivity.

Notwithstanding the provisions of the second paragraph, a financial undertaking is not obliged to comply with subparagraphs c or d if it can demonstrate that, given the nature and scale of its activities, these requirements are too onerous and that its compliance function is satisfactory in other respects.

8. FME wishes to point out especially that the senior management<sup>3</sup> of a financial undertaking is responsible for ensuring that obligations set for it by laws and rules are satisfied, cf. the first paragraph of Art. 6 of the Regulation. In addition, senior management is to regularly assess and review the efficacy of the policy, arrangements and procedures which have been established to fulfil statutory requirements and to take suitable measures to rectify any deficiencies, cf. the second paragraph of the same Article.

9. The substance of these Guidelines shall apply to financial undertakings licensed to conclude securities transactions; the extent to which the substance of these Guidelines applies to each financial undertaking is determined by their respective license.

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<sup>3</sup> See further the definition of senior management in Section 2.5.

## **2. The status of a financial undertaking's compliance function**

### **2.1 Independence of compliance**

10. A financial undertaking shall establish and maintain an effective compliance function which operates independently of other aspects of its activities. Such independence is a premise for an effective compliance function and shall characterise the status and all work of compliance. Compliance is part of the structure of a financial undertaking and one aspect of its internal surveillance system. The compliance function may not be responsible to the head of another business unit within the financial undertaking and shall be visible, independent and separate from other units in the organisational chart.

11. The independence of the compliance function also implies that it must be financially independent of other units of the financial undertaking and have at its disposal sufficient funds to be able to fulfil its duties satisfactorily. When the budget is being prepared each year, FME recommends that the Compliance Officer express his/her opinion with regard to its allocation to the compliance function before a decision is taken. FME also considers it appropriate to prepare a specific budget for the compliance function. If significant cutbacks are anticipated to the operations of the compliance function, it is appropriate to present and provide grounds specifically for them to the Compliance Officer and Internal Audit, which is responsible for surveillance of the Compliance Officer within the financial undertaking. In his/her next report to the Board of Directors, the Compliance Officer should account for the impact of such cutbacks. The same applies if the Compliance Officer is of the opinion that the funds intended for the compliance function are insufficient for the operation of an efficient compliance unit as provided for by laws and rules. Reporting to senior management is discussed in more detail in Section 2.5.

12. The independence of the compliance function implies, furthermore, that employees of compliance work independently within the financial undertaking without concern for their position within the undertaking. Employees of the compliance function should be able, for instance, to present their conclusions to the relevant parties within the company without this negatively affecting their position.

### **2.2 Compliance Officer and employees of the compliance function**

#### ***2.2.1 Hiring and departure of the Compliance Officer***

13. A financial undertaking shall appoint an individual to serve as Compliance Officer. The Compliance Officer shall be responsible for the compliance function within the financial undertaking and FME recommends that the undertaking's Board of Directors formally confirm the Compliance Officer's appointment and specify his/her terms of employment. Similarly, FME recommends that an alternate Compliance Officer be appointed.

14. Written notice must be sent to FME without delay on the appointment of the Compliance Officer and alternate Compliance Officer. FME considers the notification to be the responsibility of the CEO of the financial undertaking.

15. If a Compliance Officer ceases employment, this must be notified to the financial undertaking's Board of Directors. If a Compliance Officer is dismissed, this action must be presented to the Board for approval or rejection, and the Board's conclusion recorded in the minutes of the Board meeting. The Compliance Officer shall be given an opportunity to express him-/herself regarding the termination of employment, without the involvement of the CEO, before the Board of Directors takes its decision. As Internal Audit shall supervise the work of Compliance Officers, Internal Audit must be notified in writing if a Compliance Officer ceases employment and the reason for such. In addition, FME must be notified in writing and without delay if a Compliance Officer ceases employment, whether he/she has been dismissed or leaves voluntarily. Such notification shall include an explanation as to why the Compliance Officer concerned has ceased employment. FME considers the notification to be the responsibility of the CEO of the financial undertaking.

### ***2.2.2 Issuance of a formal statement of duties***

16. FME recommends that, when hiring a Compliance Officer, the Board of Directors of a financial undertaking provide him/her with a formal statement of duties. It is suitable to have such a statement of duties apply for 12 months and/or be reviewed and renewed following the Board's review of the Compliance Officer's report. The formal statement of duties shall provide, for instance, for the following aspects:

1. It shall discuss the Compliance Officer's position within the financial undertaking, indicating specifically how his/her independence shall be ensured.
2. It shall provide specifically for the compliance function's access to all data.
3. Reference shall be made to procedures on the Compliance Officer's authorisations and remedies available, which are approved by the financial undertaking's CEO.
4. An account shall be provided of the responsibilities of the compliance function in the financial undertaking, specifically stating if the Board intends the compliance function to fulfil more extensive duties than provided for in the Act on Securities Transactions and rules adopted by virtue of it. The duties of the Compliance Officer are determined by what is prescribed by the Board of Directors in the formal statement of duties.
5. It describes the Board's emphases concerning those risk factors which the Compliance Officer has described in his/her report.
6. The responsibility of the Board of Directors of the financial undertaking for the undertaking's compliance function is underlined.

### ***2.2.3 Expertise in compliance***

17. The Compliance Officer shall be responsible for the work of the compliance function and must possess extensive specialised knowledge of securities trading and the laws and rules which apply to the activities of a financial undertaking licensed to trade in securities. Furthermore, the Compliance Officer must possess the qualifications and expertise to assume responsibility for the tasks intended for the compliance function pursuant to the Act on Securities Transactions and Regulations adopted by virtue of it. The same demands are made of alternate Compliance Officers.

18. The Compliance Officer shall hire employees for the compliance function as he/she deems necessary. FME recommends that the number of compliance employees correspond to the nature

and scope of the undertaking's activities and the duties of the compliance function within the financial undertaking. The employees of the compliance function shall possess sufficient qualifications, knowledge and specialist expertise to perform their duties. FME recommends that Compliance Officers make an effort to ensure that employees jointly possess the broadest knowledge possible, such as knowledge of the laws and rules which apply to the activities as well as specialised expertise concerning the framework and implementation of securities transactions. The Compliance Officer should also be authorised to request specialised assistance from individual employees of other business units of the financial undertaking, as well as external experts, if he/she deems this necessary.

19. In view of the expertise which it is considered necessary for the Compliance Officer and employees of the compliance function to possess, FME urges the CEOs and Compliance Officers of financial undertakings to ensure that each annual budget consider specifically employees' in-service training and continuing education.

#### ***2.2.4 Job security and remuneration to compliance employees***

20. FME considers the Compliance Officer's job security an intrinsic premise for an independent compliance function. FME therefore recommends to financial undertakings that the notice of dismissal prescribed in a Compliance Officer's employment contract be of sufficient length to provide satisfactory job security. In this connection, FME regards a minimum of nine months as advisable.

21. FME considers it appropriate to take into consideration the financial undertaking's overall financial situation when determining remuneration, i.e the salaries of the Compliance Officer and employees of the compliance function. Their salaries may not be conducive to affecting their objectivity in their duties and FME recommends that financial undertakings have regard for the salaries of other employees in positions with similar responsibilities, such as risk management and Internal Audit of the financial undertaking concerned, in determining the amounts. The salaries of employees working in risk management, Internal Audit or compliance shall, in accordance with the first paragraph of Art. 13 of FME Rules No. 700/2011, on bonus schemes of financial undertakings, be sufficient so that qualified and experienced individuals seek such positions. Salaries shall also reflect the responsibility borne by such employees and be competitive. It is also pointed out that, according to these same rules, employees working in compliance may not be paid bonuses, cf. the second paragraph of Art. 13 of the Rules.

### **2.3 Compliance function's access to data**

22. It is necessary for those parties responsible for compliance in a financial undertaking to have access to all the data which the Compliance Officer considers necessary to be able to perform their duties in a suitable manner; the Compliance Officer shall determine what data is concerned in each instance.

23. Employees and managers of individual units within a financial undertaking may neither impede access by compliance nor refuse it access to data subject to its supervision. FME recommends that compliance obtain data from the managers of the relevant units. Compliance should also be able to turn to employees of individual units, without the knowledge of their superiors, to obtain data to which the employee in question has access. It is important to ensure



that compliance can obtain data without the involvement of employees and/or managers of individual units if appropriate, e.g. if data needs to be verified.

24. The compliance function shall have access to all data in connection with securities transactions, including documents, contracts, electronic documentation (such as e-mail communications, discussion threads), telephone recordings, real-time access to trading systems and other systems which are used in concluding securities transactions. The Compliance Officer shall have access to those establishments of the financial undertaking handling securities trading.

25. A financial undertaking must have satisfactory information and documentation systems to keep track of and classify all data concerning securities transactions and related data, e.g. contracts, transaction receipts and trading orders. By such means, ready access to data shall be ensured, including access by the Compliance Officer to data enabling him/her to fulfil his/her duties.

26. The compliance function shall have access to meetings of the financial undertaking's committees and/or their minutes as considered necessary by the Compliance Officer for compliance work. The Compliance Officer shall also be authorised to request a special meeting with a specific committee if he/she considers it necessary to obtain as accurate a picture as possible of the activities under the Compliance Officer's supervision. FME urges the CEO of a financial undertaking to invite the Compliance Officer to regular consultation meetings held with other managers of the undertaking's business units (e.g. heads of departments, managing directors etc.).

27. Furthermore, the CEO of a financial undertaking and/or manager of a business unit shall take the initiative in informing the compliance function specifically and in good time if they possess information of which the compliance function must be made aware. This applies, for example, to circumstances of which the compliance function is not aware but which could possibly create conflicts of interest.

#### **2.4 Compliance function's authority and remedies**

28. A financial undertaking must ensure that its compliance function has the necessary authority and remedies to fulfil its duties. Ensuring its independence is a prerequisite for compliance to be considered to have such authority and to be able to apply the measures it provides.

29. FME recommends that specific procedures be defined within a financial undertaking which specify the authorisations and measures of the compliance function, and furthermore describe how they are to be applied.

30. The procedures are expected to be developed by the Compliance Officer in co-operation with the CEO and approved by the latter. The procedures shall be specifically presented to all managers of business units. Financial undertakings are to ensure that employees who handle actual securities trading and are subject to supervision by the Compliance Officer are made aware of the above-mentioned procedures when commencing employment and of all modifications to them.

31. In FME's estimation, it is appropriate to include in the Compliance Officer's authorisations the right to demand improvements within specific business units if the Compliance Officer considers

this necessary and, as the case may be, to raise objections to an employee's working practices. The Compliance Officer shall then direct demands for improvements to the manager of the business unit. If the Compliance Officer raises objections to an employee's working practices, he/she shall notify the manager of the business unit thereof at the same time as the employee is notified. It is the responsibility of the manager concerned to make the changes required and respond to the Compliance Officer's recommendations.

32. The compliance function shall follow up on demands for improvements and/or objections, thus ensuring that the financial undertaking always fulfils its obligations pursuant to laws and rules. The manager of the business unit shall inform the Compliance Officer of the changes made and the manner in which the Compliance Officer's recommendations have been responded to; the compliance function is responsible for monitoring and assessing those actions taken to rectify the undertaking's deficiencies in compliance.

33. The Compliance Officer shall inform the financial undertaking's CEO immediately if serious violations to laws or rules occur, in the Compliance Officer's opinion. The same applies if the Compliance Officer considers it likely that a violation will occur in connection with a specific case. The Compliance Officer shall also notify the financial undertaking's Board of Directors of such, without involving the CEO, if he/she considers this urgently necessary. Such a matter shall be dealt with at a Board meeting and entered in the minutes; the Compliance Officer shall be entitled to attend this Board meeting. Following such notification, the Compliance Officer shall demand improvements and/or raise objections as provided for above.

34. The Compliance Officer shall inform FME if his/her demands for improvements and/or objections in connection with serious violations do not result in the intended response and the Compliance Officer is of the opinion that the actions taken are insufficient. The Compliance Officer shall also inform FME in the case of flagrant and/or repeated violations.

## **2.5 Compliance's reporting to senior management**

35. The Compliance Officer is responsible for all reporting to senior management concerning matters subject to his/her supervision. Senior management shall receive at regular intervals, and at least once each year, written reports on compliance issues, specifying in particular whether suitable measures have been taken if deficiencies have been found in activities. Senior management is to regularly assess and review the efficacy of the policy, arrangements and procedures which have been established to fulfil statutory requirements and to take suitable measures to rectify any deficiencies.

36. Point 12 of Art. 2 of Reg. No. 955/2007 defines the concept of senior management as directors, the CEO and managing director of a financial undertaking.<sup>4</sup> FME recommends, however, that the Board of Directors and CEO (the managing director of a financial undertaking, as the

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<sup>4</sup> Based on Commission Directive 2006/73/EC, of 10 August 2006, implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive. According to Point 9 of Paragraph 2 of this Directive, "*senior management*" means the person or persons who effectively direct the business of the investment firm as referred to in Article 9(1) of Directive 2004/39/EC. The concept has in this context been translated in Icelandic by *yfirstjórn*, cf. "*yfirstjórn*": one or more persons who effectively direct the business of the investment firm as referred to in Paragraph 1 of Article 9 of Directive 2004/39/EC".

concept is applied in the Act on Financial Undertakings),<sup>5</sup> receive regularly and at least once each year<sup>6</sup> the above-mentioned report of the compliance function, including the following points:

- a. A discussion of the status of the Compliance Officer and compliance function within the financial undertaking. The Compliance Officer is expected to assess the situation based on applicable laws and rules as well as these Guidelines (see Sections 2.1-2.4). The Compliance Officer shall give an account of objections raised and proposals for improvements. The Compliance Officer shall explain specifically whether he/she considers the authorisations and remedies available under the procedures developed to be sufficient.
- b. The Compliance Officer shall give an account of the tasks carried out by the compliance function since the last report, cf. Section 3, including a summary of the instances where authority was invoked or measures applied, cf. Section 2.4. Specific mention shall be made of any repeated demands for improvements within individual business units of the financial undertaking or of repeated objections to the work of individual employees.
- c. In view of the responsibility and role of the Board of Directors, FME recommends that this report give an account of the risk factors which the Compliance Officer deems could exist in connection with the financial undertaking's securities trading.

37. The Compliance Officer is expected to attend a Board meeting, give an account of the report and reply to directors' questions and comments. The financial undertaking's Board of Directors is also expected to respond to the Compliance Officer's comments and enter its response in the minutes.

38. FME recommends that the Compliance Officer and CEO of a financial undertaking hold regular meetings, e.g. quarterly, to discuss the status of compliance, its tasks, improvements, comments and the progress of compliance programmes within the financial undertaking. In addition to other issues of contention in connection with compliance work.

39. FME also recommends that the Compliance Officer deliver to the managers of the financial undertaking's business units involved in securities trading a regular report, at least once a year, on compliance issues concerning their units. This report shall specify in particular whether suitable measures have been taken, in the Compliance Officer's estimation, regarding any deficiencies.

## 2.6. Outsourcing compliance

40. The laws and rules applicable to activities of financial undertakings licensed to trade in securities do not limit their authorisation to outsource the compliance function. FME considers it necessary, however, to underline that the activities of an outsourced compliance function must always comply with laws, rules, a financial undertaking's internal criteria and these Guidelines. The

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<sup>5</sup> Point 6 of the first paragraph of Art. 1 of the Act on Financial Undertakings: "*Managing director [CEO]:* The person engaged by the Board of Directors of a financial undertaking to direct its operations in accordance with the provisions of the Companies Act or this Act, regardless of his/her title in other respects."

<sup>6</sup> FME urges larger financial undertakings to have the compliance function deliver a report to senior management at least twice yearly.

relevant considerations are similar to those concerning outsourcing of a financial undertaking's internal audit function.

41. FME recommends that the compliance function only be outsourced in instances where the financial undertaking cannot establish and maintain an effective compliance function whose independence of other aspects of the company's activities is ensured. FME also emphasises that the external party to which the compliance function is outsourced must possess adequate expertise in this area.

42. In those instances where a financial undertaking has properly outsourced to a third party tasks which would be part of the Compliance Officer's supervision, the Compliance Officer shall be responsible for supervision in accordance with the outsourcing; this shall be provided for in an agreement between the parties.

43. The Board of Directors of a financial undertaking shall see to it especially that the access of an external Compliance Officer to information is ensured, together with his/her authority and remedies.

44. The Board of Directors of a financial undertaking shall conclude a written agreement with the party concerned equivalent to a formal statement of the Compliance Officer's duties and shall treat this agreement as such (the formal statement of duties is discussed in Section 2.2). The parties' agreement must include, for instance, the following, in addition to the aspects contained in the formal statement of duties:

1. a general analysis of the tasks of the compliance function and the Compliance Officer's authority;
2. the Board of Directors, Internal Auditor and FME shall have access to all data in connection with compliance tasks;
3. the responsibility of the Board of Directors of the financial undertaking for the compliance function shall be underlined;
4. provision shall be made for arrangements giving the Compliance Officer access to data;
5. provisions on the term and termination of the agreement. Emphasis is placed on avoiding unrealistic demands regarding the scope of the work or cost;
6. provision shall be made for confidentiality.

45. FME regards it as desirable that the outsourcing contractor have access to work facilities on the premises of the financial undertaking, where he/she has ready access to information.

46. Similar concerns apply to the commencement and termination of the contractual relationship as apply to the appointment and departure of a financial undertaking's in-house Compliance Officer.

47. A financial undertaking shall analyse the impact of outsourcing the compliance function on its overall risk strategy and internal quality control system, for instance, with regard to the operational risk involved in outsourcing. FME recommends that a financial undertaking have a contingency plan to respond to possible termination of outsourced compliance, providing both for the selection of a new party and arrangements for ensuring compliance until a new outsourcing agreement is concluded.

48. Outsourcing of compliance may not result in the conclusion by the financial undertaking's Internal Audit or by FME that they cannot perform their tasks satisfactorily.

49. FME draws attention to the fact that, in addition to the above, outsourcing of tasks of UCITS and investment funds is subject to provisions of Act No. 128/2011 on UCITS, Investment Funds and Institutional Investor Funds; and Reg. No. 792/2003, on UCITS and Investment Funds.

50. In other respects reference is made to laws and rules, as well as these Guidelines, regarding outsourcing of the compliance function to external individuals.

### **3. Scope of a financial undertaking's compliance function**

51. A financial undertaking's compliance function is part of the undertaking's internal quality control system. The role of compliance is to monitor and assess on a regular basis the adequacy and efficacy of specific measures used by a financial undertaking and actions taken to rectify deficiencies in fulfilling its obligations pursuant to the Act on Securities Transactions. Closely related to this supervisory function is the role of compliance in providing employees of a financial undertaking, who are responsible for concluding securities transactions, with the necessary instruction, advice and assistance to enable them to fulfil the undertaking's obligations pursuant to the Act on Securities Transactions. It is also the role of compliance, for instance, to receive notifications from employees due to suspicion of market abuse and insider misconduct and to notify FME of such suspicions. Furthermore, the Board of Directors of a financial undertaking may entrust compliance with additional duties, as specified in the Compliance Officer's formal statement of duties, provided that such work is compatible with the responsibilities of compliance provided for in laws and rules and sufficient capacity exists to carry this out.

The following sections discuss individual aspects of the compliance function.

### 3.1 Supervision by compliance

#### 3.1.1 A financial undertaking's policies and processes concerning securities transactions

52. This discusses the organisation of financial undertakings licensed to trade in securities pursuant to the Act on Securities Transactions, which states that continuous and regular activities and services to clients should be ensured within the financial undertaking, including systems and work processes; undertakings must possess the necessary expertise and in addition have secure work procedures for management, accounting, internal quality control and risk management. A financial undertaking shall adopt rules and work processes ensuring that the company, its management, employees and tied agents comply with the laws and rules which apply to its activities. A detailed discussion of the organisational requirements of financial undertakings is found in Reg. No. 995/2007.

53. The first paragraph of Art. 6 of the Regulation states that financial undertakings shall establish and maintain adequate policies and processes designed to detect any risk of failure by the undertaking in question to comply with its obligations under the Act on Securities Transactions, and to put in place procedures to minimise such risk and enable the Financial Supervisory Authority to exercise its powers effectively. Measures taken by a financial undertaking for the purpose of satisfying the above requirements concerning compliance shall take into account the nature and scale of the undertaking's activities. In this connection a financial undertaking shall have regard for the general and specific rules of conduct in Chapter II of the Act on Securities Transactions and the Regulation adopted on its basis. The general rule of conduct is laid down in Art. 5 of the AST, which states that financial undertakings shall operate in accordance with proper and sound business procedures and practices in securities trading, with a view to ensuring the integrity of the financial market and client interests. The specific rules of conduct found in Chapter II of the AST are developed in more detail in the Regulation.

54. It is the role of the compliance function, according to subparagraph a of the third paragraph of Art. 6 of the Regulation, to monitor and assess on a regular basis the adequacy and efficacy of specific measures used by a financial undertaking and actions taken to rectify deficiencies in fulfilling its obligations.

55. The role of compliance is to examine at regular intervals whether a suitable policy and processes exist in the financial undertaking and to assess whether their substance complies with relevant laws and rules and whether they are sufficiently effective. The compliance function shall also have an overview of the policies and processes of the financial undertaking adopted to this end. In addition, the compliance function is to monitor regularly that these are complied with by employees.

56. Should any flaws/deficiencies be revealed in the policy and/or procedures of a financial undertaking, compliance shall be authorised to demand rectification by the business unit concerned. Should it be revealed that an employee does not comply properly with the policy and/or processes, compliance shall raise objections to his/her working practices. Compliance shall also follow up on such demands for improvements and objections, to ensure that the financial undertaking fulfils its obligations pursuant to laws and rules, including modifying its policy and processes if deemed necessary. In other respects reference is made to Section 2.4, *Authority and remedies available to the compliance function*, cf. also the procedures defined within the financial undertaking.

In addition, the following discussion will deal especially with particular aspects in connection with supervision by the compliance function.<sup>7</sup>

### **3.1.2 Client classification and assessment of client eligibility and suitability of financial services**

57. Investors shall be enabled to conclude securities transactions on equal footing by obliging financial undertakings to classify all their clients, inform them of the financial instruments, investment options and services on offer and provide them with advice and recommendations in accordance with their expertise, experience and financial capacity. By so doing, retail clients shall have access to the same opportunities as professional clients with regard to advice and access to trading systems and markets. Financial undertakings shall bear in mind the objectives of the provisions when preparing suitable policies, processes and procedures; the Compliance Officer shall pursue these objectives in his/her surveillance.

#### *a. Client Classification*

58. A financial undertaking shall classify its clients as retail clients, professional clients or eligible counterparties according to the statutory requirements. In addition, financial undertakings may classify their clients in various ways in general and in connection with various types of transactions.

59. A financial undertaking shall adopt procedures on client classification which define, for instance, criteria as to what products and services are available to clients, based on their classification, and the procedure to be followed in this regard, for instance, what should be done if an employee and/or the Compliance Officer becomes aware that a client no longer fulfils the requirements for the undertaking's classification. A financial undertaking should also maintain a register of all classification of its clients.

60. FME recommends that financial undertakings appoint one or more employees, however, not employee(s) of compliance, to be responsible for assessing clients' eligibility, as it may require a subjective assessment when a party requests a classification other than that originally given by the financial undertaking, both in general and for specific transactions.

61. FME recommends that the compliance functions of financial undertakings ensure that within a financial undertaking suitable procedures and processes exist for client classification and that employees follow them in their work.

62. Supervision by compliance includes, for instance, ensuring that clients are properly classified before concluding transactions and that the documentation which is used as a basis for their classification is updated as appropriate to provide the most accurate picture. In addition, it is part of compliance's supervision to ensure that notifications to clients of their classification accord with laws and rules, for instance, on their initial classification, changes to their classification and other aspects which may arise concerning parties' classification. Furthermore, compliance shall

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<sup>7</sup> It should be reiterated that this is not an exhaustive list. It should be borne in mind that Section 3.1 provides only a general discussion of individual aspects of investor protection, only for explanation purposes, to account for the participation of compliance of the financial undertaking.

ensure that a register is kept by the financial undertaking on classification of all clients and updated if changes occur.

63. The financial undertaking must have defined remedies available to the Compliance Officer if he/she is of the opinion that client classification does not satisfy laws and rules. The Compliance Officer thus shall be authorised to demand that the business unit concerned rectify its client classification with an amended and/or improved policy and processes as appropriate. The Compliance Officer shall also be authorised to raise objections to an employee's working practices. In other respects reference is made to Section 2.4, *Authority and remedies available to the compliance function*, cf. also the procedures defined within the financial undertaking.

*b. Assessment of client eligibility and suitability of financial services*

64. An assessment of whether certain securities transactions and certain services or goods are suitable for a client is one of the basic aspects of investor protection through which financial undertakings are obliged to ascertain that clients are competent to conclude certain transactions.

*Do certain securities transactions suit a client?*

65. When a financial undertaking provides a client with investment advice or handles asset management for a client the financial undertaking must gather specific information from the client in order to assess whether the client is qualified to conclude the requested transactions. The financial undertaking shall thereby ensure that the client has the understanding, expertise and experience to comprehend the risk involved in the securities and products in which the client intends to invest. Financial undertakings shall also only provide clients with advice on those investment options and risk which their financial situation allows.

66. FME recommends to financial undertakings that the compliance function supervise that an assessment of eligibility is made of clients. Satisfactory information must be obtained on the client's financial situation, objectives, understanding, expertise and experience to assess the client's eligibility; the compliance function shall ensure that the criteria applied by a financial undertaking accord with laws and rules. Financial undertakings are also advised to have compliance monitor that assessment of clients' eligibility is reviewed at regular intervals and updated, so as to give the best picture of a client's expertise, experience and financial position. Compliance shall also supervise whether transactions concluded on behalf of a client accord with the financial undertaking's assessment of the client's eligibility.

67. Measures must be designated within a financial undertaking which the Compliance Officer can take should he/she be of the opinion that assessment of clients' eligibility does not satisfy applicable laws and rules. The Compliance Officer shall be authorised, for instance, to demand that assessment of clients' eligibility be updated, renewed or redone following amended and/or improved procedures and processes, as appropriate. The Compliance Officer shall furthermore be authorised to raise objections to an employee's working practices. In other respects reference is made to Section 2.4, *Authority and remedies available to the compliance function*, cf. also the procedures defined within the financial undertaking.



*Is a certain service or product suitable for a client?*

68. When a financial undertaking provides its clients with securities trading services other than investment advice or asset management, it must obtain information on the expertise and experience of the client or potential client and the client's understanding, in order to be able to assess whether the requested investment, service or product is suitable for the client.

69. FME recommends to financial undertakings that the compliance function supervise that assessment of the suitability of transactions is made of clients. Furthermore, satisfactory information must be obtained on the client's expertise and experience when the suitability of a client's transactions is assessed; the compliance function shall ensure that the criteria applied by a financial undertaking accord with laws and rules. Financial undertakings are also advised to have compliance monitor that assessment of the suitability of transactions is reviewed at regular intervals and updated, so as to give the best picture of a client's expertise and experience. Compliance shall also supervise whether transactions concluded on behalf of a client accord with the financial undertaking's assessment of the suitability of transactions for the client.

70. Measures must be designated within a financial undertaking which the Compliance Officer can take should he/she be of the opinion that assessment of the suitability of clients' transactions does not satisfy applicable laws and rules. The Compliance Officer shall be authorised, for instance, to demand that assessment of the suitability of clients' transactions be updated, renewed or redone following amended and/or improved procedures and processes, as appropriate. The Compliance Officer shall furthermore be authorised to raise objections to an employee's working practices. In other respects reference is made to Section 2.4, *Authority and remedies available to the compliance function*, cf. also the procedures defined within the financial undertaking.

### **3.1.3 Information disclosure to customers**

71. Detailed rules apply concerning what information financial undertakings are to disclose to their customers and how they may market securities trading services. Information intended for customers, including marketing material, must be prepared so that the information is clear and fair and may not be misleading. The information must enable customers to make an informed investment decision.

72. Financial undertakings should therefore ensure that those employees who are involved in preparing and presenting information, including marketing material, contracts and summaries of financial instruments and risk, which are intended for clients, have sufficient expertise in the area concerned to ensure that the information complies with the undertaking's policy on information disclosure to clients, which must accord with laws and rules. Preparation of such must also accord with the undertaking's defined processes.

73. FME recommends to financial undertakings that the compliance function regularly monitor that information intended for clients, including marketing material, contracts and summaries of financial instruments and risk, accord with the undertaking's defined policy. In this connection it is important that Compliance Officers have ready access to real-time information in this connection within the financial undertaking, are, for instance, informed of plans in this regard and changes to be made, and have, for example, access to meetings within the financial undertaking in this

connection, cf. also the discussion in Section 2.3. The compliance function shall ensure that such work accords with the undertaking's defined processes.

74. Measures must be designated within a financial undertaking which the Compliance Officer can take should he/she be of the opinion that information intended for clients does not satisfy the undertaking's policy. The Compliance Officer shall, for instance, be authorised to prevent or suspend the publication of certain information for clients. The Compliance Officer shall also be authorised to raise objections to an employee's working practices. In other respects reference is made to Section 2.4. *Authority and remedies available to the compliance function*, cf. also the procedures defined within the financial undertaking.

#### **3.1.4 Order execution and best execution of transactions**

##### *Order execution*

75. A financial undertaking shall execute client orders promptly and fairly and in a specified proper order. Orders shall be immediately and precisely recorded and directed through the proper channel. A financial undertaking must therefore have a designated policy and processes to ensure that those employees who receive client orders always execute them in accordance with laws and regulations.

76. FME recommends to financial undertakings that the compliance function supervise that a suitable policy and processes exist in the financial undertaking and that they accord with laws and rules. Compliance shall also monitor that they are sufficiently effective. Furthermore, compliance shall monitor that employees execute orders in accordance with the above.

##### *Best execution*

77. A financial undertaking shall achieve best execution for its clients based on the objectives and expectations of the client concerned regarding the investment and should have designated processes and procedures to ensure the best possible outcome for clients, having regard to many specified interrelated factors. A financial undertaking must take the necessary measures to fulfil its obligations, including having access to systems which enable it to achieve best execution for its clients, based on the services that the financial undertaking concerned offers its clients. A financial undertaking shall adopt procedures on best execution and should review and revise these procedures at least annually.

78. FME recommends to financial undertakings that the compliance function ensure that procedures exist within a financial undertaking so that efforts are always made to achieve best execution for clients, that this execution complies with laws and rules and that its efficacy is satisfactory. FME also recommends that the compliance function monitor that clients are always informed of the financial undertaking's policy on best execution and that they agree to this before concluding transactions. FME recommends to financial undertakings that the compliance function also ensure that best execution policy is reviewed and updated, in order to always provide the best picture of how the financial undertaking intends to obtain best execution for its clients.

79. FME emphasises that the Compliance Officer have an overview of the financial undertaking's implementation of its best execution policy. In this connection, FME recommends that

the compliance function participate in designating and developing those measures which the financial undertaking intends to take to achieve best execution in this regard.

80. Within a financial undertaking, measures must always be designated which the Compliance Officer can take concerning order execution and best execution of orders. The Compliance Officer must have designated measures available if deficiencies are revealed in this connection and he/she shall demand improvements as appropriate. The Compliance Officer shall also be authorised to raise objections with an employee if appropriate. In other respects reference is made to Section 2.4, *Authority and remedies available to the compliance function*, cf. also the procedures defined within the financial undertaking.

### 3.1.5 Conflicts of Interest

81. A financial undertaking shall take all available measures to prevent conflicts of interest from damaging the interests of its clients. It must detect potential conflicts of interest between clients and also between the financial undertaking itself, including its employees, and its clients.<sup>8</sup> Financial Undertakings shall also set and maintain an effective, written policy against conflicts of interest and maintain a register of the activities where risk of such conflicts has arisen.

82. Compliance's supervision shall ensure that a policy to counter conflicts of interests exists within a financial undertaking, which defines those conflicts of interest which the undertaking considers could arise in its activities and describes the measures which the financial undertaking intends to take to prevent conflicts of interest. Furthermore, the compliance function shall ensure that the internal structure, rules, processes and similar aspects within the financial undertaking accord with the company's policy. The same applies to the financial undertaking's record of activities where a risk of conflicts of interest has arisen.

83. FME emphasises that the Compliance Officer have an overview of the conflicts of interest which could arise in the financial undertaking's activities, including between its business units, and which could be detrimental to clients' interests. In this connection, FME recommends that the compliance function assist and/or provide advice in defining conflicts of interest concerning these aspects.

84. The compliance function shall ensure that the above-mentioned policy is followed and that a response is effected if conflicts of interest, which have not already been defined, arise or could conceivably arise. In this connection it is important that Compliance Officers have ready access to real-time information in this connection within the financial undertaking, including access to meetings, cf. the discussion in Section 2.3. Furthermore, the CEO or managers of individual business units within the financial undertaking shall notify the Compliance Officer specifically and in good time of conflicts of interest or potential conflicts of interest which have not been defined in advance.

85. Should circumstances or events arise which, in the Compliance Officer's estimation, could create conflicts of interest detrimental to clients' interests and/or to prevent certain circumstances or events from arising, the Compliance Officer must have designated measures which he/she can

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<sup>8</sup> It should be underlined that this involves defining internal conflicts of interest in the financial undertaking, i.e. between business units within the financial undertaking as appropriate.

apply in response to such events or circumstances. The Compliance Officer therefore must have the authority, for instance, to intervene in individual transactions. The Compliance Officer shall furthermore have designated measures to apply if transactions have been concluded.

86. FME recommends to financial undertakings' compliance functions that they ensure that the undertaking's policy to prevent conflicts of interest be reviewed and updated regularly, so that it always presents the best picture of those instances which the undertaking considers could create conflicts of interests. It is especially important to review and update the policy if deficiencies have been revealed, and a demand made to the business unit concerned for improvements. The Compliance Officer shall also be authorised to raise objections to an employee's working practices if appropriate. In addition, the compliance function shall ensure that a record of the activities where a risk of conflicts of interest has arisen is updated regularly. In other respects reference is made to Section 2.4, *Authority and remedies available to the compliance function*, cf. also the procedures defined by the financial undertaking.

### **3.1.6 Own transactions by employees of a financial undertaking**

87. A financial undertaking must have arrangements to ensure that transactions by its employees comply with the laws and rules applicable to such transactions. Thus a financial undertaking should ensure that those employees involved in activities which could create conflicts of interest or who have access to inside information, in the understanding of the Act on Securities Transactions, or other confidential information connected to clients or transactions with or for clients, do not undertake transactions which could cause conflicts of interest or avail themselves of the above-mentioned information in violation of laws and rules.

88. FME recommends to financial undertakings' compliance functions that they that see to it that arrangements exist within the undertaking to make sure that employees' own transactions are concluded lawfully, for instance by adopting a policy on employees' own transactions and processes to handle such transactions. Compliance's supervision shall also include ensuring employees follow these arrangements. The Compliance Officer must have designated measures available if deficiencies are revealed in this connection and shall demand improvements as appropriate. The Compliance Officer shall also be authorised to raise objections with the employee concerned. In other respects reference is made to Section 2.4, *Authority and remedies available to the compliance function* and to the procedures defined within the financial undertaking.

89. FME also recommends to financial undertakings that all transactions by employees, executed by that financial undertaking or by others, be notified to the compliance function before the transaction is concluded and that compliance keep a record of all employee transactions.

### **3.1.7 Products**

90. When a financial undertaking intends to offer its clients a new product or service in securities transactions and/or offers its clients access to new markets or trading systems, the financial undertaking shall ensure that the innovation offered fits the eligibility of the clients in question, is suitable for the clients it is intended for, and accords with the financial undertaking's best execution and its policy against conflicts of interest.

91. Thus financial undertakings should ensure that those employees involved in the preparation, production and presentation of new products intended for customers, have sufficient expertise in the area concerned to ensure that information satisfies the provisions of laws and rules. FME recommends that the compliance function be an *advisor* in the initial stages of the process of developing a new product and supervise that new products which are intended for customers comply with laws and rules. For this reason it is important that Compliance Officers have ready access to real-time information in this connection within the financial undertaking, including access to meetings, cf. the discussion in Section 2.3.

92. Measures must be designated within a financial undertaking which the Compliance Officer can take should he/she be of the opinion that new products, intended for clients, do not satisfy applicable laws and rules. The Compliance Officer shall, for instance, be authorised to prevent or suspend the offering of certain products. The Compliance Officer shall also be authorised to raise objections to an employee's working practices. In other respects reference is made to Section 2.4, *Authority and remedies available to the compliance function*, cf. also the procedures defined within the financial undertaking

### **3.1.8 Handling of complaints**

93. Financial undertakings shall have a transparent procedure to ensure that handling and resolution of complaints from retail clients or potential retail clients in connection with securities transactions is prompt and fair. Financial undertakings should also keep a record of all complaints received and their resolution.

94. FME recommends to the compliance functions of financial undertakings that they ensure the handling of complaints in the financial undertaking complies with the provisions of laws and rules. Following the handling of a complaint, the policy and/or processes which the substance of the complaint concerns shall be reviewed if necessary. The compliance function shall demand improvements and/or raise objections as appropriate. It is up to compliance to monitor and assess those actions taken to rectify the company's deficiencies in satisfying its obligations. In other respects reference is made to Section 2.4, *Authority and remedies available to the compliance function*, cf. also the procedures defined by the financial undertaking.

### **3.1.9 Public investment advice**

95. If a financial undertaking provides public investment advice, it must be ensured that the information is presented in accordance with FME's Rules on Public Investment Advice, No. 1013, of 2 November 2007. Regarding supervision by the Compliance Officer of public investment advice, reference is made to Art. 10 of the Rules.

## **3.2 Instruction, advice and assistance from compliance**

96. Financial undertakings shall ensure continuous and regular activities and services for their customers, for instance, by having the necessary expertise within the company. Part of the role of compliance is to provide employees of a financial undertaking, who are responsible for concluding securities transactions, with the necessary instruction, advice and assistance to enable them to fulfil the undertaking's obligations pursuant to the Act on Securities Transactions.

97. Employees who work on concluding securities transactions must be informed especially of the activities of the compliance function, its authorisations and remedies, as well as compliance's authorisation to access information within the financial undertaking. Furthermore, employees authorisation to seek assistance and/or advice from the compliance function must be explained, and the details of how compliance's assistance and advice is provided shall be defined by the compliance function.

98. Employees shall be given instruction on market abuse and intermediation by a financial undertaking, as referred to in Art. 117 of the AST, and on insider misconduct and intermediation by a financial undertaking, as referred to in Articles 123-124 of the same Act. Employees must be made specifically aware of the obligation to notify which rests upon them if suspicions arise of possible misconduct, as well as the role of the immediate superior and Compliance Officer in this regard.

99. FME emphasises that instruction of employees should begin upon the commencement of their employment and take place subsequently at regular intervals during their employment. FME recommends that a schedule be followed on how employee instruction should be effected. The Compliance Officer and managers of the relevant business units in the financial undertaking shall together assess the need for instruction to employees of each unit. The need for instruction of employees and updating instructional and promotional material shall be assessed at regular intervals.

### **3.3 Market abuse**

100. The Act on Securities Transactions states that if an employee of a financial undertaking suspects market abuse, as referred to in Art. 117 of the AST, and/or insider misconduct, as referred to in Art. 123 of the AST, the employee must at once inform his/her immediate superior or the Compliance Officer, as provided for in the third paragraph of Art. 117 and the second paragraph of Art. 124 of the AST. The company concerned must inform the FME immediately of such suspicions; the employee may do so as well.

101. FME recommends that, when an employee notifies his/her immediate superior of suspicions of this sort, the latter shall inform the compliance function of the notification, and the undertaking (i.e. the Compliance Officer, the immediate superior or the employee) is to inform FME immediately of such suspicions.

102. FME recommends to financial undertakings that they draft a special policy within the undertaking in connection with employees' response if suspicion arises of market abuse and/or insider misconduct and that a process be prepared within the financial undertaking for such cases, for instance, on how employees should respond and how the information that FME has been notified of the said suspicion is treated. FME also recommends that the Compliance Officer stress the importance of confidentiality to those parties who have information on the employee's suspicions.

103. The compliance function is to examine whether policy and processes exist in the financial undertaking for this purpose and assess whether their substance complies with relevant laws and rules and whether they are sufficiently effective. In addition, the compliance function shall regularly

check that employees work in accordance with the policy and processes; should it be revealed that an employee does not comply with them, compliance shall raise objections to his/her working practices. The compliance function shall also follow up on such demands for improvements and objections, to ensure that the financial undertaking fulfils its obligations pursuant to laws and rules, including modifying its policy and processes if deemed necessary. In other respects reference is made to Section 2.4, *Authority and remedies available to the compliance function*, cf. also the procedures defined within the financial undertaking.

### **3.4 Additional duties of compliance**

104. A financial undertaking shall ensure that employees who work in compliance are not involved in the performance of services or activities which they supervise. A financial undertaking, in exceptional instances, may not be obliged to ensure this if it can demonstrate that, given the nature and scale of its activities, these requirements are too onerous and that its compliance function is satisfactory in other respects.

105. FME recommends that if a Board of Directors entrusts the compliance function with performance of a service or activity, which compliance does not supervise, then this should be specified in the Compliance Officer's formal statement of duties. FME considers it important that any such additional duties comply with the role of the compliance function as provided for in the Act on Securities Transactions and Regulations adopted on its basis and that sufficient capacity exists in compliance work to carry this out.

106. In this connection, FME points out that the Compliance Officer may be appointed as Reporting Officer on actions to combat money laundering and terrorist financing, since he/she is a member of the senior management of the financial undertaking, as referred to in Act No. 64/2006, cf. FME Guidelines No. 3/2011.

Reykjavík, 12 December 2011

FINANCIAL SUPERVISORY AUTHORITY

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