



British Columbia
Securities Commission

2015 Annual Compliance Report Card

British Columbia Securities Commission

May 2015

BCSC 2015 ANNUAL COMPLIANCE REPORT CARD

This compliance report card summarizes, for Chief Compliance Officers (CCOs), the compliance strengths and weaknesses we found at BC-based portfolio managers (PMs), investment fund managers (IFMs), and exempt market dealers (EMDs) this past year (April 1, 2014 to March 31, 2015). CCOs can use this information to improve their compliance programs.

Our firms

The Capital Markets Regulation (CMR) division regulates 114 firms and their associated individuals directly registered with the BCSC (excluding IIROC and MFDA firms and their individual dealing representatives) consisting of:

- 83 adviser/IFM firms
- 31 dealer firms

We also register mutual fund dealers and their individual dealing representatives.

This year, we reviewed the compliance of unregistered market participants that we thought might be required to register.

Our approach to regulation - risk and outcomes based

Our goal is to foster a culture of compliance. Where we find serious non-compliance or dishonest conduct, we will take decisive action.

To foster a culture of compliance, we maintain open communications with registered firms through dedicated relationship managers who communicate with the firms assigned to them. Our relationship managers aim to understand each firm's business and state of compliance. We encourage our firms to contact their relationship managers with compliance-related questions or to report changes in their business or personnel. Please contact us if you do not know your relationship manager (see our contact particulars at the end of this report card).

We use a predictive risk model to assess the risks for BC-based registered firms. We track firm risk from the answers firms provide to our bi-annual risk questionnaires and the firm's examination results. We will update our questionnaires in 2015. The risk model score predicts the likelihood of compliance failures.

We select firms for regular compliance reviews based on our risk rating, the length of time since our last compliance review, changes in the nature or size of business, or other information about a firm. If we receive information or complaints that indicate serious non-compliance or dishonesty, we conduct a "for cause" review. We generally tailor our compliance reviews to test our compliance concerns for each firm.

COMPLIANCE REVIEW FINDINGS

Our firms' strengths and weaknesses

Registered firms - positive findings

We saw these positive practices among firms with good cultures of compliance:

- They developed a proactive approach to communicating with their BCSC relationship manager. We encourage firms to reach out to us to ask questions or clarify new requirements.
- Where possible, firms segregated key roles, and included cross reviews among key personnel of each other's work.
- Some firms started changing their systems to develop client account statements to meet the requirements of CRM2, ahead of these requirements coming into effect.
- Although we continue to find a large number of policy and procedure manual (PPM) deficiencies, we saw fewer out-of-date PPMs.
- Some firms require staff to update themselves continually on the changes to the firm's PPM (as opposed to requiring staff to read the PPM annually). This increases the potential to keep staff informed, but can only work if firms highlight their PPM changes to staff.
- We generally saw improvements in relationship disclosure information (RDI) following our RDI sweep last year.
- We saw improvements in marketing practices since the 2010 CSA marketing sweep. In general, fewer firms made unsubstantiated claims.

Registered firms - top five deficiencies

This year, we conducted 33 compliance reviews, and found an average of 4.64 deficiencies per review.

The top five deficiency categories were:

Deficiency Type	Number of Deficiencies	% of all Deficiencies
Policies and procedures	24	16%
Disclosures	18	12%
Administrative filings	16	10%
Compliance officer function	12	8%
Know-your-client and suitability	11	7%
Total	81/153	53%

COMPLIANCE REVIEW FINDINGS

We tested 49 different categories, and found 153 compliance deficiencies in total. The top five deficiencies represent approximately 53% of all of the compliance deficiencies we found.

Examples of the compliance deficiencies we found in the various deficiency categories include:

Policies and procedures – Business continuity plan (BCP)

BCPs must address the risk of losing key advising or dealing persons. Smaller firms may not have another advising or dealing representative to make decisions when the principal is incapacitated. Many BCPs point to an adviser at another firm to step in; however, current regulations do not allow simultaneous registration at different firms. Small firms should think through the mechanics of having someone step in, and consider whether they will need any exemptive relief. Section 11.1 of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103) requires registrants to establish, maintain, and apply policies and procedures to manage the risks associated with their businesses. The companion policy to NI 31-103 specifically mentions business interruption.

Disclosures - Relationship Disclosure Information problems

We expect firms to take reasonable steps to notify clients, in a timely manner, of changes to their RDI. For example, since May 1, 2014, section 14.2(4)(j) of NI 31-103 requires a firm to disclose to clients, who have complaints about any trading or advising activity (see section 13.16), the firm's obligations and the steps the client must take for independent resolution of the dispute. Although we saw improvement, we still found some firms had not delivered RDI updates to their existing clients. See CSA Staff Notice 31-338 *Guidance on Dispute Resolution Services Client Disclosure for Registered Dealers and Advisers that are not members of a Self-Regulatory Organization*.

Administrative filings - outside business activities

We continue to see individual registrants overlooking the obligation to report changes in their registration information to the BCSC through the National Registration Database. This includes changes to, or the addition of, outside business activities.

The January 11, 2015 amendments to Form 33-109F4 *Registration of Individuals and Review of Permitted Individuals* clarify that individuals must list, under item 10, all officer or director positions and any other equivalent positions held, as well as positions of influence. The individual must provide information about whether or not:

- the individual receives compensation for such services
- any such position is business related

COMPLIANCE REVIEW FINDINGS

CCO function - Annual assessment of compliance with securities legislation

We found that many CCOs do not conduct and document an annual assessment of compliance with securities legislation by their firms, and the individuals acting at those firms. This finding was particularly prevalent among smaller firms, where the CCO is often the firm's owner and may not realize that the annual assessment is a requirement, regardless of the firm's size. The purpose of the CCO's annual report is to not only document the assessment, but also to ensure that the firm's board members or owners have direct access to this information. This requirement is found in section 5.2(d) of NI 31-103. We expect to see evidence that CCOs have considered their compliance program in light of their firms' changing business environment and risks.

Updating know-your-client (KYC) and suitability

We found firms stating in their PPMs that they will update KYC information "periodically". This does not meaningfully communicate the firm's expectations and regulatory commitments. In addition, we continue to find failures to take reasonable steps to keep KYC information current, as required by section 13.2(4) of NI 31-103.

CSA Staff Notice 31-336 *Guidance for Portfolio Managers, Exempt Market Dealers and Other Registrants on the Know-Your-Client, Know-Your-Product and Suitability Obligations* provides guidance that PMs (and EMDs with an ongoing relationship with their clients) should update KYC information at least annually, and more often if there is a material change in a client's circumstances. This is critical. Without adequate and timely KYC information, registrants cannot meet their suitability obligation to clients.

Registered firms - other deficiencies

In addition to the top five categories of compliance deficiencies, we also noted:

Directing income to personal corporations

We continue to see many instances where dealing and advising representatives direct their firms to pay commissions or management fees to personal corporations. We understand this is tax efficient, but it is not allowed. A personal corporation that receives commissions or management fees from trading in, or advising on, securities is acting in furtherance of trades in securities. Only a registrant may do this. Section 1 of the Act defines a "trade" as any act, advertisement, solicitation, conduct or negotiation directly or indirectly in furtherance of the disposition of securities. Section 34 of the Act provides that a person must not trade in a security, unless they are appropriately registered.

COMPLIANCE REVIEW FINDINGS

Overreliance on referral agents

Referral arrangements between registered firms and referral agents (whether registered or not) are common. Registrants should not facilitate referral agents advising on, or dealing in, securities for which they do not have registration. We expect that referral agents will not take an active role in trading or advisory activity after making the referral.

The referral agent can maintain a working relationship with the client. The registrant should ensure both the referral agent and client understand that suitability assessment, investment recommendations, and instructions about the client's accounts or circumstances, are the responsibility of the registrant.

Although a referral agent can provide basic biographical information (i.e., name, address, age, net income and net worth) about the client, the registrant must engage in meaningful dialogue with its clients to make necessary enquiries to obtain a solid understanding of its clients' investment needs and objectives. Refer to CSA Staff Notice 31-336 *Guidance for Portfolio Managers, Exempt Market Dealers and Other Registrants on the Know-Your-Client, Know-Your-Product and Suitability Obligations*. The CSA Staff Notice states that the registrant has the obligation to "know" the client and the client's investment needs and objectives. If an unregistered individual or firm collects KYC information or explains products to clients, these activities may become registerable dealing or advising activities (since these activities may constitute acts in furtherance of a trade).

Both the referring and receiving parties should assess their compliance procedures to detect and prevent such occurrences. This includes communicating to staff their expectations on how to manage referral arrangements.

No books and records

Some firms do not have their own system to track clients' investment positions. We found these firms to be wholly reliant on the clients' custodian for records of client portfolio holdings. Section 11.5(1) of NI 31-103 requires a firm to maintain records of its business activities, financial affairs, and client transactions. Section 11.5(2)(f) of NI 31-103 requires a firm to maintain records that permit the identification and segregation of client cash, securities, and other property.

COMPLIANCE REVIEW FINDINGS

Unregistered market participants

We reviewed compliance among unregistered market participants who appeared to be in the business of trading in securities.

We reviewed compliance at 51 unregistered market participants. We found that 35 market participants conducted registerable activities, of which 32 could claim a registration exemption. Two market participants will seek exemptive relief. We obtained an investigation order against one market participant and we are taking compliance action against it.

How we treat non-compliance

When we see non-compliance, we can:

- require a firm to rectify its compliance program
- recommend imposing registration conditions to reduce the risk of non-compliance
- recommend suspending registration
- take enforcement action

Examination focus 2015 - 2016

We will continue to focus in our compliance reviews of registered firms on the top five deficiencies. We will also focus on the management and avoidance of conflicts of interest and firm-specific issues that indicate a poor culture of compliance.

In addition, we will test compliance of:

- select firms with head offices outside BC that have a large presence in BC or present risk to BC clients
- market participants that rely on the north-western (NW) and mortgage investment entity (MIE) exemptions in BC (BCI 32-513 and BCI 32-517)
- unregistered market participants that appear to be in the business of trading in securities

When facing reviews, unregistered market participants should prepare by ensuring they meet the requirements of the exemption they rely on. CCO's of registered firms should consider the practices mentioned in this report card and the numerous CSA guidance notices. If you have questions about how to qualify for registration exemptions, please contact our registration staff. For registered firms wishing to strengthen their compliance program, contact your relationship manager or any member of the compliance team at the BCSC.

COMPLIANCE REVIEW FINDINGS

Registration team update

This section should help you avoid filing rejections. The following are the top deficiencies with initial and reactivation applications for registration:

- Applicants do not disclose all their outside business activities. If the applicant is a director or officer of any firm, they must disclose this as current employment. Refer to CSA Staff Notice 31-326 *Outside Business Activities* for additional guidance.
- Applicants overlook that a CCO must be an officer, and the ultimate designated person (UDP) must be the chief executive officer (or the equivalent) of the registrant firm.
- An individual's previous registrant firm often remains listed as "current employment".
- Applicants often miss disclosing that they are shareholders of 10% or more of the voting securities.
- Applicants don't disclose other registrations or licenses held.

For comprehensive guidance about the issues staff consider when reviewing relevant investment management experience for advising or associate advising representatives, please refer to CSA Staff Notice 31-332 *Relevant Investment Management Experience for Advising Representatives and Associate Advising Representatives of Portfolio Managers*.

New regulatory requirements

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

CONNECTING WITH THE BCSC

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

Sandy Jakab, Director, Capital Markets Regulation – sjakab@bcsc.bc.ca or 604-899-6869

Mark French, Manager, Dealer Compliance team – mfrench@bcsc.bc.ca or 604-899-6856

Martha Kane, Acting Manager, Adviser/IFM Compliance team – mkane@bcsc.bc.ca or 604-899-6563

Karin Armstrong, Manager, Registration - karmstrong@bcsc.bc.ca or 604-899-6692

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