



2012 Compliance Report Card

We publish our annual compliance report card to inform key staff at registered firms about our examination findings and registrant regulation priorities. We also provide suggestions for a healthy compliance oversight program, and review compliance action we take against firms that do not demonstrate strong cultures of compliance.

2011 examinations

Who we regulate

The BCSC monitors the compliance programs and solvency of all registered firms that we principally regulate (PR). As of March 31, 2012, we had 97 such firms, registered in these categories:¹

| Registration Category | BC PR Firms | Non-PR Firms | Total # of Firms |
|-------------------------|-------------|--------------|------------------|
| Portfolio manager | 80 | 309 | 389 |
| Investment fund manager | 47 | 50 | 97 |
| Scholarship plan dealer | 0 | 7 | 7 |
| Exempt market dealer | 48 | 312 | 360 |
| Restricted dealer | 2 | 1 | 3 |
| Total | 177 | 679 | 856 |

How we select firms for review

We identify higher risk firms for examination. We profile each PR firm and score it on a risk scale. Where we see risky business models or conduct, we increase the firm's risk score for that firm. A firm's risk score dictates the scope and frequency of our examinations of it. We visit firms with a higher risk score more frequently, and examine them in more detail, than a comparable firm with a lower risk score.

In addition to risk, we use other criteria to select firms for review:

- **Cycle examinations** – we review all registered firms in a 1 to 5 year cycle.
- **New firms** – we review new firms within 24 months of their initial registration.
- **For cause exams** – we conduct special reviews of firms where we question the integrity of their compliance system. These reviews usually result from client complaints or detrimental information from other sources.
- **Sweeps** – we review firms periodically as participants in Canadian Securities Administrators (CSA) programs or other focused reviews.

From April 1, 2011 to March 31, 2012, we completed 31 compliance reviews (almost 32% of total registrant population).

¹ Many firms register in multiple categories. The number of registered firms is consequently less than the total number of registration categories.

What we found

In our compliance reviews, we found:

- **Policies and procedures manuals** were deficient in 89% of our reviews. In most cases, firms had changed operational procedures without updating their manuals.
- **Advertising deficiencies** occurred in 56% of our reviews. Firms that offered services beyond their registration or expertise and misleading website advertising caused most of the deficiencies in this category.
- **Know-your-client (KYC) and suitability** deficiencies occurred in 48% of our reviews. Some firms failed to complete KYC documents, and others had client asset mixes inappropriate for clients' stated risk profiles. Many firms had no regular program to update their KYC information.
- **Business continuity and disaster recovery plans** were deficient in 41% of our reviews. In most cases, firms had inadequate plans. In addition, most firms had not tested or had not planned to test their business continuity plans.
- **Conflicts of interest** management policies were deficient in 33% of our reviews. Firms had inadequate policies to manage conflicts, and some lacked controls for personal trading.
- **Disclosure deficiencies** occurred in 30% of our reviews. These included disclosures about fees, conflicts of interest, risk, leveraging risks, allocation policies, and referral arrangements.
- **Firm capital** monitoring procedures were inadequate in 26% of our reviews.
- **Administrative filing** deficiencies surfaced in 22% of our reviews. These included failing to report an exempt distribution and failing to file an offering memorandum.

What we expect from you

We expect firms to operate their businesses and make decisions that minimize risk. You must demonstrate a strong culture of compliance, and can do this in the following ways:

- Be transparent and honest in all dealings with clients. This is a core obligation, consistent with the fair dealing requirements under the *Securities Rules* that registrants must deal fairly, honestly, and in good faith with their clients.
- Review and clarify the roles and expectations of the Chief Compliance Officer (CCO) and Ultimate Designated Person (UDP). We believe that the CCO and UDP must have the authority to influence business decisions of the board or senior management of the registrant to demonstrate a registrant's commitment to a culture of compliance. The CCO and UDP, together with senior management, must consistently send a strong and consistent top-down and firm-wide message to all staff about the importance of good compliance practices and strong ethics.
- Provide adequate resources for compliance, and frequently update compliance policies and procedures manuals to track the changing regulatory environment and market trends. In addition, firms that demonstrate strong cultures of compliance will train staff appropriately on their compliance policies and procedures. Firms can test their compliance programs by periodically hiring a compliance consultant or adviser to provide an independent assessment.

Compliance and enforcement action

Where PR firms do not meet our compliance expectations, we may take compliance or enforcement action against them. We adopt a graduated approach to compliance failures as follows:

- We recover examination costs from firms that have a high number of deficiencies, are not cooperative, or have not established a reasonable compliance program (section 22, Item 26 of the *Securities Regulation*).
- Cases that are more serious include those with repeat significant deficiencies, substantial failures of the firm's compliance systems, or substantial non-compliance with the requirements of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103). In these cases, in addition to billing for our time, we may take compliance or enforcement action to discipline the firm by publicly imposing a sanction.
- The most serious cases include those where a PR firm or its individual registrants fail to remedy significant compliance deficiencies, lie to or act dishonestly toward clients, or attempt to mislead staff. In these cases, we may commence enforcement action to suspend the firm's registration and impose a significant public sanction against the firm and its management.

This following table lists 2011 regulatory actions against firms:

| Registrant | Reasons for compliance action | Outcome |
|---------------------------------|---|--|
| Portfolio manager K | Overall compliance system failure; capital deficient. | The firm immediately remedied all the compliance deficiencies and hired a compliance consultant to test its compliance system. In addition, the firm paid a \$12,000 sanction. |
| Portfolio manager D | Poor compliance practices for custody of client assets. | The firm immediately changed its custody arrangements, and received a reprimand. |
| Exempt market dealer R | Questionable holding out practices; sharing registerable business with a related unregistered entity. | The dealer immediately changed its policies and procedures manual, revised its website, and undertook to cease sharing business with the unregistered entity. |
| Exempt market dealer M | Three breaches of condition requiring quarterly filing of financial statements. | The firm agreed to surrender its registration and cease business. |
| Portfolio manager UDP, B | UDP had not set the compliance tone for the firm, had abandoned his duties as UDP, and lacked the competence to direct the firm's compliance program. | The firm agreed to hire a UDP and CCO acceptable to staff. The UDP will not in future seek registration as a UDP or CCO of any firm. |

Creating a strong compliance program, and testing it frequently, is the best medicine to protect a firm from regulatory intervention, market crises, and risk.

If you have questions about this report or the BCSC's approach to reviewing compliance, contact Sandy Jakab, Director, Capital Markets Regulation at sjakab@bcsc.bc.ca.