

ALBERTA SECURITIES COMMISSION  
2003 Oversight Audit of the  
Investment Dealers Association of Canada  
Prairie Regional Office

## **EXECUTIVE SUMMARY**

Between October 20, 2003 and November 4, 2003, Alberta Securities Commission (“ASC”) Staff conducted an oversight audit of Sales Compliance, Financial Compliance, Membership and Registration Departments of the Prairie Regional Office of the Investment Dealers Association (“IDA”). This audit was organized and coordinated with other members of the Canadian Securities Administrators (“CSA”). The ASC last audited these departments in October 2000. At that time, ASC Staff noted several areas that required significant improvement in order to ensure effective regulation of IDA members. These audit findings were documented in ASC Staff’s report dated January 22, 2001 (“2001 Report”).

Between October 20, 2003 and December 4, 2003, ASC Staff conducted an oversight examination of the Enforcement Department of the Prairie Regional Office of the IDA. This audit was organized and coordinated with other members of the CSA. While other CSA members audited a 3 year period, the audit undertaken by ASC Staff was a follow up to one conducted between May and June 2002. The 2002 audit mainly focused on examining the significant changes that had recently been made to policies and procedures, reporting structures and systems since the 2001 Report. The 2003 audit checked that these new policies, procedures and changes were implemented and operating effectively.

### **Sales Compliance Department**

Overall, ASC Staff were satisfied with the operations of the Sales Compliance Department (“SC Department”). Sales compliance examinations were detailed and complete. Staff of the SC Department were knowledgeable, well trained and helpful during the oversight examination. In addition, the SC Department’s sales compliance manual is an excellent resource for IDA Staff.

In the previous audit, ASC staff noted concerns with the staffing level of the SC Department. These concerns have been addressed by dedicating a full-time manager to the SC Department’s activities. Further, the IDA added an additional full-time sales compliance officer to the SC Department. These actions have ensured a professional and well-staffed department.

In the previous audit, ASC Staff also noted that sales compliance examinations did not contain detailed documentation of examination procedures. This issue was addressed by the SC Department and all examinations reviewed by ASC Staff appeared thorough and well-documented, except as to determination of sample sizes and methods of sample selection.

ASC Staff continue to have concerns regarding a number of issues. The most significant outstanding issue is the timely issuance of examination letters. ASC Staff believe that the current benchmarks for completion of examination letters are too generous. Further, the SC Department did not meet these benchmarks in 2001 or 2002.

In addition, ASC Staff are concerned that the limited detail provided in Member's responses to IDA examination letters has resulted in Members not addressing the deficiencies in a complete and/or timely manner. Additional detail in Member responses would enable the SC Department to ensure the Member has resolved the deficiencies.

### **Financial Compliance Department**

Overall, ASC Staff were satisfied with the operations of the Financial Compliance Department ("FC Department"). ASC Staff were impressed by the knowledge and assistance provided by staff of the FC Department. Financial examinations were detailed, complete and well-documented, except as to determination of sample sizes and methods of sample selection.

In the previous audit, ASC Staff noted concerns with the qualifications of Chief Financial Officers ("CFO") at Members. The IDA addressed this issue by implementing new requirements for a Member's CFO to complete an examination administered by the Canadian Securities Institute. ASC Staff believe that this is a positive action on the part of the IDA.

However, ASC Staff have noted areas which require improvement. Most significantly, ASC Staff are concerned that limited detail provided in Member's responses to IDA examination letters has resulted in Members not addressing the deficiencies in a complete and/or timely manner. Additional detail in Member responses would enable the FC Department to ensure the Member has resolved the deficiencies.

### **Registration Department**

Overall, ASC Staff were satisfied with the operations of the Registration Department. Registrations are generally being performed in accordance with

policies and procedures, exemptions are documented and deficiencies are dealt with appropriately.

In the previous audit, concerns were noted with regard to the IDA's ability to retain skilled registration officers. This appears to have been dealt with appropriately and the staffing level is no longer a concern.

ASC Staff continue to have concerns with the review procedures of staff. In the 2001 Report, ASC Staff commented that the Registration Department was functioning without an adequate level of review procedures. Our assessment is that this is still a concern. There was no evidence of Registration Manager review of the registration officers' work since the launch of the National Registration Database. ASC Staff recognize that applications where the individual does not meet prescribed requirements are sent to District Council for approval. These are first reviewed by the Registration Manager and then the Vice-President, Member Regulation. However, only reviewing applications where staff have identified a risk or problem is not sufficient because it will not identify risks and problems overlooked by the registration officers. Examples of overlooked matters were noted during the testing of new applications. Therefore, the lack of review of the registration officers' work continues to be an issue.

### **Membership Process**

Overall, ASC Staff were satisfied with the IDA's handling of membership applications. Applications are reviewed on a timely basis and the IDA's decision to grant or deny membership appears fair and properly supported by the work performed.

In the 2000 audit, ASC Staff noted that the membership files lacked documentation with regard to additional work performed, issue resolution, and senior level review. From ASC Staff's review of the membership files in the 2003 audit, this issue has been addressed. The files contained appropriate documentation to support the IDA's recommendation and contained evidence of senior level review.

### **Enforcement**

Overall, ASC Staff were satisfied with the operations of the Enforcement Department. In previous audits conducted by the ASC it was observed that the Enforcement Department experienced some difficulty in attracting and retaining an adequate number of experienced Enforcement Counsel and investigators. The IDA addressed this issue and increased Staff positions and salaries to attract and retain professional staff. Training was also previously identified as an issue.

Again the IDA is addressing these concerns by the creation of training programs and the identification of courses for its employees to attend. The Department now has a full complement of proficient professional staff who appear committed to performing their various duties in a timely manner.

Since the last review, the Enforcement Department has completed the creation and implementation of Policies and Procedures Manuals that are detailed and comprehensive. The manuals give guidance to Staff of the Central Complaints Bureau, Investigations and Enforcement. Staff observed an improvement in the quality of the investigations and prosecutions and in overall file management. The IDA now conducts Quality Assurance Reviews of the regional offices to ensure the Enforcement Department operates in keeping with its manuals and key performance indicators (“KPIs”).

During the past year, the Enforcement Department was complimented by John James, a former Alberta Provincial Court Judge who was the public member and chair of the Hearing Panel, for its diligence, professionalism and thoroughness in the investigation and enforcement action against of Zona Armstrong.

To achieve its stated mission to protect investors, the IDA has instituted ComSet (Complaints and Settlement Reporting System). The IDA requires its members to report all client complaints and disciplinary matters as well as other actions. Staff observed that ComSet is working and were informed that with collection of more data, issues and trends will be identified. Staff expects that this information has the potential to greatly assist the IDA in its regulatory function.

The IDA has implemented KPIs for each area within the Enforcement Department. At the time of the audit, the Department was meeting its KPIs, completing cases in an efficient manner, and current with its caseload.

## **SALES COMPLIANCE DEPARTMENT**

### **1.0 PURPOSE AND SCOPE**

ASC Staff's purpose in conducting the 2003 audit was to evaluate the effectiveness of the SC Department by reviewing the adequacy and quality of work performed by the SC Department from October 1, 2000 to September 30, 2003. ASC Staff also assessed the SC Department's structure, staffing, budget, and business plan.

ASC Registration Examiners performed the audit which included:

- Review of the SC Department's implementation of their agreed upon actions to resolve the issues noted in the 2001 Report
- Review of the SC Department's Policy and Procedure Manual
- Interviews with IDA Staff
- Review of a sample of the SC Department's examination files

### **1.1 REVIEW OF FINDINGS IN THE 2001 REPORT**

#### **1.1.1 Quality of the Reviews**

##### **1.1.1.1 Completion of Review Program**

###### **Previous Audit Finding**

ASC Staff noted that often review programs were completed with yes or no answers. It is not sufficient simply to ask the questions and note yes or no answers on file, as this may indicate that either the compliance officer did not ask enough questions to address the issue in appropriate detail, or the work done was not documented properly. Similarly, program steps were often signed off with no exceptions noted. This response did not give the Sales Compliance Department Manager ("SC Manager") sufficient information to assess whether the appropriate review procedures were completed, or whether the results of the procedures were assessed properly.

###### **IDA Resolution**

The IDA replied that the SC Department would ensure that documentation of the steps performed and the results found are included in the "Physical Review" section of all sales compliance modules completed during an examination.

## **2003 Assessment**

The review programs completed between October 1, 2000 and September 30, 2003 indicate that this finding has been addressed by the SC Department. Examination files contained detailed information and documentation has been improved.

### **1.1.1.2 Verification of Controls Over Suitability**

#### **Previous Audit Finding**

Based on the review of investigation reports, one of the most common investor complaints was unsuitable investments. This should have been an area of focus in all sales compliance examinations. However, from a review of examination files this did not appear to be the case.

#### **IDA Resolution**

The IDA replied that suitability issues identified during their examinations had been one of two types. The first type involved investments that were unsuitable for a particular client. The second type involved a failure to update documents to reflect a change in a client's circumstances. The IDA explained that while the first type was more serious, the second type could also be dangerous, as it could breed complacency and lead to the first type.

The IDA ensured that in these situations their SC Department would stress to the Member the importance of keeping client suitability information current. They further emphasized that their SC Department considered suitability to be a cornerstone of regulation at the IDA and committed to ensuring that Members view suitability problems as a serious issue.

## **2003 Assessment**

ASC Staff continue to have concerns over the identification of unsuitable investments. Review of two examination files indicated that IDA Staff are identifying suitability issues during file review. However, IDA Staff are only asking the Member to correct the deficiencies identified during file review; they do not require the Member to review the entire population and resolve the deficiency throughout the population. Further, IDA Staff did not ask the Member to implement policies and procedures to ensure investment

suitability is properly documented and reviewed in the future. IDA Staff did not appear to identify suitability deficiencies as symptomatic of control and supervision problems, which may also suggest that IDA staff do not understand the nature and implications of audit sampling.

### **Recommendation**

ASC Staff believe IDA Staff should provide further documentation on resolution of suitability concerns noted. IDA Staff must be able to conclude, with documentation, that suitability problems they identify in their audits are unrepresentative for the Member. Otherwise, they should require the Member to implement supervision and control procedures to ensure that suitability is properly reviewed.

#### **1.1.1.3 Deferring Responsibility to Head Office**

##### **Previous Audit Finding**

ASC Staff noted that in several instances when branch managers were questioned about controls and procedures, the Member replied that the particular issue or procedure was the responsibility of the Member's head office (such as the review of daily and monthly exception reports). The IDA Staff accepted this as a sufficient answer, and no corroborating procedures were completed to ensure the validity of this response. However, ASC Staff felt it was possible that the branch believed a procedure was completed by head office, but head office believed the branch completed the procedure. This would result in an unidentified gap in controls.

As a result, ASC staff recommended that any indications by the branch of head office conducting a control procedure should be verified through discussions with the responsible individuals at the Member's head office, or through discussions with the IDA office responsible for the head office examination of the Member.

##### **IDA Resolution**

The SC Department changed procedures to ensure that corroborating evidence would be obtained for all areas identified as the responsibility of the Member's head office during the completion of branch office reviews.

## **2003 Assessment**

Through evaluation of the examination programs completed in the review period, this finding appears to have been addressed by the SC Department.

### **1.1.2 Timely Completion of Sales Reviews**

#### **Previous Audit Finding**

As of the date of the previous examination the SC Department had completed the field work on 10 examinations since February 2000 and had issued 4 deficiency reports. The SC Department's goal was to complete head office reviews of the 17 Member firms in their jurisdiction in one year. While it seemed likely that all field reviews would be completed, it seemed unlikely that all 17 deficiency reports would be issued.

Further examination showed that the 4 deficiency reports issued in 2000 were issued on average 154 days (5 months) after the completion of the field work. IDA Staff had indicated that in 2001 their goal was to issue all draft reports within 60 days.

ASC Staff believed that 154 days to issue a draft report was excessive. This resulted in an unacceptable period of time before Members addressed some of the issues raised, reduced the effectiveness of the review, and gave the impression of an inefficient regulatory body.

ASC Staff suggested that IDA Staff should be able to issue a draft report within 35 calendar days following the completion of field work. This allowed two weeks for the examiner to prepare the report, two weeks for Manager review and revisions, and one week for senior level review.

#### **IDA Resolution**

The SC Department initially agreed to issue examination reports within six weeks of completion of field work or to document the reasons for issuing the report after the six week benchmark. However, subsequent to this agreement, the IDA proposed to the Canadian Securities Administrators to use a benchmark of issuing 60% of examination letters within 15 weeks of completion of fieldwork and all letters issued within 6 months.



## 2003 Assessment

ASC Staff reviewed the period of time between completion of fieldwork and issuance of the final report to the Member. As shown in the following table, the SC Department is not meeting the IDA's own benchmark.

	2001	2002	2003 (to date)
Average Number of Weeks to Issue a Report to Members	21 weeks	25 weeks	16 weeks
% of Final Reports Issued within 15 weeks	33%	4%	56%

ASC Staff are also concerned that the current benchmark is an overly generous timeline for completion of an examination report particularly since the IDA only requires the SC Department to meet this deadline for 60% of examinations.

## Recommendation

ASC Staff believe the IDA should document the following:

1. Actions of the SC Department to address their failure to meet the national benchmark in 2001 and 2002.
2. An update on the status of the SC Department's ability to meet the benchmark in 2003.
3. A summary of the specific components of the examination letter preparation process that requires 15 weeks to complete.
4. The circumstances in which the SC Department would not meet the 15 week deadline.

### 1.1.3 Response Follow-up

#### Previous Audit Finding

The ASC audit revealed that there was no follow up on four examination responses received from Members. Staff noted the risk that without proper follow-up, Members would fail to adequately address the issues raised in the initial examination report and these deficiencies would continue. Also, failure by IDA Staff to follow up noted deficiencies may diminish the significance of the entire examination process in the eyes of Members and their staff. ASC Staff believed that, given the resources that go into

performing the examination and writing the report, the review of the Member's response should be done diligently, and the follow up letters should be reviewed by the SC Manager.

### **IDA Resolution**

IDA Staff acknowledged the delay in issuing follow-up letters and said they would implement procedures to ensure all Member response letters were followed up within two to four weeks after receipt. The SC Department Manager agreed to review all responses to follow-up letters before they were issued to the Member.

### **2003 Assessment**

ASC Staff continue to have concerns regarding the follow-up of examination letter responses. In the review of examination files, ASC Staff noted that Member responses are generally brief, simply stating that the Member will resolve the issue. These responses do not contain the method of resolution or the time period for resolution. During the review of subsequent Member examination letters, ASC Staff noted that most examination letters identified one or more issues that remained unresolved from prior examinations. This indicates that additional information is required by IDA Staff to ensure the Member has addressed the issue in a timely manner.

### **Recommendation**

ASC Staff believe IDA Staff should require Member responses to document the manner in which an issue will be resolved, the time period for resolution and, if the issue is significant, evidence of resolution.

#### **1.1.4 Branch Office Reviews**

##### **Previous Audit Finding**

ASC Staff found that during 2000, the SC Department conducted two branch reviews, while they were responsible for approximately 128 branches in their region.

ASC Staff observed that past IDA self-assessments had noted that provincial securities commissions had been pushing for an increased number of branch reviews. According to the 1999 IDA Self Assessment, branch reviews are necessary to ensure that necessary controls at the

branches were functioning properly, and to ensure that head office controls over branch operations were actually operating.

ASC Staff recommended that the SC Manager should determine which branches are a priority to review based on a risk evaluation which could include:

- \$ previous head office or branch reviews;
- \$ complaints filed; and
- \$ investigations / enforcement action.

### **IDA Resolution**

The IDA was completing an assessment of all branch offices in Canada through a questionnaire that was sent to all Member firms that operated branch offices in January 2001. The results of the questionnaire were to be compiled at the Toronto office and a risk evaluation completed. The SC Department would then conduct reviews of the branches located in the Prairies with the “highest risk scores” beginning in the second quarter of 2001.

### **2003 Assessment**

The SC Department has addressed this issue through an increase in the number of branch office reviews. There were 8 branch office reviews completed in 2001, 10 in 2002 and 12 in 2003. The SC Manager also stated that the new risk based approach for completion of head office examinations may allow more time for IDA Staff to complete branch office reviews.

Additionally, new Member regulation requires Members to complete branch reviews of all their branches on a regular and timely basis. According to the SC Manager, IDA Staff assess the Member’s generic branch review program and the branch review schedule during head office examinations. ASC Staff believe that appraisal of a sample of branch reviews is required to address the ASC’s concerns.

### **Recommendation**

In order to increase review coverage of the branch offices, ASC Staff believe that the SC Department should, as part of its head office examinations, expand review of the Member’s branch office review program. Increased review should include review of a sample of the Member’s branch reviews.

### **1.1.5 Sub-branch Office Reviews**

#### **Previous Audit Finding**

ASC Staff noted that the Prairie Regional Office conducted 11 sub-branch reviews during 2001, while the office was responsible for approximately 194 sub-branches in Alberta, as well as those in Saskatchewan and Manitoba.

While ASC Staff felt that the number of sub-branch reviews should be increased, a larger issue was the quality of the review program and consequently of the review itself. The review program focused on issues of signage and a separately identifiable premises, while questions about controls over operations were few and limited. ASC Staff believed this program needed to be expanded to include issues such as the solicitation of clients, suitability of trades, supervision and visitation by a branch manager, and policies and procedures. Many of the branch review procedures were equally applicable to the sub-branches.

#### **IDA Resolution**

The IDA did not believe that it was a justifiable expenditure of resources to do extensive sub-branch reviews, as their experience had shown very few problems with sub-branches. They explained that their focus was on the systems and supervision in place and that the systems could be monitored effectively through branch and head office reviews.

Further, the IDA responded that their ability to detect a problematic sub-branch was enhanced by the proposed amendments to Policy 8 “Reporting Requirements”. The amendments would allow the IDA to detect when a branch or sub-branch had been subject to an abnormal number of complaints, and in such a case the IDA would send in a sales compliance team.

#### **2003 Assessment**

ASC Staff agree with the IDA’s assessment regarding examination of sub-branches. However, we believe that in reviewing supervision at the head office or branch location, it is important to perform interviews with individuals from the sub-branches. Although interviews with individuals at the head office and branch locations take place, it is the experience of ASC Staff that it is not adequate to meet only with the supervisors and not the supervised. Interviews with supervised registered representatives (“RR”)

allow the examiner to identify situations where expectations of the supervisor differ from those of the supervised.

### **Requirement**

ASC Staff believe the SC Department should implement RR interviews as part of the examination process.

#### **1.1.6 Risk Assessments**

##### **Previous Audit Finding**

Detailed file reviews conducted by ASC staff indicated that although the IDA completed a risk assessment before each examination, the conclusions drawn were sometimes inappropriate and the assessments were not being considered during the examination field work.

ASC Staff were advised that although the risk assessments were used in Toronto to determine how detailed an examination would be, the Prairie Regional Office completed examinations of all Members as though they were high risk because it was their first year conducting examinations. This led ASC Staff to believe that the impact of any incorrect risk assessments over the past year had not been a serious issue. Despite this, it was noted that in the next year it would become necessary to prioritize branch examinations and determine the extent of head office examinations that were to be completed. As a result, the importance of conducting accurate risk assessments and making full use of them was emphasized.

##### **IDA Resolution**

For 2001 examinations, IDA Staff were planning to implement a risk-based approach subject to approval by the Commissions and the CIPF (“Canadian Investor Protection Fund”), which would require detailed and accurate risk assessments to be completed for future examinations. As outlined, these assessments would involve both SC Manager review prior to the field examination, and review of the file by the SC Manager based on the conclusions reached. The IDA believed this would ensure greater care on completion and use of such risk assessments in the future.

##### **2003 Assessment**

The SC Department has increased the quality of the risk assessment process. Each examination reviewed by ASC Staff contained a detailed assessment of the Member’s risk. However, ASC Staff noted that while the

IDA Staff documented risks specific to the Member's operation, there was generally no documentation in the file regarding increased procedures to address areas of high risk.

### **Recommendation**

The IDA should implement procedures for identifying and increasing examination coverage of areas with high risk.

#### **1.1.7 Staffing**

##### **Previous Audit Finding**

ASC Staff found that the Prairie Regional Office of the IDA was responsible for sales compliance reviews of 17 head offices, 128 branch offices, and several hundred sub-branches. At the time of review, there was one manager supervising two compliance officers. This did not appear to be an adequate number of staff for the work involved.

##### **IDA Resolution**

The IDA added another sales compliance officer to address the problems experienced.

##### **2003 Assessment**

The current staffing level of one department manager and three sales compliance officers appears reasonable.

#### **1.1.8 RR's Operating in Provinces Where They are Not Registered**

##### **Previous Audit Finding**

ASC Staff noted that two of the IDA's compliance examinations identified Members that had accounts for individuals in jurisdictions where the Member was not registered. In both instances the deficiency letter included a reminder that the Member was violating securities laws in other provinces or in the United States.

ASC Staff found that Member responses to these reminders indicated that the Members felt they were not breaching the law either because they were not soliciting orders, or they were dealing with registered retirement saving plans or similar tax-advantaged accounts. ASC Staff pointed out that the Securities and Exchange Commission rules implemented in June 2000 are very complicated and could not be reduced to statements such as these. For

example, the rules only apply in certain states, and some states require a limited registration in order to qualify to deal with tax-advantaged accounts. In addition, there are no registration exemptions available in Canada in either of these situations, and trading with clients in a jurisdiction in which the salesperson was not registered is an offense under securities laws and should be treated by the IDA as such.

ASC Staff were concerned that failure to challenge Members' responses in this area would provide Members with false assurance that their interpretation was correct, i.e. that they were not violating any laws. This was inappropriate, but may indicate that IDA Staff do not understand securities laws.

ASC Staff also noted that the IDA had asked the Canadian securities commissions to take action against United States based dealers who had been accepting Canadian clients without being registered here. It appeared inconsistent for the IDA to accept these same violations from its own Members.

### **IDA Resolution**

The IDA responded that there was no rule relating to handling of "foreign" clients in IDA rules, or the rules of any Securities Commission. Accordingly, any action must be taken as "conduct unbecoming", rather than a specific rule violation. The IDA outlined that they had done so in one egregious case, but given the lack of similar actions by other regulatory bodies, they were reluctant to do so on a wide basis.

The IDA explained that if a Member was found to be dealing with clients in jurisdictions in which the Member was not registered, the examination letter would direct the Member to register in the relevant jurisdictions or immediately cease dealing with those clients. Enforcement action would be taken against Members continuing to deal with clients in jurisdictions where the Member was not registered.

### **2003 Assessment**

An IDA examination, which took place in 2002, identified that the Member was servicing clients in jurisdictions in which the Member was not registered. This issue was not raised directly in the examination letter due to the assurance from the Member that it was applying for registration. ASC Staff believe that due to the seriousness of this issue, IDA Staff should have included the finding in the examination letter and followed up with the Member to ensure the Member registered in the jurisdiction. IDA Staff

stated that the failure of Members to register is viewed as minor because securities commissions have not been taking enforcement action. ASC Staff disagree with this assessment of the importance of the issue. ASC Staff also note that the ASC has taken enforcement action in a number of cases where the dealer was not registered in Alberta.

### **Recommendation**

ASC Staff believe that significant violations of securities laws uncovered in an audit, such as trading in jurisdictions in which a Member or an employee of a Member is not registered, should be included in the examination letter. IDA Staff should also consider referring these cases to the securities commission for enforcement action.

## **1.2 NEW EXAMINATION FINDINGS**

### **1.2.1 Sample Size Selection and Documentation**

#### **Finding**

From a review of examination files, ASC Staff noted that IDA Staff do not document supporting evidence for the selection of sample size or the method of sample selection. ASC Staff were unable to determine if sample selection and size was representative because there was no documented information on population size or sample selection method.

#### **Recommendation**

Document of population size, determination of sample size, and the method of sample selection is necessary to have an adequately-documented audit. ASC Staff believe that these should be included in the IDA's audit files.

### **1.2.2 Identifying the Same Deficiency During a Subsequent Examination**

#### **Finding**

In four of the eight examination files reviewed by ASC Staff there was no evidence of IDA Staff review of previous examination deficiencies. Review by SC Department Staff would ensure that the Member had adequately addressed the previous finding. IDA Staff advised that although there was no documentation, review of the previous sales compliance report was completed on all examinations and included as part of the current risk assessment.



In one examination report, it was noted that two deficiencies were not identified as repeat deficiencies nor were they documented in the subsequent examination letter as a priority item. ASC Staff believe that deficiencies arising for the second time should be documented as a priority due to the Member's failure to address the issue after the previous examination. As noted above, failure by IDA Staff to follow up deficiencies from an audit may diminish the significance of the IDA's audits in the eyes of the Members and their staff.

### **Recommendation**

The SC Department should ensure that they are documenting their review of previous examinations. Deficiencies repeated from a previous Member examination should be clearly identified as such in the examination report.

## **FINANCIAL COMPLIANCE DEPARTMENT**

### **2.0 PURPOSE AND SCOPE**

ASC Staff's purpose in conducting the 2003 audit was to evaluate the effectiveness of the Financial Compliance Department ("FC Department") by reviewing the adequacy and quality of work performed by the FC Department from October 1, 2000 to September 30, 2003. ASC Staff also assessed the FC Department's structure, staffing, budget, and business plan.

ASC Registration Examiners performed the audit which included:

- Review of the FC Department's implementation of their agreed upon actions to resolve the issues noted in the 2001 Report
- Review of the FC Department's policy and procedure manual
- Interviews with IDA Staff
- Review of a sample of the FC Department's examination files

### **2.1 REVIEW OF FINDINGS IN THE 2001 REPORT**

#### **2.1.1 Timely Completion of Financial Reviews and Response Follow-up**

##### **2.1.1.1 CIPF Minimum Standards for the Completion of Field Examinations**

###### **Previous Audit Finding**

ASC Staff noted that the CIPF's Minimum Standards state that the IDA must complete at least one surprise field examination of each Member under its primary audit jurisdiction during the Member's fiscal year. However, it was not clear from the Minimum Standards whether this meant that the field work must be complete, or whether the examination letter must be issued to the Member. ASC Staff felt that the examination letter must be issued for the examination to be considered complete.

As of the date of that review the FC Department had completed the field work on 12 of 17 Members but had issued only 8 examination letters to Members. The IDA expected the field work for the remaining examinations to be completed in November and December.

## **IDA Resolution**

IDA Staff responded that CIPF issued a Quarterly Report stating that examinations must be substantially complete to meet their minimum standards. “Substantially complete” was defined as “sufficient examination work has been carried out so that if there were a capital, operating or compliance problem, it would be detected.”

Further, the IDA stated that they met the CIPF minimum standards in this area, with the exception of one Member whose particular situation did not allow for completion of an examination in the required time period. CIPF was advised of this situation. The IDA undertook a subsequent examination of this Member.

## **2003 Assessment**

The FC Department is meeting CIPF’s Minimum Standards.

### **2.1.1.2 Timely Issuance of Field Examination Reports**

#### **Previous Audit Finding**

The period from the date the examination field work was completed, to the date when the draft examination report was sent to the Member ranged from 60 days to 87 days, with an average of 75 days. IDA Staff indicated that for 2001 their goal was to issue all draft reports within 60 days.

ASC Staff believed that an average of 75 days to issue a draft report resulted in an excessive period of time before Members addressed some of the issues raised, reduced the effectiveness of the review, and gave the impression of an inefficient regulatory body.

ASC Staff outlined their belief that IDA Staff should be able to issue a draft report within 35 calendar days following the completion of field work. This would allow two weeks for the examiner to prepare the report, two weeks for the Manager to review and revise, and one week for the Vice President to review the report.

## **IDA Resolution**

The FC Department initially responded that beginning in 2001, Financial Compliance had developed measurements for the

completion of examinations that will be incorporated in the performance evaluation of IDA Staff. These were:

- Type B firms (largest firms) – 6 to 8 weeks.
- All other firms – 4 to 6 weeks.

However, the IDA sent a letter to the ASC on January 29, 2003 advising that they could not meet the above benchmarks while maintaining quality of file review and work priority. The revised benchmark is to issue 60% of examination letters within 8 weeks of completion of fieldwork and all letters within 6 months of completion of fieldwork.

### **2003 Assessment**

Staff of the ASC reviewed the period of time between completion of fieldwork and issuance of the final report to the Member. As shown in the following table, the FC Department met the national benchmark in 2002, and in 2003 up to the date of the review.

	<b>2001</b>	<b>2002</b>	<b>2003 (to date)</b>
Average Number of Weeks to Issue a Report to Member	9 weeks	9 weeks	7 weeks
% of Final Reports Issued within 8 weeks	52%	67%	92%

ASC Staff are concerned by the current benchmark. Eight weeks is a generous timeline for completion of an examination report particularly since the IDA only requires the FC Department to meet this deadline for 60% of examinations.

### **Recommendation**

ASC Staff believe the IDA should document the following:

1. An update on the status of the FC Department's ability to meet the benchmark in 2003.
2. Outline the circumstances in which the FC Department would not meet the eight week deadline.

### **2.1.1.3 Timely follow up of Examination Responses**

#### **Previous Audit Finding**

The ASC's audit showed that there had been a failure to follow up on examination responses received from Members. There was a risk that without proper follow-up, Members were failing to address the issues raised in the initial examination report. This reduced the effectiveness of the examination as a whole.

#### **IDA Resolution**

The IDA stated that their policy was to require a response to an examination in 30 days, and to have responses evaluated within five days. Further follow-up was to be determined at that time. The IDA noted that they would only issue responses to Member's examination letters if issues remained outstanding or the point was not adequately addressed.

#### **2003 Assessment**

According to a conversation with the Financial Compliance Department Manager ("FC Manager"), second response letters are only sent to Members in rare circumstances. ASC Staff believe that the issuance of second response letters is required in many circumstances to ensure that the Member is addressing the deficiency in an adequate and timely manner. ASC Staff's findings indicate that IDA Staff should be sending out more second response letters. ASC Staff reviewed five examinations which identified deficiencies that had not been appropriately resolved from prior examinations. One of the Members had provided a response to the IDA that was considered by ASC Staff to be very brief. The Member advised the IDA that they would comply with the IDA's requirements but did not state how they intended to comply or when they would implement the changes. Given that previous examinations revealed that the Member had not adequately addressed a number of findings, ASC Staff believe that detailed information should be required from the Member to ensure resolution of the issues.

During ASC Staff's exit interview with the FC Manager, the manager stated that a number of second response letters had been issued to Members in the past four months.

## **Recommendation**

The IDA should develop a policy about when to issue second response letters to ensure that such letters are issued in all appropriate circumstances.

### **2.1.1.4 Timely Issuance of Audit Working Paper Review Letters**

#### **Previous Audit Finding**

ASC Staff noted that the CIPF's Minimum Standards require the IDA to review the auditor's working papers within six months of the filing date of the audited Joint Regulatory Financial Questionnaire and Report ("JRFQR"). ASC Staff believed that this review should not be considered complete until the comment letter was sent out.

The audit found that the FC Department had completed the field work associated with these examinations, but not all comment letters had been sent within six months.

#### **IDA Resolution**

The IDA acknowledged the delay in sending final letters to the auditors regarding review of the auditor's working papers. They explained that it was mainly due to a lack of resources and a focus on completing examinations and training new examiners during this period. The IDA intended to issue all final letters within 6 months of the due date of the JRFQR for all future filings and did not expect any problems meeting this goal.

#### **2003 Assessment**

ASC Staff noted three audit working paper reviews for which the examination letter was not completed within six months of the filing date. These reviews took place in 2001 and 2002.

The FC Manager also stated that the IDA has recently implemented a three-month benchmark for review of high risk company's JRFQR. This appears to adequately address the problem.

### **2.1.1.5 Timely Follow-up on Audit Working Paper Review Responses**

#### **Previous Audit Finding**

ASC Staff noted that an approved panel auditor performed five Member audits but failed to respond to the IDA's audit working paper review letters. ASC Staff believed that failure to require a timely response to these letters meant issues were not being addressed for an extended period of time and that deficiencies in a Member audit might occur again in other Member audits. Failure to require a timely response was also believed to undermine the authority of the IDA as a regulatory organization.

#### **IDA Resolution**

The IDA responded that as of the ASC's review date there were three outstanding response letters from a panel auditor. IDA Staff indicated that they had subsequently received a response to the three outstanding letters, and they would not permit a reoccurrence of this situation.

#### **2003 Assessment**

The FC Department has adequately addressed this issue.

### **2.1.2 Panel Auditors**

#### **Previous Audit Finding**

ASC Staff understood that the requirement that Member firms use panel auditors was to ensure that the auditing firm and engagement partner had sufficient experience in the securities industry.

ASC Staff also understood that completion of the Canadian Institute of Chartered Accountants ("CICA") In-Depth Broker Course was required for acceptance as a panel auditor. However, a letter dated November 3, 2000 from the IDA to a partner at a panel auditor included the following comment: "Non-Attendance of the CICA In-Depth Broker Course by Engagement Partner - In two previous letters dated December 23, 1998 and October 22, 1999 you stated that you will attend this required course. However, in your most recent letter dated December 24, 1999, you disclosed that you had not done so. Please confirm your attendance in the

course. Failing that, you are hereby given notice that your status as a panel auditor is now being questioned.” ASC Staff asked, “Is it typical to give a Panel Audit Partner three chances to meet the stated requirements?”

ASC Staff reviewed the results of various audit working paper reviews, and the comment letters sent to the panel auditors. Although it was not specifically noted as an issue, ASC Staff wanted to understand what the IDA’s procedures would be if a particular panel auditor was repeatedly or seriously deficient in their work.

### **IDA Resolution**

The IDA outlined the procedures for approving a new panel auditor, which were as follows:

- A request for approval as a panel auditor should be submitted to the IDA through a Member.
- The auditor must be qualified with a minimum of five years experience, of which part must have been in brokerage industry audit. If the proposed auditor does not have the required brokerage industry audit experience the IDA will consider a “mentoring” arrangement with another panel auditor until the experience is gained.
- The audit partner’s curriculum vitae must be submitted as evidence of the required qualifications and experience.
- The proposed auditor must submit proposed audit procedures that are tailored to the brokerage industry for review.
- The auditor must attend the CICA In-Depth Securities Course.

The IDA explained that performance is monitored through an annual review of the auditor’s working paper files. Further, in the event of a poor audit, after warning, IDA Staff would discuss the problem with the auditor. IDA Staff believe that this generally results in improved performance or resignation by the auditor. In extreme cases, IDA Staff would request that the District Council remove the auditor from the approved list of panel auditors.

The IDA planned to follow-up to ensure the panel auditor took the CICA In-Depth Securities Course that year.

### **2003 Assessment**

ASC Staff did not note any concerns relating to this issue in our 2003 audit.



### **2.1.3 Qualified Chief Financial Officers at Member Firms**

#### **Previous Audit Finding**

ASC Staff noted that finding a qualified CFO appeared to be a challenge for many IDA Member firms. Although having a CFO with securities industry experience was not a registration requirement, the individual's qualifications were assessed as part of the Financial Compliance review of new Members. ASC Staff found that in several situations the solution was to have the panel auditing firm assist the Member firm.

It was found that one Member engaged its panel auditor to perform its bookkeeping and file its Monthly Financial Reports with the IDA. CIPF expressed a concern about the panel auditor doing both the bookkeeping and the audit of the Member, and ASC Staff shared this concern.

#### **IDA Resolution**

The IDA responded that the FC Department would ensure all new Members had qualified accountants on staff who were capable of preparing financial filings, subject to review (not preparation) by their carrying broker or an approved panel audit firm while they gained the appropriate industry experience. Further, it was detailed that the FC Department would only accept contracting out the responsibilities of a CFO as an interim measure and only where the contractor was receiving regular reports of the company's financial position and both the contractor and the Member's management were aware of capital issues on a timely basis and management was held responsible for the Member's financial position.

#### **2003 Assessment**

The IDA has taken significant steps in 2003 to further address this issue. By-laws 1 and 7 were amended to require each Member to appoint a CFO who must be a partner, officer or director of the Member. The IDA has also amended By-law 7 and Policy 6, Parts I and II to require all CFOs to pass a qualifying examination. The examination is administered by the Canadian Securities Institute and was made available in January 2004. CFOs registered when the examination was implemented have 18 months to pass the examination. Anyone applying for approval as a CFO after January 1, 2004 will be required to pass the qualifying examination within 90 days. ASC Staff believe that these changes address the previous audit findings, and are a very positive step by the IDA.

## **2.1.4 Payment of Commissions to Personal Corporations**

### **Previous Audit Finding**

ASC Staff found that the field examination of a Member identified and questioned payments made to a Manitoba numbered company representing the president's compensation for his management responsibilities and for revenue derived from his book of business. The response from the Member said "the monthly payment to the president's holding company is as described, but does not include revenue derived from his client book. That element is part of the discretionary bonus authorized by the owner at year-end. We thus propose, and have started paying the president a basic salary, subject to statutory deductions, and the balance to his management company." Based on the ASC Staff's review, it appeared that this explanation was accepted by the IDA.

ASC Staff did not believe that this explanation was adequate or reasonable, and that in fact the payments were still being made inappropriately. ASC Staff felt that if the president's salary was being made to him personally and the balance was paid to his management company, this indicated that trading commissions were being paid to his corporation. ASC Staff noted that this is contrary to IDA rules, and to the CSA Distribution Structures Committee Position Paper.

### **IDA Resolution**

The IDA responded that the issue was forwarded to the Toronto Sales Compliance Department for further investigation. The FC Department acknowledged that they failed to follow-up appropriately to ensure resolution. The IDA stated that they would ensure this does not happen again.

Updating their findings, the IDA noted that further investigation found that any recognition of commissions generated was done directly through the bonus, which was paid to the president, not to his holding company.

### **2003 Assessment**

ASC Staff did not note any concerns relating to this issue in our 2003 audit.

## **2.2 NEW EXAMINATION FINDINGS**

### **2.2.1 Sample Size Selection and Documentation**

#### **Finding**

From the review of examination files, ASC Staff noted that IDA Staff do not document supporting evidence for the selection of sample size or the method of sample selection. ASC Staff were unable to determine if sample selection and size was representative because there was no documented information on population size or sample selection method. The FC Manager noted that sample selection focuses on delinquent reports, PDO (“Partners, Directors, and Officers”) account selections and accounts where the margin reduction is greater than materiality. Sample size is determined by professional judgment and the sample is extended if errors or problems are found.

#### **Recommendation**

Documentation of population size, determination of sample size, and the method of sample selection is necessary to have an adequately-documented audit. ASC Staff believe that these should be included in the IDA’s audit files.

### **2.2.2 Review of PDO’s Accounts**

#### **Finding**

In two of the examination files reviewed, there was no evidence of review of PDO’s accounts for adherence to cash and margin account rules. Breaches of cash and margin account rules by a PDO represent a financial risk to the member. The IDA’s audits are the only independent review of PDO’s accounts for such breaches.

#### **Recommendation**

The FC Department should ensure that a significant sample of PDO accounts are reviewed and that the working papers clearly document the review as a PDO account review.

### **2.2.3 Risk Assessments**

#### **Finding**

From the review of one Member file, it was noted that the Member made several mistakes in the calculation of Risk Adjusted Capital. Each mistake was viewed by FC Department Staff as a stand-alone error and no consideration was given to the overall environment that gave rise to the errors. IDA Staff did not view these errors as a control issue or a problem with the knowledge of the CFO. Further, ASC Staff were concerned to the note that the risk rating of the firm was reduced subsequent to the examination.

#### **Recommendation**

IDA Staff should look at repeated errors as a possible indication of systematic problems with the Member. Changes in risk ratings of a Member should include consideration of errors in the Member's submissions.

## **REGISTRATION DEPARTMENT**

### **3.0 PURPOSE AND SCOPE**

ASC Staff's purpose of the 2003 audit was to evaluate the effectiveness of the Registration Department by ensuring that the review of all applications was carried out completely and effectively, that adequate documentation was maintained, that all deficiencies were identified and documented, and that the deficiencies were adequately and consistently dealt with. The period under review was from October 1, 2000 to September 30, 2003 ("review period").

The audit included:

- Review of the Registration Department's implementation of their agreed upon actions to resolve the issues noted in the 2001 Report
- Review of the Registration Department's policy and procedures manual.
- An interview with the Manager of Registration and discussions with Registration Officers.
- Review of a sample of new applications, transfers, terminations, exemptions, change of categories, branch openings, and branch closings.

During the review period, in March 2003, the National Registration Database ("NRD") was launched. As a result of the implementation of NRD, firms now file submissions electronically instead of submitting paper filings. The scope of the audit included a random sample of submissions both before and after the launch of NRD.

ASC Registration Examiners executed the audit. This report summarizes findings identified during the entire review period. ASC Staff acknowledge that some findings in the Registration Department before NRD may no longer be an issue due to the implementation of NRD.

### **3.1 REVIEW OF PREVIOUS AUDIT FINDINGS**

#### **3.1.1 Supervision of the Registration Department**

##### **3.1.1.1 Review Procedures of Staff**

###### **Previous Audit Finding**

ASC Staff felt that the Prairie Regional Office Registration Department was functioning without an adequate level of review procedures. The Registration Manager was found to be responsible for reviewing the registration activities carried out by junior

registration staff. However, once a registration officer had become proficient at one task, the level of review decreased for that task. The registration officer was then taught a new task, which was reviewed until there was a level of proficiency.

ASC Staff noted that the Registration Manager did not review the Senior Registration Officer's work, because the Senior Registration Officer had been in the position for several years. Although it was reasonable for some reliance to be placed on this senior staff member's experience, ASC Staff felt that registration activities should be reviewed at least on a selected basis.

ASC Staff concluded that there should be some level of review for all registration activities on a regular basis.

### **IDA Resolution**

The IDA indicated that the Registration Manager would implement random sampling of all applications.

### **2003 Assessment**

ASC Staff continue to have concerns with regard to the review procedures of IDA registration staff and conclude that this previous audit finding has not been adequately addressed. The Senior Registration Officer's work is still not being reviewed by the Registration Manager. There was no evidence of random sampling of any registration officer's work after the launch of NRD.

### **New Findings**

Based on ASC Staff's testing of submissions selected from the review period, there were several deficiencies that support the conclusion that the Registration Department is still functioning without an adequate level of review. The findings from the 2003 audit were:

- An individual was improperly approved as a non-trading officer, even though correspondence between the firm and the registration officer with regard to the individual's job description indicated the individual should have been registered as a trading officer.

- An individual who had a prior settlement agreement with the ASC was simply approved for registration by the registration officer, and not sent to District Council for approval, approval with conditions, or refusal of registration.
- The Uniform Termination Notice of an employee indicated the employee's termination was solicited by the Member, and then subsequently the employee resigned in lieu of termination. However, there was no evidence of follow up in the file.
- One new application file contained no signed Alberta Waiver form on file.
- Two new applications indicated no middle name for the individual. There was no evidence in the file that the registration officer confirmed that the individual in fact had no middle name.
- One new application file did not contain evidence of an IRIS check.
- Four new application files did not contain evidence of the returned Canadian Police Information Centre check.
- Three new application checklists were not fully completed by the registration officer.

### **Recommendation**

The Registration Manager should randomly select applications for review to ensure that they are being handled appropriately.

#### **3.1.1.2 Supervision from Head Office**

##### **Previous Audit Finding**

Although the Prairie Regional Office Registration Department did submit reports on a monthly basis to head office and the Registration Manager was in regular contact with head office regarding registration matters, ASC Staff found little evidence of supervision by the Manager of Registrations located in Toronto. It was found that the Toronto-based Manager did not have access to registration files, and she did not review registration decisions on a regular basis.

ASC Staff noted that in the Prairie Region, the IDA was responsible for registering both individuals and companies, while in Ontario the

IDA only registered individuals while companies were registered handled by the Ontario Securities Commission. ASC Staff had concerns that the Registration Department in the IDA Office in Toronto could not effectively supervise all of the Prairie Regional Offices activities if it had no experience in registering companies.

Therefore, ASC Staff had concerns that head office was not adequately supervising the Registration Department of the Prairie Regional Office. Also, ASC Staff had previously commented that it was appropriate to appoint an active and independent Director of Member Regulation in Alberta to take on these supervisory responsibilities.

### **IDA Resolution**

The IDA agreed to provide quarterly reports of exemptions granted and terms and conditions imposed to CSA Members. Prairie Region information would be reviewed by both the Director in Calgary and the Manager in Toronto.

### **Assessment**

ASC Staff questioned whether the proposed solution represented a satisfactory review of the work performed by the Registration Department. Reviewing only the exemptions and the terms and conditions covered only applications where IDA staff had identified a risk or a problem and forwarded it to management. This would not identify risks or problems that IDA Staff had failed to recognize and therefore were never passed on to management.

ASC Staff's concerns with regard to supervision from head office were addressed with the appointment of a Vice-President, Western Canada, Member Regulation ("VP, Western Canada") in July 2001. The IDA explained that the Registration Manager would report to the VP, Western Canada, who is located in Vancouver. ASC Staff noted that the VP, Western Canada would review and sign off on IDA Staff recommendations before they were forwarded to District Council, and that the VP, Western Canada had access to NRD. ASC Staff found that both the Registration Manager and the VP, Western Canada indicated they have daily correspondence by email, weekly by phone, and that the VP, Western Canada travels to the Calgary office at least quarterly. ASC Staff found that this issue had been satisfactorily addressed.



### **3.1.2 Quality of Registration Computer System**

#### **Previous Audit Finding**

ASC Staff noted the AS/400 Broker Registration System (“AS400”) lacked basic reporting and printing functionality, and reliability of information was a concern. The system was written in 1990 and its age caused several problems.

While ASC Staff did not expect the IDA to undertake a system conversion given the impending launch of NRD, the IDA was asked to comment on interim measures to cope with the system issues until the implementation of the NRD. The IDA was asked to explain how it would ensure that their data would be up to date and accurate for the conversion to the NRD.

#### **IDA Resolution**

The IDA replied that the AS400 would be phased out once NRD was available. The IDA could not justify making significant expenditures to a system with an expected life of less than two years.

The IDA further indicated that the problems outlined in the ASC report had been issues for several years and the department had addressed them internally. The problems with the AS400 had to do with the output of reports, some renewals and formatted letters. The IDA explained that the data within the AS400 had been verified with Members and that the IDA believed it to be reliable, accurate and up to date.

#### **2003 Assessment**

Given the March 2003 launch of NRD, this finding is no longer an issue.

### **3.1.3 Turnover of Staff**

#### **Previous Audit Finding**

ASC Staff found that in the six months prior to the 2000 audit, two of the three senior registration officers had left their positions with Prairie Regional Office Registration Department. One individual left for an outside firm, while the other moved to another internal position.

ASC Staff pointed out that the retention of skilled registration officers should be a concern for the IDA. ASC Staff believed that moving forward,

the IDA should try to ensure that they have knowledgeable and skilled individuals in the registration officer positions.

### **IDA Resolution**

The IDA addressed this issue with new salary range increases made effective January 1, 2001 and the hiring of a contract registration clerk in October 2000.

The IDA believed the departure of the two senior registration officers was motivated essentially by the workload of staff in 2000 and the promise of higher salaries in other departments/firms.

### **Assessment**

The Registration Manager has been there for nine years. The Senior Registration Officer has been there for seven years. The other two registration officers have been there for two years. A new registration clerk was hired in August 2003 to help alleviate the registration officers' work load.

The issue has been satisfactorily addressed.

## **3.2 NEW EXAMINATION FINDINGS**

### **3.2.1 Quarterly Exemption Reporting**

#### **Finding**

During the testing of exemption applications, ASC Staff noted that an individual to whom an exemption was granted was not recorded on the quarterly exemption report sent from the IDA to the ASC.

#### **Recommendation**

The IDA should develop procedures to ensure that the quarterly exemption report is accurate and complete.

### **3.2.2 Branch Manager**

#### **Finding**

During testing of sub branch openings, ASC Staff noted one sub branch for a Member was opened in Alberta in March 2003, however the Branch Manager responsible for supervision was located in Toronto. A sub branch should not be approved unless IDA Staff can positively conclude that the Member's supervision arrangements for the sub branch will be adequate.

#### **Recommendation**

A sub branch file, for which supervision is not provided by an Alberta Branch Manager, must contain IDA Staff's explanation as to why they concluded that the supervision procedures were adequate."

### **3.2.3 Exemption Applications**

#### **3.2.3.1 Branch Manager**

During testing of exemption applications, ASC Staff reviewed two exemption applications where the individuals applying for approval as a Branch Manager did not meet the requirement of two years experience as a salesman of a securities dealer or investment dealer; both had previously been employed by mutual fund dealers. In both cases the exemptions were granted, however one individual had terms and conditions attached to the approval and the other individual's approval was granted without terms and conditions. ASC Staff are concerned with the IDA's lack of consistency in applying terms and conditions.

#### **Recommendation**

The IDA should train staff and develop procedures to ensure that applicants in the same fact situations receive the same regulatory results.

#### **3.2.3.2 District Council Review**

#### **Finding**

ASC Staff noted during their testing of exemption applications, that an individual was granted an exemption from the full time

employment requirement by two District Council members because they believed that the rule with regard to full time employment was outdated and embarrassing. ASC Staff believe this is an inappropriate exercise of the delegation of registration to the IDA and of the discretion granted to members of the District Council.

### **Recommendations**

The IDA should ensure District Council members understand that the delegation of registration authority should not be used to subvert the application of securities laws.

## **MEMBERSHIP PROCESS**

### **4.0 PURPOSE AND SCOPE**

ASC Staff's purpose of the 2003 audit was to ensure the IDA reviews all membership applications on a timely basis and to ensure the IDA's decisions to grant or deny membership were fair and properly supported by the work performed. Staff also reviewed resignations and suspensions. The period under review was from October 1, 2000 to September 30, 2003 ("review period").

ASC Registration Examiners performed the audit which included:

- Interviews with staff members.
- Review of a sample of new membership applications including testing of work performed by Sales Compliance Department, Financial Compliance Department and Registration Department.
- Review of a sample of corporate amendments, changes in shareholder information, resignations, and suspension/expulsion from membership.

### **4.1 REVIEW OF PREVIOUS AUDIT FINDINGS**

#### **4.1.1 Quality of New Member Applications**

##### **Previous Audit Finding**

ASC Staff noted in the Financial Compliance Department review of New Membership Applications that the files revealed poor documentation of procedures performed. It was found that in files where the IDA had identified issues, there was no clear documentation of whether extra procedures were performed. The files examined did not adequately document the resolution of issues and lacked documentation to support the IDA's decision to grant membership. Furthermore, there was no evidence of a senior level review.

In the Sales Compliance Department review of New Membership Applications, ASC Staff noted that an extensive list of deficiencies was noted in a firm's policies and procedures, but these were not rectified by the firm prior to the IDA granting membership. ASC Staff noted that reviews appeared insufficient, citing such deficiencies as: the site review did not cover off all the steps in the review program, the program was incomplete and there was no evidence of work done for several program steps, the documents and forms checklist was incomplete and there was no evidence that these documents had been received.

## **IDA Resolution**

The IDA indicated the problem in the Financial Compliance review occurred as a result of the coordination between Toronto and Calgary staff at a time when they did not have adequate staffing in Calgary. They explained that all new member applications would now be fully completed in the Calgary office with the Financial Compliance Manager completing a review of the file before it went to the Alberta District Council for approval. The IDA agreed to ensure that new member application files would be fully documented and that there was appropriate support for all conclusions made.

The IDA indicated the file deficiencies noted in Sales Compliance occurred because these were the first new member application files reviewed solely by the Calgary office and were assigned to the Calgary office before the new Sales Compliance Manager's start date. They explained that all new member applications would now be fully completed and reviewed in the Calgary office, with the Sales Compliance Manager conducting a full review of all aspects of the new member application. The IDA felt this would ensure all issues would be adequately addressed and documented in the file before clearance was given to register the member for all future applications.

## **2003 Assessment**

From the review of New Membership files, the above findings have mostly been addressed by the Departments. The files contained more detailed information and improvements in documentation. All issues were resolved and documented before new member was recommended for acceptance. All files reviewed contained evidence of manager review.

## **New Findings**

ASC Staff noted that in one new membership file, the registration checklist was not complete. There was no evidence to confirm that work was performed with regard to the officers and directors of the firm meeting the requirements of the IDA.

In two new membership files, there was no evidence that Financial Compliance had approved the Chief Financial Officer.

## **Recommendation**

The final review before granting membership should ensure that all checklists have been completed and that all membership requirements have been met.

## **ENFORCEMENT DEPARTMENT**

### **5.0 PURPOSE AND SCOPE**

ASC Staff's purpose in conducting the 2003 audit was to evaluate the effectiveness of the Enforcement Department by reviewing the adequacy and quality of work performed by the Enforcement Department from August 2002 to September 2003.

ASC Securities Investigators performed the audit which included:

- Review of current procedures manuals for IDA's Central Complaints Bureau ("CCB") applicable to its Enforcement function
- Review of statistics on the Department's file load and accomplishment of Key Performance Indicators ("KPIs")
- Review of a sample of complaint, investigation and prosecution files closed between August 1, 2002 and September 30, 2003
- Interviews of all Managers in the Department and the majority of the employees regarding the above topics.

### **5.1 EXAMINATION FINDINGS**

#### **5.1.1 Communication**

According to the Quality Assurance Review of the Prairie Regional Office, conducted by the IDA in August 2002, the Manager of Investigations had initiated bi-monthly meetings with enforcement counsel and investigators, to share information on current investigations, identify any potential issues of concern, and obtain legal opinions where and when required. The team meetings were meant to facilitate and ensure the continuation of open communication between investigators and enforcement counsel.

ASC Staff's interviews indicated that these meetings no longer take place. There is an assumption that in a small office such as the Prairie Regional Office, informal communication will occur and suffice. To the contrary, ASC Staff suggest that informal communication channels do not always disseminate all necessary information to all interested parties.

ASC Staff are not concerned that there is a lack of communication between enforcement counsel and investigators on individual files; however, the individuals who were interviewed indicated that formal meetings allowed them to discuss file strategies, learn of emerging issues within the IDA, and become aware of training opportunities from their respective managers.



Department meetings for CCB and Investigations would be useful to discuss at each stage various files that are going ahead and those that are being closed so that each Complaint Inquiries Officer (“CIO”) and investigator understands better why files are closed and how management reaches such decisions. These meetings would also be useful to discuss changes to policies and procedures such as the exhibit log policy.

ASC Staff recommend that formal department meetings for CCB and Investigations should be implemented going forward. Suggestions for agenda items should be considered from all employees. Managers could pass on relevant information from their management meetings. Perhaps the VP Western Canada Member Regulations could attend these meetings periodically to foster two way communication between senior management and individual employees within the Enforcement Department.

ASC Staff note that these matters were raised in our interviews with CIO’s and Investigators. Furthermore, poor communication can quickly undermine the smooth operation of a department, employee morale and job satisfaction.

Please indicate what steps the IDA will take to address this recommendation.

### **5.1.2 Key Performance Indicators for the Central Complaints Bureau**

CCB has an objective of resolving 80% of complaints received within 75 days. According to the Member Regulations Quarterly Report dated June 30, 2003, this benchmark was not achieved at March 31, 2003 (63% of files were less than 75 days old) but it was achieved at June 30, 2003 (90% of files were less than 75 days old) and at September 30, 2003 (86% of files were less than 75 days old).

ASC Staff’s discussions with the CIOs revealed that while this benchmark is reasonable for most files, it is difficult to achieve for complaints received through ComSet (Complaints and Settlement Reporting System) maintained from the IDA’s Toronto office. When a CIO works on a ComSet complaint, he / she must first request information from the member firm and then invite the clients to complain. Typically it takes about 3 weeks from the time that a ComSet complaint file is opened until the CIO receives further information from the member firm. Often this is because the member firm has reported an incident before its compliance department

has had the opportunity to complete its own review and assemble relevant documentation.

ASC Staff recognize that the Enforcement Department appears to be able to achieve its benchmarks in this area. While KPIs are important to ensure the efficient and timely completion of files, they should not be set at levels that impede full review of a complaint.

ASC Staff recommend that the IDA consider either modifying the objective of resolving 80% of complaints within 75 days for ComSet files. Two possibilities include having the time allowed to investigate start once the CIO receives a response from the member firm or increasing the timeframe applicable to ComSet files to 100 days.

Please indicate what steps the IDA will take to address this point.

### **5.1.3 Files Closed because the Respondent is no longer a Registrant**

There is a concern that files are being closed without enforcement action being taken because the individual is no longer a registrant. Therefore, ASC Staff asked the IDA to provide a copy of the CCB Memo, Investigation Report, or Enforcement Report on each file during the period of the audit that involved an individual who was no longer a registrant. The IDA provided a list of 6 such investigation files and 16 such prosecution files. Documentation was provided on all 6 investigation files and 8 of the prosecution files (all those that had been closed). The IDA did not provide any information on CCB files, and advised that it would be extremely onerous to review 545 CCB files to determine which ones involved registrants whose registration had lapsed during investigation of complaints.

Of the 6 investigation files and the 8 prosecution files reviewed, ASC Staff only questioned the outcome of 1 investigation file. Concerns stemmed from an email which stated:

Allowing a person to continue as a registrant with that type of character flaw would unlikely be seen as enhancing confidence in the capital markets. In the case at hand, the person is no longer a registrant, therefore there is a diminished concern about the confidence in the capital markets being tarnished. There would appear to be no risk to the investing public. Given that fact, I would not be inclined to expend resources to prove a point, when the person is out

of the industry. I realize a lot of work has gone into the file, however, the result we have is probably sufficient ie. loss of employment.

When questioned about this file the IDA responded, “the decision to close the file was based upon weakness of the facts. The fact that the individual was no longer in the industry was simply an additional fact and not the deciding factor.” ASC Staff invite the IDA to clarify its comment about “weakness of the facts” as ASC Staff’s review of the investigation report did not reveal such weakness.

While the file review only reveals one investigation with a questionable outcome, given that ASC Staff did not have the opportunity to review any other CCB files that pertained to individuals with lapsed registration, the point warrants further discussion.

The IDA has stated that:

When determining the type of action to take, we consider the potential harm to the investing public. In certain cases, where we believe that it is highly unlikely that the registrant will return to the industry, we may decide not to pursue formal disciplinary proceedings in order that we may allocate more resources to file involving registrants who are still in the industry. For those files that involve significant misconduct, we take formal enforcement action regardless of whether the individual remains in the industry.

ASC Staff agree that the potential harm to the investing public is an appropriate factor to consider and acknowledges that the IDA must set priorities as it cannot fully investigate all complaints; however, ASC Staff believe that it is important to prosecute enforcement action against individuals with lapsed registrations for the following reasons:

1. It is important that industry members understand that they cannot avoid sanctions for misconduct by leaving their positions as registrants. There must be seen to be consequences for misconduct.
2. Unless at least a warning letter is issued, the IDA will have little basis to prevent an individual from returning to the industry and being registered in the future. Such person will not have a disciplinary history nor has a message been communicated to the industry and the marketplace that the conduct was unacceptable.

3. Individuals may leave their positions as registrants, but continue to participate in the industry. For example, these individuals may go on to be promoters. Disciplinary action against such individuals may encourage them to leave the industry.

Finally, ASC Staff note that investigating the conduct of an individual who has left the industry might be significant in revealing underlying problems at the registrant's firm. While a firm may take action by terminating the employment of its registrant, it may not have addressed whether its internal controls failed to prevent the violation in the first place.

ASC Staff noted that there were a few files involving individuals who had left the industry, after disciplinary action was taken. In one file it was noted that the individual received a warning letter and was required to give an undertaking "never to seek registration or approval from the Association for any position with any member of the Association for which approval or registration from the Association is required." ASC Staff have been told that in future, such an undertaking would be noted in the regulators notes in NRD. This appears to effectively address point #2 above.

Please comment on this point.

#### **5.1.4 Referrals to Sales Compliance**

ASC Staff's discussions with CIO's and the manager of CCB indicated that there was no reporting back from CCB to Sales Compliance during 2003 regarding potential problems detected in the course of Enforcement investigations.

It is understood that Sales Compliance either sends e-mail requests to enforcement or accesses CTS directly to assess a firm's enforcement history prior to an examination or as part of a risk review.

ASC Staff's concern is that there are no apparent process or procedures to ensure that information regarding potential problems detected during Enforcement inquiries are communicated to Sales Compliance unless such information is specifically requested. ASC Staff understand that Sales Compliance performs a limited number of branch reviews and that risk assessments are done on the firm and not on the branch level. Awareness by Sales Compliance about recent problems in a certain branch may precipitate a review in a branch that would not otherwise occur.

ASC Staff are not suggesting that a matter be investigated by both the enforcement group and the compliance group; rather, when CCB determines that a file does not warrant enforcement action, there is no reason that any procedural or control issues should not be conveyed to and addressed by compliance and an appropriate process be implemented to ensure the sharing of such information.

Please indicate what steps will be taken to address this point.

### **5.1.5 Supervision**

It is important that the IDA prosecute enforcement action against both individuals and member firms when the circumstances merit such action.

ASC Staff noted that adequacy of supervision is addressed on every investigation report, but not on every closing memo prepared by CCB. While the manager of CCB considers adequacy of supervision on every file, ASC Staff recommends that like investigations, CCB comments on adequacy of supervision on every report.

ASC Staff observed that ComSet checks are done on the individual respondent in every file. Staff recommends that a check be also done on the branch involved to identify any systemic supervision or internal control problems.

Please comment on these recommendations.

### **5.1.6 Closing files in CTS prior to File Completion**

ASC Staff observed that files were closed in CTS before the closing memos were sent out. Given management's emphasis on KPIs, this may be an effort to achieve its statistical objectives.

The IDA has noted that this is not its policy.

Please confirm what action has been taken to ensure compliance with the IDA policy.

### **5.1.7 Exhibit Log Policies**

Section 5.1.2 in the CCB manual states that for files referred to Investigations, the CIO must complete the exhibit report (log); however,

CIO's are not actually completing exhibit logs. The investigators are creating these.

Discussions with CIO's and investigators revealed some confusion about their responsibilities in this regard. Discussions with the managers of CCB and Investigations showed that CIO's are not expected to complete the exhibit reports.

Expected practice in this area should be clarified and IDA policy changed as necessary. The decision on this matter needs to be clearly communicated to local management and employees.

Please confirm what action will be taken to address this point.

### **5.1.8 CTS Administration**

ASC Staff noted one file that was closed with "no action" recorded regarding it in CTS, when in fact the case was referred to RS Inc.

The IDA has indicated that the status of this case was misreported because this file was in Prosecutions section, and CTS does not have a category in Prosecutions for "referred to third party". The IDA has stated that it will have its IT department create a new category for such referrals.

ASC Staff are satisfied with this response.

### **5.1.9 Regional Director's Position Description**

The Regional Director's position description is outdated. This was last updated January 11, 2000. It states that he reviews investigation files, makes recommendations on penalties to be offered in settlements, and manages the hearing process for the council as required.

Please ensure that this job description is updated.