

1.1.2 2006 Report of the Compliance Team, Capital Markets Branch, OSC

2006 REPORT

COMPLIANCE TEAM, CAPITAL MARKETS BRANCH, OSC

TABLE OF CONTENTS

Introduction

1. Compliance initiatives
 - Limited market dealer sweep*
 - Hedge fund manager review*
 - Referral arrangements*
 - OSC Staff Notice 33-723 – Fair allocation of investment opportunities*
2. Common ICPM deficiencies identified during reviews
3. Significant ICPM deficiencies
4. Addressing the deficiencies

Introduction

Our 2006 Report summarizes our activities for the two fiscal years from April 1, 2004 to March 31, 2006. This report also includes the combined results of our reviews of investment counsel and portfolio managers (ICPMs) for fiscal years 2005 and 2006.

During this period, we performed fewer ICPM reviews because significant resources were allocated to the following projects:

- mutual fund market timing probe
- scholarship plan dealer reviews
- hedge fund manager reviews
- limited market dealer reviews

We encourage ICPMs to use this report as a self-assessment tool to strengthen their compliance with Ontario securities law and to improve their internal controls.

Effective April 1, 2005, we made several changes to our deficiency reports. One of the major changes was identifying significant deficiencies in deficiency reports. This encourages senior management to focus on the key issues. It also assists us in identifying trends and monitoring areas of significant regulatory concern.

This report is divided into four sections:

1. Compliance initiatives. This section describes various compliance initiatives relating to market participants.

2. Common ICPM deficiencies identified during reviews. This section deals with common deficiencies identified during our reviews of ICPMs. We have included some suggested guidelines to help ICPMs improve existing procedures, establish procedures in areas where they are lacking, and to give general guidance on improving overall compliance. We have also highlighted changes in our findings from the previous two annual reports for comparison.

We use a risk-based approach in selecting ICPMs for review. Our reviews primarily focus on those ICPMs with a higher risk ranking. However, we also select ICPMs for review on a random basis.

3. Significant ICPM deficiencies. This section summarizes the top three significant deficiencies of ICPMs and how we are responding to them.

4. Addressing the deficiencies. This section describes the various regulatory tools that we may use to address serious conduct issues or violations of securities law.

1. Compliance initiatives

This section describes various initiatives undertaken during the past two years.

Limited market dealer sweep

In 2005, we conducted our first compliance review focussed on limited market dealers (LMDs). Our goals were to better understand the business operations of LMDs, review their compliance with securities law and identify any regulatory gaps. This review was a first step in enhancing compliance oversight and helping LMDs develop stronger compliance and internal controls. The results of this review will also assist the Canadian Securities Administrators (CSA) Registration Reform Steering Committee in harmonizing registration requirements by identifying any specific risks this category poses to investor protection.

We issued OSC Staff Notice 11-758 on June 16, 2006, which summarizes the results of our review. For details, please visit www.osc.gov.on.ca. We will be conducting regular field reviews of LMDs to ensure that they comply with securities law. We expect that this initiative will assist LMDs in enhancing their compliance structure and will result in a more effective regulatory regime.

Hedge fund manager review

In 2005, Ontario, British Columbia and Quebec conducted co-ordinated field reviews of 13 hedge fund advisers and managers. The reviews included 37 hedge funds with a total value of \$1.25 billion and nine principal protected notes (PPNs) with a value of \$1.4 billion. We chose the market participants based on their size, and the number and types of products offered (hedge funds, funds of hedge funds and PPNs). We also chose some of the market participants randomly.

The reviews focused on a number of areas, including safeguarding of client assets, valuation processes, marketing materials and offering documents, the extent and type of fees charged, product liquidity, the existence of referral arrangements and product distribution.

Referral arrangements

We are working with the CSA, Investment Dealers Association of Canada (IDA) and the Mutual Fund Dealers Association of Canada (MFDA) on a project to review referral arrangements. We are examining a number of issues, including what parties can enter into these arrangements. The goal is to develop rules or other guidance for the industry that will be consistent for all categories of registration.

OSC Staff Notice 33-723 – Fair allocation of investment opportunities

On September 23, 2005, we issued OSC Staff Notice 33-723 – *Fair Allocation of Investment Opportunities - Compliance Team Desk Review*. This staff notice summarizes the results of our desk review of the fairness policies and related business practices of 40 ICPMs. It also provides guidance to ICPMs on what to disclose in their fairness policy. For details, please visit www.osc.gov.on.ca.

Since issuing the notice, we have seen a decline in the number of deficiencies related to fairness policies (see the common deficiency table in section 2). The staff notice will continue to assist ICPMs in enhancing their compliance with Section 115 of R.R.O 1990, Regulation 1015 made under the Act (the Regulation).

2. Common ICPM deficiencies identified during reviews

This section discusses the results of our reviews of ICPMs during the period from April 1, 2004 to March 31, 2006. As highlighted earlier in this Report, we use a risk-based approach in selecting ICPMs for review. The majority of the ICPMs reviewed had a higher risk ranking.

The table below categorizes the 10 most common deficiencies we identified and how they compare with the previous two years.¹ There was no change in the types of common deficiencies compared with 2003 and 2004.

We identified a number of issues under each category. An ICPM is included in a category if it had at least one of these issues. None of the firms we reviewed was deficient in all issues identified under a category.

¹ We also identified issues in many other areas, including statement of client's portfolio, conflicts of interest, cross transactions, soft dollars, related registrant disclosure, annual consent to trade securities of related and connected issuers, compliance function, adhering to the terms and conditions of registration, insurance coverage, exempt securities, early warning and insider trading reporting, proxy voting, referral arrangements, United Nations Suppression of Terrorism monthly reporting, internal controls, segregation of duties, trust accounts, agreements with service providers, confidentiality agreements and "holding out" issues.

Common deficiency	2005/06² Ranking	2004 Ranking	2003 Ranking
1. Policies and procedures manual	1	1	3
2. Marketing	2	8	8
3. Maintenance of books and records	3	5	1
4. Capital calculations	4	6	4
5. Statement of policies	5	3	5
6. Policy for fairness in the allocation of investment opportunities (fairness policy)	6	2	2
7. Personal trading	7	9	10
8. Know your client (KYC) and suitability information	8	10	9
9. Portfolio management including advisory contracts	9	4	7
10. Registration issues	10	7	6

Trends

Areas where ICPMs have improved

ICPMs have improved since 2003 and 2004 in the following areas:

- fairness policy
- statement of policies
- portfolio management including advisory contracts
- registration issues

The most significant improvement was in the fairness policy area. We believe this improvement is a direct result of OSC Staff Notice 33-723, which provides guidance to ICPMs on what to disclose in the fairness policy (see section 1).

Areas ICPMs need to work on

ICPMs have fallen behind since 2003 and 2004 in the following areas:

- marketing
- personal trading
- KYC and suitability information

The most negative trend was in marketing. Marketing issues were also identified as the number one significant deficiency (See Section 3). In general, ICPMs have become more aggressive in their marketing materials and websites. In many instances, they presented performance returns that could not be substantiated. Personal trading, and KYC and suitability information are other areas showing an increase in the number of deficiencies over past years.

Common deficiencies

The following is a discussion of the 10 most common deficiencies we identified. To assist ICPMs in understanding the common deficiencies, we have included the applicable legislation and suggested practices to address each deficiency. We encourage all ICPMs to use this as a self-assessment tool to strengthen their compliance with Ontario securities law.

² We have combined the results for fiscal years 2005 and 2006 in this report. The rankings are based on the number of ICPMs that had at least one issue under the category.

1. Policies and procedures manual

Section 1.2 of OSC Rule 31-505 requires ICPMs to establish and enforce written policies and procedures that will enable them to serve their clients adequately. ICPMs are required to maintain a policies and procedures manual, which also includes all relevant regulatory requirements. Policies and procedures that are clearly documented and enforced contribute to a strong compliance environment.

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 ICPM's business).
- The manual did not reflect recent changes to Ontario securities law or other applicable legislation, in particular those related to the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act and Regulations*.
- Procedures for key areas of the business were missing.
- There was insufficient detail about policies and procedures.

Suggested practices

Each ICPM should establish and enforce written policies and procedures that are sufficiently detailed and cover all areas of its business. ICPMs should also evaluate and review their policies and procedures on a regular basis such as for changes in industry practice or securities legislation. A copy of the manual should be readily accessible by all employees of the ICPM. 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
- procedures for ensuring 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
- guidelines on supervising sub-advisers and associate portfolio managers
- procedures for ensuring that investments and trades are suitable for each client
- procedures for ensuring compliance with regulatory and other investment restrictions (e.g. National Instrument 81-102 (NI 81-102))

Trading and brokerage:

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

Personal trading and conflicts of interest:

- procedures for approving personal trades, including requiring written pre-approval
- definition of material non-public information, and 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're signed
- guidelines for ensuring that clients receive appropriate and adequate disclosure of referral arrangements

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 ICPMs to deal fairly, honestly, and in good faith with clients. ICPMs must also meet the requirements of Part 15 of NI 81-102 when marketing mutual funds.

During our reviews, we observed the following:

- Internal marketing requirements were not met (e.g. not following procedures in policies and procedures manual).
- Marketing materials had incorrect information (e.g. incorrect data or statistics).
- Marketing materials were outdated or had inadequate disclosure.
- Website information was incorrect, outdated or contained inadequate disclosure.
- Performance data incorrectly used returns from a different fund, period or both.
- Returns were compared to inappropriate or misleading benchmarks.
- Composites used in marketing materials did not include all fee-paying accounts or were not grouped according to similar investment mandates.
- References to the Association for Investment Management and Research (AIMR) (now the CFA Institute) were used when the firm was not AIMR compliant or were incorrectly worded. (Note: Compliance with global investment performance standards (GIPS) is now required for periods after December 31, 2005.)
- Claims of "superior performance" that could not be substantiated.
- The disclosure and warning language required by 15.2(2) of NI 81-102 was missing.
- Performance data of mutual funds was not disclosed for the required time periods.

- 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.

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.
- Review part 15 of NI 81-102, where applicable, to ensure compliance with mutual fund sales communications.
- Require someone not involved in preparing marketing materials to review and approve the content for accuracy and compliance with securities legislation.

3. Maintenance of books and records

ICPMs are required to maintain books and records necessary to properly record their business transactions, trading transactions and other financial affairs. Section 113(1) of the regulation requires ICPMs 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

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

4. Capital calculations

ICPMs 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 are to be based on monthly financial statements prepared in accordance with generally accepted accounting principles (GAAP). ICPMs are required to inform the OSC immediately if they become capital deficient. They are also required to correct capital deficiencies 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 calculation 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 an incorrect amount was included.
- The minimum capital deduction was incorrect.
- Financial statements were not prepared in accordance with GAAP.
- Long-term assets and liabilities were incorrectly included in the calculations of working capital and/or current assets and liabilities were incorrectly excluded.
- There was no evidence that someone other than the preparer reviewed the calculation.
- Copies of monthly capital calculations were not maintained.
- ICPMs repaid subordinated debt without first notifying the OSC in writing.
- There was inadequate insurance coverage.

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 ICPM's capital position becomes deficient or it repays subordinated debt.

5. Statement of policies

ICPMs are required to disclose certain relationships when they provide advice relating to their own securities or to securities of certain issuers who are connected or related to them. Every registrant is required to include this disclosure in a statement of policies, which is to be filed with the OSC and distributed to each client. Regulation 223 requires that registrants prepare and file a statement of policies with the OSC and provide a copy to their clients.

During our reviews, we observed the following:

- There was no statement of policies.
- The most current statement of policies was not filed with the OSC or provided to clients, or both.
- The statement of policies did not include all related issuers.
- ICPMs did not list related issuers who were reporting issuers.
- ICPMs did not adequately describe the nature of their relationships with related and connected issuers.
- The disclosure required in Regulation 223(1)(d) was not in bold type.

Suggested practices

- Prepare and file a current statement of policies with the OSC and distribute it to all clients.
- If a significant change occurs, file a revised statement of policies with the OSC and distribute it to all clients.

- Include in the statement of policies a complete listing of all related issuers who are reporting issuers and a concise description of the nature of the relationship with each related issuer.
- Include in the statement of policies the disclosure required in Regulation 223(1)(d) in bold type.

6. Fairness policy

Every ICPM must have standards to ensure that investment opportunities are allocated fairly among its clients as required by Regulation 115(1). ICPMs are required to prepare written fairness policies dealing with the allocation of investment opportunities among clients. These policies must be filed with the OSC and distributed to all clients.

During our reviews, we observed the following:

- There was no fairness policy.
- The most current fairness policy was not filed with the OSC or was not provided to all clients, or both.
- The fairness policy did not include a methodology for allocating block trades and determining security prices and commissions.
- The fairness policy did not include a methodology for allocating partial fills and limited issues.
- Clients did not get a complete fill because ICPMs 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.

Suggested practices

Each ICPM should tailor its fairness policy to address all relevant areas of its business. See OSC Staff Notice 33-723 for additional guidance. At a minimum, it should state:

- How prices 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 allocating prices and commissions for block trades that are filled in different lots and/or at different prices
- Policies on completely filling clients’ trades before filling accounts of proprietary or personal accounts when blocked trades are partially filled

7. Personal trading

ICPMs 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 investment 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.
- Pre-clearance approval instructions had no or excessive time limits.

- Personal trading policies were inconsistent with actual practice.
- Personal trading procedures did not detect violations of the personal trading policies.
- Pre-approval forms were not always matched against the brokerage statements of access persons.
- Monthly brokerage statements were not reviewed.
- A log of personal trading pre-approvals was not maintained.
- Employees were not required to sign a code of ethics or annual certification of compliance with the code.
- Individuals with access to investment making decisions were not subject to personal trading policies.
- Definitions of “non-public” or “material” information were not provided in the procedures.
- Personal trading policies did not include blackout periods.
- There were no penalties for breaches or violations of personal trading policies.

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.
- Review brokerage statements of access persons and reconcile all trades against the approvals granted each month or quarter.
- Implement a process to address personal trading violations, including penalties for non-compliance.

8. KYC and suitability information

ICPMs 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). ICPMs 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 not collected for clients who bought non-prospectus qualified investment funds (i.e. pooled funds).
- KYC information was incomplete.

- KYC information was not updated periodically.
- KYC information was not formally documented.
- KYC forms were not signed or dated by clients.

Suggested practices

- Collect complete KYC information for all clients, including clients who buy non-prospectus qualified investment offerings (i.e. sold under prospectus exemptions).
- Update KYC information at least once a year.
- Ensure that clients sign the KYC information 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.

9. Portfolio management

This includes managing the investment portfolio of clients through discretionary authority granted by the client. It also includes advisory agreements governing the 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 of the parties, clients' investment objectives and restrictions, the timing and billing of fees, the degree of discretion in managing client assets and terms for ending the agreement.

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

During our reviews, we observed the following:

- There were no advisory agreements with clients.
- Advisory agreements were not signed by clients.
- Clauses in agreements contradicted the advisor's fiduciary duty to the client.
- The client's investment objectives and restrictions were not documented.
- Portfolio holdings were inconsistent with the stated investment restrictions.
- Advisory fee schedules were not included in the advisory agreements.
- The timing and method of billing was not included in the agreement.
- Responsibility for voting client proxies was not addressed.
- Responsibility for insider reporting or early warning reporting on the client's behalf was not addressed.
- Client's written consent to charge fees based on performance was not obtained.
- Management fees were paid to parties other than the ICPM.
- 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 ICPMs 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.
- Ensure that management fees are paid directly to the registered ICPMs.

10. Registration issues

ICPMs are responsible for ensuring that they maintain appropriate registration for the activities conducted. 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.

ICPMs are required to notify the OSC of any change in the status of directors and/or officers within five business days. An ICPM is 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 sets out the requirements for changes to registered firm and individual information.

Trade names can be used when conducting registerable activity if the ICPM has previously notified the OSC.

During our reviews, we observed the following:

- Affiliated entities of the ICPMs were performing advisory activities that they were not registered for.
- Officers and/or directors were not registered with the OSC.
- Portfolio managers, representatives and compliance officers were not registered with the OSC.
- Individuals acting as advisers did not have the required proficiency.
- The OSC was not notified of changes in registration.
- Notices were filed late with the OSC.
- Trade names or parent company names were used in signage, correspondence, business cards and marketing materials without notifying the OSC.
- Branch office locations of ICPMs were not registered with the OSC.

Suggested practices

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

3. Significant ICPM deficiencies

We made several enhancements to our deficiency reports to help ICPMs understand the key issues that they need to focus on. One of the major changes was identifying significant deficiencies in reports issued after April 1, 2005 (fiscal 2006).

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

In addition to these criteria, we take into account other factors, including:

- current issues such as best execution and referral arrangements
- frequency of findings
- impact of the deficiency on a market participant's operations

The process of identifying significant deficiencies was not in place during fiscal 2005. To allow a comparison between common deficiencies and significant deficiencies for the two-year period, we applied the above criteria to deficiency reports issued in fiscal 2005.

The average field review of ICPMs in fiscal years 2005 and 2006 resulted in 14 deficiencies. Five or 35% of these deficiencies were identified as significant. For suggested practices, please refer to section 2 of the report.

We only showed the top three significant deficiencies as the percentages were relatively higher than other deficiencies category. Please also note that the top three significant deficiencies are not the same as the top three common deficiencies. As mentioned above, we applied various criteria and professional judgment when determining whether a deficiency should be identified as significant.

1. Marketing

ICPMs tended to be more aggressive in their marketing materials and presented performance returns that could not be substantiated. Also, they did not have a formal process in place to review their marketing materials and websites. Examples included:

(a) Incorrect construction of performance composites. Performance composites presented to clients were incorrectly constructed. For example, not all clients with the same investment strategy were included in the composite or some clients were included in the wrong composite.

(b) Inappropriate use of benchmarks. Some ICPMs compared the return of their funds or accounts to benchmarks that were inappropriate and misleading to clients. For example, they used the S&P 500 and NASDAQ 100 to compare the performance of an investment fund that only holds Canadian equities which is considered misleading.

(c) Combining performance returns of other funds. Some ICPMs combined the performance returns of an investment fund with another fund with similar investment strategy without disclosing this to investors. In particular, the performance returns for a new fund were combined with the actual performance of another similar fund. This may mislead an investor to believe that the returns of the other fund were the actual returns of the new fund.

2. Personal trading

We also identified significant deficiencies in the area of personal trading. Examples included:

- (a) No policies and procedures on personal trading and no designated officer responsible for monitoring the personal trades of access persons.
- (b) Not enforcing policies and procedures on personal trading to ensure compliance with securities law. In some instances, we identified the following practices that were not allowed under the ICPM's policies and procedures:
 - Access persons traded in a security on the same day as their clients and received a better price.
 - Access persons' trades were not cleared first by the compliance officer.
 - The compliance officer did not review the monthly brokerage statements and reconcile the access persons' trades to the pre-clearance forms.

3. KYC and suitability information

We also identified significant deficiencies in the area of KYC and suitability information. Examples included:

- (a) Not collecting and documenting sufficient KYC and suitability information from their clients, for example, investment objectives, risk tolerance and time horizon. This issue was also noted in ICPMs who were registered as limited market dealers. Without this information, ICPMs cannot assess the suitability of proposed trades for their clients. Since the ICPMs did not collect and document sufficient KYC information, we were unable to determine whether the managed portfolios were suitable for clients.
- (b) KYC information was not updated to reflect changes in clients' investment objectives, risk tolerance and financial condition.

New trend - Back-tested performance data. Although we did not identify the use of back-tested performance data in ICPM reviews in 2005 and 2006, we have seen an increasing use of back-tested performance data during our recent reviews of ICPMs, fund managers and limited market dealers.

Back-tested performance data is simulated historical trading performance that does not represent actual results. It has been used in prospectuses, offering documents and marketing materials. It is typically presented as actual results of the fund or the investment strategy. We have seen inadequate disclosure of the methodology used in preparing this performance data, transaction fees and issues relating to any slippage that occurred during trading. In some cases, simulated performance returns combined with actual returns were presented to investors. As well, no standard periods were used for presenting back-tested performance returns. Therefore, there may be a tendency to present back-tested performance returns only during the best performing periods.

Our response

One of the reasons for tracking and analyzing the common and significant deficiencies of ICPMs is to highlight the areas that are of regulatory concern so that we can take appropriate action to improve compliance.

Based on our analysis, marketing is one of the key areas with a growing number of deficiencies in the past two years. To address this issue, we will be conducting a sweep in the marketing area during fiscal 2007.

The sweep will focus on key areas such as composite construction, review of marketing materials, performance returns, use of benchmarks and back-tested performance data. We will share the results of the sweep in a separate report/staff notice or in our next report. We will continue to focus on areas such as personal trading, KYC and suitability information in our regular compliance reviews.

4. Addressing the deficiencies

At the end of each review, we issue a deficiency report identifying areas of non-compliance with securities law. However, there are situations where a report alone may not be adequate to address the deficiencies.

Depending on the severity of issues identified, we may use one or more of the following regulatory tools:

- closely monitor the market participant
- hold an examination of the registrant under Section 31
- impose terms and conditions on registration
- refer the matter to Enforcement for further follow up and appropriate action

We expect that the use of appropriate regulatory tools will enhance compliance and foster an effective regulatory regime.

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