2022 Annual COMPLIANCE Report Card

BC Securities Commission
Invest Right

May 2023

This compliance report card summarizes the findings that our compliance teams made in the course of their reviews of the compliance programs of B.C.-based portfolio managers (Advisers), investment fund managers (IFMs), and exempt market dealers (EMDs) from January 1, 2022 to December 31, 2022.

We provide this report card to chief compliance officers (CCOs) and compliance professionals to help them improve their compliance programs. The report card highlights problem areas we saw and explains our approach to compliance examinations.

Our firms

At December 31, 2022, the British Columbia Securities Commission (BCSC) had 159 directly registered firms (excluding IIROC and MFDA firms). Based on the nature of each firm's business, our directly registered firms consisted of:

- 85 Adviser firms (including IFMs), that the Adviser/IFM compliance team oversees
- 74 Dealer firms (including EMDs), that the Dealer compliance team oversees

Our approach to regulation – risk and outcomes based

Our goal is to foster a culture of compliance among market participants. Where we find serious, systemic or repeat compliance failures or dishonest conduct, we will take decisive action. The past year, we found significant failures of compliance that resulted in the imposition of terms and conditions on registration and/or a referral to our Enforcement branch.

We help our registered firms foster a culture of compliance by assigning dedicated relationship managers (RMs) to each firm. Our RMs maintain communications with the firms assigned to them. They understand each firm's business and compliance program. We encourage firms to contact their RMs to discuss compliance-related issues or to report changes in their business or personnel. Please contact us if you do not know your RM (see contact details at the end of this report card).

To gage compliance among the firms we regulate, the BCSC has developed a new risk model that is more efficient and easier to complete. We will introduce the new risk questionnaire in June 2023. Risk questionnaire responses help us identify new information for registrants such as significant growth, management changes, new products, and higher risk investment strategies. The risk questionnaire information and the risk model help us choose firms with factors or patterns that may increase a firm's risk for our compliance examinations. We also include some firms for review based on the time elapsed since their last review. Once we choose a firm to review, we use the information we know about that firm to tailor our compliance review program to test any compliance risks we have identified.

If we receive information or complaints that indicate any market participant may be seriously non-compliant or dishonest, we may conduct a "for cause" review.

COMPLIANCE REVIEW FINDINGS - TOP DEFICIENCIES

In our compliance reviews of registrants, we tested 49 deficiency categories covering nine operational areas.

From January 1, 2022 to December 31, 2022, we conducted 27 compliance reviews and found 126 compliance deficiencies, averaging 4.85 deficiencies per review.

Year[1]	Average number of deficiencies per review
2022	4.85
2021	6.77
2020	8.14
2019	8.93
2018	6.57

Out of the 27 compliance reviews, 17 reviews were part of the Canadian Securities Administrators (CSA) Client Focused Reforms - Conflicts of Interest sweep where we mostly identified deficiencies limited to conflicts of interest. These limited scope reviews contributed to a comparatively lower average number of deficiencies in 2022. The average number of deficiencies per firm is meant to be a reference and not a definitive measure of a firm's compliance status.

The five top ranking deficiencies in 2022, averaged between EMD and Adviser/IFM businesses, represent 92 out of 126 (approximately 73%) of all of the compliance deficiencies we found, as follows:

Deficiency type	Number of Deficiencies	% of all Deficiencies	*Average overall rank*
Policies and procedures	24	19%	1
Conflicts of interest (COI)	23	18%	2
Advertising, marketing and holding out	14	11%	3
Client statements and reporting	13	10%	4
Know-your-client (KYC) and suitability	9	7%	5
Records	9	7%	5
Total	92/126	73%	

Examples of the compliance deficiencies we found in the above deficiency categories and in the other categories we examined are set out below.

[1]For 2021, the deficiency tracking period is from January 1, 2021 to December 31, 2021, and for 2020, the tracking period is from April 1, 2019 to December 31, 2020. For all other previous years, the deficiency tracking period is from April 1 of the previous year to March 31 of the noted year (for example the tracking period for 2018 is from April 1, 2017 to March 31, 2018)

Alongside other members of the CSA, both compliance teams participated in a sweep to review the implementation of the conflict of interest (COI) provisions included in the Client Focused Reforms (CFRs). This focused review resulted in a significant increase in the identification of deficiencies related to COIs.

The CSA has published guidance on the CFRs (including COIs) in the companion policy to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103CP) as well as *Client Focused Reforms: Frequently Asked Questions* last published on April 29, 2022 (FAQs). The CSA is considering the next steps as a result of the sweep; and we share some of the observations from the sweep.

Registered firms must take reasonable steps to identify material COIs between the firm and the client, and between each individual acting on the firm's behalf and the client. Material COIs between a client and the firm, including each individual acting on its behalf, must be addressed in the best interest of the client. If the conflict is not, or cannot be addressed in the best interest of the client, then the conflict must be avoided.

Approximately 50% of the COI deficiencies found in adviser/IFM firms relate to the firms' process in dealing with COIs, which include mechanisms to adequately identify, assess, address, and/or disclose material COIs.

Failure to identify COI

The first step in the COI process is to identify what conflicts exist at a firm. Some firms responded to the sweep that they had no material COIs in their business. However, these firms failed to recognize common material COIs such as personal trading, outside business activities, and fair allocation of investment opportunities. We expect firms to consider all circumstances where the interests of the firm and/or its registered individuals do not align with the interests of clients, and the existence of such circumstances may be reasonably expected to affect either or both of the decisions of the client and the registrant. NI 31-103CP discusses examples of conflicts of interest, but each firm will need to consider any conflicts that are specific to the firm's unique operations.

Failure to adequately assess and address COIs:
We observed that some firms identified COIs, but failed to conduct any assessment of the conflicts or determine any mitigation or resolution to address the conflicts.

Some firms identified COIs but incorrectly assessed them as immaterial and did not put any controls in place for the conflicts. To determine if a conflict is material, a firm needs to consider whether the conflict may be reasonably expected to affect either, or both of the following: the decisions of the client in the circumstances, and the recommendations or decisions of the registrant in the circumstances.

Failure to adequately disclose COIs
Our sweep identified some firms that failed to provide updated COI disclosure to their clients immediately after June 30, 2021, when the CFR COI requirements came into effect. While other firms provided updated COI disclosures, some did not meet the requirements of section 13.4(5) of NI 31-103.

Firms did not meet the disclosure requirements in NI 31-103 because their disclosure did not clearly describe:

- the nature and extent of the conflict of interest
- the potential impact on and risk that the conflict of interest could pose to the client, and
- how the conflict of interest has been, or will be, addressed.

We also identified material conflicts in firms' internal COI documents that were not disclosed to clients. Some firms provided a boiler plate COI disclosure to clients that included conflicts that did not exist at the firm or provided disclosure that was not meaningful to clients.

A registered firm must disclose in writing **all** material COIs to a client whose interests are affected by the COI, that a reasonable client would expect to be informed of. Like any other client disclosure, the registered firm should provide information in a clear and meaningful manner in order to ensure clients understand the information. Registrants should ensure that clients or potential clients can readily understand the information. These requirements are consistent with the obligation to deal fairly, honestly and in good faith with clients.

Inadequate policies and procedures and COI records
Approximately 50% of the COI deficiencies found in adviser/IFM firms relate to the lack of policies and procedures for specific conflicts, such as gifting and referral arrangements. A few firms had no written policies and procedures to identify, assess, and respond to COIs.

Some firms appropriately identified material COIs when responding to the sweep questions. However, not all material COIs that were identified were listed in the policies and procedures manual where there should be documentation on how the firm addresses and controls the material COI. Some firms have a COI matrix but failed to provide the information to its employees.

The top COI deficiencies for the Adviser/IFM team are from the following areas:

Referral arrangements

A few firms we reviewed during the sweep have referral arrangements that pay referral agents, such as financial planners, for referring clients to the firms. Material COIs almost always exist in paid referral arrangements. Firms with paid referral arrangements have an incentive to accept referred clients to grow their assets under management and management fee revenue. Referral agents have an incentive to refer clients in order to receive referral fees. The arrangement creates a situation in which both the registered firm and referral agent can put their interests ahead of clients' interests. Some adviser/IFM firms failed to identify any material COIs in these arrangements and incorrectly disclosed to clients that no material COIs existed as a result of the paid referral arrangements.

A referral fee is not necessarily a monetary payment to the referral party. Under the expanded definition of "referral fee", it is any benefit provided for the referral of a client to or from a registrant. Some adviser/IFM firms have set up service fee collection arrangements with unregistered financial planners whereby the financial planner refers a client to a registered firm for its portfolio management services and the registered firm has agreed to deduct both financial planning fees and portfolio management fees from the client's account, with the former being remitted to the financial planner. While there is no monetary payment paid by the registrant, there are clearly benefits to both the firm and the financial planner since the firm benefits from increased assets under management and management fees, while the financial planner benefits from receiving fees. Some firms failed to recognize this scenario as a referral arrangement, and that these arrangements may not always be in the best interest of the client.

The majority of firms that have paid referral arrangements provide disclosure to their clients. However, some of these written disclosures failed to describe:

- The nature and extent of the COIs, including a description of the situation where the interests of the firm and/or the registered individual acting on behalf of the firm do not align with the interests of the client.
- The potential impact on and the risk that the COIs could pose to the client, such as a description of what will happen if the firm and/or the registered individual placed their interests before the interests of the client and the harm to the client.
- How the COI has been, or will be, addressed, such as a description of the controls that the firm uses to address the COIs.

Compensation practices

Compensation arrangements that are entirely or partially variable based on sales and revenue targets almost always create material COIs between registered individuals and their clients. Some of the adviser/IFM firms failed to identify the following as material COIs relating to compensation to registered employees:

- Providing compensation incentives that are based on revenue generation, sales and revenue targets, annual awards, promotions, and opportunities to become a partner of the firm
- Having negative consequences in compensation for failing to meet sales or revenue targets
- Paying different commission rates for certain products and/or certain clients, for example, depending on the source of the clients (such as referred clients)
- Providing commission advances to registered employees, but requiring repayment of part of the commission advance as a consequence of not meeting a quarterly sales target

The above examples of compensation arrangements create incentives for registered individuals to put their interests ahead of their clients' interests. The existence of different commission rates for products or client source also creates an opportunity for favouritism, e.g. favouring clients who provide the highest percentage commissions.

Firms also failed to disclose the material COIs in their compensation practices to clients. Some firms provided disclosure but lacked details as to how exactly the conflicts relating to commissions, sales and revenue targets etc., will impact clients' interests. While providing disclosure is necessary when a firm has material compensation conflicts, it may be insufficient to address these conflicts by disclosure only. NI 31-103CP discusses examples of how to address compensation conflicts, but each firm will need to consider any conflicts that are specific to the firm's unique compensation arrangements.

Gifting
Gifts to and from clients can result in a material COI. It can cause favouritism by a registered employee to certain clients or even suppress client complaints; thus it can create situations in which a registered individual can put their interests ahead of their clients' interests. Both compliance teams found firms that overlooked this issue.

Policies and procedures on gifts to clients were either missing or insufficient. Some firms failed to address material COIs from gifting because they did not monitor and track the gifts and entertainment that registered employees receive from or provide to their clients. If gifts to clients are allowed, firms should monitor and track them to ensure gifts are not material and frequent.

Other examples of COI deficiencies include:

- Proprietary and related party products – It is almost always a material COI for a registrant to trade in, or recommend, proprietary and related party products. While most adviser/IFM firms identified the material COI, they failed to implement policies and procedures on how to evaluate and address the COI. There are various combinations of controls that may be used to address the COI and some are listed in section 13.4.1 of NI 31-103CP.
- Disclosure alone is not sufficient to address proprietary or related party product conflicts.
- It is also insufficient to simply disclose that the firm recommends proprietary and related party products. The disclosure must include a description of the controls that the firm uses to manage the material COI.
- Negotiable management fees – We found some firms that allow clients to negotiate management fees that differ from the standard fee schedule. These firms did not provide written disclosure to all clients about the ability to negotiate fees. This creates a COI and unfair dealing between the firm and its clients who are unaware that some clients were able to negotiate their fees.
- Registered individuals' outside activities – We found some firms that failed to disclose how they control material COIs arising from registered employees' outside activities such as being the shared CCO of another firm or having roles at issuers, such as directorships.

General deficiencies

While the sweep focused on COIs, we also identified deficiencies in the following areas:

- Misleading titles – We identified firms that appointed all of the client-facing registered employees as corporate officers in order for them to use corporate officer titles. However, when we reviewed these individuals' duties, they did not have any substantive corporate responsibilities or authority. Relating to titles is the requirement for registered individuals to provide their business titles on the National Registration Database (NRD). Some individual registrants are simply disclosing their registration category such as advising representative or associate advising representative on NRD, which is not the official title these individuals hold out (for example, on business cards).
- Insufficient KYC information – The CFRs expanded the KYC obligations to specify the information required for a registrant to meet its suitability obligations. We found some firms that did not revise their KYC questionnaires and discussion points with clients to include details of personal circumstances, investment knowledge, and risk profile.
- Failing to ask the client to identify a trusted contact person – Taking reasonable steps to obtain from the client, the contact information of a trusted contact person is part of a registered firm's KYC obligations. Taking reasonable steps is not optional. Some firms failed to incorporate policies and procedures to comply with section 13.2.01 of NI 31-103 to ask for trusted contact person information. Some firms mistakenly believed that this requirement only applies to certain types of clients (for example, seniors). The trusted contact person requirement applies to all clients, regardless of the client's age and other personal circumstances.

Financial filings

We have identified more deficiencies in financial information submissions, including excess working capital calculations, from adviser/IFM firms. Common missing or inadequate items on the audited annual financial statements include:

- The auditor's report should provide an audit opinion covering two fiscal years. We require the audit opinion to refer to both the current and prior year. NI 31-103 requires comparative annual financial statements that are audited. Therefore, the auditor's report should refer to the comparative financial statements as well.
- The notes to the financial statements should include related party disclosures. IFRS[2] requires disclosure of key management personnel compensation, related party transactions, and outstanding related party balances.

[2]Registrants are required to comply with Section 3.2(3) of National Instrument 52-107 *Acceptable Accounting Principles and Auditing Standards* when preparing annual financial statements and interim financial information as required by NI 31-103. This section requires the preparation of registrant financial information in accordance with Canadian Generally Accepted Accounting Principles applicable to publicly accountably enterprises, which is International Financial Reporting Standards (IFRS).

- The notes to the financial statements should include disclosure of IFRS adoptions that may impact future periods. The rules require disclosure about any new IFRS that are issued, not yet effective, and not applied by the firm, and how the new requirements will likely impact the firm. There is a specific list of items that must be discussed in the financial statement note.
- Applicable to IFMs who must submit interim financial information, the interim financial information should also be in accordance with section 3.2(3) of NI 52-107 *Acceptable Accounting Principles and Auditing Standards* (NI 52-107). This means the presentation of the interim financial information should present financial statement line items that are consistent with the annual audited financial statements, including the presentation of current and non-current items. IFMs should not simply submit interim financial information extracted from accounting software or from an Excel spreadsheet, without ensuring that the information complies with NI 52-107 requirements.
- Lastly, we noted that some firms are discounting their subordinated debt to fair value on the financial statements, without clear valuation support. Firms and their auditors should be able to justify the discount and explain why the transaction price does not reflect the fair value of the loan. We will review the subordinated debt balance in accordance with IFRS.

We also found common errors in excess working capital calculations:

- For firms that submit quarterly, the prior period column did not match what was submitted for the previous quarter.
- Line 9 of Form 31-103F1 *Calculation of excess working capital* is missing market risk amount for short term GICs or marketable securities listed on the balance sheet. Schedule 1 of Form 31-103F1 has instructions on how to calculate market risk depending on the type of instrument or security.

Dealer-specific deficiencies for captive firms

We conducted seven compliance reviews of dealer firms that acted as dealers for their related mortgage investment entity (MIE). Because these EMDs rely substantially on distributing securities of a related MIE, we refer to these businesses as captive EMDs. Captive EMDs present COI challenges, client confidentiality, and other unique issues for our reviewers to consider. In our reviews of these captive EMD businesses we noted common deficiencies including:

- inadequate or inaccurate assessments of their relationship with clients, and the relationship between related party issuer, client, and the registered firm as dealer
- missing client reporting and CRM2 reporting
- client statements incomplete or missing, often only comprising transaction reporting
- for registered accounts, failing to recognize whether these accounts are ongoing or transactional, or that the nature of the client relationship changes over time
- client relationship disclosure information (RDI) that does not accurately reflect the relationship between client, dealer, and product issuer, particularly in the area of client assets, custody, and access to client assets by way of common mind and management
- many dealers that share common mind and management with the related party MIE fail to adequately consider access to client assets, which results in deficiencies including:
  - custody and trust arrangements for client assets
  - inadequate insurance coverage of at least 1% of the client assets they have access to
- KYC and suitability continue to be the #1 area of compliance weakness for our EMDs, irrespective of business model. We saw deficiencies in various forms on every compliance review in 2022, including:
  - Inadequate ID verification for Corporations.
  - Information collected not always being used appropriately in suitability assessment, specifically to calculate and consider concentration. Over concentration continues to be a major risk area, particularly for captive dealers.
  - PPM deficiencies where there was no guidance for concentration thresholds for different client profiles.
  - Inadequate note keeping to detail the criteria used and process followed in suitability assessments.

“Renting out” of registration and payment to unregistered entities

In last year’s Report Card, we reported on situations where, on the surface, a registered firm is the PM and IFM of a fund (a partner issuer); however, after reviewing the flow of compensation, we discovered an unregistered entity receiving the bulk of the compensation and conducting registerable activities. In addition, we found the unregistered entity holding out as if it were registered, with either no disclosure of the actual registered firm, or naming the registered firm in an ambiguous manner in tiny font. We consider this type of circumventing of the registration requirement to be a serious breach that will require compliance and/or enforcement actions.

Registration RIME Issues

BCSC’s registration staff have seen a surge in individual registration applications where they need to consider the relevant investment management experience (RIME) of the filer. RIME is a key component for registration in the associate advising representative and advising representative (AR) categories, including AR client relationship manager (AR-CRM) registration terms and conditions.

We note that in all registration applications, the onus is on a filer to demonstrate they have appropriate proficiency for the registration requested. There is substantial guidance in NI 31-103CP and CSA Staff Notice 31-332 *Relevant Investment Management Experience for Advising Representatives and Associate Advising Representatives of Portfolio Managers,* that we expect filers to consider when making their registration application. Instead, particularly in applications for AR registration, staff consistently receive exaggerated and promotional submissions with reference to tasks and roles that do not demonstrate RIME. Such submissions do not assist staff’s analysis of RIME and often cause confusion. We also see wide usage of internal titles used by firms to denote an individual’s seniority or role. These seldom have any bearing on establishing RIME. We expect an individual who seeks registration as an AR to demonstrate high quality experience that is clearly relevant to discretionary portfolio management. NI 31-103CP states that investment management experience includes:

- securities research and analysis experience, demonstrating an ability in, and understanding of, portfolio analysis or portfolio security selection, or
- management of investment portfolios on a discretionary basis, including investment decision making, rebalancing and evaluating performance

To ensure a quick response from staff and a successful result, please ensure that you consult all available guidance before filing a registration application, include only relevant information, and omit any unnecessary or extraneous information.

If you need help finding registration information, please reach out to your relationship manager or BCSC registration staff.

The CCO must monitor and assess compliance by the firm, and individuals acting on its behalf, with securities legislation. Where we find instances of non-compliance with regulatory requirements, we expect the CCO to take immediate action to resolve these deficiencies. When we see non-compliance, we can:

- require a firm to rectify its compliance program
- impose registration terms and conditions to reduce the risk of non-compliance
- suspend registration
- take enforcement action

Compliance action

We will continue to take compliance action against non-compliant firms that demonstrate significant compliance weaknesses, including imposing registration terms and conditions on them that may:

- require firms to hire a compliance monitor to work with them to remedy compliance deficiencies (see the CSA staff notice on the use of compliance monitors)
- prevent firms from accepting new clients until they have rectified their compliance failures
- prevent firms from conducting trades for clients until they update clients' KYC information and reassess suitability
- prevent firms from registering new representatives until they are able to demonstrate that they have put in place an appropriate compliance and supervisory system
- prevent firms from creating new proprietary funds or new series of existing proprietary funds
- require firms to hire a new CCO

Any conditions placed on the registration of a firm are public and reported on NRD and the public National Registration Search service.

We can also charge costs for our compliance reviews and we often do so where we see significant compliance failures, repeat deficiencies, or conduct that indicates the firm is not adequately managing its compliance program or the risks associated with its business.

Enforcement action

In past years, we referred a number of adviser and dealer firms to our Enforcement division. We refer firms for enforcement action when we see systemic or significant failures that pose risks to clients, repeat significant deficiencies that firms fail to resolve, or the need for significant further investigation. In these instances, the firms have cultures of compliance that fall significantly short of our expectations. Actual client harm is not a prerequisite for an enforcement referral. Enforcement outcomes are public.

Settlements

In 2022, we took enforcement action and reached a settlement agreement with an individual for conducting registerable activity prior to becoming registered. This individual publicly held out as a portfolio manager prior to becoming registered, and in his application for registration, outlined a number of responsibilities that clearly outlined that he had been advising and meeting with the firm's clients before applying for registration. The settlement agreement indicates how serious the BCSC considers registration matters and that we will pursue misconduct by individuals and their firms.

Settlements are a public outcome and are available at the BCSC's website.

Complaints

The BCSC Inquiries Group receives complaints about registered firms and registered individuals, which are then passed on to the compliance teams for review. We are required to review every complaint and assess its merits. We follow a process to analyze the information submitted by the complainant and with the complainant's consent, we will also reach out to the registrant to inform them of the complaint and hear the registrant's side of the complaint. BCSC staff's complaint review is separate and independent of the Ombudsman for Banking Services and Investments' (OBSI) complaint process. The complainant may submit their complaint to both the BCSC and the OBSI. Some past complaints that BCSC staff received resulted in compliance action and/or referral to our enforcement division.

Administrative Penalty Imposed by Notice (APIN)

Following recent amendments to the *Securities Act,* under section 162.01, the Executive Director now has the power to impose monetary penalties for contraventions of the regulations (which include national and multilateral instruments) or prior decisions. The maximum penalty for each contravention is $100,000 for individuals, and $500,000 for non-individuals.

If staff finds an eligible contravention in the course of their work, they may request the Executive Director impose a monetary penalty in addition to any of the measures already discussed above. For more information about the Executive Director's APIN power, see *BCN2023/03 – Administrative Penalties Imposed by Notice Section 162.01 of the Securities Act, RSBC 1996, c. 418.*

EXAMINATION FOCUS AND APPROACH 2023

2022 continued to be a challenging year for many firms due to the impact of the COVID-19 pandemic. Recognizing the ongoing challenges, our compliance teams have been conducting off-site compliance examinations by video-conference or phone interviews, and reviewing of records. In 2023, our compliance teams will adopt a hybrid approach to examinations where we will be conducting compliance examinations both in-person as well as virtually.

During the year ahead, we will continue to select firms for review based on significant changes to business, revenue, or size. In addition, we will examine firms with an emphasis on the CFRs that came into effect on June 30, 2021 and December 31, 2021. The first review of the CFRs in 2022 is a CSA sweep on the COI requirements, which we already initiated. This review may result in additional firms being selected for review. We will also expand on the CFR review with a second sweep focusing on the remainder of the CFRs that came into effect on December 31, 2021.

CONNECTING WITH THE BCSC

We remind you to subscribe to the *Weekly Report*, so that you can get early information about legislative changes on the horizon.

If you have questions or concerns, please contact your relationship manager, the Compliance Managers, or the Director.

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