



British Columbia
Securities Commission

2014 Annual Compliance Report Card

British Columbia Securities Commission

May 2014

BCSC 2014 ANNUAL COMPLIANCE REPORT CARD

This compliance report card aims to provide Chief Compliance Officers (CCOs) with useful information about compliance weaknesses we found at BC-based portfolio managers (PMs), investment fund managers (IFMs), and exempt market dealers (EMDs) this past year (April 1, 2013 to March 31, 2014). We discuss our compliance expectations, and provide some information about how we dealt with compliance failures.

This information should give CCOs insight into where the BCSC's compliance teams will focus testing and remedial efforts. We encourage you to use this report card, together with your risk rating report, past compliance review reports, and new regulatory requirements information, to refresh and fine-tune your compliance systems.

The BCSC's compliance teams are part of the larger registrant regulation team in the Capital Markets Regulation (CMR) division. CMR registers, educates, guides, tests compliance, takes compliance action, and considers exemptive relief applications for our directly regulated firms and individuals (not IIROC or MFDA members).

Directly registered firms

We oversee 109 firms. The Adviser/IFM team oversees 80 firms, whose businesses are primarily asset management focused. Our Dealer team oversees 29 firms, whose businesses are primarily focused on product sales.

BCSC approach to regulation

We foster cultures of compliance, and take decisive action where we find non-compliant or dishonest conduct.

To foster compliance, we strive to maintain open communications with our registrants by assigning a dedicated relationship manager to each firm. Relationship managers communicate periodically with the firms assigned to them, to understand the nature of the firm's business and compliance. We encourage our firms to contact their relationship managers if they have any questions about our compliance program, or changes to compliance requirements. If you do not know who your relationship manager is, please contact us (see end of report card).

In 2013, we adopted a predictive risk model that rates every BC-based firm from risk questionnaires firms complete every two years, and our examination experience of the firms. The risk model gives a score that predicts the likelihood of future compliance failures, which we consider when assessing the overall risk of a firm.

We select firms for regular compliance reviews based on our assessment of firms' risks, how long it has been since we last reviewed the firm's compliance, changes in nature or size of business, or information about the firm that comes to us and concerns us. If we receive public complaints that indicate non-compliance or dishonesty, we will commence a "for cause" review.

Our compliance reviews include examinations and inspections. Inspections are short, very targeted check-up visits. Examinations are more in-depth reviews, but we may tailor an examination to address specific compliance concerns relevant to a firm.

COMPLIANCE REVIEW FINDINGS

This year, we conducted 34 compliance reviews, including examinations and inspections, and found an average of 3.8 deficiencies per review (4.0 for examinations, 3.6 for inspections).

The top five deficiencies we found are:

Reviews Completed: 34	Total Deficiencies	% of all reviews
Policies and procedures	22	65%
Know-your-client/product and suitability	13	38%
Disclosure	12	35%
Compliance officer function	11	32%
Advertising, marketing and holding out	9	26%
Total	67	

Despite testing 49 different kinds of compliance requirements, the top five deficiencies make up approximately 51% of all the compliance deficiencies we found.

Compliance concerns

Policies and procedures - The most frequent compliance shortcoming we observed, in 65% of the reviews we conducted, was in policies and procedures. We found policies and procedures manuals (PPMs) generally did not reflect the current state of firms' businesses, and in many cases, the firm failed to train staff about the content of their PPMs. We also saw examples of firms not following their own PPMs.

You can avoid this finding, but it requires a disciplined approach to PPM updates. Build regular reviews in, but develop the habit of immediately updating the PPM when your firm's business has changed in a significant way or the regulatory requirements have changed. Roll out training programs in a timely way, so that your representatives and other compliance staff and firm decision makers are moving with the evolution of both your business and the regulatory environment.

Consider whether you have adequate resources to allow you to take the disciplined approach. If not, advocate for the resources you need. If you are a small firm, consider what work load organizational habits might shift you into a more disciplined approach to your policies and procedures.

COMPLIANCE REVIEW FINDINGS

Know-your-client/product and suitability - 38% of firms reviewed showed weakness in the areas of know-your-client (KYC), know-your-product (KYP), and consequently could not demonstrate they had met their suitability obligations to clients. We found, for example, outdated and incomplete KYC information, and no supervisory review of KYC forms.

Suitability is a cornerstone obligation for all registrants. To assist you with meeting that obligation, on January 9, 2014, we published 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*.

Disclosure and conflicts - 35% of firms reviewed did not always deliver to clients the relationship disclosure information that a reasonable investor would consider important about their relationship with the firm. Disclosure is also an important tool to manage potential conflicts of interest, discussed in more detail below. We found, for example, missing client relationship disclosures (required under section 14.2(2) of NI 31-103), and incomplete or partial disclosures, particularly about conflicts of interest.

Undisclosed conflicts of interest concerned us, especially where registrants deal in securities they issue themselves, or in securities issued by closely connected issuers or product manufacturers. Some dealers are captive to the connected issuers that control them, and deal exclusively in that issuer's securities, yet they failed to disclose this conflict. Captive dealers do not make an independent assessment of the product, and do not know the product through the perspective of an independent person providing investors suitability recommendations.

We also found these unacceptable practices:

- cross trading between a fund managed by firm and one of the firm's responsible persons
- ineffective supervision of employees' personal trading
- firms taking on powers of attorney for client accounts to give them full discretionary access to client's investment and banking accounts

Conflicts often change as the firm's business model, products, and staff change. You should build in a process to assess your firm's conflicts and client disclosure regularly to avoid this finding.

COMPLIANCE REVIEW FINDINGS

Compliance Officer Function - In 32% of the reviews we conducted, we saw compliance officer failures, mostly because the CCO was not doing the job required by NI 31-103. The examples we saw include:

- CCO delegated responsibility to other staff lacking the necessary skill
- CCO not supervising associate advising representatives
- no independent review of the advising/dealing activities of a CCO who is also a firm's advising or dealing representative
- CCO not documenting their review of compliance matters

Advertising, marketing and holding out - 26% of firms reviewed were deficient in advertising, marketing and holding out compliance. This surprised us, as the CSA recently conducted and reported out on a marketing and advertising sweep.

Firms often have these deficiencies because the compliance review did not hold marketing and advertising authors to a strict enough standard. For example, testimonials from individuals seldom give a balanced perspective. We found instances of carelessness about website information and even office signage, and representatives advertising outside business activities while working for the registrant.

We also found these unacceptable performance representation practices:

- not disclosing the basis of return (total return or price appreciation)
- not referencing the benchmark (TSX can refer to the S&P/TSX Composite Index or the S&P/TSX 60)
- not disclosing if returns are gross or net of fees
- average, firm-wide performance instead of time-weighted performance in appropriate composites

You can avoid this finding by developing guidance on acceptable firm-wide marketing practices. Compliance staff should educate marketing staff on the common deficiencies and suggested guidance provided in CSA Staff Notice 31-325 *Marketing Practices of Portfolio Managers*.

Unregistered activity alert - Although not in our top five deficiencies, we saw dealing and advising representatives directing the payment of their commissions or management fees to personal corporations. We understand it is tax efficient to do this. Only registered entities can receive proceeds from trades in securities. Under current law, receiving commissions from sales or trades in securities are acts in furtherance of trades and only a registrant may do this. This does not apply to corporations of approved persons of mutual fund dealers, which we have exempted from this registration requirement for historical reasons. Firms should review their current compensation structures to avoid this deficiency.

COMPLIANCE REVIEW FINDINGS

Examination focus 2014 - 2015

We will concentrate our efforts this year on the top five deficiencies. We will focus, particularly in the dealer category, on understanding and reviewing conflicts-of-interest of captive dealers and those that distribute a single product to retail investors.

CCOs can prepare for compliance reviews by ensuring that the weaknesses we will focus on are not present in their firm. If you have questions about how to approach strengthening one or more of these areas, contact your relationship manager.

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

Registration team report

If your firm makes its own registration filings, this section should assist it to avoid filing rejections. The top three deficiencies with initial and reactivation applications for registration are:

- 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 of the registrant firm.
- An individual's previous registrant firm often remains listed as "current employment".

FOR MORE INFORMATION

For comprehensive guidance about the issues staff consider when reviewing exemption applications for relief from advising or associate advising representatives investment management experience requirements, 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

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