



British Columbia Securities Commission

2009 Examinations Report Card Capital Markets Regulation

This communication is part of the Capital Markets Regulation (CMR) Division's outreach initiative to help you foster a culture of compliance. We hope you will use this report as a tool to assess your internal controls and compliance programs.

The first part of this report summarizes exam statistics, provides information about the firms we directly monitor and describes common deficiencies the examinations team identified between April 1, 2008 and March 31, 2009. The second part provides information and ideas to help your firm create a culture of compliance.

The information and comments in this report come from our examinations of non-self regulatory organization (SRO)¹ registrants that are regulated directly by the BC Securities Commission. Non-SRO registrants include investment counsel, portfolio managers, special limited dealers, exchange contracts dealers, scholarship plan dealers and securities advisers.

The year in review

The past year taught us that the current financial crisis has complex origins. The media has published countless stories about

- so-called industry leaders who were less than ethical
- overconfidence in advisors' abilities
- new products that were not readily understood
- poor due diligence practices
- product manufacturers' incentive programs for risky investments that benefited investment executives, but not clients
- fund-of-funds failing to make material disclosures to clients about underlying funds
- the role of fair value accounting
- the lack of transparency in OTC markets

Some dealers, advisers and fund managers seemed to forget the cardinal rule of investing: position clients to protect their capital during down markets.

Despite this painful period, registrants are weathering the storm and reviewing their corporate governance, compliance and risk management programs. If we want the public to regain confidence in our capital markets, we have to learn from these recent experiences and start rebuilding trust – both in industry and as regulators.

¹ SRO registered firms include market participants that are members of the Mutual Fund Dealers Association, the Investment Industry Regulatory Organization of Canada, and the Toronto Stock Exchange.

Part 1 2008/2009 compliance examination statistics

2008 - 2009 Compliance examinations

From April 1, 2008 to March 31, 2009, the examinations team conducted 20 compliance reviews. The CMR examinations team directly monitors 94 non-SRO registrants.

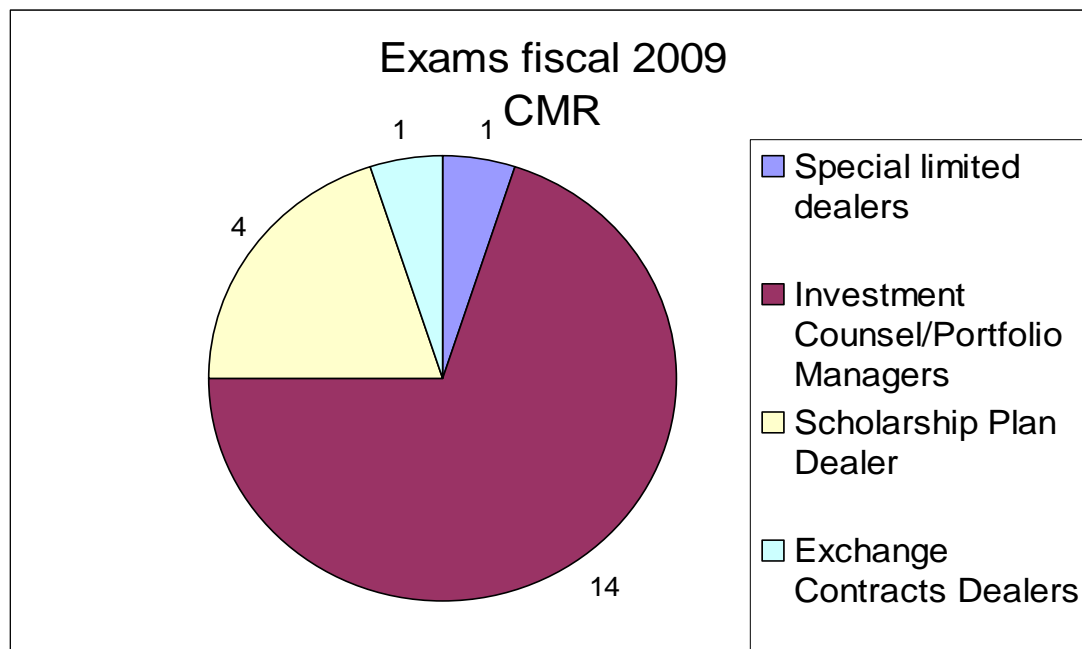
We conduct the following types of examination:

- full scope examination on advising or dealing activities;
- full or limited scope review on fund management activities;
- limited scope review or desk review on specific areas;
- a sweep of a sample of registrants on a specific topic; and
- joint compliance review with examination teams from other Canadian jurisdictions.

We cover some or all of these operational areas when we examine a firm:

- compliance structure;
- administration;
- record keeping, disaster recovery, and business continuity;
- portfolio management;
- trading practices;
- advertising and holding out;
- mutual and pooled funds management and administration;
- fund accounting;
- capital and accounting practices; and
- custody.

This chart breaks shows the number of examinations conducted by registrant type.



Type of registrant	No. of exams	Percent
Special Limited Dealers	1	5%
Investment Counsel/Portfolio Managers	14	70%
Scholarship Plan Dealer	4	20%
Exchange Contracts Dealers	1	5%
Total registrants examined	20	100%

Our 2009 examinations showed an average of **6.9** deficiencies per examination². This is an increase from **6.68** in 2008 and a decrease from **7.4** in 2007. We analyze the number of deficiencies per exam annually because one of the Commission's ongoing initiatives is to reduce compliance deficiencies.

The average risk rating for the 20 firms, however, improved - going from **4.3** in 2008 to **3.8**.³

This table shows the 10 most common deficiencies by frequency and compares them to the findings in the prior year. The findings are numeric and do not account for severity or risk presented by each deficiency.

Top 10 compliance examination deficiencies				
Rank	Compliance deficiency	2008/2009	2007/2008	Change
1	Policies and procedures	85%	74%	11
2	Know-your-client (KYC) and suitability	70%	42%	28
3	Conflict of interest and personal trading	50%	26%	24
4	Capital monitoring	50%	16%	34
5	Disaster recovery and business continuity	45%	58%	(13)
6	Disclosures	45%	26%	19
7	Fees	35%	0%	35
8	Records	30%	21%	9
9	Representative agreements and contracts	25%	11%	14
10	Client agreements and contracts	25%	16%	9

Significance of deficiencies

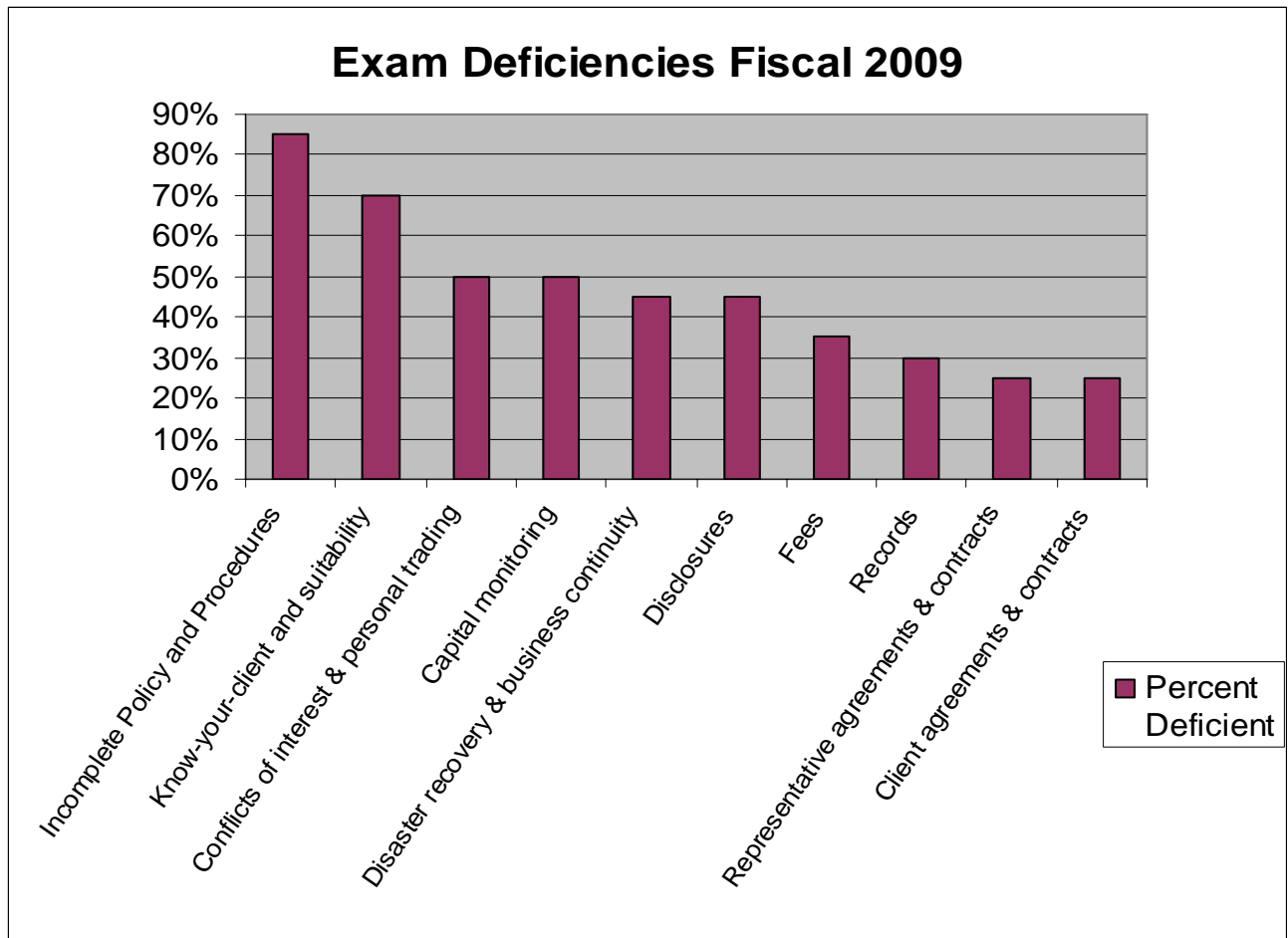
We evaluate the seriousness of each deficiency in the context of the firm's operations and the impact on clients and the capital markets. We consider these deficiencies serious in nature:

- ineffective overall compliance program;
- capital deficiencies;
- business viability issues;
- misappropriation of client assets or funds; and
- unresolved prior examination deficiencies, especially suitability non-compliance.

² Based on 138 deficiencies

³ Risk ratings go from "1" low risk, to "10" highest risk.

This bar chart shows the top 10 compliance examination deficiencies by frequency.



Trends in common deficiencies

Areas where registrants have improved most in the past year are:

- advertising, marketing and holding out;
- overall compliance programs;
- mutual or pooled fund records, trading and administration; and
- insider and early warning reporting.

Areas where registrants need to pay more attention are:

- KYC and suitability obligations;
- capital monitoring and accounting practices;
- conflicts of interest and personal trading;
- policies and procedures; and
- fee disclosures and practices.

Part 2 Creating a culture of compliance

Principles – how can they help?

Principles-based securities regulation is a valuable tool for regulators, but also a valuable operating framework for industry.

Principles can help us meet the core objectives of securities regulation:⁴

- protecting investors
- ensuring that markets are fair, efficient and transparent

Principles-based regulation is advantageous to you. In the following discussion, we explain why and we tell you what we expect from you, in your business conduct, under those principles. National Instrument 31-103 *Registration Requirements*, which we expect will come into force on September 28, 2009, includes many new principles governing your business conduct.

Principles tell you what outcome you need to achieve and provide you with flexibility in choosing how to achieve that outcome. For principles to be effective, your staff will need to thoroughly understand how those principles apply to different business activities.

The NI 31-103 and other registrant regulation principles include

- dealing honestly, fairly and in good faith with clients
- exercising fund manager powers and discharging those duties honestly, in good faith and in the best interests of the fund
- exercising the degree of care, diligence and skill that a reasonably prudent person would exercise in acting as a fund manager
- having the education, training and experience that a reasonable person would consider necessary to perform duties competently
- establishing, maintaining and applying policies and procedures for a system of controls and supervision sufficient to provide reasonable assurance that the firm and each individual acting on its behalf complies with securities legislation and that the firm manages the risks associated with the business in accordance with prudent business practices
- maintaining records to accurately record business activities, financial affairs and client transactions and to demonstrate the extent of the firm's compliance with applicable requirements of securities legislation
- know-your-client and suitability obligations
- identifying existing material conflicts and material conflicts that the firm anticipates between the firm (including individuals acting on the firm's behalf) and its clients and responding to and disclosing to clients, in a timely way, the nature and extent of the conflicts
- documenting and, in a way a reasonable investor would consider fair and effective, responding to complaints
- providing a client with all information a client would consider important about the client's relationship with the registrant

⁴ IOSCO objectives and principles of securities regulation

In preparation for NI 31-103, take stock of your systems and controls. Is your firm merely legally compliant, or have you built a strong a firm culture of regulatory compliance on a foundation of ethics and principles?

Risk management

This past year we learned that some firms had risk models that failed to manage risk in a systematic and integrated way across all business units. Some firms mismanaged liquidity, outsourcing and counterparty risks. For example, when Lehman Brothers Holdings collapsed in September 2008, many investment firms lost millions on Lehman bonds, and other investment firms who used Lehman subsidiaries as a prime broker had accounts frozen.

The Lehman Brothers situation reminds us that ongoing due diligence reviews of the brokers and custodians you use are important. For example, you may want to evaluate use of foreign prime brokers, as your legal rights may be different or your ability to settle differences may be impeded as compared to using a Canadian prime broker.

Consider integrating a firm-wide risk management program with your compliance systems for maximum effectiveness.

Ethics + compliance = trust

To foster a culture of compliance, many firms establish a code of ethics or professional conduct that outlines expectations of staff. A code of ethics sets the “tone at the top” for an organization that expects ethical behaviour. A formal code of ethics helps your firm set minimum ethical standards for dealing with clients, managing conflicts and following sound portfolio management or other client processes.

As with risk management, a code of ethics that is integrated with your compliance system will yield the best results. One good source is the CFA Institute Code of Ethics and Standards of Professional Conduct (CFA handbook). The CFA Handbook not only outlines common conduct principles and standards, but also recommends good industry practices for compliance.

To ensure that the tone does not simply stay at the top but, instead, permeates your entire firm, you will want to plan and implement initial and ongoing training for your staff. Your staff can best contribute to your culture of compliance if they understand your code of conduct and applicable regulatory requirements. You will also want to consider how to create confidence among your staff that identifying compliance violations will be rewarded, not punished.

We suggest that establishing a solid “tone at the top” that embraces ethics and compliance can go a long way to building a relationship of trust between your firm, your representatives and your clients.

Making it real

Your policies and procedures should cover the core businesses in your firm, applicable regulatory and other legal requirements and risk management. If you establish a new business line (for example, creating and managing a fund), you should revisit your written policies and procedures so that they address the regulatory and business risks of your new business line.

However, in our experience, a culture of compliance is not created by drafting a new 100 page compliance manual. Off-the-shelf policy manuals can be difficult to follow and implement and do not consider the specific scope and nature of your firm's business.

Instead, consider analyzing your firm's daily, weekly, and monthly procedures and describing them as a starting point. Identifying processes, as a first step, may allow you to better identify risks associated with those processes. From there, you will be able to create policies to prevent and detect compliance and business risks. You will also want to consider how to stress test and adjust policies and procedures on a timeline and in ways that make sense for your business.

Your policies and procedures will come alive (or not) in the hands of your staff. So, you should consider carefully how your internal training and mentoring can best develop staff members who work naturally with compliance, risk management and business objectives in mind. Consider cross-training your staff, so they appreciate the compliance implications of different positions in your firm.

Red flags

Neglecting even small compliance transgressions can, over time, turn into catastrophes. In France, le Société General found this out the hard way in 2007. Trader Jerome Kerviel is alleged to have caused a \$7.3 billion dollar loss. Until the Bernard Madoff fraud, this was the largest fraud in financial institution history.

In a report produced by the French regulators in the aftermath, they found that Kerviel's activities were known to his superiors. It was noted that his supervisors turned a blind eye and that irregularities were not reported to senior management.

In this case, small transgressions or "red flags" went unreported and unresolved. Does your supervisory system ensure that your staff can identify troubling inconsistencies and red flags? Do staff, in fact, report their observations up the chain?

Our outcomes-focused reviews

Some firms are afraid that we will use hindsight, in our compliance examinations, to unreasonably second-guess your discretionary judgments. We work hard to avoid second-guessing your decisions. We do expect, in a principles-based system, that you act reasonably and in good faith given your knowledge, and your ability to acquire relevant knowledge, at the time.

The first question we will ask in our outcomes-focused reviews is whether your firm's actions would be considered reasonable by other market participants armed with the same facts. We look to industry standards as a starting point.

The second element we will assess is business conduct risk, particularly as it relates to your clients. Our goal is to help you identify any problems before they become widespread. To do this, we will assess your business model to identify business and compliance risks. We also test your stated objectives with your business records to identify whether your business is diverging from your business plan.

A good way to test whether your firm is meeting the regulatory objectives set out in our principles-based rules is to

- identify the results of your firm's actions and
- ask whether those results meet the objectives articulated in the principles.

You should think about these questions broadly, considering the impact of your actions on the market, other market participants and your clients and potential clients.

Measuring the culture of compliance among BC registrant firms

We expect that, over time and as firms become more familiar with principles-based rules, and how to achieve the right regulatory outcomes, the average regulatory risk rating for BC firms should decrease.

If you have **questions** or comments about this report, please contact one of the following people:

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