



FINANCIAL SERVICES COMMISSION

Securities Release Management Discussion & Analysis ("MD&A")

Target Audience: Licensed Securities Dealers

Background

In 1999, the Securities Commission (predecessor to the Financial Services Commission) recognized the need for the disclosure of information over and above that which is provided in the management accounts and the audited financial statements filed by licensed securities dealers. These financial statements with accompanying notes may not provide sufficient information to enable investors, the Commission or other users to judge the quality of earnings, the likelihood that past performance is indicative of future performance and the dealers general financial condition and outlook.

The compilation and filing of the MD&A was therefore mandated to afford users the opportunity to view the dealer's business from the vantage point of management. This objective would be achieved by provision of both a short and long-term analysis of the business of the company, with particular emphasis on the licensee's prospects for the future and an identification of and discussion on, those factors and events, which could impact those prospects.

Based on the recognition of the need for this information, the then Securities Commission in the promulgation of The Securities (Conduct of Business) Regulations 1999 as amended, included the requirement for a report in the form of the MD&A. The requirement is set out in regulations 13(3) and 14 (3)(b) of those regulations. The experience over the period since the promulgation of the regulations is that dealers have had varying interpretations of what the MD&A report should contain. Invariably, the result is that reports filed with the Commission often fall short of the Commission's expectation and as a result have failed to provide the additional information to users of financial statements that were intended.

Recent developments in financial markets have led to heightened investor interest in receiving company-generated information aimed at assisting them in coming to an understanding of the factors that impact performance. Traditional financial statements do not provide much of this information. At the same time investors have become increasingly concerned about the sufficiency of disclosure regarding liquidity and market risks, and effects of "off-balance sheet" transactions and special purpose vehicles on operating results.

This release is intended to provide guidance to directors and management of licensed securities dealers, on disclosures to investors that could be reasonably expected if they are to form a reasoned view of the licensee's business.

When is Disclosure Required?

There are no set prescriptions for the situation in which a disclosure should be made. Generally however, a disclosure should be made where there is a known trend or uncertainty that is reasonably likely to have a material effect on the licensee's financial condition or results of operations. Accordingly, the development of a MD&A disclosure should begin with management's identification and evaluation of what information, including the potential effects of known trends, commitments, events and uncertainties are important to providing investors and other stakeholders with an understanding of the company's current and prospective financial position and its operating results.

Full and fair disclosure, typically in the form of the periodic MD&A, is one of the primary methods employed to address this information requirement.

What Should Management Disclose to Investors?

While there is no limit to the breadth of matters that an MD&A should consider and report on, it would be expected to include commentary on the following key areas of the dealer's business:

- i) Liquidity and Capital Resources (including off-balance sheet arrangements)
- ii) Effects of Transactions with Related Parties
- iii) Activity involving derivatives
- iv) Result of Operations

LIQUIDITY AND CAPITAL RESOURCES (INCLUDING OFF-BALANCE SHEET ARRANGEMENTS)

a) Disclosures Concerning Liquidity and Capital Resources

The liquidity and capital resources of a securities dealer are closely aligned. This relationship is recognized and reflected in The Securities (Licensing and Registration) Regulations 1996 as amended at regulations 2(2) and 2(3). Disclosures about each are likely to be affected by many of the same facts and circumstances. Management should consider these items together, as well as individually, when preparing disclosures responsive to the objectives of a MD&A report.

The key decision for management is to identify any known trends or demands, commitments, events or uncertainties that will result in or is “reasonably likely” to increase or decrease the licensee’s liquidity in any way. Management should also describe the sources of short-term funding and the circumstances that are reasonably likely to affect those sources of liquidity.

To identify trends, demands, commitments, events and uncertainties that require disclosure, management should consider the following:

- i) Provisions contained in financial guarantees or commitments, debt or lease agreements or other arrangements that could trigger a requirement for an early payment, additional collateral support, changes in terms, acceleration of maturity, or the creation of an additional financial obligation such as adverse changes in the licensee’s financial ratios, earnings, cash flows or stock price or changes in the value of underlying, linked or indexed assets
- ii) Circumstances that could impair the licensee’s ability to continue to engage in transactions that have been integral to historical operations or are financially or operationally essential or that could render that activity commercially impracticable such as the inability to maintain a specified level of earnings, earnings per share, financial ratios or collateral
- iii) Factors specific to the licensee and its markets that the licensee expects will affect its ability to raise short-term and long-term financing; guarantees of debt or other commitment to third parties; and written options on non-financial assets.

Management should hold discussion on the relevant maturity grouping of assets and liabilities based on the remaining period at the balance sheet date to the contractual maturity date. Commentary should provide information about effective periods and the way the risks associated with different maturity and interest profiles are managed and controlled.

b) Off Balance Sheet Arrangements

Licensees should provide disclosures concerning transactions, arrangements and other relationships with unconsolidated entities or other persons that are reasonably likely to materially affect liquidity or the availability of, or requirements for capital resources.

The extent of the licensee’s reliance on off-balance sheet arrangements should be described fully and clearly where those entities provide financing, liquidity, market or credit risk support for the licensee; engage in derivatives transactions , research and development services with the licensee; or expose the licensee to liability that is not reflected on the face of the financial statements.

Licensees should include information about off-balance sheet arrangements. The information should include their business purposes and activities, their economic

substance, the key terms and conditions of any commitments, the initial on-going relationships with the licensee and its affiliates and the potential risk exposures resulting from its contractual or other commitments involving the off-balance sheet arrangements.

Other disclosures that licensees should consider in order to explain the effects and risks of off-balance sheet arrangements include the following:

- i) The total amount of assets and obligations of the off-balance sheet entity, with a description of the nature of its assets and obligations and an identification of the class and amount of any of its debt or equity securities held by the licensee
- ii) The effects on the licensee's business and financial condition of the entity's termination if it has a finite life or it is reasonably likely that the licensee's arrangements with the entity may be discontinued in the foreseeable future
- iii) Extended payment terms of receivables, loans and debt securities resulting from arrangements and any uncertainties as to realization including repayment that is contingent upon the future operations or performance of any party
- iv) The amounts and key terms and conditions of purchase and sale agreements between the licensee and the counter-parties in any such arrangements
- v) The amount of any guarantees, lines of credit, standby letters of credit or commitments or other similar types of arrangements, including leasing arrangements

DISCLOSURES REGARDING EFFECTS OF TRANSACTIONS WITH RELATED PARTIES

A related party transaction comprises a transfer of resources or obligations between related parties, regardless of whether or not a price is charged and includes transactions concluded on an arm's-length basis. Related party relationships can and do have a significant influence on the financial position and operating results of many reporting dealers.

Where related party transactions are material, the MD&A should include discussion of those transactions to the extent necessary for an understanding of the company's current and prospective financial position and operating results. Discussions of the following are necessary:

- i) Identification of the related parties transacting business with the licensee
- ii) Business purpose of the arrangement
- iii) How transaction prices are determined by the parties, in particular whether they are determined at arm's-length

- iv) Whether or not exposure limits have been set for related companies and whether the transactions fall within these limits.

Related party relationships are a normal feature of commerce. Disclosure is aimed at defining related party relationships for the reader of the financial statements and should enable the formulation of a reasoned assessment of the impact of the relationship on results and outlook of the reporting entity.

DISCLOSURES REGARDING ACTIVITIES IN DERIVATIVE INSTRUMENTS

Dealing in derivative products whether on an own account basis as principal or on behalf of investors, requires extensive disclosures by dealers. This is due to the complexity and the high risks associated with derivatives. Licensees should therefore consider and determine the minimum disclosure standards regarding their activity in derivatives.

The Commission considers that as a minimum prior to engaging in derivatives, dealers should have established:

- i) A general risk management policy framework that describes the approach to management of risks inherent in derivative positions. This should include a discussion of management policies for controlling risks associated with financial instruments, including policies on matters such as hedging of risk exposures, avoidance of undue concentrations of risks and collateral requirements to mitigate risks
- ii) The criteria on which client suitability for these higher risk investment products is judged
- iii) Accounting policies including recognition criteria and the basis for measurement including an outline of the methods and assumptions applied in estimating fair values.
- iv) Disclosure of contingencies and commitments arising from interest and foreign exchange rate related items, including swaps, options and futures.

Where financial assets are carried in the financial statements in excess of fair value, dealers should disclose the carrying amount and fair value individually or for an appropriate group of assets. Disclosure should also be made of the reasons for not reducing the carrying amount, including evidence supporting their recoverability.

In addition to the general risk management framework, management should make disclosures conveying information related to the operations and financial results and effects of derivative positions, particularly in relation to the Income Statement.

In determination of the minimum disclosure standards, dealers should be guided by the requirements of the International Accounting Standards (“IAS”) and in particular IAS 32 and IAS 39.

RESULT OF OPERATIONS

In discussing results of operations, licensees should highlight the company’s products and services, facilities and future direction of the company. There should be a discussion of operating considerations and unusual events, which have influenced results for the reporting period. It is expected that operating considerations would include commentary about average interest rate, including average interest earning assets and average interest bearing liabilities for the period under review.

Additionally, any trends or uncertainties that might materially affect operating results in the future should be discussed.

CONCLUSION

This release is not meant to and could not exhaust either the approach or the matters and considerations that are to be brought to bear in the preparation and issue of a Management Discussion and Analysis report, pursuant to regulations 13 and 14 (3)(c) of The Securities (Conduct of Business) Regulations 1999. The FSC is issuing these guidelines in order to guide management as to the position and expectations of the FSC on the compilation of such a disclosure report.

In preparing MD&A disclosure, licensees should be guided by the general purpose of the MD&A report. As no two licensees are identical, a good disclosure report for one is not necessarily good for the other. Further, the report for the same licensee may differ from one period to the next. The MD&A requirements are therefore intentionally flexible and general.

For further information please contact the Securities Division

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