1.1.2 Amendments to IDA By-law 8 - Resignations and Amalgamations – Notice of Commission Approval

AMENDMENT TO IDA BY-LAW 8
RESIGNATIONS, AMALGAMATIONS, ETC.

NOTICE OF COMMISSION APPROVAL

The Ontario Securities Commission approved amendments to IDA By-law 8 – Resignations, Amalgamations, etc. In addition, the Saskatchewan Securities Commission approved, the Alberta Securities Commission did not disapprove and the British Columbia Securities Commission did not object to these amendments. The purpose of the amendments is to clarify the process of resignations or amalgamations and the process for payment of annual fees upon resignation. A copy of these amendments is published in Chapter 13 of this Bulletin.

1.1.3 OSC Compliance Team, Capital Markets Branch 2002 Annual Report

2002 ANNUAL REPORT
COMPLIANCE TEAM,
CAPITAL MARKETS BRANCH, OSC

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2002 ANNUAL REPORT
COMPLIANCE TEAM,
CAPITAL MARKETS BRANCH, OSC

Introduction

The Compliance team of the Capital Markets branch of the Ontario Securities Commission has prepared this report to provide guidance to investment counsel and portfolio managers (ICPMs) and fund managers in complying with Ontario securities laws.

The report on our activities from April 1, 2001 to March 31, 2002 is divided into four parts.

The first part provides a description of the team's mandate – which is to ensure investor protection and to foster investor confidence in the capital markets by pro-actively ensuring that market participants comply with Ontario securities laws.

The second part deals with recent team initiatives. While a major focus of the Compliance team is to conduct field reviews, Compliance staff is also involved in a number of other initiatives. Given the nature of the work, Compliance staff builds expertise in the operations of many market participants and is able to contribute to policy and other projects related to our market participants business.

The third and fourth parts deal with common deficiencies identified during our recent field reviews of ICPMs and fund managers. We also include best practice guidelines to assist market participants in improving their existing procedures, establishing procedures where they are lacking, and to give general guidance that can help in improving the overall compliance environment.

I. Mandate of the Compliance team

The mandate of the Compliance team is to ensure investor protection and to foster investor confidence in the capital markets by pro-actively ensuring that market participants comply with Ontario securities laws. Compliance aims to achieve this mandate by:

- establishing effective outreach programs to provide guidance to our market participants
- establishing and executing review procedures for the examination of market participants in order to detect and deter non-compliance

It has been our experience that market participants want to comply with securities legislation. When there is a lack of compliance, it is often because they are unaware of certain regulatory requirements or have difficulty interpreting or implementing the requirements. To provide guidance to market participants, Compliance staff participates in speaking engagements, has initiated the ICPM roundtable meetings and publishes material. This annual report, along with the CSA Staff Report – National Compliance Review of Advising Firms (2001) which was published in August, can be used as a tool to help ICPMs and fund managers to assess the effectiveness of the current compliance regimes in place.

The Compliance team focuses on the following type of examinations:

- routine examinations
- sweeps
- national compliance review

A routine examination is performed using standard examination procedures developed to assess the business functions and operations of a market participant. Market participant is very broadly defined in subsection 1(1) of the *Securities Act* (Ontario) and for the purposes of this report refers to ICPMs and fund managers.

A sweep is a review of market participants with respect to a specific issue or concern. A sample of market participants is selected and a focused, issue-oriented review is conducted. An example of a sweep of this type is our review in the 2002/2003 fiscal period of mutual fund dealers that had taken insufficient steps to become members of the MFDA by July 2, 2002. This type of review can also be used as a research tool for gathering information on various issues of concern to the Commission.

Compliance also participates, on an annual basis, in a national compliance review that involves the co-ordinated review of a market participant or issue by the Canadian Securities Administrators (CSA). The main purpose of the review is to get a national perspective on a market participant or issue of concern and to promote information sharing and cross training amongst jurisdictions.

II. Compliance initiatives

In the past fiscal year, the major initiatives that Compliance has been involved in include the following:

- risk assessment project
- Rule 31-507 – Mandatory SRO rule for securities dealers
- Rule 31-506 – Mandatory SRO rule for mutual fund dealers
- ICPM roundtable meetings

Risk assessment project

In fiscal 2001, Compliance initiated a project to develop a risk-based selection model for routine examinations. The objective of this initiative is to ensure that staffing resources are focussed on high-risk market participants and the high-risk areas of their operations. The frequency of routine examinations will be based on the level of risk posed to the investing public by the market participant.

The model looks at the detailed operations of each market participant and based on the factors that are present at the market participant, a risk "score" is calculated. The model then uses the risk "scores" to risk rank the market participant. The risk ranking dictates the frequency of compliance field reviews.

Development of the model was completed in September 2001. After completion of the model, phase 1 of project implementation was commenced. The first phase consisted of developing and mailing out a very detailed questionnaire to 20 market participants. The responses from the 20 market participants were reviewed in detail and were used to further test the model.

Phase 2 of implementation of the model is currently ongoing. Detailed questionnaires were mailed to the remaining population of ICPMs and fund managers, totaling approximately 375. Responses to the questionnaire were due in May 2002. Compliance staff is currently analyzing the responses and assigning risk "scores" to market participants. It is expected that phase 2 will be completed by December 2002.

Once phase 2 of the risk assessment model is completed and all the risk rankings have been determined, OSC staff will meet with senior management to discuss those areas of their operations which have been identified as being higher risk. Sharing this information with senior management will ensure that they have the necessary information to put the required risk management processes in place. It is our goal to work with them to ensure that they understand the risk factors that are present in their compliance environments. This will enable them to develop appropriate action plans to address the high risk areas and improve overall compliance. For those that have been categorized as lower risk, the risk ranking information will be provided to them at the completion of their scheduled compliance review.

Full implementation of the risk-based model will begin in April 2003.

Rule 31- 507 – Mandatory SRO rule for securities dealers

Rule 31-507 – SRO Membership – Securities Dealers and Brokers, requires that after March 1, 2001 a market participant registered in the category of securities dealer or broker must become a member of a self-regulatory organization (SRO) recognized by the Commission by its registration renewal date.

Staff reviewed all market participants that were affected by the Rule to determine if they had taken the appropriate steps to comply. Staff identified 30 market participants that had not yet become members of a SRO and had not taken the appropriate steps to do so.

Compliance staff assessed the fact situation at each of those identified in order to determine whether a field review was necessary. Staff visited ten securities dealers.

Based on staff's overall assessment of the registrant's operations, recommendations were made to staff legal counsel with regards to providing relief, on a limited basis, from the Rule. Where limited relief from the Rule was given, terms and conditions were imposed on the registration of the market participant. Compliance was very involved in monitoring the terms and conditions to ensure they were met.

Rule 31 – 506 – Mandatory SRO rule for mutual fund dealers

Pursuant to Rule 31-507 – SRO Membership – Mutual Fund Dealers, all mutual fund dealers were required to become members of the Mutual Fund Dealers Association (MFDA) by July 2, 2002. There were 210 mutual fund dealers affected by this rule. Compliance staff worked with the MFDA to monitor the membership process and were involved in analyzing and resolving issues that arose as a result of this rule. Compliance staff dealt with the issues surrounding this rule in a similar fashion as was done with Rule 31-507. Compliance staff assessed the fact situation at those dealers where problems existed with their membership applications due to capital issues, insurance issues or issues with their current business structure and determined whether a site visit was warranted.

Where a site visit was conducted, staff reviewed the books and records of the dealer and assessed the status of the membership application. Based on staff's assessment, recommendations were made to staff legal counsel on how to deal with the registrant until it became a member of the MFDA. Where limited relief from the Rule was given, terms and conditions were imposed. Compliance staff closely monitored those dealers where terms and conditions were imposed to ensure that they were met.

ICPM roundtable meetings

A new initiative that Compliance began in fiscal 2002, is the ICPM roundtable meeting. The objective of the roundtable meeting is to meet on a regular basis with a group of our market participants and discuss issues, share ideas, obtain feedback and improve communication.

The first and second roundtable meetings occurred in January 2002 and May 2002. Both meetings were successful. Future roundtable meetings will occur on a regular basis with market participants being invited on a random basis. If you are interested in attending a future roundtable meeting, please contact one of the authors of this report listed at the end of the report.

III. Common ICPM deficiencies

This part of the report discusses the common deficiencies identified by staff during compliance examinations conducted from April 1, 2001 to March 31, 2002 of ICPMs and fund managers. A necessary element of a market participants' business is a compliance program that effectively addresses the inherent risks in the business of advising and helps the firm meet its compliance obligations. An effective compliance program increases the firm's

compliance with regulatory requirements. This report is meant to provide guidance and help ICPMs review their compliance programs, supervisory and internal control procedures and to establish a stronger compliance environment.

This report focuses on the ten deficiencies most commonly noted at ICPMs. The top seven most common deficiencies for fund managers are discussed later in this report. The top ten deficiencies for ICPMs are:[1]

1. Statement of policies
2. Policy for fairness in allocation of investment opportunities
3. Policy and procedures manual
4. Related registrant disclosure
5. Know your client and suitability information
6. Capital calculations
7. Personal trading
8. Maintenance of books and records
9. Statements of portfolio
10. Timely reconciliation of client portfolios

While we have also noted deficiencies with respect to compliance with Rule 31-502 – Proficiency Requirements for Registrants, specifically with the proficiency requirements for advisers, these deficiencies have not been discussed in this report. The Commission is currently reviewing aspects of the rule and will issue guidance once the review is completed. The noted deficiencies are followed by best practices guidelines recommended for adoption by ICPMs to improve their adherence to their compliance requirements.

1. *Statement of policies*

ICPMs who provide advice with respect to their own securities or securities of certain issuers who are connected or related to them are required to disclose these relationships. Every registrant is required to include this disclosure in a statement of policies which is to be filed with the Commission, as well as distributed to each client.

During our reviews, staff observed some the following deficiencies:

- The ICPM had not prepared a statement of policies
- The ICPM had not filed the most current statement of policies with the Commission and/or did not provide all clients with a copy
- The ICPM had not updated its statement of policies to include all related issuers
- The ICPM did not list its own pooled funds as related issuers
- The ICPM did not describe the nature of its relationship with related and connected issuers
- The ICPM distributed a statement of policies to clients that differed from the one filed with the Commission

Best practices

- A current statement of policies should be prepared and filed with the Commission
- If a significant change occurs, a revised statement of policies must be filed with the Commission and distributed to all clients
- A copy of the statement of policies should be provided to all clients
- The statement of policies should include a complete listing of related issuers along with a concise description of the nature of the relationship with each of the related issuers
- The statement should include the disclosure required in clause 223(1)(d) of the Regulation

2. *Policy for fairness in allocation of investment opportunities*

ICPMs are required to prepare a written fairness policy dealing with the allocation of investment opportunities among clients. The policy must be filed with the Commission as well as distributed to all clients. The policy should specify the method used by the ICPM to allocate securities purchased in block trades and/or initial public offerings (IPOs) to client accounts, including their in-house pools. The policy should also include the method used by the ICPM to allocate price and commissions on these trades among client accounts.

During our reviews, staff observed the following:

- The ICPM had not prepared a fairness policy

[1] While this report focuses on those deficiencies most commonly noted, Compliance staff also identified issues in numerous other areas at ICPMs. Deficiencies were also identified in the following areas: misleading marketing materials, cross transactions, disclosure issues, proxy voting, management fee calculation errors, dealing with clients in other jurisdictions, late filing of audited annual financial statements, expired insurance, trust account issues, subordinated loan issues, trade name issues, power of attorney issues, monitoring of subadvisers, advertising of registration, soft dollar issues, conflicts of interest, best price and execution, non-compliance with clients' investment restrictions and guidelines, and registration issues.

- The ICPM did not provide clients with a copy of the fairness policy
- The ICPM did not file a copy of the fairness policy with the Commission
- The fairness policy did not include a methodology for allocating block trades or IPOs
- The ICPM did not follow the allocation practices set out in its fairness policy
- The fairness policy contained wording that was very generic and was not tailored to the ICPM's business
- The allocation of shares to client accounts was done on a "best judgement" basis instead of being done using a more independent method such as, pro-rata basis

Best practices

Each ICPM should tailor its fairness policy to address all relevant areas of its business. At a minimum, it should state:

- How price and commissions are allocated among client accounts when trades are blocked
- How block trades are allocated among client accounts when there is only a partial fill
- The process for determining which clients will participate in "hot issues" and IPOs
- The process for the allocation of prices and commissions for block trades that are filled in different lots and/or at different prices

3. *Policy and procedures manual*

ICPMs are required to establish and enforce written policies and procedures that will enable them to serve their clients adequately. ICPMs should prepare a policies and procedures manual (the Manual). They should ensure that the Manual is in sufficient detail, is updated on a periodic basis, and is made available to all relevant staff.

During our reviews, staff observed the following:

- The Manual contained out-dated references to rules and regulations of the Act
- The Manual did not contain procedures covering all major areas of the business
- The Manual was not sufficiently detailed
- The Manual was not made available to all staff

Best practices

Each ICPM should establish and enforce a written Manual that is sufficiently detailed, up to date, and which covers all relevant areas of its business. The following list of topics should be considered for inclusion in a standard Manual:

- Portfolio management, including monitoring of sub-advisers if applicable
- Trading and brokerage
- Conflicts of interest
- Personal trading
- Insider and early warning reporting
- Client complaints
- Referral arrangements
- Proxy voting
- Marketing
- Calculation of performance data
- Construction of composites

4. *Related registrant disclosure*

A principal shareholder, officer, partner or director of an ICPM that is also a principal shareholder, officer, partner or director of another registrant is required to disclose to the Commission the details of the relationship and the business reasons for its existence. The ICPM is also required to adopt policies and procedures to minimize the potential for conflicts of interest resulting from the relationship. As well, the ICPM is required to disclose to clients, in writing, the details of the relationship as well as the policies and procedures adopted to minimize the potential for conflict of interest resulting from the relationship.

During our reviews, staff observed the following:

- The ICPM did not disclose to clients or the Commission that it is a principal shareholder of another registrant
- The ICPM did not disclose to clients or the Commission a related registrant, by virtue of common ownership
- The ICPM did not disclose to clients or the Commission a related registrant that is a fully-owned subsidiary

Best practices

- Disclose, in writing, to clients and the Commission the relationship with other registrants

- Determine areas that may be susceptible to potential conflicts of interest and adopt policies to minimize the potential for conflicts of interest

5. *Know your client and suitability information*

ICPMs are required to collect and maintain current "know your client" (KYC) information that would allow the ICPM to ascertain general investment needs of its clients, as well as the suitability of a proposed transaction. ICPMs should collect client information such as investment objectives, risk tolerance, investment restrictions, investment time frame, annual income, and net worth.

During our reviews, staff observed the following:

- KYC information was not collected for all clients
- KYC information that had been collected was not complete
- KYC information had not been updated periodically or since the opening of the account
- KYC information was not formally documented
- KYC forms were not signed by clients
- A standard KYC form was not used to collect and document KYC information and suitability information

Best practices

- Complete KYC information must be collected for all clients
- KYC information should be periodically updated
- Clients must sign the KYC information form
- If possible, maintain KYC information in an electronic format which can be used to generate exception reports
- Maintain a pending file when a KYC form is incomplete
- The pending file should be cleared on a timely basis and prior to any trade execution

6. *Capital calculations*

ICPMs are required to prepare a monthly calculation of minimum free capital and capital required (capital calculation) within a reasonable period of time after each month end. The capital calculation is to be prepared based on monthly financial statements prepared in accordance with generally accepted accounting principles (GAAP). All registrants are required to inform the Commission immediately should they be become capital deficient. Registrants are required to rectify the capital deficiency within 48 hours.

During our reviews, staff observed the following:

- Capital calculations were not prepared or were not prepared on a timely basis
- Capital calculations were not prepared in accordance with GAAP
- Monthly accruals for expenses such as rent payable, utilities payable, and other monthly operating expenses were not recorded
- Management fee revenue was not properly recorded
- The insurance deductible on the financial institution bond was not included in the calculation or an incorrect amount was included
- There was no evidence that a review of the calculation was performed by someone other than the preparer
- The ICPM did not inform the Commission of a capital deficiency
- Intercompany or related party loans were treated as subordinated for purposes of the capital calculations even though the Commission was not notified of the subordination of such loans

Best practices

- The ICPM's capital position should be calculated on a monthly basis within 2 weeks of month end and should be based on financial statements prepared in accordance with GAAP
- Copies of the calculations should be maintained for purposes of an audit trail
- A person other than the preparer should review the calculations to ensure they are accurate
- Evidence of the review should be documented
- The Commission should be informed immediately should the ICPM's capital position become deficient

7. *Personal trading*

ICPMs are required to establish and enforce written procedures for dealing with clients that conform to prudent business practice. The establishment and enforcement of a detailed policy on the personal trading of responsible persons is a prudent business practice. It will ensure that conflicts of interest and abusive practices are avoided. A responsible person is defined in subsection 118(1) of the Act.

During our reviews, staff observed the following:

- There was no policy in place to monitor personal trading by responsible persons
- A personal trading policy was in place but was not being enforced by the ICPM
- The compliance officer's personal trades were not pre-approved by an independent person
- Employees' trade confirmations and statements of accounts were missing from some employees' files
- Pre-approval forms were not always matched against employees' statements to ensure all personal trades were pre-approved
- A log of all instances of non-compliance and their resolution was not maintained

Best practices

- Designate a compliance officer who is responsible for reviewing and maintaining personal trading records
- Distribute clear personal trading restrictions and reporting obligations to all responsible persons
- Personal trading procedures should include blackout periods, the requirement for pre-approval of all personal trades and a review of portfolio statements
- Require all responsible persons, on an annual basis, to acknowledge in writing that they understand and will abide by the firm's personal trading policies
- Maintain a record of personal trade approvals as documentary evidence that personal trading is being monitored
- Employees should direct their brokers to send statements of their accounts directly to their employer
- On a monthly or quarterly basis, review employee statements and reconcile all trades to the approvals granted

8. *Maintenance of books and records*

All registrants are required to maintain books and records necessary to properly record their business transactions and financial affairs.

During our reviews, staff observed the following:

- Trade instructions were provided verbally from the portfolio manager to the trader/executing broker with no record of the instruction kept
- The ICPM could not locate certain client management agreements
- The ICPM did not maintain a trade blotter or the blotter maintained was incomplete
- The ICPM did not maintain copies of each trade order or instruction
- Trade orders were not time-stamped
- A complaints log recording the nature of complaints and their resolution was not maintained
- A log of failed trades and trading errors was not maintained
- There was no documentation in client files regarding a client's directed brokerage arrangement

Best practices

A list of books and records that ICPMs are required to maintain is contained in subsection 113(3) of the Regulation. ICPMs should also retain any other books and records necessary to properly record their business transactions and financial affairs.

9. *Statements of portfolio*

ICPMs are required to send a statement of account to each client at least once every three months unless directed otherwise by the client.

During our reviews, staff observed the following:

- Portfolio statements were not provided to clients at least on a quarterly basis and there was no record of clients requesting that they not receive one
- The registrant did not prepare a client statement of account and relied on the custodian to inform clients of their security holdings

Best practices

- Unless otherwise directed by clients, ICPMs must prepare and send statements of account to each client at least every three months

10. *Timely reconciliation of client portfolios*

ICPMs are required to establish and enforce written procedures for dealing with clients that conform to prudent business practice. The preparation of timely reconciliations of client security positions between the records of the ICPM and the records of the custodian is a prudent business practice.

During our reviews, staff observed the following:

- The ICPM did not prepare a complete reconciliation of security positions between the custodian's statement and its own internal reports
- Reconciling items were not cleared on a timely basis or appropriate follow-up was not done
- The reconciliation was not reviewed and approved by someone other than the preparer

Best practices

- Client security positions should be reconciled to the custodian's statement on at least a monthly basis
- Reconciliations should be reviewed by someone other than the preparer
- All reconciling items should be investigated and cleared on a timely basis and the resolution documented

IV. Common fund manager deficiencies

This part of the report focuses on the seven most common fund manager deficiencies noted which are:

1. Treatment of NAV errors
2. Written policies and procedures
3. Distribution of interest earned
4. Overdraft charges and deductions of fees/other charges from trust accounts
5. Commingling of cash in the trust account
6. Trust account and security position reconciliations
7. National Instrument 81-102 reports[2]

Commission staff is considering what guidance should be provided with respect to National Instrument 81-105 – Mutual Fund Sales Practices and, therefore, deficiencies relating to this instrument have not been highlighted in this report. The noted deficiencies are followed by best practices guidelines recommended for adoption by fund managers to improve their adherence to their compliance requirements.

1. *Treatment of NAV errors*

Fund managers are required to exercise the powers and discharge the duties of their office in good faith and in the best interests of the mutual fund. Also, they are required to exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances.

Staff noted that many fund managers have implemented the recommendations set out in the IFIC Bulletin, Correcting Portfolio NAV Errors (IFIC Bulletin). The IFIC Bulletin defines a materiality threshold of either 50 basis points of the applicable fund's net asset value (NAV) or $50 for individual account loss. The fund manager's policy is, therefore, to not reimburse any loss below these levels of materiality.

During our reviews, staff observed the following:

- The fund manager implemented the recommendations contained in the IFIC Bulletin and applied them to each NAV error irrespective of the consequences to individual unitholders

Best practices

- Fund managers should treat each NAV error separately and determine what impact the error will have on investors before deciding whether the error is material or not
- The circumstances surrounding the error should be investigated and documented
- The impact of errors should be assessed on a case by case basis and a determination should be made whether an adjustment to client accounts is necessary
- Approval, at the appropriate level, should be required for the action to be taken for all errors that occur

2. *Written policies and procedures*

Fund managers are required to exercise the powers and discharge the duties of their office in good faith and in the best interests of the mutual fund. Also, they are required to exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances. In our view, it is a prudent business practice and in the best interest of the mutual fund to ensure a written Manual is prepared and kept current by a fund manager.

During our reviews, staff observed the following:

- Staff noted several cases where the Manual maintained by a fund manager did not adequately outline relevant regulatory requirements or detail procedures to ensure compliance with these requirements

[2] While this report focuses on those deficiencies most commonly noted, Compliance also identified issues in numerous other areas at fund managers. Deficiencies were also identified in the following areas: advertising of registration, pricing of securities, review and approval of NAV calculations, inadequate segregation of duties, monitoring of outsourced functions, timely settlement of trades, and monitoring of investment concentration limits.

Best practices

- Fund managers should prepare written policies and procedures covering all relevant regulatory requirements. These procedures should include, but are not limited to, the following:

  Trust accounting

  - Procedures to address the requirements of trust accounts
  - Procedures to ensure there is no commingling of trust account assets
  - Procedures outlining the requirements for interest distribution
  - Procedures over the preparation and review of trust account reconciliations

  Fund accounting

  - Procedures over the preparation, review and maintenance of reconciliations of cash and security positions
  - Procedures over timely and accurate recording of expenses of the funds
  - Procedures to rectify NAV calculation and/or publication errors
  - Procedures over fair-valuation of securities

  Unitholder accounting

  - Procedures for appropriate handling/storage of documentation
  - Procedures to deal with cancelled orders and trading errors
  - Procedures to ensure segregation of duties between the processing of orders, maintenance of unitholder records, and the receipt and processing of monies
  - Procedures to ensure unitholder authorization of orders
  - Procedures to ensure that unitholder transactions are entered completely, accurately, and on a timely basis

Alternatively, should the fund manager outsource one or more areas of their business to a third party service provider, policies and procedures should be documented and enforced to ensure that appropriate monitoring of the service provider is performed

3. *Distribution of interest earned*

Principal distributors are required to allocate interest earned on cash held in trust accounts to unitholders or to the mutual funds on a monthly basis if the amount of interest owing is $10 or more. If the amount of interest earned is less than $10, interest must be allocated at least annually.

During our reviews, staff observed the following:

- Trust accounts were non-interest bearing
- Interest was not allocated on a timely basis

Best practices

- Fund managers should develop and enforce a methodology for allocating interest to unitholders or mutual funds on either a monthly or annual basis as required

4. *Overdraft charges and deduction of fees/other charges from trust accounts*

Ontario securities law requires principal distributors to ensure that any charges against the trust account are not paid or reimbursed from the trust account.

During our reviews, staff observed the following:

- The trust account incurred bank service charges that were not reimbursed by the fund manager
- The trust accounts went into an overdraft position during the review period

Best practices

- The fund manager should ensure that bank service charges are not paid out of the trust account
- Trust accounts should be monitored to ensure that overdraft positions do not occur
- The trust accounts should be operated in accordance with National Instrument 81-102 - Mutual Funds (NI 81-102).

5. *Commingling of cash in the trust account*

Principal distributors are prohibited from commingling cash received for the purposes of purchasing or redeeming mutual funds from cash received for any other purpose. This includes cash received for the purpose of purchasing guaranteed investment certificates (GICs) or purchasing or redeeming segregated funds. Principal distributors are also prohibited from using cash in the trust account to finance their own operations in any way.

During our reviews, staff observed the following:

- The fund manager processed administrative expenses through the trust account
- The fund manager commingled mutual funds monies with GICs or segregated funds monies

Best practices

- Cash received for the purpose of purchasing or redeeming mutual funds should be kept segregated in a separate account

6. *Trust account and security position reconciliation*

Fund managers are required to exercise the powers and discharge the duties of their office in good faith and in the best interests of the mutual fund. Also, they are required to exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances. The timely preparation and review of trust account reconciliations and security position reconciliations between the fund manager's fund accounting system and the custodian's statements is a prudent business practice and in the best interests of the mutual fund.

During our reviews, staff observed the following:

- Reconciling items were not cleared on a timely basis
- Reconciliations did not contain evidence that reconciling items were investigated by staff at the fund manager
- Reconciliations were not reviewed and approved by a person independent of the preparer
- Trust account reconciliations were not prepared
- Security position reconciliations between the fund manager's records and the custodian's records were not prepared

Best practices

- Fund managers should prepare trust account reconciliations and security position reconciliations within a reasonable time after each month end
- Reconciliations should be reviewed and approved by someone other than the preparer
- All reconciling items should be investigated and cleared on a timely basis

7. *National Instrument 81-102 compliance reports*

The principal distributor of a mutual fund is required to complete and file with the Commission a report describing compliance by the mutual fund during the financial year with the applicable requirements of NI 81-102. The auditor of the mutual fund is also required to submit an audit opinion on the report to the Commission. The report must be filed with the Commission within 140 days after the financial year-end of the mutual fund.

During our reviews, staff observed the following:

- The NI 81-102 Compliance Report was not prepared or filed by the fund manager
- The audit opinion on the NI 81-102 Compliance Report was not prepared or filed by the mutual fund's audit firm
- The NI 81-102 Compliance Report was not in the correct format or still claimed compliance with National Policy 39
- The NI 81-102 Compliance Report claimed full compliance with the applicable requirements of the legislation even though staff at the Commission found examples of deficiencies throughout the financial year in question

Best practices

- A report on Compliance with NI 81-102 should be prepared and filed with the Commission within 140 days of the financial year end of the mutual fund
- The mutual fund's auditor should prepare an audit opinion on the NI 81-102 Compliance report and file it with the Commission within 140 days of the financial year end of the mutual fund
- The reports should be in the format detailed in Appendix B of NI 81-102
- The NI 81-102 Compliance Report should list all instances where the mutual fund was not in compliance with the applicable requirements of the legislation during the financial year

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