
2008 June Adviser Forum

BC Securities Commission

Thursday, June 19, 2008

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BRITISH COLUMBIA
SECURITIES COMMISSION

Presentation agenda

1. 2008 Adviser report card
 - BC adviser metrics
 - Exam focus
2. Concepts of:
 - Ethics
 - Professionalism
 - Fiduciary duties
3. Your Compliance process
 - Questions to ask yourself
 - What is a good compliance program
 - Where to start

Hedge funds – transparency & liquidity?



An institutional investor and a hedge fund manager walk into a bar. The investor hands the HF manager a \$20 bill and says: “Get me a drink that meets my needs. If I like your choice, I’ll buy the drinks all night” says the investor before leaving for the bathroom. Confused by the demand, the HF manager shrugs and orders them both a pint of Guinness.

The barman pours the drinks, takes the money and tells the HF manager “you should have got him a vodka”

Really, Why Vodka, Why not Guinness?

“More transparency, greater liquidity” replies the barman.

But it was too late, the investor had already gone.

Notes: risk control?

- **Note 1:** The barman, unlike the absent investor, had the power to flag the hedge fund manager's error. Had the fund manager been running a managed account with the barman, he would have stopped the investor before it was too late.
- **Note 2:** Please understand: whilst vodka is both liquid and transparent like a managed account, Hedge Funds cannot guarantee that vodka will, in general result in greater risk control. In fact, we suggest the opposite.

The 2008 Report Card can be found in the Compliance toolkit of the BCSC website

The screenshot shows a Microsoft Internet Explorer browser window displaying the BCSC Compliance Toolkit for Dealers & Advisers. The browser's address bar shows the URL <http://www.bcsc.bc.ca/compliance.asp>. The page header includes the BCSC logo and navigation links: HOME, Q&As, RELATED LINKS, CAREERS, and CONTACT US. A search bar is located at the top right of the page content.

The main content area is titled "COMPLIANCE TOOLKIT" and contains the following text:

The compliance toolkit provides registrants with easy access to frequently requested information about the [rules and regulations](#) that govern their day-to-day operations. This is an initiative of the [Capital Markets Regulation](#) division to ensure that our registrants have the necessary tools for compliance.

- [Monthly reporting under suppression of terrorism regulations](#)
- [Questions and answers about compliance](#)
- [Understanding your compliance examination](#)
- [Out of Province Registration - 2007 Adviser Notice](#)
- [2007 Adviser Annual Report](#)
- [2006 Adviser Annual Report](#)
- [2005 Adviser Sector Report](#)
- [2004 Scholarship Plan Dealer Report Card](#)
- [2003 Adviser Report Card](#)
- [2001 BC Portfolio Managers' Report on Compliance Deficiencies](#)
- [Branches and branch managers](#)
- [Dealers and their salespersons \(BC Interpretation Note 33-703\)](#)
- [FINTRAC: Financial Transactions and Reports Analysis Centre](#)
- [For financial planners](#)
- [Policy and Procedure Manual Checklist](#)
- [The role of compliance officer](#)
- [Things you should know about hedge funds: Notice to dealers](#)

The Examinations Branch holds regular forums for advising firms. Presentation materials from our forums is available on the [Adviser Forums](#) page.

BCSC staff have produced an additional [toolkit on conducting background research](#) that can assist you with meeting your gatekeeper obligations.

Please note that these materials have not been reviewed for consistency with the rules and policies of the [Investment Dealers Association](#) or the [Mutual Fund Dealers Association](#). Please contact your governing self-regulatory organization if you have any questions about their rules and policies.

Last Updated: 7/5/2007

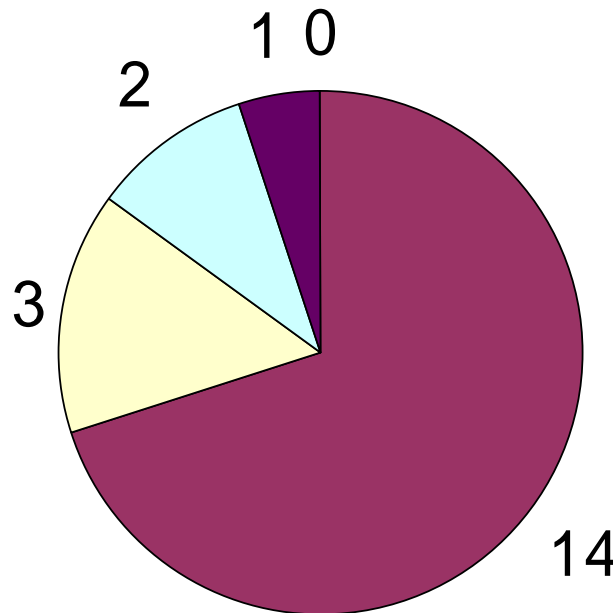
The browser's taskbar at the bottom shows the Start button, several open applications (PRESENTAT..., PAPERDOC..., 2007, Asset backe..., Microsoft Ex...), and the system tray with the date and time (6:17 PM).

BC Adviser metrics

- ICPM firms = 76
- Specialty dealers (non-SRO dealers) = 9
- Total approximate AUM = \$158 billion
- Average AUM = \$2.1 billion each
- Total advisers = 278
- Average advisers = 3.7 advisers per firm

Exam focus 2008 – 20 registrants

Exams 2008
CMR



- Mutual fund dealers
- Investment Counsel/Portfolio Managers
- Fund Examinations
- Scholarship Plan Dealers
- Exchange Contracts Dealers

Exam highlights 2008

Types of Registrants Examined	Total Exams 2008	Percent 2008
Mutual fund dealers	0	0%
Investment Counsel/Portfolio Managers	14	70%
Fund Examinations	3	15%
Scholarship Plan Dealers	2	10%
Exchange Contracts Dealers	1	5%
Total Registrants Examined	20	100%

Report Card – common deficiencies

Top Ten Deficiencies by Frequency 2008

	Total firms used for stats = 19		
	Compliance deficiency categories	Total Deficiencies	Percent Deficient
1	Policies and procedures manual issues	14	74%
2	Disaster recovery and business continuity	11	58%
3	Advertising & marketing	9	47%
4	Know-your-client (KYC) and suitability	8	42%
5	Registration administration (NRD etc)	7	37%
6	Overall compliance program	6	32%
7	Conflicts of interest & personal trading	5	26%
8	Disclosures	5	26%
9	Out-of-province or non-resident clients	4	21%
10	Insider and early warning reporting	4	21%

CFA topics

Peter Bernstein's ideas: by Jason Zweig, Money Magazine

1. Anything can happen. We do not and cannot know the future.
2. Whether you take risk depends not just on the probability that you are right but also on the consequences if you are wrong.
3. The riskiest moment is when you are right.
4. If you're comfortable with all your own, you're not diversified. Diversification is an explicit recognition of your ignorance.

Economic Psychology? – John Nofsinger

- Overconfidence in ability to pick stocks
- Herding – comfortable when other mgrs do the same
- Take mental shortcuts- look at only the info I like
- Illusion of control

▪

CFA topic: The Black Swan — Nassim Nicholas

Taleb



What is a Black Swan?

- A highly improbable event
- Carries a massive impact
- It is an outlier / long tail

Examples:

- 9/11
- Success of Google
- 1987 Crash
- Sub-prime crisis
- NYSE Chair, Richard Grasso's bonus

Concepts to consider

- **Ethics:** a firm's code of conduct; acting with integrity & professional competence of staff.
- **Professionalism;** maintain and improve professional conduct.
- **Fiduciary Duties:** while this has no clear definition or rule, it generally applies to those in a fiduciary relationship. There are more “breach of fiduciary responsibility” and regulatory suits being raised in arbitration against brokers and investment advisers.
- Q: What does a lack of these elements create?

Why is ethics important?

- Strong ethics = a powerful tool for your corporate culture
- Ethical standards guide employee behaviour
- CSI defines ethics in three basic ways:
 - Ethics represents the rules or standards governing the behavior of a particular group, such as a profession.
 - Ethics is a set or moral principles or values; morals are rules or the habits of conduct of a society established with reference to right and wrong.
 - Ethics is the study of the general nature of morals and moral choices made by individuals.

How is fiduciary duty defined?

The term "fiduciary" comes to us from Roman law, and means "a person holding the character of a trustee, or a character analogous of a trustee, in respect to the trust and confidence involved in it and the scrupulous good faith and candor which it requires."

Fiduciaries have a duty, created by undertaking certain types of acts, to act primarily for the benefit of another in matters connected with such undertaking. We utilize the term "fiduciary" to mark certain relationships where a party with superior knowledge and information acts on behalf of one who usually does not possess such knowledge and information.

Blacks law dictionary

Standard of care for fund manager

Standard of care for investment fund manager

Every investment fund manager must

- (a) exercise the powers and discharge the duties of its office honestly, in good faith and in the best interests of the investment fund, and
- (b) exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances

Section 125, *BC Securities Act*

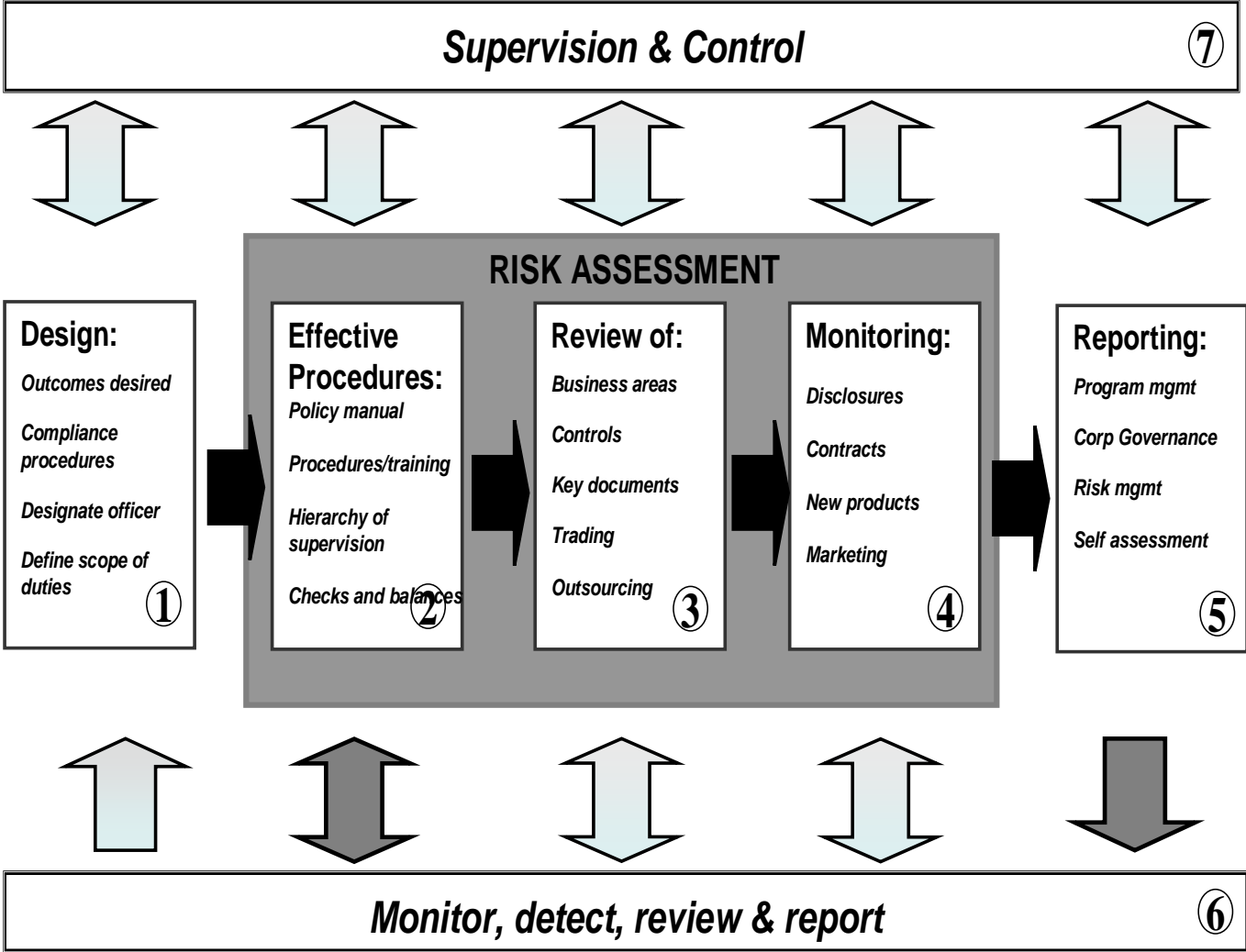
- “Canada is ripe for increased legal proceedings alleging breaches of fiduciary obligations”

Stephen Erlichmann, *Fiduciary duty and conflicts of interest in the Canadian Mutual Fund Industry*: Davies Ward & Beck.

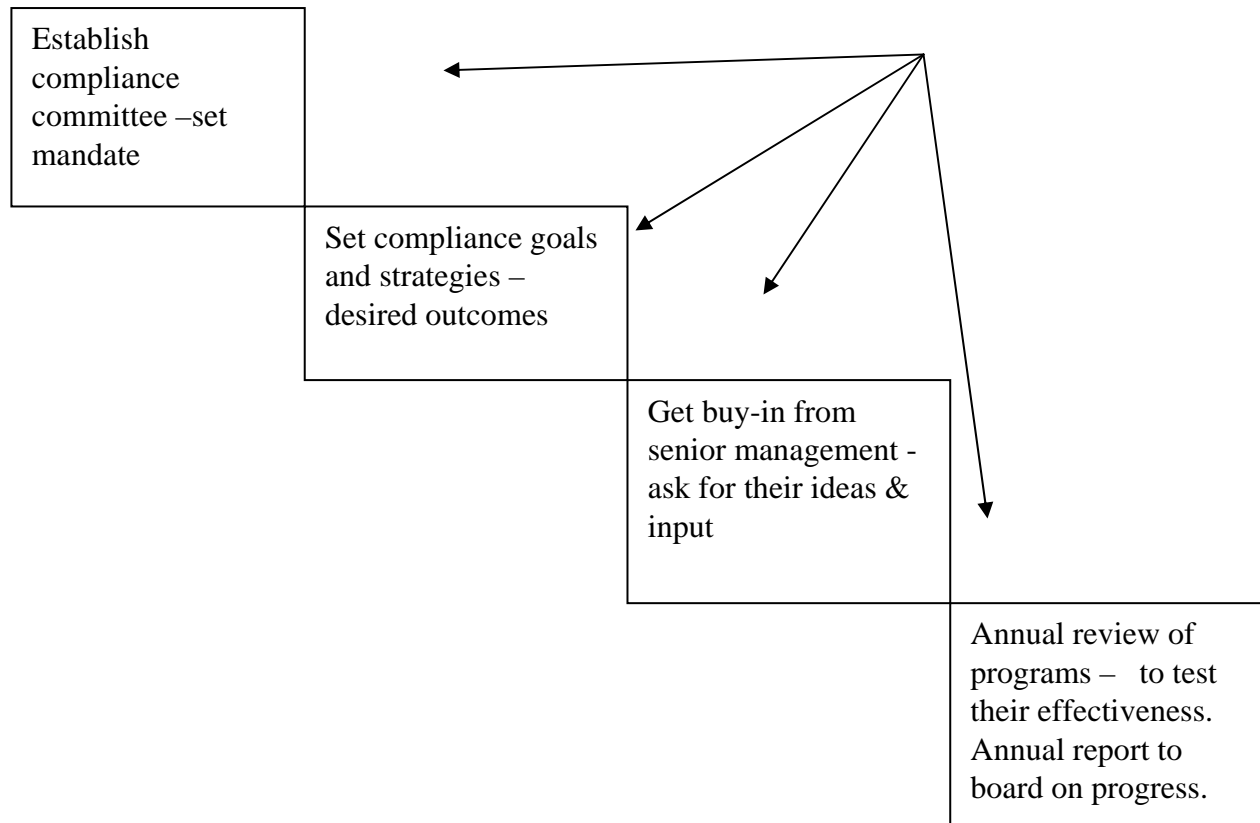
Compliance processes- questions?

- ❑ What is meant by compliance program design?
- ❑ Are the compliance committee/dept of officers known by employees?
- ❑ Is the function and scope of officer duties clear?
- ❑ Does the program outline permissible conduct?
- ❑ What data mining do you do to prevent and detect issues?
- ❑ Do you monitor specific work outsourced?
- ❑ Do you consider corporate governance and risk mgmt?
- ❑ Is your program pro-active or reactive?

What is a good compliance program?



Where to start?



Exceptional firms?



- Code of ethics
- Updated policies and procedures designed to prevent & detect violations
- Annual check-up of compliance programs
- Effective Chief Compliance Officer
- Senior management approves new procedures in writing
- Useful data mined

You can work it out



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