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COMPLIANCE PROCESS…THE MISSING LINK

"Everyone thinks they have a plan until they get punched in the mouth."
Mike Tyson

The application and ongoing refinement of methodology and process are the key to success in many fields including, professional sports, motor vehicle design, software development and, investment management.

However one of the areas where an organized approach is often lacking is in management of compliance for small and mid-size Exempt Market Dealers and other securities registrants.

The Seeds of Confusion

In 1989 the Ontario Securities Commission, introduced a "closed system" of registration, which meant that any firm in the business of trading securities had to be registered. The Exempt Market Dealer ("EMD") registration was established as a category for firms that only traded in exempt securities or exempt transactions. At the time the Commission's objective was simply to have jurisdiction over such firms in the event of an investigation or, if needed, to issue cease and desist orders.

However, as many operating businesses started to adopt the EMD license an expectation that such firms would have a formal compliance structure began to develop.

With the introduction of the EMD requirement across Canada, on September 28, 2009, many of these expectations became formalized under National Instrument 31-103. Over time these expectations have been refined and/or clarified through amendments to the National Instrument, its Companion Policy and through various other published guidance.

For many industry participants (especially those operating in business a long time) this trend appears as regulatory overreach and as adding unnecessary costs to the business.

In an attempt to deal with this hornet's nest of compliance confusion, firms have sought refuge in seminars, lawyers, consultants and other sources of technical information. Some have even chosen to seek registration in a stricter IIROC category (the equivalent of crawling into the hornets nest itself, on the basis that there is no difference being stung by a few hornets versus being stung by all of them).

Unfortunately what has never been explained is that the first and most important regulatory requirement of a member firm is to have an organized process for managing compliance.

When a new regulatory requirement or expectation is adopted, the Commission is effectively saying, "Please adjust your processes to take care of this new thing." While many industry participants often hear, "Here as some more rules and regulations that will take up a lot of your time and money and, possibly drive you out of the business."

What is a Compliance Structure?

A well-organized compliance structure is a series of processes that are integrated into the business, and that do not require management's ongoing direction. It should include:

- Tasks lists that can be diarized;
- Forms and logs;
- Guidance to staff on specific matters that must be brought to management's attention;
- Record keeping protocol to document significant and supervisory matters and client communications;
- A database and appropriate software to organize client and transaction information;
- Periodic independent reviews and checks; and
- Formal training for all affected parties.

A compliance manual and some forms to be completed by clients are not a compliance structure.

Client Reporting

To illustrate the importance of process, I'll review how the client reporting mandates set under National Instrument 31-103 assume certain processes.

These reporting requirements are intended to provide clients with greater disclosure so they can make better investment decisions. To understand the intention behind these series of rules, one has to visualize six different stages of the client account process.

Step 1: A client walks into firm's office, enquires about the firm's offering and decides to open a client account. Matters that the client should be aware of at the time of account opening are set out under section 14.2 of National Instrument 31-103. To address this requirement the firm is expected to have an organized "client fulfillment process" that includes the delivery and appropriate explanation of account opening materials (including a disclosure document that has been

previously reviewed and approved by management) and, a process for documenting the client's receipt/understanding of what they have been given.

Step 2: Though most clients will only open an account when they are ready to purchase, let's assume that this is done in two stages. When the client calls to make a purchase transaction section 14.2.1 sets out further disclosures that the client must receive regarding the costs and charges relating to the purchase (so they can make an informed decision at that time.). This assumes that the firm has a formal order acceptance process. This could include; providing Dealing Representatives with a script or checklist of matters to consider/discuss prior to accepting an order, a review/ follow up discussion by supervising staff, etc.

Step 3: The trade is settled and a confirmation along with other materials are sent to the client. Section 14.12 sets out requirements of what should be included in the trade confirmation sent to the client. This assumes the firm has a database for recording purchases and settlements, software to generate the trade confirmations and a process for post trade delivery of such information to the client.

Step 4: At quarter end, month end (if a reportable transaction occurred during the month) or, more frequently if requested by the client, a statement of activity during the period must be sent to the client. Starting July 15, 2015 the National Instrument clarifies that if the EMD has possession of the client's securities or any of the conditions under 14.14(7) or 14.14.1(1) apply, the statement (or a supplemental statement) must show the market value of settled security positions. Starting July 15, 2015, the statement must also show the cost of securities held in the account, as defined under 14.14.2(2). This assumes that the firms that must report positions on the client account statement have a database where such positions are recorded and a process for calculating their market values periodically.

Step 5: Section 14.17, describes a report on compensation earned by the firm and certain charges to the client, that must be provided annually to each client starting July 15, 2016. This assumes that the firm has an organized database of commissions and charges from which to generate the report.

Step 6: Section 14.18, describes a performance report that must be provided annually to clients, starting July 15, 2016, if the firm has to report settled positions under Step 4 above. This further assumes that the firm has a properly organized database of prior purchases and settlements and, a process for updating the market values of settled positions along with appropriate software.

My intention is not to minimize the work involved in meeting the above requirements. However, for a firm that has an organized account/ order acceptance protocol and a database of purchase and redemption activity, the client reporting

requirements are largely an exercise in database management, report generation and training.

EMDs and other securities registrants who fail to establish and maintain organized compliance processes are gambling that securities regulation, and their obligations will stay steady. Firms that have organized compliance processes know they never will.