

BRITISH COLUMBIA SECURITIES COMMISSION RELEASES RESULTS OF THEIR 2022 ANNUAL COMPLIANCE REPORT CARD

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On May 25, 2023, the British Columbia Securities Commission (the “**BCSC**”) released their [2022 Annual Compliance Report Card](#) (the “**Report**”). The Report revealed the findings of compliance examinations conducted by the BCSC of certain registered portfolio managers, investment fund managers, and exempt market dealers in British Columbia (the “**Registered Firms**”). The BCSC has two compliance teams; one team that oversees portfolio managers and investment fund managers, while the other oversees registered dealers (the “**Compliance Teams**”).

The Report disclosed that the investigations conducted by the Compliance Teams found several deficiencies by Registered Firms in meeting their compliance obligations under National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (“**NI 31-103**”), and in particular, properly handling conflicts of interest (“**COIs**”).

Background

In 2021, the Canadian Securities Administrators (the “**CSA**”), along with the Canadian Investment Regulatory Organization (CIRO) (formerly Investment Industry Regulatory Organization of Canada and the Mutual Fund Dealers Association of Canada), introduced the Client Focused Reforms (the “**CFRs**”). The CFRs are meant to enhance registrant conduct obligations. On June 30, 2021, COI specific CFRs came into force. The CFRs amended NI 31-103 to enhance COI disclosure obligations, and required Registered Firms to review their practices and procedures, and to implement changes to comply with the CFRs.

In preparation for the Report, the Compliance Teams conducted 27 compliance reviews, and identified 126 deficiencies. In accordance with a coordinated national CSA initiative focusing on COIs, 17 of those reviews were COI specific, which is more than prior years. The average number of deficiencies per review, 4.85, was lower than previous years, but because of the narrower scope of the review, COI specific deficiencies significantly increased. COI specific deficiencies were the second most common category of deficiency, making up 18% of all identified deficiencies. The main categories of recurring COI specific deficiencies are set out below.

COI Specific Deficiencies

Failing to Recognize Common Material COIs

One of the most common failures occurs at the first step of the compliance process, which was failing to recognize that a material COI exists. Many Registered Firms did not realize that activities such as personal securities trading, external business activities, and allocating investment opportunities to clients are all situations where material COIs are present. The BCSC expressed the view that Registered Firms should consider “all circumstances where the interests of the firm and/or its registered individuals do not align with the interests of clients, and the existence of such circumstances may be reasonably expected to affect either or both of the decisions of the client and the registrant”.^[1] The Companion Policy to NI 31-103 (the “**Companion Policy**”) also includes more detailed examples of COIs.

Failing to Appropriately Assess COIs

Another recurring failure occurs when a Registered Firm does recognize a COI exists, but fails to conduct an assessment of the conflict, fails to follow mitigation procedures, or fails to address the conflict at all. Sometimes, a Registered Firm will recognize a COI but does not believe that it is material. The guidance from the BCSC to determine if a conflict is material is considering “whether the conflict may be reasonably expected to affect either, or both of the following: the decisions of the client in the circumstances, and the recommendations or decisions of the registrant in the circumstances.”^[2]

Failing to Adequately Disclose COIs to Clients

Registered Firms often fail to disclose to their clients when a COI exists, how the COI could impact the client, and how the COI will be addressed. The COI CFRs introduced new requirements for Registered Firms to identify, address, and disclose material COIs.^[3] The Report revealed that many Registered Firms were not following these new requirements. In order to meet their disclosure obligation, disclosure must clearly describe:

- the nature and extent of the COI;
- the potential impact on and risk that the COI could pose to the client; and
- how the COI has been or will be addressed.

The Report also described scenarios where “boiler plate” internal COI documents were disclosed to clients who were not affected by COIs at all, or was disclosed to clients who would not have found those documents meaningful or relevant. Registered Firms should ensure relevant information is provided in a clear and meaningful manner so that clients can readily understand the information, which is consistent with the obligation to deal “fairly, honestly and in good faith with clients”.^[4]

Lack of Policies and Procedures for Specific Conflicts

The final COI specific recurring deficiency was the lack of policies and procedures in place for specific conflicts, such as gifting and referral arrangements. Of all the COI deficiencies identified in adviser and investment fund manager firms, this category made up 50% of those deficiencies. Some firms had no written policies at all, while other firms had written policies that were clearly lacking in required content. For example, firms had policies that did not address how to control all material COIs. Some firms had adequate COI policies and procedures, but failed to provide this information to their employees. Some of the more common specific conflict situations that adviser and investment fund manager firms did not have adequate policies to address were referral arrangements, compensation practices, and gifting.

Referral Arrangements

Referral arrangements are agreements where external “referral agents”, such as financial planners, refer clients to the firm and receive compensation in return. With these types of arrangements, the BCSC holds the view that material COIs almost always exist. The firm has an incentive to accept referred clients, as it allows them to grow their assets under management and increase revenue from management fees. The referral agent has an incentive to refer clients as they receive compensation, presumably increasing with each subsequent client referred. The referral arrangement creates a situation where both the firm and the referral agent can put their interests ahead of the interests of the clients.

Referral arrangements are not prohibited, but they must be disclosed to clients. The Report found that a majority of firms did disclose referral arrangements to clients, but the disclosure was inadequate. To be adequate, written disclosure must describe in detail:

- the nature and extent of the COI;
- the potential impact on and the risk that the COI could pose to the client; and
- how the COI has been or will be addressed.

Compensation Practices

Registered Firms have compensation arrangements that can be structured in a manner where compensation can be entirely or partially variable based on sales and revenue targets. Similar to referral arrangements, the BCSC holds the view that these arrangements almost always create material COIs between Registered Firms and their clients. Some Registered Firms failed to identify the following as material COIs relating to employee compensation:

- providing compensation incentives based on revenue generation, sales and revenue targets, annual awards, promotions, and opportunities to become a partner;
- having negative consequences for failing to meet targets;

- charging different commission rates for certain products or certain clients; and
- providing commission advances to employees, but requiring repayment of part of the commission advance as a consequence of not meeting a sales target.

The compensation arrangements create incentives for individuals and firms to put their interests ahead of their clients' interests. Firms must disclose these material COIs, and provide sufficient detail to explain how exactly the material COIs will impact clients' interests. The Companion Policy includes examples of how to adequately address compensation related conflicts.

Gifting

Gifts that are both sent to clients and received from clients can create material COIs. It could create favouritism by an employee to certain clients, thereby creating a situation where the employee can put the interests of some clients ahead of others. Many firms did not have policies and procedures in place regarding gifts to clients. Some firms did not monitor and tracks the gifts that employees received from or provided to clients. If gifts to clients are allowed, in order to avoid material COIs firms must monitor and track them to ensure gifts to any one individual client are not too frequent to the point where a material COI is created.

Other COI Deficiencies

The above noted COI deficiencies were the most common identified in the Report. Other COI deficiencies were also identified, including:

- it is almost always a material COI for a registrant to trade in, or recommend, proprietary and related party products;
- disclosure alone is not sufficient to address proprietary or related party conflicts;
- proprietary or related party disclosure must include a description of the controls that the firm uses to manage the material COI;
- if firms allow clients to negotiate management fees different than the standard fee schedule, this ability should be disclosed to all clients; and
- some firms failed to disclose how they control material COIs arising from registered employees' outside activities.

General Deficiencies

While the focus of the Report was on COI specific deficiencies, the BCSC also identified deficiencies in several other areas. These deficiencies include:

- firms are assigning misleading titles to certain registered employees;

- a failure to meet the CFR expanded know-your-client obligations;
- failing to ask the client to identify a trusted contact person;
- inadequate or inaccurate information in financial information submissions, including in auditor documents, working capital calculations, and financial statements;
- dealer-specific deficiencies for captive exempt market dealers;
- “renting out” of registration and payment to unregistered entities; and
- issues with the “relevant investment management experience” section in individual registration applications.

Registered Firms seeking further information on general deficiencies should consult the full Report for more details.

Conclusion

The implementation of the COI specific CFRs in June of 2021 led to the expansion of NI 31-103 and the obligations inherent in the instrument. The nationally focused 2022 review has revealed that most Registered Firms are failing to meet these expanded obligations. Proper policies and procedures must be put into place to ensure NI 31-103 obligations are adhered to. If deficiencies continue and are not rectified, consequences will follow. Significant deficiencies could result in the BCSC imposing terms and conditions on registration, including:

- requiring firms to hire a compliance monitor;
- preventing firms from accepting new clients;
- preventing firms from conducting trades for clients;
- preventing firms from registering new representatives;
- preventing firms from creating new proprietary funds or a new series of existing proprietary funds; or
- requiring firms to hire a new CCO.

Serious or numerous deficiencies could lead to public allegations of misconduct, and possible sanctions. The BCSC has developed a new risk model for registrants, and will be introducing a new risk questionnaire in June of 2023. This questionnaire will help the BCSC identify new information for registrants and identify firms with factors or patterns that may increase their risk for compliance examinations.

The CSA has published guidance for registrants to follow on the CFRs in the Companion Policy, and have also published a [FAQ](#). Registrants are advised to consult these resources in order to make sure they meet their obligations under NI 31-103. If you have any further questions on the Report or would like guidance on how to meet your NI 31-103 obligations, please contact a member of the Firm’s Investment Funds and Asset

Management Group.

[1] The Report, page 5.

[2] The Report, page 6.

[3] NI 31-103, section 13.4.

[4] The Report, page 6.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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