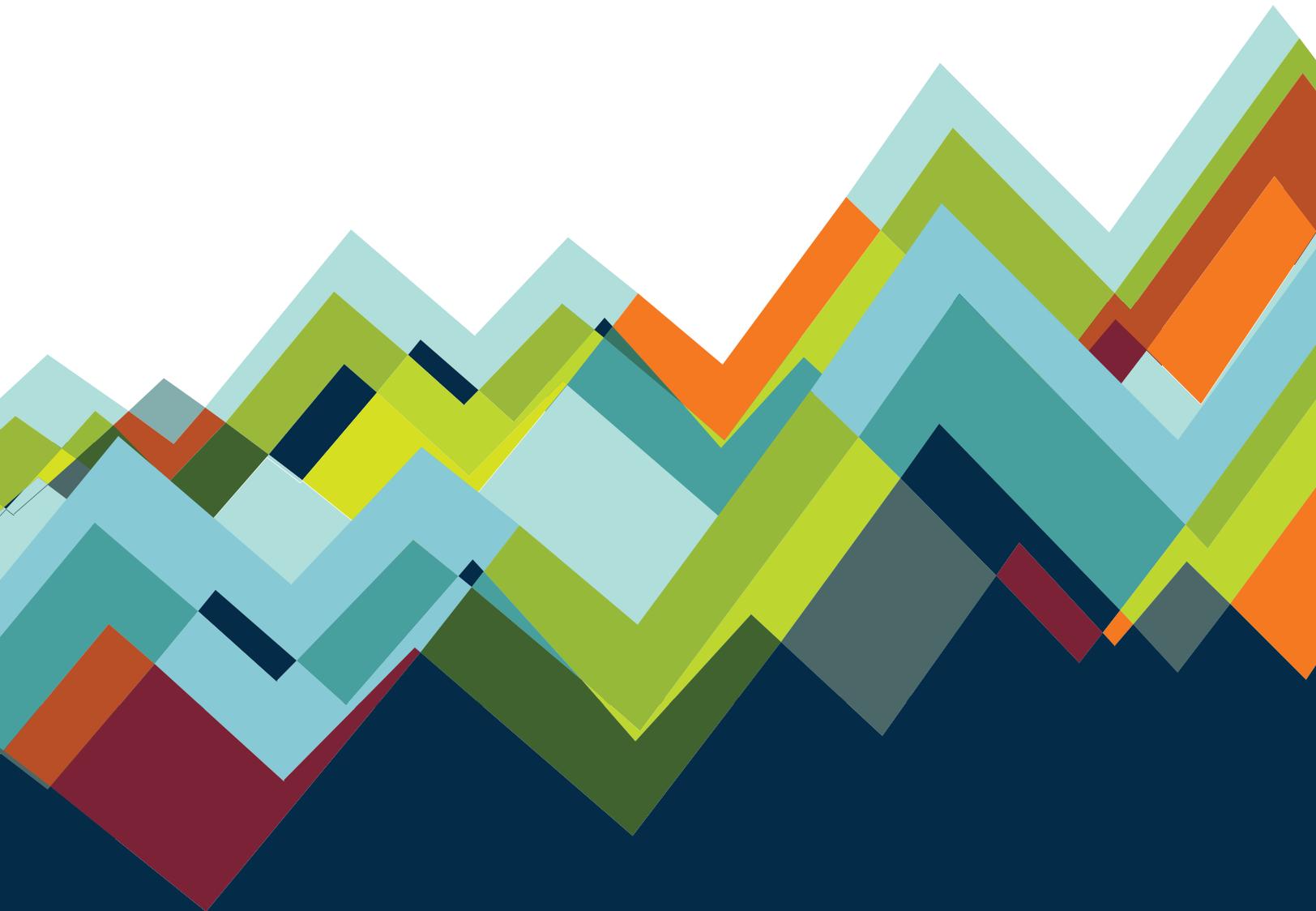




British Columbia  
Securities Commission

# Annual Compliance Report Card - 2018

Version 1.0



# BCSC 2018 ANNUAL COMPLIANCE REPORT CARD

This compliance report card summarizes the findings that our compliance teams made in the course of their reviews of the compliance programs of BC-based portfolio managers (Advisers), investment fund managers (IFMs), and exempt market dealers (EMDs) from April 1, 2017 to March 31, 2018.

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 March 31, 2018, the British Columbia Securities Commission (BCSC) had 126 directly registered firms (excluding IIROC and MFDA firms). Based on the nature of each firm's business, our directly registered firms consisted of:

- 90 Adviser firms (including IFMs)
- 36 Dealer firms (including EMDs)

In addition to our registered firms, we also continued to review the compliance of unregistered market participants that we thought might be required to register. These market participants include both issuers and finders that appeared to be in the business of trading in securities under registration and prospectus exemptions in BC.

## Our approach to regulation – risk and outcomes based

Our goal is to foster a culture of compliance among market participants. Where we find serious compliance failures or dishonest conduct, we will take decisive action. This past year, we found significant failures of compliance that resulted in the BCSC placing terms and conditions on the registrations of some firms.

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).

The BCSC continues to use its predictive risk model to assess the risks for BC-based registered firms. We take data from the answers firms provide to our risk questionnaire every two years and the firm's examination results. The data from our risk model, together with information gathered from observation, helps us predict the likelihood of compliance failures as measured by significant and repeat deficiencies. In addition to reviewing firms due for review based on the time elapsed since their last review, we choose firms with the highest likelihood of compliance failures for our compliance examinations. 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 may have identified.

If we receive information or complaints that indicate any market participant is seriously noncompliant or dishonest, we conduct a "for cause" review.

# COMPLIANCE REVIEW FINDINGS

We saw compliance strengths and weaknesses in the firms we reviewed this year, which we discuss below under “positive findings” and “top deficiencies”.

## Registered firms – positive findings

We discuss below the positive practices we saw firms with good cultures of compliance.

### *Adviser firms*

- Most firms understand the importance of suitability and keeping current know your client (KYC) information. Some of our Adviser firms kept records that integrated a client’s KYC information and investment policy statement (IPS), so they could demonstrate to us that they were at all times giving effect to the IPS and the requirements under their policies and procedures manual.
- Firms meet clients at least annually (or more frequently as needed) to update KYC information and their investment policy statement.
- With respect to conflicts of interest, some advisers chose to avoid conflicts of interest rather than managing them. We saw instances where Adviser firms refused soft dollar or referral arrangements, and declined unusual compensation structures or forms of payment because of concerns over the related conflicts.
- Generally, most firms we visited ensured that client statements met Client Relationship Model 2 (CRM2) requirements, particularly with respect to market-weighted-return performance and firm compensation information.
- Some registrants reached out to their RM proactively to update them on new developments at the firm. For example, if the firm was considering a new product or service, in addition to talking to their legal counsel, they discussed the compliance implications of the proposed changes with us. Examples we saw included:
  - a firm included us in its discussions about converting its exempt fund to a prospectus-qualified fund
  - another firm discussed its intention to extend its registration to the EMD category and its planned hiring of dealing representatives
- Some firms demonstrated that they assessed the impact on their compliance programs before they made changes to or expanded their businesses. These firms limited their risk by not chasing growth before considering their compliance programs and by first providing additional resources for their compliance programs.

# COMPLIANCE REVIEW FINDINGS

## *Dealer firms*

- Some firms realized that maintaining a simpler business model made it easier to monitor compliance. Generally, firms with simpler business models had fewer compliance deficiencies.
- In general, we noted an improvement in the cultures of compliance and a reduction in compliance deficiencies among Dealer firms that operate a “finder” business model.
- Although suitability deficiencies remain high and in our list of top deficiencies, we did observe a reduction in the number of repeat deficiencies related to suitability. We also observed that some firms improved their systems and records that track their documentation of the suitability process.

## Registered firms – top deficiencies

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

This year, we conducted 23 compliance reviews and found 151 compliance deficiencies in total, averaging 6.57 deficiencies per review. We observe an upward trend in average number of deficiencies per review:

Year	Average number of deficiencies per review
2018	6.57
2017	6.58
2016	4.29
2015	4.64

The eight top ranking deficiencies in 2018, averaged between EMD and Adviser/IFM businesses, represent 91 out of 151 (approximately 60%) of all of the compliance deficiencies we found, as follows:

# COMPLIANCE REVIEW FINDINGS

Deficiency type	Number of Deficiencies	% of all Deficiencies	Average overall rank
Policies and procedures	18	12%	1
Disclosures	14	9%	2
Know your client and suitability	13	9%	3
Compliance officer function / UDP function	11	7%	4
Client statements and reporting	11	7%	4
Administrative filings	9	6%	5
Advertising, marketing and holding out	9	6%	5
Conflict of interest and personal trading	6	4%	6
<b>Total</b>	<b>91/151</b>	<b>60%</b>	

Examples of the compliance deficiencies we found in the above deficiency categories and in the other categories we examined include:

## *Policies and procedures*

Registered firms must maintain policies and procedures that establish a system of controls to provide reasonable assurance that the firm and individuals acting for it comply with securities legislation and appropriately manage the risks associated with its business. We saw failures including:

- Some firms had not considered the risks associated with their businesses, and did not create policies and procedures that adequately managed those risks. We view these failures as systemic compliance failures.
- Some firms had policies and procedures that did not adequately address their current businesses or had policies and procedures manuals (PPMs) that were so brief as to be meaningless.
- Some firms’ PPMs contained references to repealed securities legislation indicating that their CCO did not keep current with changes in securities legislation.
- Some firms had inadequate cybersecurity policies and procedures in place. Although many firms appeared to have considered cybersecurity and addressed basic concerns, we saw PPMs that did not:
  - address password protection, laptop encryption or restrictions on laptop and mobile device usage

# COMPLIANCE REVIEW FINDINGS

- provide policies and procedures for the confidential storage of email instructions from clients and associated attachments
- mandate updating or automating the update of antivirus definitions
- provide policies and procedures for the use of personal electronic devices to access a firm's network and data
- provide policies and procedures for staff access to external networks on the firm's computers or mobile devices
- mandate training for staff on cyber security issues and social engineering threats
- describe the actions a firm should take to recover from any significant cyber-attack such as ransomware, identity theft or denial of service
- provide policies and procedures for confidentiality or security vetting for third-party vendors or service providers that access a firm's network or data

We expect to see firms understand the risks associated with their businesses and that their policies and procedures reflect that they manage these risks appropriately.

## *Disclosures*

We found weaknesses in disclosures to clients, particularly in relation to relationship disclosure information (RDI) requirements as follows:

- In many Dealer firms, we continued to see weaknesses in relation to failures to present accurate RDI information, or to present all information that a reasonable client would consider important about the client's relationship with the registrant.
- Many firms did not meet their disclosure requirements by providing all of the information required in section 14.2(2) of NI 31-103.

## *KYC and suitability*

KYC and suitability form the cornerstone of a registrant's obligation to its clients. Accurate and current client records are critical for a firm to be able to assess the suitability of a trade for a client. Failures of KYC and suitability often result in client complaints to the BCSC. We found the following failures:

- KYC information must be meaningful. For example, we saw KYC forms where clients checked off their net financial assets in wide ranges (e.g. up to \$400K/up to \$1M/over \$5M) that do not provide useful financial information.
- EMDs that conduct business as mortgage investment corporations (MICs) or mortgage investment entities, often demonstrated a poor understanding of the client-facing obligations of a registered EMD. For example they:
  - frequently failed to demonstrate that they understood the investor, not the borrower, is the client under securities legislation

# COMPLIANCE REVIEW FINDINGS

- did not understand the process to document suitability reviews
- did not understand the concept of know your product
- Some firms kept outdated or incomplete KYC forms. In some of these cases, the KYC information on file was insufficient for these firms to demonstrate they were able to consider the suitability of their clients' trades.
- Some firms with poor client records were unable to demonstrate that they had complied with their own KYC and suitability procedures.

## *Compliance officer function*

We found some CCOs failed in their roles as follows:

- In some smaller captive EMDs (firms that distribute securities of related or connected issuers with common mind and management), we noted that CCOs assumed that they know their products because they were instrumental in creating them. However, we saw examples where CCOs were unable to demonstrate that they know their product because they did not keep any information to demonstrate they considered the investment's:
  - timeline to maturity
  - redemption ability
  - inherent risks

These considerations are critical for the registrant to discharge its suitability obligation.

- We continued to see weaknesses in CCOs' record keeping. Poorly kept or missing records prevent a registered firm from demonstrating to staff that it was in compliance with securities legislation and with its own policies and procedures. We consider keeping proper books and records as part of a CCO's duties and the maintenance of a firm's risk management processes. We saw failures in some firms where CCOs did not document:
  - their supervision of personal trading and its approval
  - their supervision of associate advising representatives or other staff that require supervision
- Some CCOs did not keep up to date with changes in securities legislation with the result that their firms' PPMs contained references to repealed securities legislation.

## *Client statements and reporting*

Our reviews tested if registrants deliver and present in their client reporting, including trade confirmations and client statements, accurate information in a clear, meaningful, and timely

# COMPLIANCE REVIEW FINDINGS

manner, in compliance with Part 14 of National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations (NI 31-103). We continued to focus our reviews on whether registrants were reporting client information in compliance with current CRM2 requirements. Some firms did not comply with Section 14.14.1 of NI 31-103 and we saw compliance failures including:

- We noted weaknesses in the required content of client statements, across all businesses and categories of registrations.
- In Dealer firms, we continued to see weaknesses in:
  - written trade confirmations that did not include all the information required in section 14.12(1)(a) to (h) of NI 31-103
  - account statements that did not include all the information required in section 14.14.1 (4) and (5) of NI 31-103
- Account statements that did not provide adequate disclosure about the party that holds or controls each security, and a description of the way that the security is held.
- Account statements that did not provide information about whether the securities or account was eligible for coverage under an investor protection fund approved or recognized by the securities regulator. For some firms that do not use an IIROC custodian, they may be under the impression that no disclosure is required as this is not applicable. We expect firms to disclose if the securities and/or client accounts held at non-IIROC custodians are not eligible for protection under an investor protection fund.

## *Administrative filings*

We review whether firms meet their compliance requirements to update information about the firm and its registered individuals on the National Registration Database (NRD). Current and correct information on NRD is critical because NRD serves as a national record of all registration activity. Compliance failures in this area often indicate more substantial compliance issues. We saw failures that included the following:

- Many firms did not monitor and identify the outside business activities (OBAs) for their registered individuals, and report these activities on NRD.
- Some firms that monitored and identified OBAs, failed to update them in NRD.

Firms should ensure that individual registrants report their OBAs and that they are noted on NRD accurately. We expect firms to have procedures in place to identify, review, and assess their employees' OBAs for potential conflicts of interest.

# COMPLIANCE REVIEW FINDINGS

## *Advertising*

We saw a number of investment funds (mostly in MIC businesses) advertise themselves as fixed income products. In most cases however, the advertised returns were based on historic returns and given the nature of the funds' businesses, could not reasonably be advertised as fixed income products.

## *Conflicts of interest and personal trading*

We saw instances where the processes that firms adopted to manage their conflicts of interest lost sight of the fact that where a conflict of interest is so deep or pervasive that the firm was unable to manage it, the conflict should be avoided.

In our reviews of a number of captive Dealer firms, we saw the following compliance failures:

- Some firms were unable to describe the risks associated with their products or how those risks affect a product's suitability for different categories of investors.
- Some firms were unable to recognize that severe conflicts of interest existed in their business structures because of their shared mind and management with the issuer they were distributing securities for.
- A few firms confused the prospectus exemptions (under section 61 of the Securities Act) with their client-facing obligations under NI 31-103, believing that compliance with section 61 relieved them of their registrant obligations including, in some cases, KYC and suitability.

In our reviews of adviser firms, we found compliance failures that breached the requirements in Section 13.5 of NI 31-103 (Restrictions on certain managed account transactions), including:

- A few advisers had purchased securities where the firms' directors were also directors of the issuers, on behalf of client accounts, without disclosing their purchase and the relationships to clients and obtaining consent prior to the transactions occurring.
- Prohibited cross trades between two non-prospectus investment funds that a firm manages.

We view these types of conflicts of interest breaches as significant. Some breaches were self-reported, but some firms did not realize that they violated Section 13.5 until compliance staff uncovered the breaches and informed them. We expect firms to have proper systems in place to identify and mitigate all conflicts of interest.

We regard a failure to demonstrate consideration of the nature of the conflicts of interest inherent in a registered firm's business to be a systemic compliance failure.

# HOW WE TREAT NON-COMPLIANCE

The CCO must ensure that every aspect of the firm's business complies 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:

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

## *Compliance action*

We took compliance action against firms where we identified significant weaknesses in their compliance programs. We proposed terms and conditions of registration for two firms, one of which elected instead to surrender its registration. In addition, two firms elected to surrender their registration at the conclusion of our compliance fieldwork. When the Executive Director imposes registration conditions on firms, the imposed conditions may include:

- requiring firms to hire a compliance monitor to work with them to remedy compliance deficiencies including reviewing and reporting on their KYC documentation and rewriting their PPMs
- preventing a firm from trading until it rectifies its compliance failures
- preventing a firm from hiring additional representatives
- preventing a firm from conducting trades for clients until it updates clients' KYC information
- requiring the UDP or CCO to pass specified courses

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

We also charge costs for our compliance reviews 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 the past year, we referred four firms to our enforcement division. We refer firms when we see systemic or significant failures that pose risks to clients, or repeat significant deficiencies firms fail to resolve. 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. Our enforcement team investigates and may prosecute the compliance failures we uncover by issuing a notice of hearing. Enforcement outcomes are public.

# EXAMINATION FOCUS 2018 - 2019

During the year ahead, we will continue to focus our compliance reviews of registered firms on the top deficiencies. We will continue to select firms for review based on significant changes of business, revenue, or size. When we review firms, we will continue to focus on PPMs, KYC and suitability, and compliance with CRM2 requirements. In addition, new areas of compliance review focus will be on cybersecurity and the handling of senior clients.

## Guidance

When facing reviews, CCOs should consider the practices mentioned in this report card and the numerous guidance notices that the CSA has published. In particular, we remind firms that the CSA has provided guidance in:

- Multilateral Policy 31-202 *Registration Requirement for Investment Fund Managers*
- CSA Staff Notice 31-325 *Marketing Practices of Portfolio Managers*
- CSA Staff Notice 31-334 *CSA Review of Relationship Disclosure Practices*
- 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*
- CSA Staff Notice 31-347 *Guidance for Portfolio Managers for Service Arrangements with IIROC Dealer Members*
- CSA Staff Notice 31-350 *Guidance on Small Firms Compliance and Regulatory Obligations*
- CSA Staff Notice 31-343 *Conflicts of interest in distributing securities of related or connected issuers*
- CSA Staff Notice 33-321 *Cyber Security and Social Media*

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 about your compliance program, please contact the BCSC relationship manager for your firm, or any member of the BCSC compliance team.

# CONNECTING WITH THE BCSC

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

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