



**2005 Adviser Sector Report  
Capital Markets Regulation Division  
British Columbia Securities Commission**

## **Introduction – Executive Summary**

This report provides transparency and guidance with respect to our compliance findings in 17 ICPM examinations conducted during our last fiscal year: April 1, 2004 to March 31, 2005. We presented a similar report on Investment Counsel and Portfolio Managers (ICPMs) in 2001 and 2003.

For further information on our compliance examination process, visit <http://www.bcsc.bc.ca/compliance.asp?id=2103>

## **Some Trends**

A changing landscape requires that registrants periodically assess their practices, relationships and processes to ensure they are managing risks effectively.

- **Expanding of alternative products** – we are seeing more new and complex products such as hedge funds, principal protected notes and exchange-traded funds. These products appear to be gaining more ground in the retail markets. Firms must evaluate the due diligence on these alternative products, as they often possess unique risks and more complexity than traditional products.
- **Changing regulatory landscape** - securities markets are constantly changing as well as regulatory legislation. These changes help improve business efficiencies (for example, the National Registration Database). When regulatory change occurs, firms should review their internal controls, corporate governance practices, information systems and staff training programmes to keep them up to date.
- **Evolving trade technology** – the expanding use of technology and the internet is changing how you trade, manage accounts, keep records and communicate with clients. New technology also enables some firms to reduce their back office function by outsourcing reports and client services. Even with these changes, registrants still need to ensure their records are complete and accurate, and that computer and other systems are secure.
- **Best trade execution**- there are many discussion papers on the advantages and disadvantages of using soft dollars. Some reports cite incidents of soft dollar abuses and many argue for unbundling of soft dollar commissions hidden in trade costs. New industry guidelines encourage firms to review their best execution practices and ensure

the client comes first. A regular internal review of broker selection, trade management, conflicts of interest policies and soft dollars practices does make sense.

- **Managing operational risks** – Risk measurement and management have become increasingly important. Firms often implement risk management controls to monitor the investment decision-making process and to scrutinize complex investment products. It also becomes more common for firms to implement risk management procedures to analyze their operational risks.

## ICPMs

The ICPMs are growing in size and diversity. As of April 30, 2005 there are **275** ICPMs registered in BC. In comparison, there were 205 firms in 2003 and 166 in 2001. Of the 275 registered in BC, 75 firms (27%) have head offices in BC.

ICPMs have the greatest access and control over client assets of any registrant and also have a fiduciary duty to their clients. We expect PMs to establish a strong culture of compliance and to promote full disclosure and transparency.

## Common ICPM Deficiencies

These are the 10 most common deficiencies found during the examination. These common deficiencies are shown under broad headings and are not meant to imply that firms have compliance issues in all areas. However, if a firm has a large number of deficiencies we recommend them to review their approaches they take to meet their overall compliance objectives.

Common Deficiencies	2005 Ranking	2005 % Deficient	2004 Ranking	2004 % Deficient
Policy and procedures manual	1	76%	2	63%
Know-your-client and suitability information	2	65%	11	16%
Client Disclosures	3	59%	1	74%
Anti-money laundering procedures	4	47%	4	42%
Capital Monitoring	5	35%	7	26%
Advertising and performance presentation	6	29%	3	63%
Representative agreements and contracts	7	29%	20	5%
Out of province or non-resident clients (Registration)	8	24%	14	16%
Record keeping	9	24%	5	32%
Compliance officer responsibilities	10	24%	0	0%

In many cases, the common deficiencies identify operational areas that your firm can focus on for improvement. For example, incomplete policies and procedures manual was the most frequently identified deficiency last year in 13 of 17 exams or 76% of the firms examined. We generally find firms with complete and adequate written policies and procedures have fewer overall compliance deficiencies.

**Most improved areas compared to 2004:**

- advertising and performance presentation (29% vs. 63%)
- client disclosures (59% vs. 74%)

**Areas requiring improvement compared to 2004:**

- know-your-client and suitability (65% vs. 16%)
- representative agreements & contracts (29% vs. 5%)
- compliance officer responsibilities (24% vs. 0%)

**1. Incomplete policy and procedures manual**

– 13 of 17 exams

Firms need to establish, document and apply prudent written procedures to enable them to serve their clients. A written and relevant policy and procedure should be in place that applies to the firm's business and operations.

During our reviews, we observed the following:

- policy and procedures taken from another source with no customization and relationship to the specific operations of the firm
- weak guidance to employees about interpretation of the policy and procedure manual
- the manual did not contain all the procedures required to run the business
- the manual contained procedures that are not relevant to the firm
- the manual was not provided to or read by all employees

*Good Practices*

- establish detailed and relevant policies and procedures for each key area of responsibility
- review and update your manual regularly
- amend your manual for changes in your firm's operation or in regulation
- consider including compliance practices in the following operational areas: trading and brokerage, client identification, anti-money laundering prevention and proxy voting
- proper staff training

**2. Know-your-client (KYC) and suitability**

– 11 of 17 exams

Registrants must make enquiries to learn the essential facts relevant to each and every client and document the results. Maintaining an up-to-date KYC and suitability assessment protects both the firm and the public from potential disputes and disagreements.

During our reviews, we noted the following:

- incomplete KYC forms with missing information and dates
- no evidence that a suitability review had been conducted when the risks of the investments do not match the client's KYC information
- the KYC information was not updated periodically

#### *Good Practices*

- develop standard account opening processes and consider a checklist
- record the essential information for each client, such as the investment objectives and risk tolerance. The information can be recorded on a KYC form or on an investment policy statement
- use the client's specific objectives when deciding on your target asset allocation
- communicate to clients how you are managing their accounts
- update KYC information when necessary to reflect major changes in the clients' circumstances. A review at least annually is recommended.
- develop an audit trail to document the client process and rebalance accounts.

### **3. Client Disclosures**

– 10 of 17 exams

During our reviews, we noted that firms generally failed to disclose the following to clients:

- fee rates and calculation methodology
- firm conflicts of interest
- receipt or payment of client referral or agency fees
- proxy voting practices and the existence of soft dollars

#### *Good Practices*

- develop procedures to identify, resolve, and disclose conflicts of interest
- consider if additional disclosure is necessary when your operations change.
- inform clients clearly of forms of compensation that the dealer or representative receives with recommending a new product or service

### **4. Anti-money laundering procedures**

– 8 of 17 exams

Anti-money laundering legislation has been in place since 1993. However, some firms are still unaware of this important legislation. The *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* requires financial service providers and others to record and keep information about their clients. It also requires that these businesses report specific information on suspicious and other financial transactions to FINTRAC.

During our reviews, we noted the following:

- poor documentation of client identity or the identify of persons having access to clients' accounts, such as a trustee

### *Good Practices*

- formalize your procedures in identifying clients. Obtain an acceptable form of government identification such as their birth certificate, driver's license, passport or other similar record issued by a provincial or territorial government or the federal government
- visit and review FINTRAC's website and guidelines at <http://www.fintrac.gc.ca/>
- regularly compare your client list to the list of suspicious persons. Visit the OSFI website at [http://www.osfi-bsif.gc.ca/osfi/index\\_e.aspx?DetailID=525](http://www.osfi-bsif.gc.ca/osfi/index_e.aspx?DetailID=525)

## **5. Capital monitoring**

– 6 of 17 exams

ICPMs are required monitor working capital on a monthly basis. The working capital calculations must be performed in accordance with Canadian generally accepted accounting principles as set out in BC Form 33-905F.

During our reviews, we found that firms failed to:

- calculate or document monthly working capital calculation
- calculate working capital accurately and using required levels
- include unsubordinated long term liabilities as current liabilities
- exclude related party current assets that are not generated in the normal course of business
- inform the Commission when deficient in working capital

### *Good Practices*

- prepare working capital calculation at least monthly in accordance with BCF 33-905F
- retain copies of working capital calculations to show evidence of review.
- keep abreast of regulatory capital obligations

## **6. Advertising and performance presentation**

– 5 of 17 exams

Advertising and performance reporting is an area of concern because many advisers use performance numbers to attract new clients and retain existing clients. Performance presentations were found in advertisements, fund information sheets, presentation material, offering documents and quarterly reports.

The common deficiencies that we noted during our reviews include:

- transparency issues: disclosures that are not understandable and meaningful to the client
- showing of hypothetical results in such prominence that they appear to be actual results
- linking of simulated results with actual figures
- presenting a selective sample of results, commonly known as “cherry picking”
- failing to disclose important performance elements such as fees

ICPMs have a duty to deal fairly, honestly and in good faith with customers and clients. This naturally extends to advertising representations and communications made to the public or

clients. CFA Institute Performance Presentation Standards (PPS) and Global Investment Performance Standards (GIPS) state that composites must include actual performance.

#### *Good Practices*

- set out proper procedures for review and approval of marketing and performance presentation material by senior management
- establish sound practices that prevent unfair practices such as “cherry picking” or portraying hypothetical or simulated data as actual results
- consult GIPS standards and CFA recommended disclosure
- visit the CFA performance presentation standards at [www.cfainstitute.org/cfacentre/ips/pps/aimrpps.html](http://www.cfainstitute.org/cfacentre/ips/pps/aimrpps.html)

### **7. Representative agreements and contracts**

– 5 of 17 exams

Many of the firms that we reviewed did not have adequate employment agreements in place for their employees. Some firms had employment agreements but they failed to set out the obligations and responsibilities. Many employment agreements do not cover the following areas:

- responsibility of the employee to the firm and to the client
- requirement to follow the firm’s policy and procedure manual
- requirement to acknowledge and abide by the Securities Act and Rules
- provisions for obtaining approval from the firm and the Commission before seeking employment outside the firm

#### *Best Practices*

- develop sound hiring practices and establish the use of employment agreements

### **8. Out-of-province or non-resident clients (Registration)**

– 4 of 17 exams

ICPMs who have clients that reside outside of BC need to determine and comply with the registration in those jurisdictions. Some jurisdictions may grant a specific exemption from registration if the firm meets certain criteria. BC based ICPM firms should be aware that an adverse regulatory finding against the firm in another jurisdiction may affect their registration suitability in British Columbia.

#### *Good Practices*

- learn and understand your registration requirements in jurisdictions where your clients reside
- consult with the regulator in the jurisdiction where you have clients

**9. Record keeping**  
– 4 of 17 exams

During our reviews, we noted that firms failed to maintain:

- trade instructions or records
- trade blotters with all the key information
- client information to support investment decisions
- portfolio holdings or securities reconciliations review
- investment research records
- proxy logs and voting decisions analysis
- disaster recovery and business continuity plans

Firms can maintain records electronically. However, some firms have not been able to show adequate security and back-up provisions exist to ensure the information stored electronically is accurate and secure.

*Good Practices*

- understand that records of your firm and your clients are your responsibility which cannot be delegated or outsourced
- identify records crucial to your firm's business activities and ensure they are safe and secure
- keep records in intelligible and readily accessible form

**10. Compliance officer responsibilities**  
– 4 of 17 exams

ICPM's must appoint a compliance officer (CO) who is responsible for ensuring effective supervisory and other compliance procedures are in place. Being a CO requires many specialized skills. A CO must have senior management support if he or she is to implement a successful compliance program.

Compliance officer's responsibilities include:

- ensuring that the firm and its employees comply with current laws and regulation
- supervising and enforcing compliance policies
- updating compliance manuals and providing ongoing education and training to staff
- supervising advisers and representatives
- handling client complaints in a timely manner
- conducting trading reviews.
- addressing disclosure and risk management issues regularly

*Good Practices*

- hire a qualified compliance officer
- support the compliance officer from senior management
- provide the compliance officer the necessary tools to develop, implement, and monitor a well documented compliance system.

## Contact information

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