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Consolidated Compliance Report:

Examination Findings in the 2008/2009 Examination Cycle and the Areas of Examination Focus for the 2009/2010 Cycle

IIROC is pleased to present the first Annual Consolidated Compliance Report to assist member firms in their compliance efforts and in meeting regulatory expectations. This report has been structured to present some common examination findings of IIROC compliance teams including Financial and Operations Compliance, Business Conduct Compliance and Trading Conduct Compliance and to highlight areas of examination focus in the current year examination program.

Prior to discussing the examination findings there are some general concerns that have arisen given the current market environment which require member firm attention.

The major stock market correction, liquidity crisis and the number of institutional and product concerns that have been highlighted in the wake of these market changes have underscored the need to have strong and effective compliance and risk control systems at all firms. As many firms are now reviewing their current business models and looking for ways to effectively contain and reduce costs or alter business lines to meet the changing business environment, it is important for all firms to remain focused on maintaining effective compliance and risk control programs within their businesses. Firms have a regulatory obligation to maintain an effective compliance regime when planning restructuring efforts. Please consult IIROC Notice 09-0100 released on April 3, 2009 "Maintaining an effective compliance regime during economic and market downturns".

In addition, many firms have introduced many non-traditional securities products to augment their business lines. It is important that firms proactively review new products and have proper review processes and supervisory policies and procedures to oversee the sale of these products and ensure that the products sold to clients are suitable. New product features and risks must be clearly understood to ensure that customers receive timely, accurate and clear disclosure of the features and risks of these new products. As the market continues to evolve and create new product structures, firms must ensure they are aware of the product risks and that their registered representatives understand the products they are selling. For guidance in this area please consult IIROC Notice 09-087 released on March 23, 2009 "Best Practices for product due diligence". IIROC has issued this guidance notice to assist member firms in their efforts to ensure that they have adequate new product due diligence and oversight of the sale of these products.

IIROC Field Examination and Review Findings

During the past fiscal year, April 2008 to March 2009, IIROC examined almost 200 member firms through programs undertaken by its three compliance examination groups, including Financial and Operations Compliance, Business Conduct Compliance and Trade Conduct Compliance. Each of these compliance teams selects the firms to examine each year based on a risk assessment of the firm and the elapsed time since the previous exam. Examinations are scheduled and undertaken independently by each functional compliance area and the final report findings or deficiencies are sent to the firms on the completion of the examination. IIROC issued a total of 275 field examination and review reports during the year. It is mandatory that each firm addresses all of the issues highlighted within these reports and that adequate and timely action is taken by the firm to correct deficiencies.

During this past year IIROC has found that the majority of member firms have worked hard to be compliant with IIROC and Securities Act Rules. Firms were generally quite responsive to any deficiencies indicated by IIROC examination staff and in most cases corrected these issues during the examination year.

IIROC examination staff does, however, find that some business and compliance activities continue to require further attention by members to ensure compliance with IIROC rules.

Each compliance examination team has compiled a list of some frequent compliance examination findings that they encountered during the previous year. These lists have also been consolidated to identify some general deficiencies encountered by all three compliance teams. It is important to note that the deficiencies noted below are a compilation of those encountered across the membership. These common deficiencies were not found at all firms reviewed and no single firm received a report containing all or even most of these deficiencies.

General compliance deficiencies:

Three generally encountered deficiencies identified across all compliance examination programs are:

- Inadequate supervision of some business activities
- Inadequate internal control procedures and testing documentation
- Inaccurate or incomplete books and records

Inadequate supervision of some business activities:

The key to compliance at any firm is adequate and comprehensive supervisory procedures and effective implementation of these procedures. IIROC continues to see less than adequate supervision in some areas of firm activities and will continue to focus on the detailed testing of these practices in the current examination cycles. Firms have an obligation to have policies and procedures for supervision of all aspects of their business and to verify that these are appropriate and that they are undertaken with diligence. IIROC continues to find insufficient policies and procedures that in some cases are not updated as firm business activities change or that have not been kept current to reflect new regulatory requirements. Inadequate supervision of some trading and account activities requires attention by some firms. Supervision is fundamental for a firm to ensure that they are in compliance. Both management and the Board have an obligation to ensure that they have effective supervision in place for all of their business activities.
The UDP and CCO must ensure that there is adequate supervision and meaningful follow-up on compliance issues that are identified within the firm. It is also important that compliance

issues and the effectiveness of a firm's compliance system are reported at least yearly to the Board.

Inadequate internal control procedures and testing documentation:

A key part of adequate supervision is the establishment of appropriate and effective internal controls within the firm as well as robust testing to ensure these internal controls are effective. The implementation of inadequate internal controls or the maintenance of inadequate testing records is a frequent deficiency encountered by IIROC, including:

- lack of adequate control procedures over account documentation,
- lack of control procedures over grey and restricted lists,
- inadequate supervision of account activity,
- limited or no trade testing,
- inadequate financial internal controls,
- limited review of advertising, sales literature and research products, and
- lack of documentation of the testing of these controls.

Firms must ensure the prevention and the detection of problems, errors and irregularities by implementing a well designed internal control system that is regularly tested and validated.

Inaccurate or incomplete books and records:

A key part of adequate supervision is ensuring that firms' books and records accurately reflect the activity in the business. Compliance examination teams continue to see incomplete or inaccurate books and records in some firms. Failure to adequately record all transactions on book, missing or inaccessible supporting documentation, lack of evidence of reconciliation records and poor documentation practices are all activities that require better oversight and attention by firms. Maintaining an accurate audit trail of securities-related transactions in the books and records is fundamental for all firms to ensure that the internal controls, testing or supervision activities can be effective. Firms are obligated to maintain accurate books and records, which is also necessary as a fundamental foundation of risk management.

In addition to general deficiencies listed above, IIROC wishes to highlight some deficiencies encountered that require additional attention by some firms. Each firm should review these deficiencies and ensure that they have adequate controls and tests in place to avoid these issues.

Financial and Operations Compliance:

Inadequate margin provisions:

IIROC continues to find situations where inadequate or no margin has been provided. These include deficiencies in the reporting and margining of corporate finance deals and in some cases incorrectly calculated margin provisions for underwriting commitments of the firm. One deficiency that is of particular concern is the practice by Type 2 introducing brokers to incorrectly calculate or not provide margin on customer trade orders processed through accumulation (or average price) inventory accounts that are designated for such use by the carrying broker. In addition, some firms have used incorrect margin rates for option positions or incorrectly applied margin offset rules for convertible debentures. Firms are obligated to apply the appropriate prescribed minimum margin rules to accurately quantify their position risk exposure and effectively monitor their capital adequacy.

Inaccurate daily and weekly capital position reporting:

Monitoring the capital adequacy of a member firm is an important function of the designated Chief Financial Officer of the firm. IIROC continues to see some issues in the daily or weekly capital position monitoring of firms. These include:

- non-application of the liquidity and capital tests for Early Warning Levels 1 and 2;
- unreconciled month-end estimates and the Monthly Financial Reports (MFR) to check for material discrepancies; and
- missing information from the capital position reporting, such as underwriting commitments, significant inventory positions, unreconciled positions, accruals for contractual bonuses or other liabilities and, finally, bad debt provisions.

Firms must report accurate daily and weekly capital positions to IIROC.

Business Conduct Compliance (Sales Compliance):

Suitability reviews:

Suitability is a fundamental obligation of the RR to their clients. All products sold to clients must be assessed as suitable for the client, taking into consideration the client's risk tolerance investment objectives, and other know your client (KYC) information. All firms are required to have adequate internal controls, tools to monitor and the proper supervision in place to ensure that client interests are protected.

IIROC tests for compliance with suitability obligations during examinations. Where we detect mismatches between the KYC profiles and the investments contained in accounts, IIROC immediately follows up with the firm in order to determine whether the mismatch in question may be evidence of a suitability failure or a documentation problem. IIROC has also found inadequate or out-of-date documentation and we require firms to immediately address this situation. When inadequate testing for suitability has been detected, IIROC requires firms to immediately address the issue and improve their supervisory oversight.

Missing or inaccurate anti-money laundering documentation:

IIROC continues to see inadequate or out-of-date policies and procedures to detect and report suspicious transactions. In some instances we see a lack of testing documentation, unacceptable client verification records, reliance on foreign agents without an arrangement or agreement (as required under the most recent legislation) and outdated AML records.

Firms must establish and maintain effective controls and satisfy the requirement for ongoing training and education on anti-money laundering controls. These requirements affect account opening procedures as well as processes to detect suspicious activity. Firms are also reminded of the most recent requirements relating to Politically Exposed Foreign Persons. IIROC has issued guidance on these issues in a number of Notices, most recently in MR-0498. Firms are also referred to the Fintrac website at www.fintrac.gc.ca and to the Proceeds of Crime (Money Laundering) and Terrorist Financing Act.

Unsupervised advertising/sales literature:

IIROC sees inadequate controls around advertising and sales literature at some firms. These inadequate controls include inconsistent testing procedures, limited-to-no evidence of testing and limited-to-no evidence of the supervision of advertising and sale literature production or distribution. In some cases, IIROC has found employee websites for clients that the firm was unaware of, were not monitored for compliance and that included incorrect information.

Firms are required to supervise their business to ensure that all advertising and sales literature is accurate, supervised and includes all the appropriate disclosures. IIROC Notice MR-0281 should be reviewed and firms should take action to ensure their employees are in compliance with IIROC rules.

Unsupervised research:

Supervision of all research issued by a firm is mandatory and is an important control in managing any conflict of interest between the firm and its clients. IIROC continues to find some "research-like reports" issued by RRs at some firms. These reports are not sanctioned by the firm, do not have the appropriate disclosure, are not supervised and do not disclose any conflicts of interest to clients. These reports should not be released. Firms must supervise all of their research and are directed to IIROC MR Notice 0248. Firms must take action to ensure that their employee activities are in compliance with IIROC rules.

Inadequate management of Grey and Restricted Lists:

The proper management of Grey and Restricted lists continues to be a challenge at some firms. Safeguarding confidential and/or material non-public information is mandatory within a firm. This includes appropriate policies and procedures, education of staff, ongoing monitoring of trading and other activities at the firm, as well as physical restrictions on access to certain departments within a firm.

Continuous oversight of these processes is mandatory, as is timely, effective and accurate record-keeping at the firms as evidenced in part by the maintenance of accurate Grey and Restricted lists.

Trading Conduct Compliance (Trade Desk Compliance):

Inaccurate audit trail and order markers:

IIROC continues to find incomplete and inaccurate order and trade records at some firms. Tickets or records with missing prices, incomplete "CFO" markings, incorrect or missing timestamps, inaccurate use of client and non-client markings, absence of the insider marker and the improper use of the internal cross marker are all common errors and need to be addressed. Firms must ensure that the order audit trail is complete and accurate in order to adequately protect their clients and to enable IIROC to oversee trading in the market.

Missing trade confirmation disclosures:

With the continued launch of new equity market trading venues in Canada, firms must disclose to the client the market on which their order has been traded. IIROC sought clarification from the CSA and provided guidance to firms in RS Notice 2006-020 issued October 30, 2006. IIROC does see difficulties at some firms making this identification since some firms have not yet updated their internal processes to make this disclosure simple. Additionally, IIROC notes poor compliance with the requirement to include proper disclosures to clients when trades are confirmed at an average price.

Firms are obligated to ensure that their clients receive accurate disclosure on all of their trading confirmations.

Market Regulation:

Trade through issues:

IIROC continues to monitor the trading of firms to detect intentional trading through better priced orders and cases where firms are not taking reasonable steps to avoid trading through. With the launch of multiple trade venues and with many markets trading the same listed securities, firms must now establish procedures to ensure they are complying with Best Price and must monitor that they are not trading through better priced orders on other markets. Best price violations caused by flickering quotes, market data/router latencies, time clock disparities and simple mistakes are not issues that IIROC will pursue as these are clearly not intentional.

IIROC recognizes that the marketplace is in transition and that the CSA trade through obligation is not yet in place. During this time of transition IIROC understands that some time is needed to put in place the necessary infrastructure to access all markets. Firms that have not made reasonable efforts to either access or consider orders on all protected marketplaces or who are ignoring this requirement are intentionally trading through better priced orders and IIROC is pursuing this activity. Firms must trade in compliance with UMIR in this regard and firms should review IIROC Notices 09-0107 and 09-0108, as well as RS Notices 2008-010 and 2007-021 to ensure they are meeting their current trade through and best price obligations.

High closing:

With the market correction in late 2008, many accounts experienced significant investment losses. IIROC market regulation staff has detected some clients attempting to "high close" securities in an attempt to avoid or reduce unrealized losses or margin calls. Firms must supervise all trading at their firm and ensure that they have processes or tools in place to detect high closing, not only at month, quarter or year end, but on all trading days.

Gatekeeper reporting:

IIROC UMIR rules mandate the reporting of certain trading issues that the firm has detected and investigated. While Gatekeeper report filings have increased more than 50% over last year, many firms have not filed Gatekeeper reports.

Firms are obligated to report on trading issues that they have either resolved or are ongoing. IIROC uses these reports to detect trading issues that are occurring across or between firms. This allows IIROC to detect patterns of trading that individual firms cannot detect. Notice 2008-011 issued May 16, 2008 outlines the firm's obligation in this matter. All firms will be reviewed for compliance with this reporting obligation.

Supervision of DMA trading, Algorithmic Trading and Order execution accounts:

IIROC continues to see a growing percentage of trading in accounts that are not directly traded through a firm's trading desks. This "direct" trading is undertaken by Direct Market Access clients, algorithmic trading programs (either at the firm or by a client) and finally by order execution accounts (that are either electronically screened for margin or manually sent to client trade desks). This trading is generally reviewed and supervised after these orders are submitted to the marketplace.

It is imperative that firms undertake effective post-trade reviews of this trading since it remains the firm's responsibility to effectively oversee this trading to ensure it is in compliance with UMIR. Firms are directed to Algorithmic Trading Notices 09-0081, issued March 20, 2009, and 2008-003, issued January 18, 2008, and DMA and Order Execution Notices 2007-011 and 2007-010 dated April 20, 2007 for further information.

Summary:

IIROC has identified several examination deficiencies that will be a focus of the current year regulatory examination program, including:

- suitability reviews;
- inadequate supervision of some business activities;
- inadequate internal control procedures and testing documentation;
- inaccurate or incomplete books and records;
- inadequate margin provisions;
- inaccurate daily and weekly capital position reporting;
- missing anti-money laundering documentation;
- unsupervised advertising/sales literature;
- unsupervised research;
- inadequate management of Grey and Restricted Lists;
- incorrect audit trail and order markers;
- missing trade confirmation disclosures;
- trade through issues;
- monitoring for High Closing;
- inadequate filing of Gatekeeper Reports; and
- supervision of DMA trading, Algorithmic Trading and Order execution accounts.

All of these areas require member firms to both review and test these activities to ensure compliance with IIROC rules. Firms are reminded that in preparing for the current year's examinations by IIROC, they should pay attention to the deficiencies discussed in this notice.

In addition, IIROC has also planned regulatory sweeps in the coming year to test for compliance in specific areas, including product due diligence and best execution.

We hope that by sharing these areas of IIROC examination focus member firms will be better able to assess the effectiveness of their compliance programs, supervisory oversight and internal controls. IIROC will continue to provide assistance to firms through the designated responsible manager in each program area and through the provision of regulatory guidance notices. We encourage firms to contact their designated manager if there are any questions about this report.