



ONTARIO  
SECURITIES  
COMMISSION

OSC Staff Notice 33-732

→ 2009

## Compliance Team Annual Report

## Contents

<b>Introduction</b> .....	<b>4</b>
<b>1. Our role</b> .....	<b>7</b>
1.1 Compliance team .....	7
1.2 Who we oversee .....	8
1.3 Compliance review process .....	8
1.4 Compliance-Enforcement continuum .....	8
<b>2. Response to recent market turmoil</b> .....	<b>11</b>
2.1 Phased approach – Reviews of investment funds .....	12
2.2 Focused meetings with investment fund managers who had suspended redemptions of their investment funds .....	16
2.3 Letter to Chief Compliance Officers .....	16
<b>3. General compliance initiatives</b> .....	<b>19</b>
3.1 New registrant sweeps .....	19
3.2 LMD risk assessment questionnaire .....	20
3.3 Desk reviews of Mutual Fund Dealers who are not members of the MFDA .....	20
3.4 Future initiatives .....	21
<b>4. Significant deficiencies among market participants</b> .....	<b>23</b>
4.1 Portfolio managers.....	24
4.2 Limited market dealers.....	30
<b>5. Outcomes of our reviews</b> .....	<b>37</b>
<b>6. National Instrument 31-103 – <i>Registration Requirements and Exemptions</i></b>	<b>40</b>
<b>7. International Financial Reporting Standards (IFRS)</b> .....	<b>42</b>



# Introduction

## Introduction

This report is a summary of the Compliance team's activities for the 2009 fiscal year (April 1, 2008 to March 31, 2009). During this period, the capital markets in Ontario experienced an unprecedented period of financial and market turmoil. No doubt this was a challenging year for securities regulators, as well as market participants, around the world.

The Compliance team, as part of the Compliance and Registrant Regulation Branch at the Ontario Securities Commission (OSC), played an important role in responding to the current market turmoil by conducting a series of proactive reviews of Ontario-based investment fund managers (IFMs) covering major segments of the investment funds industry.

In this report, we discuss how the Compliance team responded to the market turmoil, our key areas of focus, and the outcome of these reviews. As in our previous reports, we also discuss the three most commonly occurring significant deficiencies from reviews of portfolio managers (PMs) and limited market dealers (LMDs).

We encourage market participants<sup>1</sup> to use this report as a self-assessment tool to strengthen their compliance with Ontario securities law and to improve their systems of internal controls and supervision.

---

<sup>1</sup> Market participants include investment fund managers, LMDs, portfolio managers and scholarship plan dealers.

**This report is divided into seven sections:**

- 1. Our role.** This section describes our role and how we continue to work to strengthen the compliance-enforcement continuum.
- 2. Response to recent market turmoil.** This section summarizes the work the Compliance team conducted in response to the market turmoil.
- 3. General compliance initiatives.** This section describes the 2009 new registrant sweeps, the desk review of mutual fund dealers, and the development of the LMD risk assessment questionnaire. It also discusses the initiatives we have planned for the 2010 fiscal year.
- 4. Significant deficiencies among market participants.** This section summarizes the three most commonly occurring significant deficiencies found in our 2009 reviews of PMs and LMDs. We also include suggested best practices to help market participants improve existing procedures and establish policies in areas where they are lacking, and to give general guidance on improving overall compliance.
- 5. Outcomes of our reviews.** This section describes the various outcomes of our reviews.
- 6. National Instrument 31-103 – *Registration Requirements and Exemptions (NI 31-103)*.** This section provides an update on the registration reform project.
- 7. International Financial Reporting Standards (IFRS).** This section provides an update to market participants on IFRS and how the move to IFRS may affect them in preparing financial statements for delivery to the OSC.



# 1. Our role

- 1.1 Compliance team
- 1.2 Who we oversee
- 1.3 Compliance review process
- 1.4 Compliance-Enforcement continuum

## 1. Our role

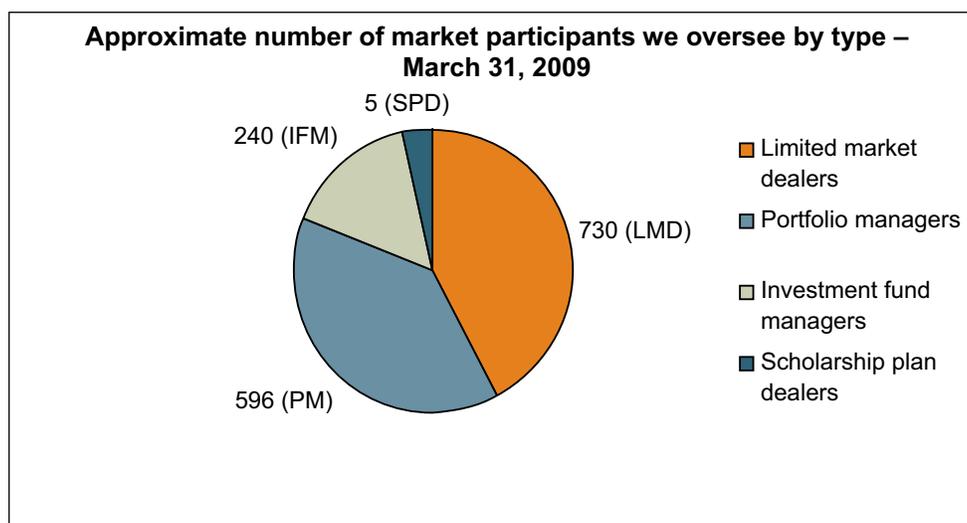
### 1.1 Compliance team

The Compliance team is part of the OSC's Compliance and Registrant Regulation Branch. Our team has 32 staff including 28 chartered accountants and lawyers. Our role is to enhance investor protection and enhance confidence in the capital markets by:

- overseeing market participants that are not members of a recognized self-regulatory organization (SRO) including PMs, IFMs, LMDs and scholarship plan dealers (SPDs)
- promoting compliance by market participants with Ontario securities law by conducting compliance oversight reviews
- recommending and taking remedial action against market participants that do not comply with Ontario securities law. This may include the issuance of a deficiency report, imposing terms and conditions, or referral to the Enforcement branch
- determining whether additional standards or rules are needed for market participants
- participating in the development of these standards or rules
- creating awareness of new or proposed rules
- fostering a culture of compliance
- coordinating with other branches of the OSC to promote effective oversight of market participants and strengthen the compliance-enforcement continuum, and
- providing guidance and information to the industry on significant issues identified during our reviews. For example, we publish staff notices, and participate in seminars and conferences.

## 1.2 Who we oversee

At March 31, 2009, we had oversight responsibility over approximately 1,600 market participants<sup>2</sup>. The following chart shows the number of market participants by type.



## 1.3 Compliance review process

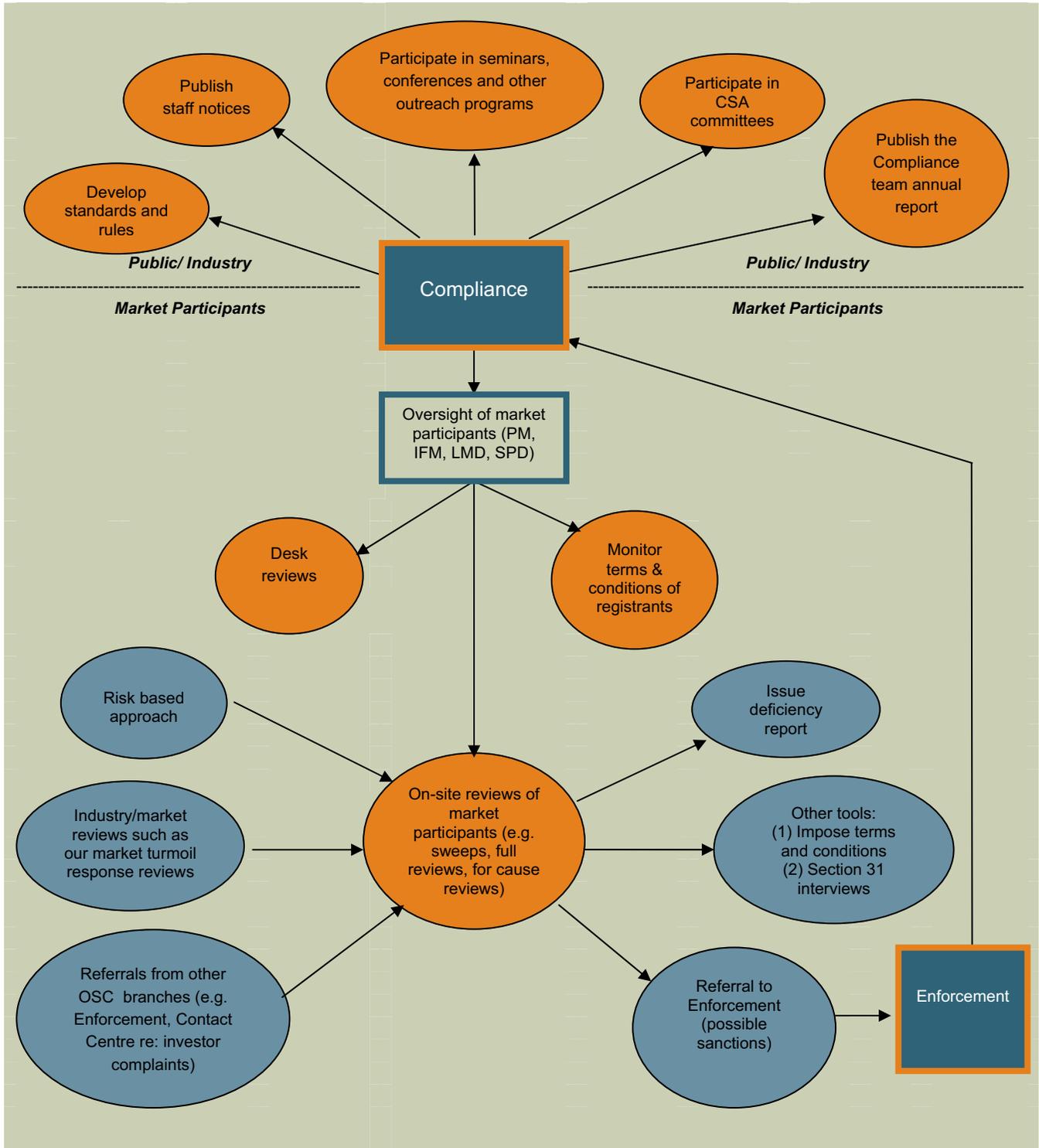
As set out in our previous annual reports, we have developed risk-assessment models to select market participants for compliance oversight reviews. The risk assessment models enable us to allocate resources more effectively and efficiently by targeting those market participants with higher risk profiles.

## 1.4 Compliance-Enforcement continuum

The Compliance team coordinates and works actively with other branches at the OSC, in particular, the Enforcement Branch. When we identify any serious violation of securities law, we discuss the findings with the Enforcement Branch and together staff determines an appropriate course of action. As well, Enforcement staff may have concerns about compliance issues at a market participant and Compliance staff will provide expert advice as required. There is ongoing information sharing between the two branches of the OSC, with Compliance (whose main focus is on prevention and remediation) on one end of the spectrum, and Enforcement (whose main focus is on protection and deterrence) on the other end.

<sup>2</sup> If a market participant is operating in more than one capacity, for example, as a portfolio manager and as an investment fund manager, it is considered to be two market participants for oversight purposes.

The flowchart illustrates our role and how we interact with our market participants, industry and other branches at the OSC.





## 2. Response to recent market turmoil

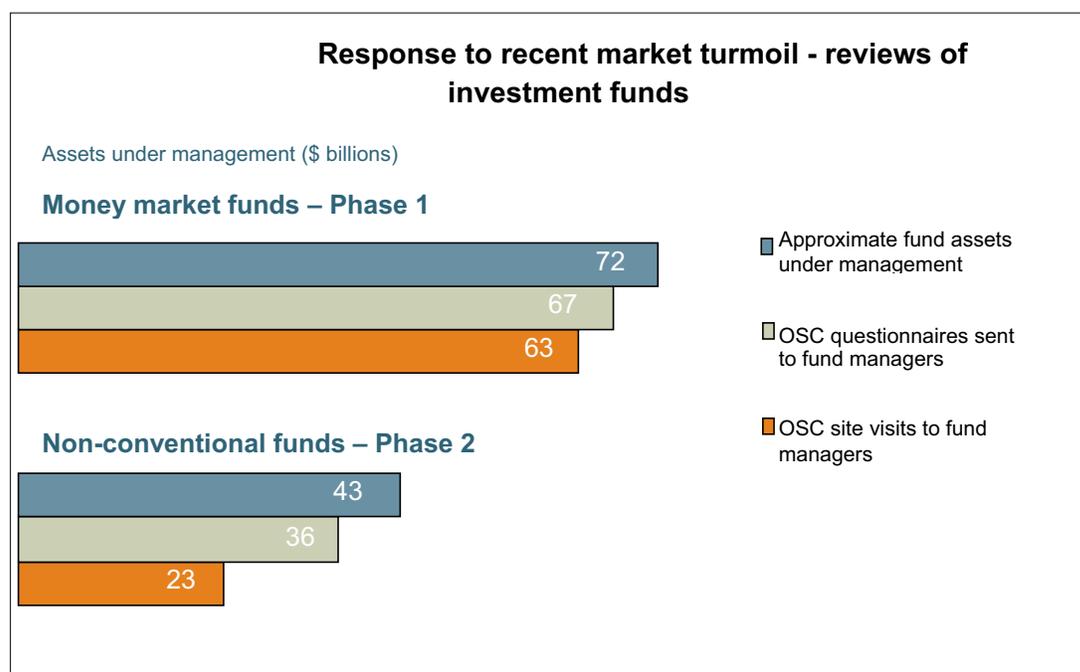
- 2.1 Phased approach – Reviews of investment funds
- 2.2 Focused meetings with IFMs who had suspended redemptions of their investment funds
- 2.3 Letter to Chief Compliance Officers

## 2. Response to recent market turmoil

The global financial services industry has experienced an unprecedented period of turmoil. In response to the concerns emerging about the current market conditions, Compliance staff (along with staff from the Investment Funds Branch on some reviews) initiated a series of on-site reviews to identify any issues at market participants that the OSC oversees that posed an increased risk to investors.

These on-site reviews were executed in phases and included IFMs and PMs that manage various major segments of our investment fund industry including money market funds, non-conventional funds and hedge funds.

The chart below shows the approximate total assets under management, the share of the respective marketplace that was targeted in our reviews, and the share that was covered by our on-site visits of IFMs.



Sources – Money market fund assets under management as at January 2009: Investment Funds Institute of Canada. Non-conventional fund assets under management as at March 2008: TMX Group.

In addition to the on-site reviews of investment funds, we also performed focused reviews of a sample of PMs who had suspended redemptions of their investment funds due to significant declines in the net asset value (NAV). Further, we also sent a letter to the Chief Compliance Officers of OSC non-SRO registered firms reminding them of the critical role played by their firm's compliance programs in meeting their obligations under Ontario securities law.

## 2.1 Phased approach – Reviews of investment funds

Staff from the Compliance team along with staff from the Investment Funds Branch implemented a phased approach for assessing the operations of IFMs who manage or administer major segments of the Canadian investment fund industry. We conducted meetings with senior management to obtain information about their portfolio holdings, valuation methodologies, exposure, if any, to illiquid assets, and counterparty risks. In addition, we discussed whether the IFMs had problems with meeting clients' redemptions and what procedures and controls were in place to monitor their investment portfolios given the current market conditions.

### (i) Phase 1 – Reviews of money market funds

In September 2008, a major money market fund in the United States known as the Reserve Primary Fund “broke the buck” due to its exposure to Lehman Brothers, a major financial institution who filed for bankruptcy protection. Money market funds are generally considered by investors to be extremely liquid and safe. Therefore, it was important for us to assess and determine whether our Ontario-based money market funds faced similar issues as those in the United States relating to exposure to financial institutions, illiquid securities and redemption levels.

#### Review process

In September 2008, we initiated a fact finding review of Ontario-based money market funds by sending a questionnaire to 50 Ontario money market fund managers.

The questionnaire focused on a number of key areas covering:

- portfolio holdings
- valuation of portfolio securities (with a focus on illiquid securities), and
- sales and redemptions levels.

We reviewed and risk-ranked the fund manager responses. We then selected a representative sample of IFMs for on-site reviews.

This sample included money market assets under management of approximately \$63 billion, representing 90% of the money market fund assets of the 50 IFMs (see our response to the market turmoil chart above).

### Focus on key risk areas

The on-site reviews focused on various key risk areas relating to:

- financial sector exposure
- concentration levels
- counterparty exposure
- levels of redemptions, and
- valuation of securities in these investment funds.

We met with senior management and performed substantive testing of the funds' portfolios to assess whether IFMs were using appropriate valuation methodologies, monitoring counterparty exposure, managing concentration risks, and levels of redemptions.

### Outcomes of our reviews

Based on our on-site reviews: we found that:

- the portfolios were generally invested in a manner consistent with a conservative investment strategy (i.e. in a combination of t-bills, bankers acceptances, deposit notes etc.)
- IFMs were generally able to meet redemptions
- valuation methodologies were generally appropriate
- we did not identify any IFMs with any material exposure to the U.S. companies experiencing financial difficulties, and
- IFMs were generally maintaining a more liquid portfolio than previously, with shorter terms to maturity.

In general, we found that the IFMs that we reviewed had adequate procedures in place to ensure compliance with their regulatory requirements. Some IFMs had automated exception reporting systems allowing them to monitor and assess compliance with regulatory requirements. If the administrative functions of a fund were outsourced to a service provider, the IFMs reviewed generally had adequate oversight procedures in place. In addition, we also noted that some IFMs had put a number of mechanisms in place to monitor investors' redemptions.

#### *(ii) Phase 2 – Reviews of non-conventional funds*

The second phase of our response to the market turmoil was led by the Investment Funds Branch with participation from the Compliance Team. We conducted on-site reviews of selected non-conventional funds. These non-conventional funds included closed-end funds and exchange-traded funds which generally invest in a broader array of asset classes and employ higher risk investment strategies than conventional mutual funds.

### **Review process**

Our review process was similar to that used for money market funds. We sent a questionnaire to 27 fund managers whose non-conventional funds are listed on the Toronto Stock Exchange. We reviewed and risk-ranked their responses. We then selected a representative sample of non-conventional fund managers for on-site reviews.

This sample represented assets under management of approximately \$23 billion, representing 54% of the non-conventional assets under management in Ontario (see our response to the market turmoil chart above).

### **Focus on key risk areas**

Our on-site reviews focused on various key risk areas relating to:

- high risk investment strategies
- going concern
- financial sector exposure
- concentration levels
- counterparty exposure
- redemptions, and
- valuation of securities in these investment funds.

### **Outcomes of our reviews**

Based on the results of our on-site reviews, we found that these funds had generally experienced losses and depletion of assets. In some cases, the market turmoil had an impact on the fund's ability to make distributions or to offer an annual redemption right at net asset value. These funds followed their previously disclosed policies with respect to such events, including appropriate public disclosure and disclosure to unit holders.

#### ***(iii) Phase 3 - Reviews of hedge funds***

In general, the hedge fund industry has also been affected by the global markets crisis. For example, some hedge funds experienced deterioration in their NAV and also faced significant pressure in meeting investor redemptions. In the face of increased redemptions from investors and shrinking asset bases, some hedge fund managers have decided to either wind down their funds or temporarily suspend redemptions.

In February 2009, Compliance staff commenced a review of hedge fund managers based in Ontario to assess whether they posed any significant risks to investors, given the prevailing

market conditions. All IFMs are market participants. However, the majority of the hedge fund managers we reviewed are either registered as PMs or LMDs. NI 31-103 will generally require registration of IFMs which includes hedge fund managers.

### **Review process**

We sent a hedge fund questionnaire to 90 hedge fund managers and asked them questions on a range of topics including:

- investment fund strategy
- number of unitholders
- composition of clients (i.e. retail versus institutional clients)
- portfolio holdings, and
- service providers.

We reviewed and risk-ranked the responses. We then selected a representative sample of hedge fund managers for on-site reviews.

### **Focus on key risk areas**

Our on-site reviews focused on various key risk areas relating to:

- custody of investors' assets
- levels of redemptions
- going concern
- concentration levels
- counterparty exposure
- valuation of portfolio securities, and
- oversight of service providers.

### **Outcomes of our reviews**

On-site reviews are still ongoing. Once the reviews are completed, we will assess whether there are any industry issues that need to be addressed.

## 2.2 Focused meetings with IFMs who had suspended redemptions of their investment funds

Compliance staff also conducted focused meetings with senior management of selected IFMs who had suspended redemptions in their investment funds due to a significant decline in the investment funds' NAV. The objective of these focused meetings was to gain a better understanding as to why these investment funds declined in value and to assess whether senior management were taking appropriate action to protect the interests and assets of all investors.

We monitored the actions of these IFMs closely through the periodic update reports we asked them to provide. Where necessary, we referred the matter to the Enforcement Branch for further review.

We will continue to conduct focused meetings where necessary, in order to assess whether investors' interests and assets are protected.

## 2.3 Letter to Chief Compliance Officers

Some registrants may have decided to downsize their compliance departments in an effort to reduce costs during the economic downturn. However, it is important that this decision fully consider the impact it will have on the firm's ability to meet its obligations under Ontario securities law.

The compliance program plays a critical role in a firm and serves as a control function to ensure clients' interests and assets are adequately protected and helps to detect and prevent misconduct. Therefore, ensuring that a firm's compliance program is adequately funded and staffed and that it is supported and monitored by senior management of the firm is integral to ensuring its effectiveness.

On March 23, 2009, the Compliance team sent a letter to the Chief Compliance Officers of all OSC non-SRO registered firms reminding them of their continuing obligations to ensure compliance with securities law and that clients' assets are protected. It reiterated that registrants must ensure that they have adequate policies and procedures to ensure compliance. Examples include:

- (1) providing appropriate disclosure about the impact of the market conditions on their portfolio investments

- (2) updating “Know Your Client” (KYC) information for all investors
- (3) for registered individuals, understanding the products they are recommending to investors, commonly known as “Know Your Product” (KYP)
- (4) using appropriate valuation methodologies for valuing investments including hard to value investments.



## 3. General compliance initiatives

- 3.1 New registrant sweeps
- 3.2 LMD risk assessment questionnaire
- 3.3 Desk reviews of Mutual Fund Dealers who are not members of the MFDA
- 3.4 Future initiatives

### 3. General compliance initiatives

This section describes the new registrant sweeps of PMs and LMDs we conducted in 2009, the LMD risk assessment questionnaire, the desk reviews of mutual fund dealers who are not members of the Mutual Fund Dealers Association of Canada (MFDA), and the initiatives we plan to conduct in fiscal 2010.

#### 3.1 New registrant sweeps

Since 2008, the Compliance team has conducted sweeps of a sample of registrants including PMs and LMDs that are newly registered with the OSC within the past year and a half. A sweep is a review of a sample of market participants focused on an issue or issues.

A sweep of newly registered PMs was conducted in the fall of 2008, and a sweep of newly registered LMDs was conducted in early 2009.

The sweeps were jointly conducted by staff from the Compliance team and the Registrant Regulation team. Our objectives were to enhance investor protection and prevent market abuse by:

- obtaining a better understanding of the new registrants' business operations
- confirming whether their current business activities are consistent with representations in their registration applications
- assessing their compliance with Ontario securities law, and
- providing guidance and information to new registrants to assist them in complying with Ontario securities law.

The sweeps also provided an opportunity for the members of our registration team to meet, in person, our registrants with whom they have continuous and frequent dealings. Reviews of new registrants now form part of our compliance oversight program.

#### ***Summary of the Results***

##### **PMs**

The following are examples of areas in which we noted commonly occurring deficiencies during our review of newly registered PMs:

- marketing
- capital calculations
- individual registration issues

- policies and procedures manual, and
- business continuity plan.

Deficiencies in each of these areas are among the 10 most commonly occurring deficiencies of PMs. Last year, we published a separate summary of the 10 most commonly occurring deficiencies of PMs and suggested best practices. For additional guidance, please refer to this summary which is available on the OSC website at [www.osc.gov.on.ca](http://www.osc.gov.on.ca). See also section 4.1 for a discussion of the most commonly occurring significant deficiencies found during compliance reviews of PMs this year.

### **LMDs**

The following are examples of commonly occurring deficiency areas that we noted during our review of newly registered LMDs:

- understanding the investment products they are recommending (KYP) and understanding their clients' circumstances (KYC) in order to make the suitability determination required by law
- individual registration issues
- policies and procedures manual
- maintenance of adequate books and records
- marketing, and
- business continuity plan.

For suggested best practices on some of these deficiencies, please refer to section 4.2 of this report.

## **3.2 LMD risk assessment questionnaire**

In 2009, we developed a risk assessment model for LMDs. A risk assessment questionnaire will be sent to the LMDs in the near future. Data from the model will be used to assist us in prioritizing and planning LMD reviews going forward.

## **3.3 Desk reviews of Mutual Fund Dealers who are not members of the MFDA**

OSC Rule 31-506 *SRO Membership - Mutual Fund Dealers* requires all registrants registered as a mutual fund dealer to become a member of the MFDA after July 2, 2002. Registrants whose

mutual fund dealer activities were limited at the time of the rule could apply for an exemption from becoming a member of the MFDA.

As the exemptions were granted approximately 6 years ago, staff from the Compliance team conducted a desk review to determine if exempted registrants were still relying on and complying with the terms and conditions of their exemption. A questionnaire was sent to all registrants exempted from becoming a member of the MFDA that are currently registered as mutual fund dealers. Overall, staff did not find any mutual fund dealers that were inappropriately relying on the exemptions provided to them.

### 3.4 Future initiatives

#### *Impact reviews*

We have further enhanced our oversight strategy for market participants. Going forward, we will perform “impact reviews” on larger market participants over a defined cycle.

In general, our compliance oversight reviews to date indicate that larger market participants tend to have adequate policies and procedures and controls in place. However, irrespective of other risk factors, a breakdown of internal controls at a larger market participant may have a significant impact on the capital markets given the larger number of clients and dollar amounts involved. As a result, we intend to focus some of our compliance oversight resources on larger market participants over a defined number of years. The impact reviews will most often be in the form of sweep reviews.

#### *Market turmoil initiatives*

We will continue to closely monitor the prevailing market conditions and will conduct special reviews or sweeps to address any significant issues which may arise.

#### *Fiscal 2010 Sweeps*

In the past few years, we have shifted towards performing more sweep type reviews than regular or full field reviews. We think that sweeps are a better oversight tool as they allow us to focus on a particular topic of interest and cover a large sample of market participants within a short period of time.

Our plan is to conduct at least one sweep each year on each of IFMs, PMs and LMDs. After we complete a sweep, we normally share our findings with the public by issuing a staff notice or an industry report. Issuing public reports helps us meet our Compliance team’s role of enhancing investor protection and preventing market abuse.



## 4. Significant deficiencies among market participants

- 4.1 PMs
- 4.2 LMDs

## 4. Significant deficiencies among market participants

If we find significant deficiencies in a market participant's operations, we identify them in the deficiency report to enable senior management to focus on the key issues identified. The identification of significant deficiencies also helps to highlight areas of regulatory concern so that appropriate action can be taken by the market participant to improve compliance. Increased regulatory compliance by market participants helps ensure that investors are protected and that market abuse is prevented.

We have established various criteria to assess whether a deficiency is significant, including:

- risk to client assets
- conflicts of interest
- misleading information to clients
- ineffective compliance structure

We also take into account other factors, including:

- current issues, such as best execution and marketing practices
- the frequency of findings
- the impact of the deficiency on the market participant's operations

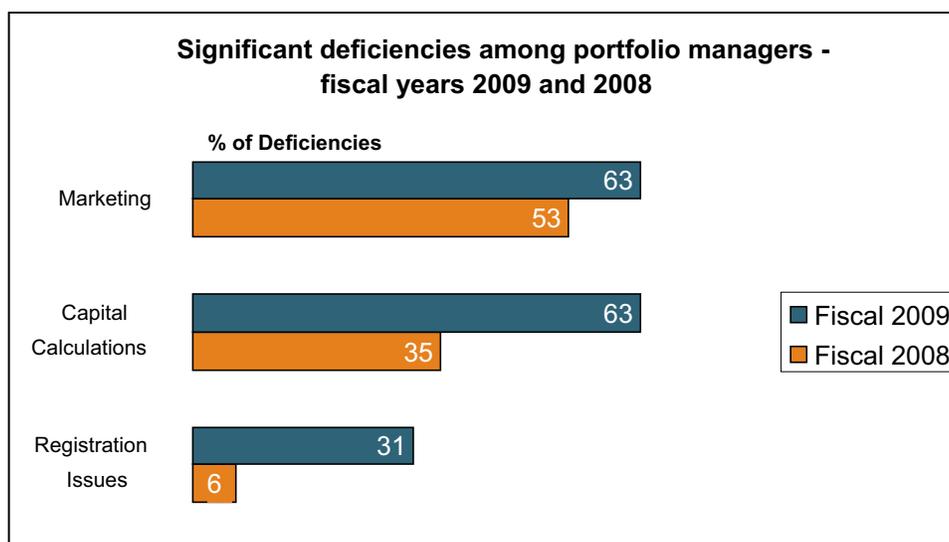
The following sections summarize the three most commonly occurring significant deficiencies for fiscal 2009 of PMs and LMDs. We did not include information on the most commonly occurring significant deficiencies for IFMs in this section as significant resources were allocated to the market turmoil reviews during this fiscal period. As a result, we are not in a position to make general comments on significant deficiencies for IFMs. Please see section 2 of the report.

Some of the most commonly occurring significant deficiencies for PMs and LMDs remain the same every year, for example, marketing materials, capital calculations and KYC. We review different firms each year and we target higher risk market participants for review. For firms reviewed, we expect them to continue to review their procedures to ensure compliance. Our expectation is that firms not yet reviewed will use this report as a self-assessment tool to improve their overall compliance. Over time, staff expect to see increased compliance in these areas and we plan on conducting sweeps in the future to verify continued compliance.

## 4.1 PMs

Our normal field reviews of PMs in the 2009 fiscal year resulted in an average of 15 deficiencies per firm reviewed. An average of six or 40% of these deficiencies were significant. The chart below shows the three most commonly occurring areas in which we found significant deficiencies among PMs, compared with the 2008 fiscal year. One of the three most commonly occurring significant deficiencies in fiscal 2009 (registration issues) is different from those identified in 2008.<sup>3</sup> See the discussion below with respect to the specific deficiencies that we identified in these areas.

We will continue to focus on these areas of significant deficiencies as part of our compliance oversight process. We expect PMs to take appropriate action in these areas to improve their compliance.



**Note:** The percentage of deficiencies represents the percentage of PMs that were deficient in this area in the reviews performed in the 2009 fiscal year.

<sup>3</sup> The three most commonly occurring significant deficiencies in the 2008 fiscal year were marketing, capital calculations and personal trading.

## 1. Marketing

Marketing remains the most commonly occurring significant deficiency. About 63% of the PMs reviewed had significant deficiencies in this area. The percentage of deficiencies in this area increased by 10% in the 2009 fiscal year. We believe this increase may be partly due to a larger number of smaller PMs being reviewed, as compared to the 2008 fiscal year.

In general, smaller PMs tend to have less developed processes and procedures for preparing, reviewing and approving marketing materials prior to use. We intend to conduct another sweep review of the marketing practices of PMs in the near future. We expect to see increased compliance with Section 2.1 of OSC Rule 31-505 – *Conditions of Registration* (OSC Rule 31-505) and OSC Staff Notice 33-729 – *Marketing Practices of Investment Counsel/ Portfolio Managers* (OSC Staff Notice 33-729). As well, we will consider taking appropriate action, up to and including enforcement action, when we identify serious deficiencies in a PM's marketing materials.

Section 2.1 of OSC Rule 31-505 requires registrants to deal fairly, honestly and in good faith with their clients. This provision is a broad principle that applies to registrants generally. We expect registrants to apply it to all areas of their activities, including marketing practices and marketing materials.

For additional guidance, please refer to OSC Staff Notice 33-729. This notice provides guidance to market participants on complying with applicable legislation and best practices in the preparation and use of marketing materials. OSC Staff Notice 33-729 is available on the OSC website at [www.osc.gov.on.ca](http://www.osc.gov.on.ca).

We found the following marketing-related issues:

### **Inadequate disclosure relating to performance data**

As in the previous fiscal period, some PMs did not disclose whether performance returns were gross or net of fees, or the names of the composites or pooled funds that the performance returns related to. Others provided inadequate disclosure of the differences between client account returns and the benchmarks to which they are compared.



***Suggested best practices – performance data***

- Provide clear and adequate disclosure in marketing materials to ensure that performance data is meaningful and comparisons are fair and not misleading. This includes providing:
  - a description of the investment strategy that is reflected in the performance data
  - a statement about whether returns are net or gross of portfolio management fees and/or other expenses
  - key information about client portfolios in the composite, such as minimum asset level.
- Update marketing materials regularly to ensure all information is complete, accurate and not misleading to clients.
- Establish and enforce procedures for preparing, reviewing and approving marketing materials.
- Establish guidelines for preparing performance data, using benchmarks and constructing composites.
- Have someone independent of the preparer review and approve marketing materials for accuracy and compliance with securities law.

**Exaggerated claims**

Some PMs made exaggerated claims about their skills, performance or services. For example, they included statements such as “proven performance, superior to index returns” and “best in its class” in marketing materials. They did not provide appropriate information to support the claim and to ensure that clients were not misled.

***Suggested best practices – claims***

- Substantiate all claims made in marketing materials. Information supporting the claim should be referenced to where the claim is made in the marketing material so that it is easily accessible by clients.
- Ensure that all claims accurately reflect the PMs performance, skills, education, portfolio management experience and services.
- PMs should follow provisions in the Securities Act (Ontario) (example, section 38) that deal with specific types of claims made by a registrant (i.e. future value or price of a security).

### **Inappropriate use of benchmarks**

Some PMs compared the return of their funds or accounts to benchmarks that, in staff's view, were inappropriate or misleading to clients. Also, there was inadequate disclosure provided for some of the benchmarks used. For example, there was no disclosure of the name of the benchmark or inadequate disclosure regarding the components of a blended benchmark.

#### ***Suggested best practices – benchmarks***

- Use benchmarks that are relevant to the investment strategy employed.
- The benchmark's full name should be disclosed. Where a blended/customized benchmark is used, disclose the components and names of the benchmarks used.
- If a widely known and followed benchmark is not similar to that of the investment strategy, adequate disclosure should be provided to explain the relevance of use, including a discussion of the differences between the benchmark and investment strategy of the portfolio manager.

## **2. Capital calculations**

PMs are required to prepare monthly calculations of regulatory capital (capital calculations) within a reasonable period of time after each month end (Regulation 113(3)). Capital calculations must be based on monthly financial statements prepared in accordance with Canadian GAAP. If a PM has inadequate regulatory capital (i.e. it is capital deficient), the PM should inform the OSC immediately and to correct the capital deficiency within 48 hours. As well, higher levels of regulatory capital and insurance are required if a PM takes possession of client assets.

About 63% of the PMs reviewed had significant deficiencies in this area. Overall deficiencies in capital calculations increased by 28% from the previous fiscal year. This significant increase may be partly due to additional reviews conducted on smaller firms in fiscal 2009. In addition, some PMs took possession of clients' assets, however, they were not aware of the higher capital and insurance requirements. We noted a number of PMs with inadequate insurance coverage and capital deficiencies as a result of incorrectly using the lower insurance and capital requirements.

We found the following issues relating to capital calculations:

- Capital calculations were prepared using:
  - financial statements that were not in accordance with Canadian GAAP
  - an incorrect minimum capital or insurance deductible

- Capital calculations were not prepared on a monthly basis or were not prepared at all.
- There was a lack of evidence that someone independent of the preparer reviewed the capital calculations.
- Higher capital and insurance requirements were not maintained for PMs who had the ability to take possession of clients' assets.

To enhance investor protection, if a registrant files annual financial statements that indicate that it was capital deficient at its year end or if we identify a registrant during the course of an on-site review that was capital deficient during the review period, staff generally recommends that terms and conditions be imposed on its registration. The recommended terms and conditions include providing us with unaudited financial statements and capital calculations each month for a minimum six-month period. Also, a registrant must review its compliance procedures and file a report with the OSC. The report must describe the measures that will be taken to prevent capital deficiencies in the future. The registrant must also certify that it has reviewed its compliance system and has rectified the problems that led to the capital deficiency.

With the implementation of NI 31-103, PMs will be required to maintain a minimum capital of \$25,000 regardless of whether they hold or have access to clients' assets.

For additional guidance on capital calculations, please refer to OSC Staff Notice 33-730 – *Capital Calculations for Investment Counsel/Portfolio Managers*.

#### ***Suggested best practices – capital calculations***

- Prepare capital calculations on a monthly basis
- Prepare capital calculations using financial statements prepared in accordance with Canadian GAAP.
- Maintain copies of the capital calculations.
- Have someone independent of the preparer review the capital calculations for accuracy on a timely basis.
- Keep a record of the review.
- Inform the OSC immediately if a capital deficiency occurs.
- Inform the OSC immediately if you take custody or have the ability to take possession of clients assets. For example, if a PM is a signatory of a client account or acts as a general partner for a limited partnership advised by the firm.

### 3. Registration issues

There was a significant increase in registration related deficiencies from 6% to 31% in the 2009 fiscal year. This significant increase was mainly due to senior officers of the firm performing advising activities without being registered. We will take appropriate action, up to and including enforcement action, when we identify individuals performing registerable activity without registration.

We found the following issues relating to registration:

- Individuals at PMs were advising without registration.
- directors and officers of PMs were not approved or registered.
- the OSC was not notified of specific changes to registered firm and individual information.

Paragraph (1)(c) of section 25 of the Act states that no person or company shall act as an adviser unless the person or company is registered as an adviser, or is registered as a representative or as a partner or as an officer of a registered adviser and is acting on behalf of the adviser. PMs are responsible for ensuring that they maintain appropriate registration for the activities conducted.

PMs are required to notify the OSC of any change in the status of directors and/or officers within five business days. PMs are also required to notify the OSC of the opening of any office or branch, and of any changes in the status of the compliance officer, PMs and representatives. National Instrument 33-109 – *Registration Information* sets out the requirements for notification of changes to registered firm and individual information.

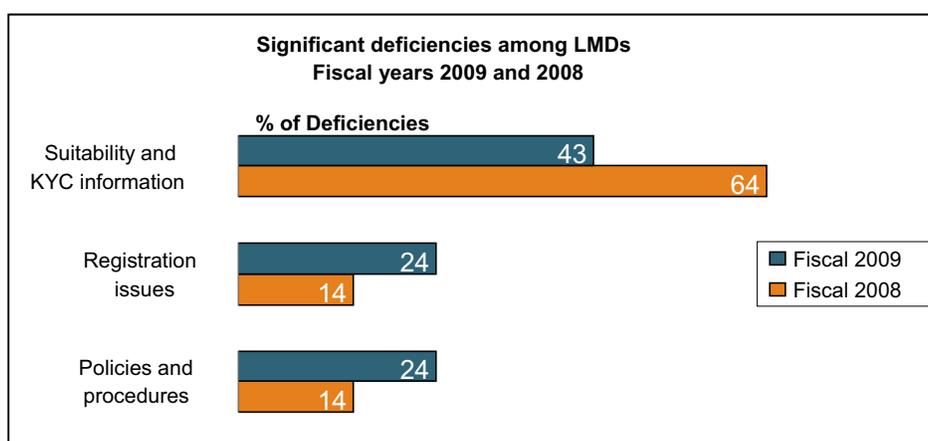
#### ***Suggested best practices – registration matters***

- Ensure that individuals who provide advice to others are appropriately registered as PMs.
- Promptly notify the OSC of all changes to registration.
- Promptly register branch office locations.
- Notify the OSC when trade names are used.

## 4.2 LMDs

The field reviews of LMDs we conducted in the 2009 fiscal year resulted in an average of five deficiencies per firm reviewed. An average of two or 40% of these deficiencies were significant. Please note that we review different LMDs each year.

The following chart shows the three most commonly occurring significant deficiencies we found among LMDs, compared with the 2008 fiscal year.<sup>4</sup> We will continue to focus on these areas of significant deficiencies as part of our compliance oversight process. We expect LMDs to take appropriate action in these areas to improve their compliance.



**Note:** The percentage of deficiencies represents the percentage of LMDs that were deficient in this area in the reviews performed in the 2009 fiscal year.

<sup>4</sup> The three most commonly occurring significant deficiencies in 2008 fiscal year were suitability and KYC information, use of prospectus and registration exemptions and disclosure in offering memorandums.

## 1. Suitability: KYC and KYP

Dealers are required under section 1.5 of OSC Rule 31-505 – *Conditions of Registration* to collect and document sufficient and appropriate KYC information to ensure that trades are suitable for clients. This requirement applies to both trades in securities under a prospectus exemption and trades in prospectus-qualified securities.

Improperly collecting and documenting KYC information remains the most commonly occurring significant deficiency for LMDs. About 43% of the LMDs reviewed in the 2009 fiscal year had significant deficiencies in this area, an improvement from 64% noted in 2008. LMDs, in general, are more aware of the requirements to collect and document KYC information. However, some still did not have a formal process in place and others did not collect KYC information for certain types of clients.

To ensure that trades are suitable for their clients, LMDs must have a thorough understanding of the investment products they are recommending (KYP) and an understanding of their clients' circumstances (KYC). LMDs have a suitability obligation to all investors. LMDs may not contract out of or delegate their duty to ensure that trades are suitable for clients.

For additional guidance, please refer to Canadian Securities Administrators Staff Notice 33-315 *Suitability and know your product*. The CSA staff notice is available on the OSC website at [www.osc.gov.on.ca](http://www.osc.gov.on.ca).

We identified the following issues relating to KYC information and the suitability determination:

- Risks associated with an investment were not adequately explained to clients.
- Some LMDs did not collect or document KYC information.
- KYC information was, in part, inadequate or incomplete.
- KYC information was not collected for certain clients, e.g. clients who subscribed to private placements, foreign clients or corporate clients.
- There was no evidence of an independent review of trades for suitability.
- There was no process in place to verify if clients were able to rely on a valid prospectus exemption, such as the accredited investor exemption.
- Some LMDs did not always maintain documentation to support whether clients qualify either as accredited investors or under another prospectus exemption.
- Some LMDs tried to contract out of their duty to collect KYC information and to ensure that trades are suitable for their clients.

### ***Suggested best practices – suitability obligation***

- LMDs have a suitability obligation to all clients, including accredited investors, corporations and partnerships. LMDs should collect and document KYC information for each of their clients for the suitability determination. This includes the client's investment needs and objectives, investment restrictions, investment time frame, risk tolerance, investment knowledge, and financial circumstances (such as annual income and net worth).
- Clients should sign and date their KYC information.
- The salesperson and the compliance officer should review and approve the client's KYC documentation to ensure that KYC information collected from the client is sufficient for the LMD to make the suitability determination and is appropriate for the types of securities being traded.
- LMDs should review and maintain the subscription agreements and accredited investor certificates completed by investors.
- LMDs and their salespeople should understand the attributes and associated risks of the securities being traded or recommended in order to make an appropriate suitability determination. This includes understanding the general features and structure of the product, product risks including the risk/return profile and risks such as liquidity risks, management and financial strength of the issuer, costs, and any eligibility requirements of each product.

## **2. Registration issues**

About 24% of the LMDs reviewed had significant deficiencies in this area, an increase from 14% noted in 2008. The LMDs selected for our review this year are larger in size and some have multiple business lines. It is important for LMDs to ensure that individuals, the firms or affiliated entities are appropriately registered with the OSC prior to conducting registerable activities.

Paragraph 25(1)(a) of the Act states that no person or company shall trade in a security unless the person or company is registered as a dealer or as a salesperson, a partner or an officer of a registered dealer and is acting on behalf of the dealer. Meeting with current and prospective investors to provide information on an investment product is engaging in activities that require registration.

Paragraph (1)(c) of section 25 of the Act states that no person or company shall act as an adviser unless the person or company is registered as an adviser, or is registered as a representative or as a partner or as an officer of a registered adviser and is acting on behalf of the adviser. Section 99 of R.R.O. 1990, Regulation 1015 (the Regulation) sets out the categories of registration, and requires an entity to be registered as an ICPM in order to carry out the business of advising and managing the portfolio of others.

We identified the following issues relating to registration:

- Individuals who were not registered in any capacity were engaged in trading activities of the LMDs.
- LMDs or their affiliates were advising and making investment decisions for investment products distributed by the LMDs; however, they were not registered as PMs.

#### ***Suggested best practices – registration issues***

- LMDs should ensure that individuals or entities that conduct registerable activities are registered with the OSC in the appropriate categories of registration.
- Policies and procedures should be developed and enforced by LMDs to assist them in ensuring that individuals or affiliated entities are appropriately registered if they are carrying out registerable activities.

### **3. Written policies and procedures**

Section 1.2 of OSC Rule 31-505 requires LMDs to develop and enforce written policies and procedures for dealing with clients that conform to prudent business practice and enable LMDs to serve their clients adequately. LMDs should develop policies and procedures that cover all areas of their businesses, including all relevant regulatory requirements.

We identified the following issues relating to written policies and procedures:

- Some LMDs did not have any written policies and procedures.
- Written policies and procedures were inadequate and did not cover all business areas.
- Policies and procedures were not enforced.
- There were no policies and procedures on employees' personal trading, particularly policies to prevent insider trading even though LMDs could have access to material non-public information. Also, there was no review and approval of personal trades.

**Suggested best practices – policies and procedures**

Policies and procedures that are clearly documented and enforced contribute to a strong compliance environment in a firm and thereby enhance investor protection and prevent market abuse. LMDs should develop and enforce policies and procedures that are sufficiently detailed and cover areas relevant to their business operations and allow them to serve their clients adequately. LMDs should also regularly review, assess and update their policies and procedures for changes in securities legislation and industry practices. Adequate training should be provided to all employees of the LMDs to ensure employees understand the established policies and procedures and understand how to incorporate them in their daily business activities.

The policies and procedures should address, at a minimum, the following areas:

**Compliance**

- duties and responsibilities of the compliance officer.

**KYC and suitability information**

- collection, documentation and timely update of KYC and suitability information.
- review and approval of KYC and accredited investor information.
- new product review process.
- performance of sufficient research and due diligence to support recommendations to clients.

For additional guidance, please refer to Canadian Securities Administrators Staff Notice 33-315 *Suitability and know your product*. The CSA staff notice is available on the OSC website at [www.osc.gov.on.ca](http://www.osc.gov.on.ca).

**Disclosure in offering documents**

- guidelines to ensure appropriate and adequate disclosure on general features and structure of the product, risks, fees, management and financial strength of the issuer, and any eligibility requirements of each product.
- review and approval of offering documents prior to distribution to investors.

**Marketing**

- guidelines on the preparation, review, approval and regular updates of marketing materials and website content.
- guidelines on the preparation, review and approval of performance data.
- ensuring compliance with securities legislation, including prohibitions on holding out a non-registered person as being registered, advertising the LMDs' registration, and representations that the OSC has passed upon the financial standing, fitness or conduct of the LMDs, or upon the merits of any security or issuer.

**Personal trading and conflicts of interest**

- procedures for approving and reviewing personal trades, including written pre-approval.
- definition of material non-public information and policies and procedures to restrict the dissemination of any non-public information.

**Books and records**

- the time period for the maintenance of books and records.
- maintenance of business agreements.
- disclosure to clients regarding conflicts of interest and fees arrangements.

**Referral arrangements**

- criteria used to set up referral arrangements and requirements for referral arrangements.
- review and approval by senior management prior to signing referral agreements.
- guidelines to ensure appropriate and adequate disclosure is provided to clients.
- review and approval of the disclosure given to clients.

**Client complaints**

- handling of client complaints.
- identification, monitoring and resolution of client complaints.



## 5. Outcomes of our reviews

## 5. Outcomes of our reviews

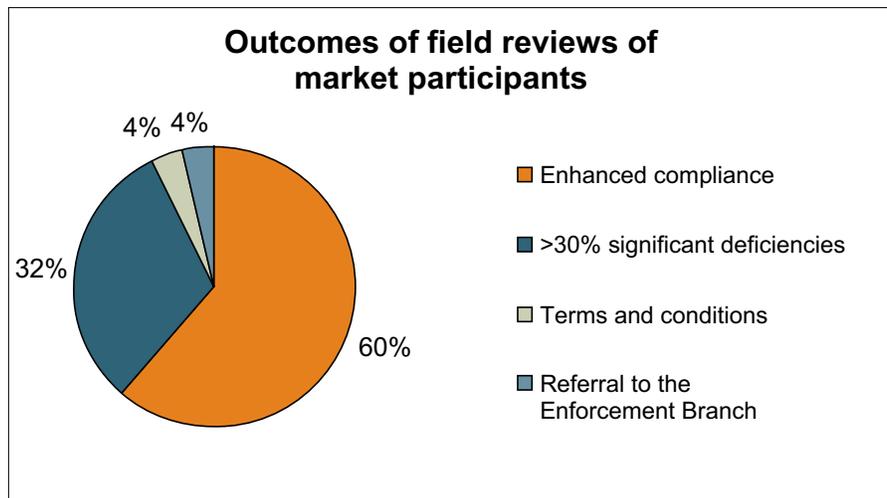
After we complete a review, we normally send a report to the market participant outlining the deficiencies that we found. A market participant normally has 30 days to respond in writing to the report. The response should set out the steps that the market participant will take, or has taken, to address the deficiencies.

However, if we find a large number of significant deficiencies at a market participant, we may not issue a deficiency report and may instead refer the file to the Enforcement Branch for further review.

Listed below are the possible outcomes from our reviews. In most cases, the OSC staff deficiency report to the market participant is sufficient to cause the market participant to resolve the identified compliance deficiencies. In other cases, we may have to take further action to assist us in obtaining compliance by market participants.

- **Enhanced compliance.** At the end of each review, we generally issue a deficiency report to the market participant identifying areas of non-compliance with securities law. We work with the market participant to ensure that all deficiencies are resolved to our satisfaction. Our compliance reviews generally have the effect of enhancing overall compliance of these market participants.
- **Monitoring of market participants with greater than 30% significant deficiencies.** We monitor a market participant when 30% or more of the deficiencies found in its review are significant. We may conduct a follow-up review, if necessary. We may also monitor market participants with less than 30% significant deficiencies if we think that further follow up is appropriate.
- **Terms and conditions.** We may impose terms and conditions to further assist in monitoring how a registrant is complying with Ontario securities law. Registrants have an opportunity to be heard before terms and conditions are imposed by the Director. Terms and conditions are posted on the OSC website.
- **Referral to the Enforcement Branch.** If we identify a serious breach of Ontario securities law, we discuss our findings with the Enforcement Branch of the OSC. The Enforcement Branch together with our staff will assess the case and determine an appropriate course of action.

The following chart shows the outcomes of our reviews of market participants (PMs, LMDs and IFMs) during the 2009 fiscal year:





## 6. National Instrument 31-103 – *Registration Requirements and Exemptions*

## 6. National Instrument 31-103 – *Registration Requirements and Exemptions*

On July 17, 2009, the Canadian Securities Administrators (CSA) published NI 31-103. The purpose of NI 31-103 is to harmonize, streamline and modernize the registration regime across Canada for firms and individuals who deal in securities, provide investment advice or manage investment funds.

The new rules recognize that the registration regime must accommodate a wide variety of business models, scales of operation, clients and products. The new regime is more flexible and easier to use, enhances investor protection and benefits industry by bringing increased efficiencies to the registration system.

The new regime has higher proficiency standards for some registrants, and enhanced rules for consumer disclosure, referral arrangements, handling investor complaints, and disclosing and addressing conflicts of interest. It also introduces a registration requirement for IFMs, exempt market dealers and senior officers responsible for compliance.

NI 31-103 and related rules and amendments is expected to come into force on September 28, 2009. It is important that market participants come to fully understand the new regime and how it impacts their operations and develop appropriate procedures to ensure a smooth transition. For details of the Instrument, please visit the OSC website site at [www.osc.gov.on.ca](http://www.osc.gov.on.ca).

**NI 31-103 – effective September 28, 2009**



## 7. International Financial Reporting Standards

## 7. International Financial Reporting Standards (IFRS)

In February 2008, the Canadian Accounting Standards Board (AcSB) confirmed that all publicly accountable enterprises will be required to report their financial results under IFRS for fiscal periods beginning on or after January 1, 2011.

IFRS will replace current Canadian standards and interpretations as Canadian generally accepted accounting principles. Non-publicly accountable enterprises are permitted, but not required, to adopt IFRS in 2011.

At present, all registrants (except LMDs) who are not members of a self-regulatory organization (SRO) are required to deliver financial statements to the CSA.

On September 12, 2008, the CSA issued CSA Staff Notice 33-313 *International Financial Reporting Standards and Registrants* which set out its view that all non-SRO registrants<sup>5</sup> who hold or have access to clients' assets would be required to prepare and deliver IFRS financial statements to the CSA.

On July 10, 2009, the CSA issued CSA Staff Notice 33-314 *International Financial Reporting Standards and Registrants*. In this notice, the CSA set out its view that all non-SRO registrants would be required to deliver IFRS financial statements to the CSA in 2011.

The CSA is currently in the process of preparing proposed amendments to National Instrument 52-107 – *Acceptable Accounting Principles, Auditing Standards and Reporting Currency* reflecting the proposed requirement, as well as other amendments necessary to the rule and other rules as a result of Canada's changeover to IFRS. These amendments are expected to be published for public comment later this year.

Non-SRO registrants should review and assess the impact on them of converting to IFRS. It is important that non-SRO registrants have adequate resources to ensure a smooth transition to IFRS. For details of the CSA staff notices, please visit the OSC website site at [www.osc.gov.on.ca](http://www.osc.gov.on.ca).

**IFRS coming in 2011**

<sup>5</sup> Non-SRO registrants include portfolio managers, scholarship plan dealers and limited market dealers. National Instrument 31-103 *Registration Requirements* includes new registration categories, including exempt market dealers and investment fund managers.



ONTARIO  
SECURITIES  
COMMISSION



**If you have questions or comments about this report, please contact:**

Carlin Fung, CA, ACA  
Senior Accountant, Compliance  
E-mail: [cfung@osc.gov.on.ca](mailto:cfung@osc.gov.on.ca)  
Phone: 416-593-8226

Jennifer Li, CA  
Accountant, Compliance  
E-mail: [jli@osc.gov.on.ca](mailto:jli@osc.gov.on.ca)  
Phone: 416-593-3658

Sam Aiello, CA  
Accountant, Compliance  
Email: [saiello@osc.gov.on.ca](mailto:saiello@osc.gov.on.ca)  
Phone: 416-593-2322

Marriane Bridge, FCA  
Manager, Compliance  
E-mail: [mbridge@osc.gov.on.ca](mailto:mbridge@osc.gov.on.ca)  
Phone: 416-595-8907

September 25, 2009



As the regulatory body responsible for overseeing the capital markets in Ontario, the Ontario Securities Commission administers and enforces the provincial Securities Act, the provincial Commodity Futures Act and administers certain provisions of the provincial Business Corporations Act. The OSC is a self-funded Crown corporation accountable to the Ontario Legislature through the Minister of Finance.