British Columbia Securities Commission

2010 Examination Report Card
An annual status report on compliance examination deficiencies

This report, by the Examinations Branch of the Capital Markets Regulation Division, summarizes the Examination team's activities[1] for the 2010 fiscal year (April 1, 2009 to March 31, 2010). During this period, global markets were in turmoil, bringing uncertainty and volatility to our markets

Who are we?

The Examination team is part of the BCSC's Capital Markets Regulation Division. Our seven staff members include CFA charter holders, accountants, and an administrator. We support the Commission's four goals through our work. The goals are:

1. Foster a culture of compliance
2. Act decisively against misconduct
3. Educate investors
4. Advance cost-effective regulation

The Examination team assists in protecting investors and the ensuring the integrity of our capital markets by:

- monitoring registrants that are not members of a recognized self-regulatory organization (SRO), including
  - portfolio managers
  - investment fund managers (IFMs)
  - restricted dealers
  - exempt market dealers (EMDs)
- monitoring new products
- reviewing registrants' capital adequacy
- promoting a culture of compliance through posting articles on the BCSC's website, publishing newsletters, and presenting at compliance outreach sessions
- leading the Canadian Securities Administrators' (CSA's) Compliance Committee
- conducting various types of on-site reviews
- sending out questionnaires and conducting focused sweeps

[1] This report provides general information only and you should not rely on it for legal advice on securities related matters. You are responsible for designing and monitoring your compliance program and to determine what risks exists, and how to manage those risks.

Who do we directly monitor?

In BC, as at September 30, 2010, 16,662 firms and individuals are registered with us, as reported on the National Registration Database.

Category	BC based	Outside based	Total # of firms	BC based representatives	Outside based representatives	Total # of representatives
Portfolio manager[2]	78	307	385	311	151	455
Investment fund manager	11	9	20	0	0	0
Scholarship plan dealer	0	7	7	0	896	896
Exempt market dealer	14	87	101	36	48	84
Restricted dealer	3	1	4	9	0	9
Total number of directly regulated	**83**	**355**	**438**	**338**	**1,092**	**1,423**

How do we monitor?

We use a risk-based assessment program to determine how to use our resources for compliance monitoring. We want to spend more time monitoring high-risk firms. Factors that could cause a firm to have a higher risk ranking include:

- high number of examination deficiencies
- repeat and significant deficiencies – failure to learn from the past
- financial insolvency – going concern issues
- failures in managing conflicts of interest and key disclosures
- self dealing
- high-risk investment strategies
- poor record-keeping and internal controls

Field examinations test registrants' compliance programs and determine how well they are meeting current securities legislation. All of our field reviews result in a compliance report to the firm outlining the deficiencies. Our report asks firms to set out a plan to correct the deficiencies and improve their compliance programs.

[2] We directly monitor and review BC based firms (those with head offices in BC); these are 78 portfolio managers, 11 investment fund managers and 17 dealers (83 firms in total, with many having multiple registrations).

Selected metrics

Year ended March 31, 2010,[3]	Registrants examined	Total deficiencies	Average deficiency
2009-2010	16	120	7.50
2008-2009	20	138	6.90
2007-2008	19	127	6.68

An important function of examination field reviews is to identify weaknesses in compliance programs and internal controls that may allow securities violations or fraud to occur. We find some type of deficiency in most examinations. Our metrics show that the average deficiency by frequency has gone from 6.68 to 7.5 per review in the past three years.

While this could indicate that the culture of compliance is getting worse in the industry, we think there are some good reasons for this trend. First, one cannot look at all deficiencies equally. Some deficiencies are more serious or systemic, while some are one-off issues. Therefore, counting significant deficiencies, rather than the total number of deficiencies, gives us a clearer picture. Second, NI 31-103 came into force on September 28, 2009. It is natural that firms are finding new or differently articulated requirements challenging. Third, having a deficiency in one operational area does not mean the firm fails to have internal controls in every aspect of that area. For example, a deficiency in the policy and procedure manual does not mean the firm has no or weak policies and procedures in all areas. It may just reflect that there is a weakness in one area.

Our biggest concern is the increased number of findings in the 2010 fiscal year of an inadequate overall compliance program. Last year, 25% of firms examined had faulty overall compliance programs. This is up from 10% in fiscal 2009.

Significant and repeat deficiencies are also something we looked at closely. Last year, 25%[4] of registrants reviewed had some significant deficiencies. We are concerned about repeat and significant deficiencies because they indicate that the registrant does not have a culture of compliance and has not learned from past mistakes.

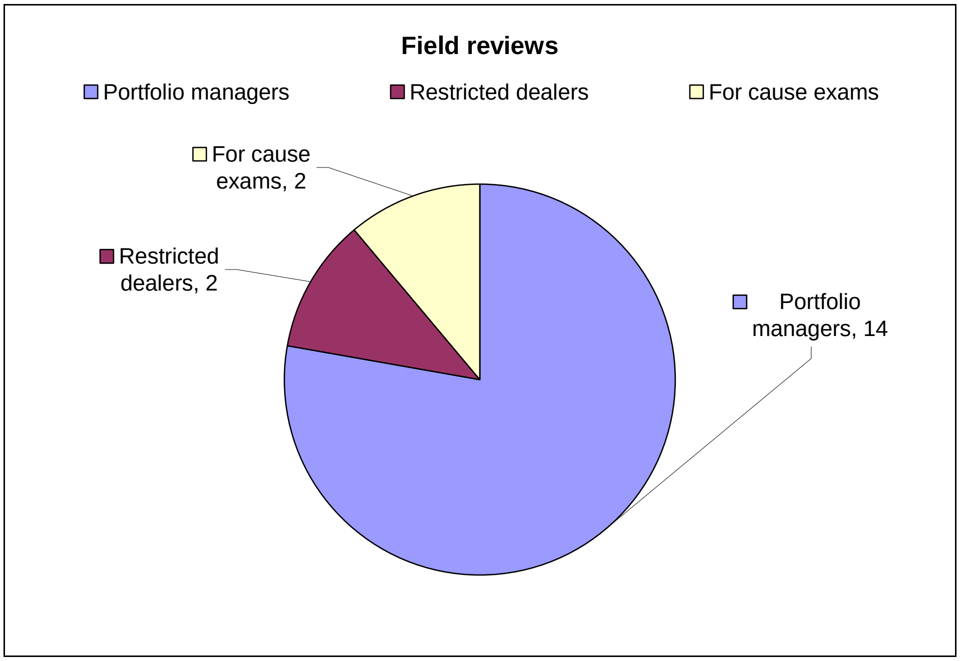
Despite all the regulatory and compliance related information readily available, some registrants still fail to learn the basics of regulation and fail to establish an adequate compliance structure. When we identify significant deficiencies during an examination, we refer our findings to the Compliance branch for further remedial action. We may also bill the firm for our examination time. On occasion, we refer the firm directly to our colleagues in Enforcement.

---

[3] We did not include for-cause examinations in the 2010 stats to calculate the average deficiencies per firm.
[4] 4 of 16 of firms examined

Field reviews conducted

We conducted 18 field reviews in fiscal 2010.



Highlights of common deficiencies

Some common deficiencies are the same every year. This can indicate a lack of a formal top-down compliance approach at some firms where clear compliance procedures and controls are missing. Here are the top deficiencies in the 2010 fiscal year, by frequency:

- Policies and procedures manual issues remain the most common deficiency found in 75% of the reviews. In some cases, firms do not update their manuals or simply use an off-the-shelf manual that does not fit the firms' operations.
- In 63% of reviews, know-your-client (KYC) and suitability deficiencies were found. This is largely due to firms not collecting updated client information. We also often find that firms failed to document reasonable explanations for changes to asset allocations and client portfolios.
- In 50% of reviews, we saw that firms did not establish well thought-out or stress-tested disaster recovery and business continuity plans.
- In 44% of reviews, firms did not manage the conflicts of interest adequately. For example, firms failed to disclose affiliated or related entities or relationships adequately.
- In 44% of reviews, we found inadequate and inconsistent fee or other disclosures, making it difficult for the client to understand the associated costs relating to their investments.
- In 44% of reviews, we found that personal trading practices are not being appropriately managed.
- In 44% of reviews, we saw no marketing policies and procedures in place.

- In a few reviews, we found that firms were not monitoring their electronic communications adequately. Staff were working offsite (e.g. at home) and unsupervised.

Top 12 common compliance deficiencies

We grouped the exam deficiencies in broad categories for reporting purposes. A firm having a deficiency in one category does not imply that this firm has compliance problems in all aspects of that category.

Top compliance deficiencies by frequency					
Rank	**Type of deficiency**	**2010**	**2009**	**2008**	**Three year change**
1	Policies and procedures	**75%**	**85%**	**74%**	**1%**
2	KYC and suitability	**63%**	**70%**	**42%**	**21%**
3	Disaster recovery and business continuity	**50%**	**45%**	**58%**	**-8%**
4	Capital monitoring	**50%**	**50%**	**16%**	**34%**
5	Conflicts of interest and personal trading	**44%**	**50%**	**26%**	**18%**
6	Disclosures	**44%**	**45%**	**26%**	**18%**
7	Advertising, marketing and holding out	**44%**	**15%**	**47%**	**-3%**
8	Compliance officer function	**38%**	**15%**	**11%**	**27%**
9	Trade execution	**31%**	**5%**	**21%**	**10%**
10	Compliance program	**25%**	**10%**	**32%**	**-7%**
11	Registration administration	**25%**	**20%**	**37%**	**-12%**
12	Records	**25%**	**30%**	**21%**	**4%**

Trends in common deficiencies

The largest increases in deficiencies in the past three years are:
- capital monitoring practices (34%)
- compliance officer function (27%)
- KYC and suitability (21%)
- advertising and performance presentation (19%)
- conflicts of interest and personal trading (18%)
- disclosures (18%)

The largest decreases in deficiencies in the past three years are:
- client agreements and contracts (-16%)
- out-of-province or non-resident clients (-15%)
- registration administration (-12%)
- on-site branch reviews (-11%)
- representative agreements (-11%)
- complaint handling procedures (-11%)

How can you improve compliance?

While your industry will continue to face serious challenges, we encourage firms to develop strong compliance programs and become financially strong. So what can you do? Here are eight compliance related tips that may assist you in developing a stronger culture of compliance and in meeting the NI 31-103 principle-based requirement that you appropriately manage your compliance and business risks Depending on your firm's specific operations, may not be practicable for your firm to implement.

$\boxed{1}$ **Regularly review your compliance programs**. Examiners review how robust your compliance program is, who manages it, and the specific work done. In some recent reviews, examiners observed that a firm had expanded by taking on new branches, yet it did not broaden its compliance umbrella to ensure the new branches were supervised and monitored adequately. For example, not all investment strategies employed and trading was supervised and approved.

We encourage firms to conduct annual reviews or "stress tests" of specific parts of their compliance programs to determine if controls and procedures are effective. In your review, it is easier to break up your program into manageable parts and assess each separately to determine if they need revision and if controls are effective. If you conclude they are no longer effective, you can then revise your policies and procedures accordingly.

These are some questions we think may be good to consider in gauging the effectiveness of your program:

- Are clear procedures set out for compliance policies?
- Did your program detect any actual compliance problems? If not, why not?
- Have you learned from past lessons, examinations, or errors?
- Are your compliance problems resolved swiftly, with quality, and ethically?
- Does your staff talk candidly about compliance issues, and would they escalate potential issues to compliance staff in a forthright fashion?
- Do you have active orientation and training programs?
- Are your disclosures designed to meet the new requirements set out in NI 31-103?
- Is risk management linked into your compliance program?
- Does your staff understand and follow the firm's code of ethics?

$\boxed{2}$ **Maintain knowledge of current regulation.** In some recent examinations, we found compliance officers were not familiar with current disclosure requirements. For example, a common finding is where a firm establishes a new investment fund, but fails to learn the filing and other requirements for the fund(s). Some firms failed to understand the new firm registration requirements. While we understand that NI 31-103 set out many new requirements and changes from previous rules, we expect firms to be proactive in learning the new regulatory requirements and to update programs and practices accordingly. We expect you to understand and operate your firms in compliance with current regulation.

3 **Learn your lessons from past examinations.** All examinations include a review of how past deficiencies were resolved, and whether you followed through with your plans. In some recent reviews, we found some firms have been too casual about ensuring prior deficiencies were resolved. For example, new policies and procedures were not enforced and compliance action plans fell short of being completed. Repeat deficiencies were also found in supervisory obligations.

4 **Update your management procedures:** Advising firms and dealers face numerous risks. Many of your firms are managed on a line-of-business basis with a variety of business segments, as determined by the products and services provided. Firms may also face risks generated by affiliated firms such as business partners, brokers, and custodians. A formal risk management program can help mitigate the risks and improve overall compliance. In its 2009 Annual Report, JP Morgan stated: "**The heart of the problem - across all sectors - was bad risk management."** In the BCSC 2009 Annual Report Card, we said that some firms had risk models that failed to manage risks in a systematic and integrated way across all business units. We recommend firms integrate a firm-wide risk management program with your compliance systems for maximum effectiveness.

5 **Update your KYC information:** Examiners select a sample of client files to review whether firms documented KYC information and that investment strategies made on behalf of clients are suitable. While many firms indicate they know their clients well, it is common to find they have not documented current client information in client files. When client information, such as investment objectives or risk tolerance changes, you must update this information in your client files or in your systems. In firms with effective compliance systems, it is common to see client information updated annually after an in-person meeting.

6 **Manage your conflicts of interest:** Examiners always review conflicts of interest between the firm and affiliated companies, brokers, fund companies, or business partners. In many cases, conflicts of interest require additional disclosures. In order to manage conflicts of interest, adequate controls must be put in place to identify them. Then assess them to determine an appropriate type of action. If the conflict is affecting investment decisions or increasing costs to the client, an analysis should be made to determine if this practice is fair and reasonable. If the adviser or firm benefits in some way from specific relationships, does the adviser or the firm disclose this? For example, if the firm receives some form of kick-back or special fees from buying specific securities for clients, does the adviser clearly disclose this, and in plain language? Firms with good compliance programs have procedures to mitigate and manage conflicts of interest, and adopt full disclosure policies.

7 **Implement outsourcing controls.** Another area examiners focus on is where firms outsource work to service providers such as custodians. Types of outsourced services may be fund administration, valuations, client reporting etc. A good practice is to ensure that you have a contract in place for these services and that you have thought about the types of supervision work you will do to oversee these providers. You want to ensure the outsourced party is meeting your standards, being fair to your clients, as well as meeting current securities legislation requirements. Here are some questions to ask:

- Do your control practices include regularly reconciling account balances and transaction details between your records and the custodial records?
- Is there adequate follow-up to resolve all unreconciled items?
- Do you ensure the custodian independently determines the value of each security position near the date of each statement sent to the client?
- Do your procedures include randomly testing the fees charged to clients to ensure they are accurate and fair?

8 **Put your clients first.** You are operating in an unprecedented period of uncertainty and market volatility. Developing strong ethical and responsible business practices makes your firm stronger. This goes along with setting high firm standards for transparency. Examiners find that firms with strong compliance cultures embrace transparency and take time to ensure that the clients understand the services, the investment strategies, and the decision-making process. Spending up-front time with clients also helps you protect clients from themselves.

Looking forward

We have developed a new risk assessment model and scoring system. You recently received a risk assessment questionnaire, which will help us risk-rank registrants more accurately and effectively. The information we are getting from you will provide us with more industry metrics and ultimately enable us to determine the type and frequency of compliance oversight tools we need to use.

We continue to use a variety of examination modules to optimize our reviews of different types of registrants. We review operational areas such as compliance structures, operational procedures, disclosures, contracts, portfolio management, client files, conflicts of interest, funds under management, risk management, internal controls and disaster recovery systems. We are also working on an initiative to strengthen fraud awareness among our staff and improve our fraud detection skills. Preventing fraud is very important. In many fraud cases, not only do clients lose everything, the fallout to the industry and market participants is very severe.

In closing, we have seen that regulators are not exempt from structural and other problems any more than dealers and advising firms. However, we must continue to work together to innovate ourselves while managing risks at the same time. We must evaluate how we can do a better job, be candid, and not miss any opportunities to rebuild public trust in the financial industry.

We appreciate hearing from you, so please share your views, comments and questions to these staff:

Michael Sorbo, CGA, CFA
Manager Examinations
msorbo@bcsc.bc.ca
604-899-6689

Janice Leung, CA, CFA
Senior Securities Examiner
jleung@bcsc.bc.ca
604-899-6752

Ray Harding, CGA
Senior Securities Examiner
rharding@bcsc.bc.ca
604-899-6572

Edwin Leong
Securities Examiner
eleong@bcsc.bc.ca
604-899-6682

Nirwair Sanghera, CGA
Securities Examiner
nsanghera@bcsc.bc.ca
604-899-6861

Jason Chan, CA, CFA
Securities Examiner
jchan@bcsc.bc.ca
(604) 899-6697

Fax: 1-888-469-1736
Toll free number (BC and Alberta only): 1-800-373-6393

Lena Lew
Administrative Assistant
llew@bcsc.bc.ca
604-899-6650