



British Columbia Securities Commission

**2007 Examination Report Card  
Capital Markets Regulation  
British Columbia Securities Commission**

## **Introduction**

The Examinations team of the Capital Markets Regulation (CMR) division regularly examines various registrants including investment counsel, portfolio managers, exchange contracts dealers, scholarship plan dealers, and other non-SRO registrants. The purpose of conducting examinations is to ensure that registrants comply with securities legislation. The examination process encourages firms to build a strong compliance program, which in turn helps protect the investors and the integrity of our securities markets.

The examinations test compliance with securities laws. The information we gather during examinations allows us to make the Commission aware of new developments and areas of potential risk in the securities industry. Due to the diverse range of registrants and the complexity of the securities market, our examinations staff have various backgrounds, from professional accountants or CFA Charterholders to those with strong industry training.

### **Investment Advisers (ICPMs)**

Examiners are responsible for regularly examining 76 registered, BC-based ICPM firms. These firms employ approximately 289 registered advisers and manage total assets under management (AUM) of approximately \$157 billion. The ICPM group has the highest proficiency of any of our registrant categories.

The ICPM profile reveals that AUM in BC is relatively concentrated in a few ICPM firms. In addition, the profile also shows that the average ICPM firm has approximately three to four registered advisers.

## **Some industry trends**

**Lack of clear client focus** - Fundamental to discretionary management of client assets is the adviser's duty to act with care and in the best interests of its clients. Firms must place clients' interests before their own. In some cases, we found that firms ignored basic compliance principles, such as not providing full disclosure on fees, related parties, and conflicts. We think a proactive and transparent approach to disclosure on client issues is important. Understanding and focusing on clients' needs is essential.

**Expanding market in alternative and derivatives-based products** – Strong demand and market growth for alternative funds and structured finance products continue. You are likely to see more of these come across your trade desk. Structured finance products include market-linked notes, mortgage-backed securities, collateralized debt obligations, principal protected notes and non-principal protected notes. Investor Economics estimated annual growth rates between 2005-2014 to be 18.4%<sup>1</sup> for hedge funds and 20.4%<sup>1</sup> for hybrid assets. One concern

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<sup>1</sup> Source: Investor Economics 2005 Household Balance Sheet Report: Update & Rebased Forecast, Exhibit 4.17

is product complexity. Many new products combine financial instruments with derivatives, where potential returns may involve multiple variables. Do the distributors of these hybrid securities fully understand the underlying risks? This raises the issues of who can sell these products, how they can be sold, and what point of sale disclosures is appropriate. Increased product complexity heightens the need for registrants to have strong due diligence process to meet their know-your-product (KYP) obligations.

**Evolving trading technology** – Trading technology continues to evolve with new electronic communication networks, smart router technology, new order execution systems, and fast execution. Industry is facing new challenges to meet “T” or same day settlement. To deal with some new market and trade reporting issues, the Canadian Securities Administrators have:

- published National Instrument 24-101 *Institutional Trade Matching and Settlement*.
- proposed amendments to National Instrument 21-101 *Marketplace Operation*. The amendments update the concept of “best execution”, impose direct obligations on clients that have direct market access, and propose a framework for managing trade-through in a multiple marketplace environment.
- proposed National Instrument 23-102 *Use of Client Brokerage Commissions as Payment for Order Execution Services or Research* which covers issues surrounding soft dollar practices.

### Outreach and education

The Examinations team communicates important issues for ICPMs by email notices and posting them on the compliance toolkit of the BCSC’s website. The team also hosts regular adviser forums. The forum provides a channel for registrants, Commission staff, and other industry professionals to discuss regulatory changes and compliance practices. It is also a chance for advisers to engage regulators and each other in thoughtful dialogue on compliance issues.

### Common compliance deficiencies

The following is the top ten most common deficiencies in 2007.

	<b>Compliance Deficiency</b>	<b>Fiscal 2007</b>	<b>Fiscal 2006</b>	<b>Change</b>
1	Policies and procedure manual issues	42%	57%	-15%
2	Compliance officer responsibilities	25%	14%	11%
3	Record keeping	25%	24%	1%
4	Disaster recovery and business continuity	25%	43%	-18%
5	Compliance program	21%	24%	-3%
6	Disclosure issues	21%	29%	-8%
7	Capital monitoring	21%	57%	-36%
8	Conflicts of interest and personal trading	17%	33%	-16%
9	Out-of-province or non-resident clients	17%	33%	-16%
10	KYC and suitability	17%	57%	-40%

Because the BCSC conducts risk-targeted examinations, these examination findings describe compliance at firms that were examined, not compliance at firms that were not examined. The exam deficiencies are grouped in broad categories for reporting purposes. A firm having a

deficiency in one category does not imply that this firm has compliance problems in all aspects of that category.

The Examinations team does not provide detailed guidance on best practices. Each firm must thoughtfully consider the requirements of securities legislation and the risks of its business in designing its compliance, supervision, and risk management systems. When it comes to compliance, a one-size-fit-all approach does not work. Compliance structures vary from firm to firm due to different operations, sizes, services, and products. No best practices will fit all firms.

**Most improved areas compared to 2006:**

- KYC and suitability (records and practices) (57% vs. 17%)
- capital monitoring (57% vs. 21%)

**Areas requiring improvement compared to 2006:**

- compliance officer responsibilities (14% vs. 25%)

## Compliance issues

In this section, we highlight four compliance issues that we are concerned about. This is certainly not an all-inclusive list, but it may assist you in critically assessing your own programs.

### 1. Policies and procedures

Having solid policies and procedures will assist you to establish, maintain, and enforce a system of controls at your firm. A policy manual is not something you create solely for regulators. The process of constructing, documenting, and drafting your manual, forces you to review key business areas with your operating staff. This helps you identify potential risks, learn about process weaknesses, and review any technological issues.

The policy manual should be a **living document**, distributed and reviewed by all of your staff on an ongoing basis. The manual is also a good orientation tool, which helps staff to understand the compliance obligations they have in the securities industry. Therefore, it is important to keep your manual up-to-date.

**Questions to ask when establishing effective policies and procedures:**

- Is your manual current and is it a living document?
- Have you provided the manual to staff and used it as a learning tool?
- Are there new regulatory requirements, operational structures, or processes that you have not updated in the current manual?
- Have you identified the documents and reports used to achieve compliance?
- Have you documented your disaster recovery and business continuity plan?
- Do you oversee outsourced duties you may have for third party service providers, such as custodians, sub-advisers, or prime-brokers?
- Is the manual too general to be effective?
- Does management approve the manual?

## **2. Testing your compliance systems and controls**

In our experience, firms that periodically assess and test their compliance programs have fewer deficiencies, and accordingly we spend less time in reviewing these firms. In some cases, firms have internal auditors to test their controls. However, if you do not have an internal audit function, your compliance staff, risk management staff, external auditors or a combination of these people can perform this internal review.

There are many benefits of self-assessment. You may uncover serious issues, or simply determine what is or is not working in your system. It gives you a chance to detect problems, to promote a good compliance structure, and to correct issues promptly as they occur.

### **Questions for testing your own compliance programs:**

- Who is the best person to conduct the review?
- How often do you test your program?
- Has the program identified and tested all the risks present?
- Is there effective linkage between the risks and the compliance controls?
- Does the program check to determine if investment decisions are consistent with clients' mandates?
- Does the program check to see if investment allocations are fair and consistent?
- Does the program test the quality of trades for best execution?
- Does the program check to see if prior deficiencies or potential weaknesses were effectively resolved?
- Is senior management aware of compliance issues, findings, and remedial actions?
- Is there a process to notify staff about appropriate findings?

## **3. Due diligence, KYC, and KYP**

With the proliferation of new and more complex products, firms need to ascertain whether their due diligence processes are up-to-date and adequate for the type of security being reviewed. As an adviser, you interface directly with clients and make investment decisions for them. Therefore, you must understand the products that you recommend. Your KYP obligation is part of your KYC and suitability obligation. Failing to know your product, you will not be able to make the appropriate asset allocations or portfolio decisions for clients. Various organizations have guidelines available, such as the Alternative Investment Management Association [http://www.aima-canada.org/aima\\_can\\_publications.html](http://www.aima-canada.org/aima_can_publications.html), or the Investment Dealers Association of Canada [http://www.ida.ca/Files/Compliance/PPNGuidelines/GuidelinesComplete\\_en.pdf](http://www.ida.ca/Files/Compliance/PPNGuidelines/GuidelinesComplete_en.pdf).

### **Questions to think about your due diligence process:**

- Do you have due diligence questionnaires?
- Is your questionnaire appropriate for the type of security under review?
- Do you have a clear product approval process?
- Do you research the issuer to determine their background and regulatory history?
- Do you research their operational structure, investment management team, and past performance?
- Does the product meet proper regulatory requirements?

- Have you considered the fees structure?
- Have you identified any punitive redemption restrictions?
- Do you understand the investment strategies of the product?
- Do you ask about valuation procedures and pricing of assets?
- Do you understand who the key players are (e.g. prime broker, custodian or auditors)?
- Do you use adequate search technology such as SEDAR and EDGAR?

#### **4. Personal trading practices**

We found that personal trading is an area where firms may have policies in place but do not follow them, or have no records to show compliance with the policies. The establishment and enforcement of a detailed personal trading policy is essential. It will help to mitigate conflicts of interests and to prevent abusive trading practices, such as insider trading and front running. If your advisers have knowledge of upcoming client trades, they should not be trading in advance of the clients. In addition, you may want to question if any of your advisers receive warrants and options, or participate in IPOs of securities your clients may purchase. Your advisers may put their own interests before the clients in order to participate in these limited opportunities. Some industry organizations, such as the CFA Institute <http://www.cfapubs.org/toc/ccb/2005/2005/3> and the Investment Counsel Association of Canada <http://www.investmentcounsel.org>, have issued guidelines on personal trading.

#### **Questions to think about your personal trading policies:**

- Do you have personal trading policies and procedures in place?
- Have you clearly explained the policy to your staff?
- Does your program require pre-trade compliance and have an effective blackout period or restricted list?
- Do you require all staff's trade confirmations and brokerage statements sent to your compliance staff for review?
- Do you really know all the brokerage accounts your staff have?
- Do you allow your advising staff to open multiple personal brokerage accounts?
- Do your advising staff have special relationship with the brokers that are handling your client trading?
- Have you reviewed and revised your overall policy when violations are detected?
- Does your policy clearly define what is "non-public" or "material" information?

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