

BC PORTFOLIO MANAGERS: REPORT ON COMPLIANCE DEFICIENCIES

JULY
2001

CAPITAL MARKETS REGULATION DIVISION



BRITISH COLUMBIA SECURITIES COMMISSION

BC PORTFOLIO MANAGERS: REPORT ON COMPLIANCE DEFICIENCIES

July 30, 2001

The British Columbia Securities Commission (the Commission) has published this report to help registered advisers establish and maintain a compliance environment that emphasizes high ethical standards and minimizes the potential for securities violations. The report is a summary of key deficiencies our Capital Markets Regulation Division staff identified during the compliance examinations of twenty portfolio management firms in BC. These examinations were conducted between October 1996 and December 2000. Over the next year, we intend to examine the remaining portfolio managers registered in the province.

A necessary element of an adviser's business is a compliance program that effectively addresses the inherent risks in the business of advising and helps the firm meet its compliance obligations. The Commission is concerned about the significant number of serious compliance deficiencies identified during our examinations. These deficiencies indicate inadequate compliance practices and procedures that can lead to breaches of securities legislation – seriously harming the industry's reputation and threatening a firm's continued registration. Over the next 12 to 18 months, we plan to re-examine many of the firms discussed in this report. If serious deficiencies persist, we will refer the failure to correct deficiencies to our Compliance Branch for disciplinary proceedings.

We recognize that compliance with regulatory requirements is becoming more challenging due to technological changes, consolidations, new SROs, significant growth in the area of private asset management, and a renewed focus by regulators on compliance examinations. Many advisers have chosen to voluntarily comply with the Association for Investment Management and Research's (AIMR) *Standards of Practice Handbook*. As well, many registered advisers in BC are Chartered Financial Analysts and are obligated as members to follow AIMR's *Code of Ethics and Standards of Professional Conduct*. While the Commission does not enforce the AIMR code and handbook, we recommend that all advisers use AIMR's professional code and standards, in addition to the requirements of our provincial securities legislation, as the basis for their compliance program. We encourage advisers to stay current with issues raised by AIMR.

We hope this report will help you review your compliance programs, including supervisory and internal control procedures, and establish an effective and ethical compliance environment. We encourage you to provide us with any comments you have on the report. Please send your comments to Michael Sorbo, Manager, Examinations, Capital Markets Regulation Division, via e-mail at msorbo@bcsc.bc.ca or by telephone in Vancouver at (604) 899-6689 or toll free throughout BC at 1-800-373-6393.

Sincerely,

A handwritten signature in black ink, appearing to read 'Gerry Halischuk', written in a cursive style.

Gerry Halischuk
Director, Capital Markets Regulation
British Columbia Securities Commission

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SUMMARY OF COMPLIANCE DEFICIENCIES

INEFFECTIVE COMPLIANCE PROGRAM

The BCSC expects all portfolio management firms to have effective compliance programs in place. The examinations revealed 11 firms with deficient compliance programs. The most common deficiencies involved firms not putting adequate procedures in place and compliance officers who did not ensure their firm met legal requirements and minimum industry standards.

INCOMPLETE POLICY AND PROCEDURES MANUAL

This was the most common deficiency – with 15 of 20 firms cited for an incomplete policy and procedures manual. A firm's policy and procedures manual is a guidebook for conducting business in accordance with legal and ethical standards. A current policy and procedures manual also indicates to regulators that the firm is attempting to comply with all requirements of the *Securities Act*.

DEFICIENT KNOW-YOUR-CLIENT (KYC) PRACTICES

Portfolio managers are expected to know the essential facts about their clients and to maintain current information about them and the type of investments best suited to their needs. The review found 14 of 20 firms had deficiencies relating to the know-your-client rule.

INADEQUATE RECORD-KEEPING PRACTICES

In order to ensure compliance with the *Securities Act*, portfolio managers must keep full and accurate records. Ten of 20 firms showed deficiencies in record-keeping procedures.

INADEQUATE PERSONAL TRADING PROCEDURES

Firms must have adequate procedures in place to deal with personal trades made by employees. Ideally, firms will have a designated person in charge of reviewing and maintaining personal trading records. Examinations showed nine of 20 firms were deficient in handling personal trading issues.

ADVERTISING & MARKETING CONCERNS

Firms must ensure their marketing materials do not use misleading information, particularly when it comes to performance claims. Firms should establish written guidelines covering all advertising and marketing materials. The examinations found nine of 20 firms had deficiencies related to their advertising and marketing materials.

UNREGISTERED ADVISING STAFF

Unless exempted, anyone advising clients, directly or indirectly, about securities must be registered with the Commission. The examinations revealed eight of 20 firms had advising employees on staff who were not registered. Firms must ensure that all employees are registered in accordance with the *Securities Act*.

LACK OF DISCLOSURE

Portfolio managers have a duty to make clients aware of all fees, conflicts of interest, risks including leveraging risks, fairness in allocation policies and referral arrangements. Several firms gave inadequate disclosure in one or more of these areas.

OTHER COMPLIANCE DEFICIENCIES

Our examinations also identified the following deficiencies:

- inadequate account opening procedures
- lack of proper trade desk procedures
- failure to review trade blotters
- failure to adhere to investment guidelines
- inappropriate calculation of management fees
- soft dollar issues
- failure to file BC Form 45-902F for distributions of pooled fund units
- failure to meet financial and insider reporting obligations of pooled funds
- commingling of funds (lack of trust accounts)
- inadequate client statement reconciliation practices, and
- failure to calculate and monitor capital level.

BC PORTFOLIO MANAGERS: REPORT ON COMPLIANCE DEFICIENCIES

THE COMPLIANCE DEFICIENCIES AND BEST PRACTICES HIGHLIGHTED IN THIS REPORT INCLUDE THE POLICIES, PROCEDURES AND PRACTICES WE OBSERVED DURING OUR COMPLIANCE EXAMINATIONS OF 20 REGISTERED PORTFOLIO MANAGEMENT FIRMS IN BC.

1. INEFFECTIVE COMPLIANCE PROGRAM	<table border="1"> <tr> <td data-bbox="841 420 982 472">11 FIRMS</td> </tr> <tr> <td data-bbox="841 472 982 522">20 EXAMS</td> </tr> </table>	11 FIRMS	20 EXAMS
11 FIRMS			
20 EXAMS			

An ineffective compliance program means that the portfolio manager has not established proper compliance procedures. The number of deficiencies identified during our examinations indicates that 55% of the firms examined have compliance programs that are not working. This is unacceptable.

An ineffective compliance program increases the risks of violating securities laws. Some specific steps to establishing a good program include:

- understand all compliance obligations and regulatory requirements
- implement a compliance program in the workplace
- train managers to understand professional codes and ethical standards
- draft and distribute a written compliance policy and procedures manual
- establish effective supervision and delegation practices
- enforce these policies and procedures, and
- promote a pro-active compliance culture.

Provincial securities rules and policies, AIMR materials and various securities industry courses are readily available resources that document key compliance requirements and standards. Senior management – including compliance officers with supervisory responsibility – must understand how to assess compliance requirements and monitor the effectiveness of their controls.

BEST PRACTICES

- establish a compliance committee with senior management support
- conduct regular compliance committee meetings to review compliance and ethical issues as they arise
- provide in-house training, which guides staff through regulatory standards and practices
- document policy and procedures clearly in a compliance manual
- enforce the manual through effective supervision, and
- investigate all complaints and “red flags” that arise in a timely manner.

2. INEFFECTIVE COMPLIANCE OFFICER FUNCTION

8 FIRMS
20 EXAMS

As a prerequisite of registration, portfolio managers must appoint compliance officers who are responsible for ensuring the firm has effective supervisory and other compliance procedures in place. Compliance officer responsibilities include:

- supervision and enforcement of compliance policies and procedures
- approval of all advertising and marketing materials
- handling client complaints and concerns
- reviewing daily trading, and
- approving all new client accounts.

The compliance officer must have the support of senior management to implement and maintain an effective compliance program that ensures proper procedures and practices are defined, followed and enforced.

Selecting a qualified and capable compliance officer is a critical personnel decision – since non-compliance may result in financial loss or sanctions by the Commission. It is also important to ensure that the compliance officer has sufficient time to perform the necessary duties of the job. Of equal importance is the assurance that, if certain duties are delegated, the compliance officer provides adequate supervision to junior staff.

We observed the following ineffective compliance officer functions during our examinations:

- delegation of key compliance duties to junior staff with no follow-up supervision of their activities
- delegation of compliance duties to staff members who lacked the necessary knowledge of industry regulations and proficiency required to take on such a role
- the compliance officer did not review and approve new client accounts
- the portfolio manager drafted a comprehensive manual but never made it clear who was responsible for various supervisory functions
- the compliance officer was often out of the office marketing the firm's pooled funds, leaving no officer to supervise the day-to-day operations, and
- the compliance officer failed to distribute and enforce the firm's policy and procedures manual.

BEST PRACTICES

- take a “hands on” approach to ensure compliance with legal and ethical standards
- ensure that registered staff understand the proper procedures to follow and that they have an updated manual
- conduct regular presentations to employees on various internal control and compliance issues, and
- use compliance exception reports to identify failures to comply.

3. INCOMPLETE POLICY AND PROCEDURES MANUAL

15 FIRMS
20 EXAMS

A portfolio manager's obligation to establish and apply written business procedures is a fundamental requirement under the *Securities Act*. The policy and procedures manual is the blueprint for the operations of the firm. For the benefit of both the firm and its clients, the manual should be reviewed and revised (if required) at least semi-annually.

The BCSC often looks to written policies as evidence that a registrant has properly addressed its business risks and compliance obligations. Our examinations revealed a serious lack of due diligence in this area. Portfolio managers often cited various reasons for not having a current manual such as the small size of the firm or their mainly institutional clientele.

Registered portfolio managers must have a policy and procedures manual, regardless of size or type of clientele. This manual must be kept up-to-date.

Examples of manual deficiencies identified during our compliance examinations include:

- a portfolio manager with an outdated manual that did not meet the minimum requirements set out in BC Policy # 31-601 (formerly Local Policy Statement # 3-22)
- failure to outline requirements for personal trading or the account opening process, including required documentation
- failure to outline requirements for advertising and disclosure of performance numbers, including pre-approval of marketing materials by a compliance officer prior to use
- lack of proper procedures to track aggregate security positions for the purpose of insider reporting requirements (BC Form 55-901F)
- a portfolio manager failed to include procedures for providing clients with a copy of its written standards of fairness for the allocation of investment opportunities, as required by section 44 (1) of the *Securities Rules*
- lack of defined duties for the compliance officer in the areas of account approval and trade activity review
- lack of policies relating to trade approval, execution and required documentation
- lack of procedures relating to the reporting, handling and documentation of client complaints, and
- lack of policies and procedures relating to controls over money laundering and to ensure compliance with the reporting requirements of the *Proceeds of Crime (Money Laundering) Act*.

BEST PRACTICES

- provide and update compliance procedures in a comprehensive policy and procedures manual
- include this manual with employee orientation materials, and
- maintain a separate manual to cover issues on corporate governance.

4. DEFICIENT KNOW-YOUR-CLIENT (KYC) PRACTICES

14 FIRMS
20 EXAMS

A portfolio manager is responsible for learning the essential facts about every client. Portfolio managers should ensure they collect and update KYC information in a timely manner. This is normally documented on a KYC form or an Investment Policy Statement (IPS). The portfolio management process requires that the portfolio manager develop an IPS that documents an investor's objectives and constraints prior to formulating and implementing appropriate investment strategies.

As most portfolio managers have full discretionary authority over their clients' assets, they also have a fiduciary duty to exercise due care, skill, prudence and diligence in managing these assets. Portfolio managers should design the KYC form or IPS to evidence how they will manage and allocate a client's funds across various investment opportunities.

We found KYC practices deficient during our examinations for the following reasons:

- incomplete KYC forms or investment policy statements
- forms that failed to adequately address client objectives, constraints and risk tolerance
- outdated client information forms
- no plan or policy to update KYC information in a timely manner, and
- the IPS failed to identify asset mix parameters.

BEST PRACTICES

- use a software package to record KYC and IPS information electronically – this client information can be easily updated, and
- use software that provides exception reports to assist in managing asset allocations.

5. INADEQUATE RECORD-KEEPING PRACTICES

10 FIRMS
20 EXAMS

The increased volume of investment activity in the market coupled with regulatory requirements and the public's demand for information and accountability has generated a need for extensive and detailed record-keeping.

During our examinations, we found portfolio managers' books and records deficient for the following reasons:

- the books and records were incomplete or inaccurate
- the portfolio manager failed to follow-up on missing documents
- the portfolio manager failed to have procedures in place to ensure records were maintained for seven years, and

- a certificate of incorporation, a corporate resolution and a list of directors had not been obtained for all corporate accounts.

BEST PRACTICES

- develop checklists to ensure all required documentation is complete
- use software or checklists that flag certain information if it is missing, and
- obtain corporate charters or resolutions authorizing trading for corporate accounts.

6. INADEQUATE PERSONAL TRADING PROCEDURES

9 FIRMS
20 EXAMS

During the examination process, examination staff carefully review all the supporting documentation used for personal trades. Some portfolio managers had procedures and policies in place but did not enforce them. In some cases, registered staff were unsure of the details of their firm's personal trading policy, while other firms failed to have adequate restriction periods for the accumulation of securities.

At one firm, the compliance officer had delegated the review of personal trading to clerical staff and had not supervised them to ensure proper procedures were followed. In another example, portfolio managers failed to report personal trades to their firm in a timely manner and the compliance group took no action.

BEST PRACTICES

- designate a compliance officer who is responsible for reviewing and maintaining personal trading records, and
- distribute clear, written personal trading restrictions and reporting obligations to all employees.

7. ADVERTISING AND MARKETING CONCERNS

9 FIRMS
20 EXAMS

Many portfolio managers do not have clear, written procedures or guidelines for marketing their business and for making performance representations for securities or financial markets. In some cases, performance representations were clearly misleading.

The following examples raised concerns:

- a portfolio manager represented in marketing materials that "... these indicators have an accuracy factor of over 70% in forecasting the direction of financial markets ..."

- performance results were presented for only selected portfolios or “cherry picked” accounts rather than the performance results for all accounts held under management
- performance results of back-tested models were included with actual performance results, and
- a portfolio manager claimed "full compliance" with AIMR standards when many of the AIMR disclosure requirements had not been met.

BEST PRACTICES

- develop well-defined guidelines and procedures for advertising the business and for marketing materials, and
- assign review responsibilities to a few individuals who become well-versed in these issues.

8. UNREGISTERED ADVISING STAFF	8 FIRMS <hr style="width: 50%; margin: 0 auto;"/> 20 EXAMS
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In accordance with section 34 of the *Securities Act*, a person engaging in the act of advising must be registered under the *Act*, unless an exemption applies. Registered portfolio management firms must ensure that staff who conduct "registerable" activities in the province are registered as required under the *Securities Act*.

Key questions to consider include:

- (i) Does the person, if resident in BC:
- provide advice (such as security selection, including pool selection, or recommendations of asset allocation) to clients, whether directly or indirectly
 - represent him or herself to clients as an adviser or a portfolio manager
 - offer an opinion about the investment merits of securities (including funds), or
 - have supervisory or other compliance duties that relate to dealing or advising in securities?
- (ii) If the portfolio manager or its advising employee is not resident in BC, does the employee do any of the above for BC-resident clients, including BC-based pooled funds?

BEST PRACTICES

- establish clearly defined guidelines on what “registerable” activities include, and
- discuss them with all new employees of the firm during a compliance orientation session.

9. INADEQUATE FEE DISCLOSURE

7 FIRMS
20 EXAMS

Our examinations reviewed the disclosure portfolio managers provide to clients about fees. When a portfolio manager fails to disclose information about the fees a client pays for advisory services, clients are unable to make informed decisions about entering into the relationship.

Portfolio managers' fee disclosure was found deficient for the following reasons:

- a fee schedule was not provided
- the fee schedule did not adequately disclose the exact method of fee calculation, and
- the firm did not show how fees were calculated when an account was closed.

BEST PRACTICES

- clearly outline in every client information package how fees are charged
- provide each client with a fee schedule and ensure every client signs-off once they have received the schedule, and
- ensure the fee schedule clearly outlines fees, rebates where applicable, and how management fees are calculated.

10. INADEQUATE CONFLICT OF INTEREST DISCLOSURE

7 FIRMS
20 EXAMS

In accordance with section 77 of the *Rules*, all portfolio managers must disclose conflicts of interest to clients. In British Columbia, the required conflict of interest form is BC Form 33-907F (previously Form 69). This form should be completed, filed with the Commission and provided to all clients and prospects at the account opening stage. Some portfolio managers failed to provide any conflict of interest disclosure, even though they had in-house pooled trusts that many clients used as an investment vehicle. Some firms had no procedures to establish what conflicts may exist between senior officers and reporting issuers. Others made disclosure, but the disclosure was incomplete and not in a form similar to BC Form 3-907F.

BEST PRACTICES

- follow AIMR requirements and make full disclosure to clients and prospects of all conflicts of interest
- establish procedures for querying staff when potential conflicts may exist, and
- make conflict of interest disclosure available to clients before they sign a management agreement with the firm.

11. FAILURE TO DISCLOSE FAIRNESS OF ALLOCATION POLICY

7 FIRMS
20 EXAMS

Section 44(1)(5) of the *Securities Rules* requires that, as part of its business procedures, a portfolio manager must have written standards of fairness for the allocation of investment opportunities among its clients and must provide a copy of the standards to each client. This disclosure should be specific and relate to the fair allocation of IPO and other securities to segregated client accounts, and to the distribution of securities among various pools or funds the firm manages.

The exams found that several portfolio managers did not properly disclose the firm's "fair allocation of investment opportunities" policy. This disclosure should describe the procedures the firm uses to allocate securities to clients and in-house pools, as well as the pricing policy that applies.

BEST PRACTICES

- include fairness of allocation disclosure as part of the account opening materials provided to each new client.

12. FAILURE TO PROVIDE LEVERAGE DISCLOSURE DOCUMENT

7 FIRMS
20 EXAMS

Notice and Interpretation Note # 87/67 provides a standard leverage disclosure document that portfolio managers must provide to all clients who are borrowing funds to invest. Some portfolio managers failed to ask the client if the funds to be invested were borrowed and, if they were, to provide the client with a leverage disclosure document. Some other firms simply failed to provide the disclosure document even though the client clearly used borrowed funds.

BEST PRACTICES

- determine whether the client intends to use borrowed funds to invest and, if so, provide a leverage disclosure document.

13. FAILURE TO FILE BC FORM 45-902F FOR POOLED FUND DISTRIBUTIONS

7 FIRMS
20 EXAMS

Under section 139 of the *Securities Rules*, a pooled fund that distributes its securities under an exemption must file BC Form 45-902F, disclosing details of the distribution, and pay the applicable fees, on or before the 10th day after the distribution. In certain

circumstances, the filing requirement is extended to no later than 10 days after the end of the calendar year in which the distribution took place. Seven firms examined failed to file the required form for distributions of units in their pooled funds.

An alternative to the BC Form 45-902F filing requirements for distributions of pooled fund units is available under certain circumstances. The alternative filing requirements (BC Instrument 45-505 and related forms) were published in December 2000 and can be found on our website at www.bcsc.bc.ca/Policy/forms.asp. The alternative filing requirements are intended to reduce the number of filings required, the number of trades to be reported and the applicable fees.

BEST PRACTICES

- become familiar with the reporting obligations for distributions of pooled fund units and file the appropriate forms in a timely manner.

14. INCOMPLETE ACCOUNT OPENING PROCEDURES

7 FIRMS
20 EXAMS

Section 47 of the *Securities Rules* stipulates that a portfolio manager must designate a compliance officer to be responsible for approving all new accounts. The role of the compliance officer is not only to ensure documents are completed properly, but also to ensure high-risk clients are identified and all concerns are addressed. Failure to meet the requirements of this rule contributes to incomplete KYC information and "suitability of investment" problems.

Our examinations found that:

- some firms failed to ensure that account opening procedures were approved by the designated compliance officer, and
- the approval function at some firms was delegated to junior staff, rather than to the compliance officer in charge of opening new accounts.

BEST PRACTICES

- provide clear account opening procedures or checklists to assist staff to open new client accounts correctly
- record all the required client information
- clearly identify the type of account
- complete and sign all relevant documents including the management agreement
- establish follow-up procedures that ensure corporate documents such as the corporate charter are received
- obtain trading authorizations for individuals or corporations
- provide all disclosure documents including conflicts of interest forms to the client, and
- ensure the compliance officer signs-off on the account prior to any transactions taking place.

15. FAILURE TO REVIEW TRADE BLOTTER

5 FIRMS
20 EXAMS

An important part of a portfolio manager's compliance program is the review of trading activity. The *Securities Act* requires that a portfolio manager maintain and regularly review the trade blotter.

In order to identify front-running and other improper trading activities, our examination staff review the trade blotter to identify unusual transactions and to compare personal trades by employees of the firm to the trade blotter.

Our examinations found firms failing to maintain a trade blotter. In other cases, firms failed to reconcile the blotter to other internally generated trade records, or delegated these duties to junior clerks.

BEST PRACTICES

- implement proper procedures, through the use of trade blotters and exception reports, to review all trading activities
- create daily, weekly and monthly trade reports
- review these trade reports regularly to detect delays in trading, unusual impact or commission costs, excess trade activity, front running, improper cross trading or improper employee trading, and
- designate a compliance officer to be responsible for regularly reviewing and signing-off on trade reports.

16. FAILURE TO CALCULATE AND MONITOR CAPITAL LEVEL

5 FIRMS
20 EXAMS

Section 41 of the *Securities Rules* requires that portfolio managers prepare capital calculations within 30 days of each month end and submit them to the Commission. The portfolio manager must monitor capital on a monthly basis to ensure it meets minimum requirements. These calculations must be presented in the same format as BC Form 33-905F (previously Form 62). These calculations should be readily available for inspection during an examination.

Our examinations revealed that some portfolio managers were not completing capital calculations on a monthly basis and that some firms were not following generally accepted accounting principles (GAAP) when making their calculations. For example, our examinations found that some firms were making their calculations:

- using an incorrect minimum capital level
- including related party receivables in the working capital calculation

- using pre-booked receivables as current working capital
- using a cash basis instead of an accrual basis, and
- using an incorrect bond deductible amount.

BEST PRACTICES

- calculate the firm's working capital on a monthly basis in the proper form using GAAP and maintain books and records to support all financial reports.

17. INADEQUATE TRADE DESK PROCEDURES

4 FIRMS
20 EXAMS

An important function of the trade desk is to document the trade initiation, approval, and execution processes. A firm's compliance staff needs to physically oversee and approve these trading activities. Compliance staff should record evidence of their approval by initialling the trade blotter. Use of time stamps and trade tickets are also important components of proper trade desk procedures.

BEST PRACTICES

- implement a formal trade desk policy
- ensure this policy includes checks by appropriate staff members to detect improper trade desk procedures
- confirm that compliance staff supervise other employees to ensure they complete all trade tickets and forms in accordance with the firm's standards, and
- prepare a trade record identifying each client prior to any trade, including a pooled fund (if applicable).

18. FAILURE TO ADHERE TO INVESTMENT GUIDELINES

4 FIRMS
20 EXAMS

Portfolio managers need to ensure all client portfolios meet the investment guidelines set out in the firm's investment policy statement or other documentation used to outline asset allocation. The firm must adhere to any special client considerations or restrictions. Even when the firm conducts its business through investment pools, it must carefully consider individual investment objectives. The compliance officer is responsible for establishing applicable procedures and for ensuring portfolio rebalancing as necessary.

Portfolio managers' practices were found deficient for the following reasons:

- compliance staff did not review the investment allocation practices of registered staff
- compliance staff did not oversee regular re-balancing of client portfolios

- pools managed by tactical short-term strategies had clients with "income" and "long-term" objectives – the strategy used did not match the client's investment objectives
- the client's investment policy statement had investment restrictions that were not followed
- retirement clients were found participating in some risky "wrap programs" that did not appear to be consistent with their documented investment objectives, and
- a portfolio manager put a client into a pool with objectives of 100% growth, when the client's investment policy statement indicated 50% income and 50% long-term growth.

BEST PRACTICES

- establish internal procedures that require regular reviews of client investment objectives and constraints against actual portfolio allocations, and
- use software to assist in comparing current holdings to guidelines and to provide exception reports.

19. COMMINGLING OF FUNDS	4 FIRMS
	20 EXAMS

If a portfolio manager takes custody of client funds, the portfolio manager must implement various procedures, including separate trust accounts. Section 57 of the *Securities Rules* requires that the portfolio manager deposit all client funds received directly into an interest-bearing trust account.

Some firms were holding client funds in temporary bank accounts that were registered in the firm's name. These accounts do not qualify as trust accounts and were not, in these examples, interest-bearing.

BEST PRACTICES

- become knowledgeable about the recent changes set out in Part 11 of National Instrument 81-102 (which replaced National Policy # 39), and
- put client funds immediately into interest-bearing trust accounts administered by a custodian, normally a financial institution.

20. FAILURE TO DISCLOSE REFERRAL ARRANGEMENTS

3 FIRMS
20 EXAMS

Section 53 of the *Securities Rules* requires that portfolio managers disclose to clients referral arrangements involving compensation paid to another person or firm.

We found that some portfolio managers had referral arrangements for legal, accounting, financial planning and estate planning services. However, these same firms did not have a written policy on referrals, and did not provide disclosure to clients about these referrals.

BEST PRACTICES

- develop a written policy on referrals, and
- provide the policy to all staff to ensure they make appropriate disclosure to all clients and prospects.

21. INADEQUATE CLIENT STATEMENT RECONCILIATION PRACTICES

3 FIRMS
20 EXAMS

Our examiners review a sample of each firm's client statements to ensure they are accurate. We also check for effective internal controls on:

- the settlement of trades
- the transfer of funds to and from trust and custodial accounts
- the reconciliation of client statements to trust account statements
- the reconciliation of security balances per custodian records to physical counts
- the review of completed reconciliations
- the pricing of securities on client statements, and
- the calculation of fees and how they are disbursed.

In some cases, examiners found little supervision of these activities. Some firms did not ensure reconciliations were performed. Other firms did not review the work of junior staff that performed reconciliations. Some billing practices were found to be inconsistent and unethical. Some firms failed to show clearly how they charged client management fees. In another example, the firm did not perform an independent review of an analyst's bond price valuation at month-end.

BEST PRACTICES

- establish policies and procedures for creating and reconciling client statements
- ensure these procedures include a regular reconciliation of client accounts to the trust account and an independent review
- ensure these procedures include standard billing practices and independent checks on month-end security valuations, and
- resolve any security or cash differences promptly.

22. FAILURE TO MEET REPORTING OBLIGATIONS OF POOLED FUNDS

3 FIRMS
20 EXAMS

Many portfolio managers administer their own pooled funds. Most pooled funds meet the definition of mutual fund as defined in section 1 of the *Securities Act*. Section 145 of the *Securities Rules* requires that mutual funds file annual financial statements. Financial reporting obligations for pooled funds may include: annual audited financial statements, a statement of investment portfolio, a statement of portfolio transactions and other financial information. Portfolio managers that administer pooled funds must review and understand these filing obligations and ensure compliance with section 145 of the *Rules*. Portfolio managers also may have to file insider reports for transactions by their pooled funds, as required under section 70 of the *Securities Act*.

Our examinations found one portfolio manager did not file annual financial reports for its pooled funds as required under section 145 of the *Rules*. Another firm did not have any procedures in place to track aggregate security positions for the purpose of monitoring potential control or insider positions.

BEST PRACTICES

- become familiar with the reporting obligations of pooled funds, including financial and insider reporting.

23. SOFT DOLLAR ISSUES

2 FIRMS
20 EXAMS

The AIMR *Soft Dollar Standards* require that firms apply soft dollar credits to the payment of research services. Soft dollar credits must directly assist the portfolio manager in the investment decision-making process.

Our examinations found that some portfolio managers used soft-dollar costs for computer purchases and payment of expenditures that could be considered operational costs – not payments made for research services.

While the BCSC does not have specific legislation on soft dollar costs, we refer portfolio managers to AIMR guidelines.

BEST PRACTICES

- establish a compliance committee that maintains a policy and a financial ceiling on soft-dollar expenditures
- ensure that all soft dollar arrangements and standard disclosure documents for clients are approved by the committee, and
- consult with AIMR for clarification on whether the credits relate to expenditures for research.

SPREADSHEET OF COMPLIANCE DEFICIENCIES IDENTIFIED DURING EXAMINATIONS

The purpose of this chart is to show the major deficiencies found during the examination of 20 portfolio management firms registered in British Columbia. Period of examinations: October 1996 to December 2000

DEFICIENCY	FIRM 1	FIRM 2	FIRM 3	FIRM 4	FIRM 5	FIRM 6	FIRM 7	FIRM 8	FIRM 9	FIRM 10	FIRM 11	FIRM 12	FIRM 13	FIRM 14	FIRM 15	FIRM 16	FIRM 17	FIRM 18	FIRM 19	FIRM 20	TOTALS	
Overall compliance program			◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	11
Compliance officer duties			◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	8
Policy and procedures manual		◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	15
Unregistered advisers			◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	8
Record-keeping		◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	10
KYC and suitability review		◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	14
Account opening procedures		◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	7
Trade blotter review			◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	5
Trade desk procedures			◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	4
Disclosure:																						
Fees charged							◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	7
Conflicts of interest - Form 69			◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	7
Fairness in allocation			◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	7
Leverage - NIN 87/67			◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	7
Statement of Financial Condition			◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	5
Referral arrangements				◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	3
Adherence to investment guidelines				◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	4
Personal trading issues				◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	9
Complaint practices/procedures				◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	2
Advertising & marketing issues				◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	9
Presentation of performance #'s				◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	2
Commingling & trust accounts				◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	4
Client statement reconciliations				◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	3
Pooled fund reporting obligations				◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	3
Calculate & monitor capital levels				◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	5
Custodian issues				◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	2
Compliance reports				◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	3
Soft dollar issues				◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	2
Proxy voting (corporate governance)				◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	1
Allocation of prices on trades				◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	1
Filing of BC Form 45-902F				◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	◆	7
TOTAL DEFICIENCIES FOUND	3	7	6	18	11	11	14	13	11	7	10	7	5	14	8	9	6	6	0	9	7	