

10 Most Common Deficiencies Among Portfolio Managers

Introduction

The following is a summary of the 10 most common deficiencies we identified during our reviews of investment counsel and portfolio managers (portfolio managers). The purpose of this summary is to help portfolio managers improve existing procedures and establish procedures in areas where they are lacking, and to give general guidance on improving overall compliance.

We have included details of specific issues we identified under the 10 most common deficiencies, the applicable legislation and suggested practices for addressing the deficiencies. We encourage all portfolio managers to use this as a self-assessment tool to strengthen their compliance with Ontario securities law.

For additional guidance on improving overall compliance, please refer to our Compliance Team Annual Report (the Report) which we publish every year for our market participants in the OSC Bulletin. The Report is also available on the OSC website at www.osc.gov.on.ca.

10 most common deficiencies among portfolio managers

10 most common deficiencies	
1.	Policies and procedures manual
2.	Marketing
3.	Portfolio management, including advisory contracts
4.	Registration issues
5.	Capital calculations
6.	Fairness policy
7.	Maintenance of books and records
8.	Personal trading
9.	Business continuity plan (BCP)
10.	Know your client (KYC) and suitability information

1. Policies and procedures manual

Section 1.2 of OSC Rule 31-505 requires portfolio managers to establish and enforce written policies and procedures that will enable them to serve their clients adequately. Portfolio managers are required to maintain a policies and procedures manual, which also includes all relevant regulatory requirements.

During our reviews, we observed the following:

- The procedures used in practice were inconsistent with the procedures outlined in the manual.
- The procedures outlined in the manual did not apply to the type of business conducted (i.e. they were generic and were not customized to the portfolio manager's business).
- Procedures for key areas of the business were missing.
- There was insufficient detail about policies and procedures.

Suggested practices

Policies and procedures that are clearly documented and enforced contribute to a strong compliance environment. Portfolio managers should establish and enforce written policies and procedures that are sufficiently detailed and cover all areas of their business. Portfolio managers should also regularly evaluate, review and update their policies and procedures for changes in industry practice or securities legislation. A copy of the manual should be readily accessible by all employees of the portfolio manager.

The following is a list of topics and guidelines that should be included in a standard manual:

Marketing

- how to prepare, review and approve marketing materials to prevent false or misleading statements and to ensure compliance with securities legislation
- how to prepare performance data, use benchmarks and construct composites to be used in marketing materials
- procedures for ensuring:
 - marketing materials are reviewed and approved by someone other than the preparer
 - compliance with securities legislation, including prohibitions on holding out a non registered person as being registered, on advertising of registration, representations that the OSC has endorsed the financial standing, fitness or conduct of any registrant

Portfolio management

- how to collect and document client KYC and suitability information and how frequently it should be updated
- guidance on proxy voting to deal with issues such as executive compensation (e.g. stock options), take-over protection (poison pills) and acquisitions
- procedures to ensure compliance with clients' specified investment restrictions or other instructions
- guidelines on:
 - performing sufficient research to support investment decisions supervising sub-advisers and associate portfolio managers
 - procedures for ensuring: that investments and trades are suitable for each client compliance with regulatory and other investment restrictions, for example NI 81-102

Trading and brokerage

- guidelines on:
 - how brokers are selected
 - soft dollar arrangements with brokers
- policies for:
 - obtaining best price and best execution for clients
 - allocating investment opportunities fairly among client accounts
 - executing trades in a timely manner and according to instructions
- procedures for monitoring and resolving failed trades and trading errors

Personal trading and conflicts of interest

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

Referral arrangements

- criteria used for setting up referral arrangements
- procedures for reviewing and approving referral arrangements before they are signed
- guidelines for ensuring that clients receive appropriate and adequate disclosure of referral arrangements

Money laundering prevention

- definition of “money laundering” and examples of suspicious transactions
- handling of prescribed and suspicious transactions
- procedures to report prescribed and suspicious transactions to the Financial Transactions and Reports Analysis Centre of Canada
- documenting the records that should be maintained under the Proceeds of Crime (Money Laundering) and Terrorist Financing Act and Regulations, and the period for which these records should be maintained
- establishing a compliance regime to ensure you meet your obligations under the Proceeds of Crime (Money Laundering) and Terrorist Financing Act and Regulations

Compliance and supervision structure

- handling of client complaints
- opening and closing of client accounts
- insider and early warning reporting, including collecting and updating clients’ status as insiders of reporting issuers
- identification, monitoring and resolution of client complaints
- dealing with clients resident in jurisdictions where their adviser is not registered
- preparation, review and monitoring of monthly capital calculations
- guidelines on the maintenance of books and records

2. Marketing

All marketing materials must include information that is accurate, complete and not misleading to clients. Subsection 2.1(1) of OSC Rule 31-505 requires portfolio managers to deal fairly, honestly, and in good faith with clients.

During our reviews, we observed the following:

- Internal marketing requirements were not met (e.g. procedures in policies and procedures manual were not followed).
- Marketing materials had incorrect information (e.g. incorrect data or statistics).
- Marketing materials had not been reviewed or approved.
- There was no disclosure to clients about whether performance returns were calculated gross or net of fees.
- Returns were compared to inappropriate benchmarks or there was inadequate disclosure about relevant differences between benchmarks and the investment strategies.
- Composites were not constructed properly, for example, all relevant accounts in a composite were not included or new accounts were not included in a composite on a timely basis.

- Marketing materials included claims of compliance with the Global Investment Performance Standards (GIPS) when not all of the requirements were met.
- Exaggerated and/or unsupported claims were made in marketing materials.

Suggested practices

- Update marketing material 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 on preparing performance data, using benchmarks and constructing composites.
- Require someone not involved in preparing marketing materials to review and approve the content for accuracy and compliance with securities legislation.

For additional guidance, please refer to OSC Staff Notice 33-729 – Marketing Practices of Investment Counsel/Portfolio Managers.

3. Portfolio management, including advisory contracts

Section 1.2 of OSC Rule 31-505 requires portfolio managers to develop written procedures for dealing with clients. The written procedures should conform to prudent business practice and enable portfolio managers to serve their clients adequately. This includes advisory agreements for portfolio management of discretionary accounts and for portfolio management activities that advisers perform on behalf of their clients.

Advisory agreements should contain adequate disclosure of all material facts, including the responsibilities of each party, the client's investment objectives and restrictions, the timing and billing of fees, the degree of discretion in managing client assets and terms for ending the agreement.

During our reviews, we observed the following:

- There were no advisory agreements with clients.
- The client's investment objectives and restrictions were not documented.
- Portfolio holdings were inconsistent with the stated investment restrictions.
- Responsibility for voting client proxies was not addressed.
- Responsibility for insider reporting or early warning reporting on the client's behalf was not addressed.
- No written consent was obtained for investments in issuers where responsible persons are directors or officers of the issuers.

Suggested practices

- Have clients sign advisory agreements before portfolio managers begin managing the account.
- Update advisory agreements when terms change.
- Include details about the roles and responsibilities of each party in advisory agreements.
- Review client holdings frequently to ensure that they are consistent with stated investment objectives and restrictions.
- Obtain written consent from the client before investing in issuers where responsible persons are directors or officers.

4. Registration issues

Paragraph (1)(c) of section 25 of the Act states that no person or company shall act as an adviser unless registered to do so. Portfolio managers are responsible for ensuring that they maintain appropriate registration for the activities conducted.

Portfolio managers are required to notify the OSC of any change in the status of directors and/or officers within five business days. Portfolio managers 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, portfolio managers and representatives. Multilateral Instrument 33-109 -- Registration Information sets out the requirements for changes to registered firm and individual information.

During our reviews, we observed the following:

- Affiliated entities of the portfolio managers were performing advisory activities but were not registered.
- Portfolio managers, representatives or compliance officers were not registered with the OSC.
- The OSC was not notified of changes in registration.
- Trade names or parent company names were used in signage, correspondence, business cards and marketing materials without notifying the OSC.
- Portfolio managers were performing activities that require registration as a limited market dealer (LMD), but were not registered as an LMD.
- Portfolio managers had advisory clients in jurisdictions where they were not registered and had not taken appropriate steps to determine whether they required registration in those jurisdictions.

Suggested practices

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

5. Capital calculations

Portfolio managers are required to prepare monthly calculations of minimum free capital and capital required within a reasonable period of time after each month end (see paragraph 10 of Regulation 113(3)). Capital calculations must be based on monthly financial statements prepared in accordance with generally accepted accounting principles (GAAP). If a portfolio manager becomes capital deficient, it is required to inform the OSC immediately and to correct the capital deficiency within 48 hours.

Our practice is to impose terms and conditions on all registrants that are identified as capital deficient. This includes providing us with unaudited financial statements and capital calculations each month.

During our reviews, we observed the following:

- Capital calculations were not prepared monthly or were not prepared on a timely basis. This suggested that the firm was not regularly monitoring its capital.
- Capital calculations were incorrect.
- The insurance deductible on the financial institution bond was not included in the calculation or was incorrect.
- The minimum capital deduction was incorrect.
- Financial statements were not prepared in accordance with GAAP.
- There was no evidence that someone other than the preparer reviewed the calculation.
- Copies of monthly capital calculations were not maintained.
- Portfolio managers were capital deficient for a period of time.

Suggested practices

- Calculate the capital position monthly and base it on financial statements prepared in accordance with GAAP.
- Maintain copies of the calculations.
- Have someone other than the preparer review the calculations to ensure they are accurate. Keep a record of the review.
- Inform the OSC immediately if the portfolio manager's capital position becomes deficient or it repays subordinated debt.

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

6. Fairness policy

Regulation 115(1) requires portfolio managers to have standards to ensure that investment opportunities are allocated fairly among their clients. Portfolio managers are required to prepare written fairness policies dealing with the allocation of investment opportunities among clients, file these policies with the OSC and distribute them to all clients.

During our reviews, we observed the following:

- The most current fairness policy was not filed with the OSC or was not provided to all clients, or both.
- Clients did not get a complete fill on their orders because portfolio managers included proprietary, employee and/or personal accounts in block trades and allocated a pro-rata share of partially filled blocked trades or initial public offerings (IPOs) to these accounts.
- The fairness policy stated that preference may be given to weaker performing accounts or accounts of a certain size. As well, weaker performing accounts were shown preference during the allocation of a partial fill of a block trade.
- The fairness policy did not reflect actual trading practices.

Suggested practices

Portfolio managers should tailor their fairness policy to address all relevant areas of their business. See OSC Staff Notice 33-723 Fair Allocation of Investment Opportunities Compliance Team Desk Review for additional guidance.

At a minimum, the fairness policy should state:

- how prices and commissions are allocated among client accounts when trades are blocked
- how block trades and IPOs are allocated among client accounts when there is only a partial fill (e.g. pro-rata)
- the process for determining which clients will participate in IPOs
- the process for allocating prices and commissions for block trades that are filled in different lots and/or at different prices
- policies on filling clients' trades before filling accounts of proprietary or personal accounts when blocked trades are partially filled

7. Maintenance of books and records

Portfolio managers are required to maintain books and records necessary to properly record their business transactions, trading transactions and other financial affairs. Subsection 113(1) of R.R.O. 1990, Regulation 1015 made under the Act (the Regulation) requires portfolio managers to maintain the books and records that are necessary to properly record their business transactions and financial affairs.

The following are examples of books and records that were missing or incomplete:

- trade blotters
- copies of trade orders or instructions
- trade orders (not time-stamped)
- a log of failed trades and trading errors
- advisory agreements
- client investment objectives and restrictions
- a complaints log, including the nature of the complaint and the outcome
- proxies voted or proxy logs
- cash and security reconciliations
- monthly financial statements
- written agreements with third parties

Suggested practices

Regulation 113(3) lists the books and records that portfolio managers are required to maintain. Portfolio managers should also keep any other books and records necessary to properly record their business transactions, trading transactions and other financial affairs.

8. Personal trading

Portfolio managers are required to establish and enforce written procedures on dealing with clients. These procedures must conform to prudent business practice.

The establishment and enforcement of a policy on the personal trading of all employees is a prudent business practice. This ensures compliance with Part XXI - Insider Trading and Self-Dealing of the Act and helps prevent and detect conflicts of interest and abusive practices. For example, under section 119 of the Act, no person can purchase or sell securities for his or her account where a client's investment portfolio holds the same security and where the person has information relating to the securities and uses the information to his or her benefit or advantage.

In this report, employees who have access to investment information about client portfolios are referred to as "access persons".

During our reviews, we observed the following:

- There were no personal trading policies.
- Personal trades did not require pre-clearance.
- Employees were not required to sign a code of ethics or annual certification of compliance with the code.
- Individuals with access to investment decision making were not subject to personal trading policies.
- There was no evidence that personal trading had been reviewed.
- Personal trading policies and procedures were not adequately enforced.

Suggested practices

- Distribute clear personal trading restrictions and reporting obligations to all employees and access persons.
- Develop and implement personal trading policies.
- Include blackout periods, the requirement for pre-approval of all personal trades and a timely review of brokerage statements in personal trading procedures.
- Require all access persons to acknowledge every year in writing that they understand and will follow the firm's personal trading policies.
- Require all access persons to direct their brokers to send statements of their accounts directly to the officer responsible for monitoring the personal trading policy.
- Maintain a record of personal trade pre-approvals and brokerage statements of access persons as proof that personal trading is being monitored.
- Have the Compliance Officer review and oversee all personal trading records.

9. Business continuity plan (BCP)

Portfolio managers should develop and enforce a written BCP to allow them to mitigate, respond and recover from a range of potential disasters or disruptions which may impact their ability to provide services to clients, and clients' ability to access their assets.

Section 1.2 of OSC Rule 31-505 requires portfolio managers to develop and enforce written procedures for dealing with clients. The written procedures should conform to prudent business practice and enable portfolio managers to serve their clients adequately.

Portfolio managers should develop and enforce a written BCP appropriate to their size, risks, and the nature of their operations to allow them to mitigate, respond and recover from a range of potential disasters or disruptions. The BCP should be regularly tested, updated and assessed for effectiveness.

During our reviews, we noted that some portfolio managers did not have a written BCP.

Suggested practices

At a minimum, a written BCP should include the following:

- Identifying the impact to your key business functions, employees, premises, systems, and records from a range of potential disasters or disruptions
- procedures to mitigate, respond and recover from a potential disaster or disruption
- appointment of person(s) responsible for BCP
- communication with employees, key service providers and clients
- process for backing-up the firm's key records
- testing, updating and assessing the effectiveness of the BCP
- availability and location of alternate site to resume operations
- where outside service providers are used for key functions, assessment of the adequacy of their BCP
- staff awareness and training on BCP

10. Know your client and suitability information

Portfolio managers are required to collect and document current KYC information so they can assess the general investment needs of their clients and the suitability of proposed transactions (see section 1.5 of OSC Rule 31-505 -- Conditions of Registration (OSC Rule 31-505)). Portfolio managers should collect and document client information such as investment objectives, risk tolerance, investment restrictions, investment timeframe, annual income and net worth.

During our reviews, we observed the following:

- No KYC and suitability information was collected or documented.
- KYC information was incomplete.
- KYC information was not updated periodically.
- KYC information was not formally documented.
- Written policies and procedures on collecting and documenting KYC and suitability information did not reflect actual practices.

Suggested practices

- Collect complete KYC information for all clients, including clients who buy non-prospectus qualified investment offerings.
- Update KYC information at least once a year.
- Ensure that clients sign the KYC form.
- Maintain a pending file for incomplete KYC forms and clear them on a timely basis, in particular before executing any trades for the client.

For more information

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