



British Columbia Securities Commission

**2008 Examinations Report Card
Capital Markets Regulation
British Columbia Securities Commission**

Introduction

This is the Examinations team's most recent report that provides transparency about the deficiencies identified in examinations. This report provides a high-level overview of the most common compliance deficiencies we found from April 1, 2007 to March 31, 2008.

We use a risk-based exam program with a 3-5 year cycle. Areas where we find the highest number of deficiencies involve compliance and supervision, registration, books and records, know-your-client (KYC) and suitability, and in general, unethical business practices.

We regularly review the following types of registrants:

- portfolio managers
- investment counsel
- exchange contracts dealers
- scholarship plan dealers
- other non-SRO registrants

Common compliance deficiencies

We examine a different set of firms each year. This may be based on high-risk and routine reviews, which include visits to new registrants. We note the deficiencies from the compliance reports sent to your firms and record these into 46 different categories.

Our 2007/2008 examinations showed an average of **6.68** deficiencies per examination¹ in the 46 categories, a decline from 7.4 in 2006/2007.

In the table below, we list the 12 most common deficiencies by frequency. Because of the diversity in nature, size, and operations of advising firms, there is no one-size-fits-all solution when it comes to compliance. Compliance regulation is not precise and while you may ask us for specific solutions, we cannot provide detailed guidance on how much compliance is enough.

You must determine the scope of procedures, checks and balances, permissible conduct, reporting, and the controls that are necessary for your specific type of firm. Factors that you want to consider when developing your compliance structure include your clientele, products, and services provided.

¹ Based on a total 127 deficiencies from 19 examinations



Rank	Compliance deficiency	2007/08	2006/07	Change
1	Policies and procedure manual issues	74%	71%	+3
2	Disaster recovery and business continuity	58%	43%	+15
3	Advertising and marketing	47%	36%	+11
4	KYC and suitability	42%	29%	+13
5	Registration administration (NRD etc)	37%	21%	+16
6	Overall compliance program	32%	21%	+11
7	Conflicts of interest and personal trading	26%	29%	-3
8	Disclosures	26%	36%	-10
9	Out-of-province or non-resident clients	21%	17%	+4
10	Insider and early warning reporting	21%	7%	+14
11	Trade execution	21%	29%	-8
12	Record keeping	21%	43%	-22

Policies and procedures – the number one deficiency, again, relates to a firm’s policy and procedures manual. With the speed in which securities legislation continues to evolve, firms should review and update their policies and procedures manual regularly, perhaps even a few sections each year. This keeps the manual more dynamic and a “live” document. A current manual also promotes areas such as training, ethics, and risk management.

Disaster recovery and business continuity – Examiners continue to encourage firms to develop, implement, and test procedures for disaster recovery and business continuity. Firms should consider how their businesses would operate to service clients in the event of a business disruption. A good disaster recovery and business continuity program is not only about systems backups and data recovery. It is also about letting employees know what will happen if a firm’s business location and key management members are unavailable during a business disruption.

Advertising and marketing – a compliance officer should know about all of the marketing activities that the firm, its branches, and its representatives carry out. Advertising materials should not have misleading statements, claims, or performance figures. It is important to include relevant information, such as calculation assumptions, together with advertising materials, as this information gives readers the context to evaluate the materials.

Other compliance issues

Working capital deficiencies – working capital is the primary means that examiners monitor the financial health of firms. Firms must manage and meet their working capital requirements. Compliance officers should ensure that the firm is aware of these regulatory responsibilities, and that it has policies in place to maintain positive working capital at all times.



Firms may become working capital deficient for various reasons, such as paying out bonuses or dividends for tax planning purposes. As a registrant, you are required to maintain minimum working capital. If you become capital deficient, you must notify the BCSC immediately in writing and indicate how you plan to correct the deficiency. Firms can resolve working capital deficiencies by having shareholders inject more capital into the firm or make subordinated loans to the firm.

Subordination agreements – a firm’s shareholders may make subordinated loans to the firm to cover start-up costs or to cover working capital deficiencies. We have found that some firms have repaid subordinated loans without the BCSC’s prior approval.

A subordination agreement is a three-party agreement between the party lending money to the firm, the firm, and the BCSC. Before a firm can repay a subordinated debt, the firm must obtain the BCSC’s approval. The firm should also provide supporting documents, such as a current report of working capital and unaudited financial statements, to prove that it has the financial ability to repay the debt. After our review, we will confirm our approval, in writing, to allow for repayment of a subordinated loan.

Some industry trends and challenges

Market volatility – the fallout from the crash of the sub-prime mortgage market and asset-backed commercial papers (ABCP) sparking the “credit crunch”, still resonates in 2008. While institutional investors held the largest dollar amounts in ABCP investments, a large number of retail investors found that they had direct exposure to ABCP. Market extremes are more prevalent and our industry must be more cognizant to the interaction between risks – market, credit, and liquidity.

This raises a question about whether advisers need to review their assumptions about the risk of certain complex products, and whether to recommend them to clients, or include them in their own funds. KYC and suitability is still cited as a deficiency in compliance examinations. We find weaknesses in the overall clarity of how firms establish a portfolio management framework. KYC should not be a one-time function of completing an investment policy statement, but a process that includes implementing a strategy, regular monitoring, and rebalancing.

Demographic changes – advisers have expertise in accumulating and managing assets; however, as the baby-boomer generation enters retirement, the demographics will change considerably in Canada. Advisers will have to shift their expertise from asset gatherers to income managers to meet the needs of their most affluent clients.

National Instrument 31-103 Registration Requirements - this proposed instrument will change the regulatory landscape in Canada, as the provincial securities commissions harmonize the rules for registration. Some of the changes that will affect the advising community include:



- The addition of an Investment Fund Manager registration category
- The elimination of Investment Counsel as a registration category
- The registration category of Restricted Portfolio Manager
- The requirement for an Ultimate Designated Person and a Chief Compliance Officer
- The change in individual proficiency requirements for advisers

You can review NI 31-103 at the BCSC's website at
<<http://www.bcsbc.ca/policy.aspx?id=6243>>.

Proceeds of Crime (Money Laundering) and Terrorist Financing Act

In June 2008, the Financial Transactions and Report Analysis Centre of Canada (FINTRAC) will introduce updated rules for client identification and reporting requirements under the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* (PCMLTFA).

Currently, Canada is the chair of the Financial Action Task Force, an international body that develops and promotes policies to combat money laundering and terrorist financing. Because of this leadership role, Canada has updated the PCMLTFA to conform to international standards.

Firms should be aware of the June 2008 changes and that FINTRAC will take on more robust compliance reviews and examinations of securities dealers. Visit the FINTRAC website for additional information at <<http://www.fintrac.gc.ca/>>.

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