

## **Concerns about inadequate compliance systems and Chief Compliance Officers not adequately performing responsibilities (The Ara Commentary)**

The Ontario Securities Commission recently circulated an e-mail titled, “Concerns about inadequate compliance systems and Chief Compliance Officers not adequately performing their responsibilities”.

In direct and forceful language, the one and a half page notice lists four “common signs of concerns” which the Commission found during its on-going reviews of registered firms. It then outlines steps the Commission may take, including regulatory action directly against the Chief Compliance Officer (“CCO”) and Ultimate Designated Person (“UDP”) if a firm is determined to have an inadequate compliance structure.

While reading the notice, we imagined Commission staff wondering, “Why can’t the CCO of these firms be more like that nice lawyer or chartered accountant at Mega National Portfolio Management Inc. That nice lawyer or chartered accountant always has a good binder of materials for us to review when we visit, gets what the “business trigger” really means, and is more than willing to “circle back” to us on important matters.” We imagine that small and mid-size independent registered firms may appear like troubled teenagers in comparison.

In this article, we will explore the seeds of compliance confusion and explain how the Ara support program was designed to address the unique compliance challenges of independent Portfolio Managers.

In the words of many self-help authors in regards to troubled teens, “there is nothing wrong with Johnny (i.e. independent firms). He just needs to do things differently.”

### **Technology and Operations:**

The growth of independent registered firms can be credited (or blamed) on readily available third party technology and operational support. For example, competition and excess capacity have gradually lowered costs and improved the quality of custodian and correspondent services. Software tools for portfolio management, record keeping, client relationship management and other applications have gradually become less expensive and easily accessible through the web. Fund administrators allow firms to contract out fund accounting and transfer agent functions.

Consider a national portfolio management firm that employs hundreds of staff across Canada. If one chips away at technology, operations and accounting support personnel, the firm is typically left with two small tribes. These are senior management that oversees the firm and, the analysts, portfolio managers and marketers that create and sell financial offerings.

Portfolio managers, analysts and marketers are now able to replicate the services of hundreds of support staff through the engagement of third party providers and, in the process, leave senior management to start their own firms.

## **The Secret Lives of CCOs:**

It is interesting to note that the second “common compliance deficiency” listed in the OSC e-mail notice is: “CCOs have limited involvement in the compliance function, give it inadequate attention or do not focus on important regulatory obligations. This may be due to, for example, inadequate resources for oversight, supervision and monitoring of the firm’s operations or the CCO inappropriately balances competing job responsibilities.”

The role of senior management at Mega National Portfolio Management Inc. or any other national or major regional firm is not too dissimilar from that of a professional hockey or basketball coach and general manager.

In a well-funded team, the coach and general manager must find players with specific specialized skills and deploy them like chess pieces for specific plays or situations. If a star player is temporarily injured, the coach might replicate those missing skills with one or more players that can be called up from the bench.

Now, consider how the decisions and style of the hockey or basketball team would change if the coach was fired and players were told to manage themselves.

Independent firms are effectively hockey teams managed by their players. The fundamental challenge for most independent firms is that senior management typically has a job on the side, either in sales or portfolio management. They have little time to ponder matters such as market positioning, succession planning, technology project prioritization and five year strategic plans.

## **Understanding Johnny’s Real Strengths and Weaknesses:**

However, the key compensating factor that regulators and other industry participants such as pension plan consultants miss, is that small and mid-size independent firms often have significantly less inherent business risk than their larger competitors.

Small and mid-size portfolio managers and other registered firms are unlikely to explore new offerings outside their core competency. For example, they don’t typically manage multiple lines of business across various regions or spend time and money trying to integrate the culture and operations of firms they have acquired. Small and mid-size portfolio managers and other registered firms offer a few financial products or services to a specific client base.

Secondly, key personnel are highly incentivized to perform in the best interest of shareholders and the long-term interests of the business. In fact, key personnel will often shower with a shareholder and stare at them in the mirror when shaving in the morning.

In our experience, there are only two genuine risks to consider for small and mid-size registered firms that have a reasonable revenue base to support continued operations:

1. The use of inferior or inappropriate technology and/or operational support; and
2. The inability to analyze and integrate regulatory rules and concepts into their business.

On the latter point, the CCOs definitely have the motivation and their firms have the operational simplicity to easily address compliance obligations. The CCO’s just need access to knowledge, experience and judgment on compliance matters. That’s why Johnny appears to be struggling.

## Looking for Compliance Support in all the Wrong Places

The regulatory requirement that independent firms appoint a dedicated chief compliance officer should always be given careful thought, as the wrong decision can be counterproductive.

Small and midsize firms may try to hire a seasoned compliance executive as the CCO, get someone junior and cheaper, or appoint an internal person who can hopefully learn on the job.

However, a junior person or internal hire will struggle to learn compliance in a small or mid-size firm. That person will never have the opportunity to develop knowledge, experience and judgment from working on a wide range of compliance matters that the CCO of a larger organization may address over the course of his/her career. Hence, management may find they don't have access to the necessary skills when needed most.

Unfortunately, hiring a senior seasoned CCO is an even worse option. If being the CCO of a national firm is like holding the title of Chief Cardiologist at a prestigious hospital, the CCO of an independent firm is akin to being an emergency room doctor in a hospital with poor equipment...in rural India.

Many senior compliance professionals may have difficulty transitioning to a small firm environment and they often don't chose this path in their careers. The CCO may have trouble operating without the infrastructure of a larger firm, operating under time and resource pressures of a smaller firm, and/or proposing solutions appropriate to the firm's technology, operations and business.

Senior industry compliance professionals are usually more comfortable dealing with the hockey coach and general manager, rather than directly with the hockey players.

In a small or mid-size firm, the senior compliance person may gradually become oppositional to management or cave in to their opinions, thereby providing no effective support.

As soon as they have an opportunity to get rehired by another national firm, one can be assured they will catch the next flight out of rural India.

Legal counsel is another source of guidance that firms typically reach out to for compliance support. Though counsel can provide invaluable advice on fund or issuer related matters, experienced counsel are usually reluctant to address compliance matters. The legal function is about analyzing rules and requirements. Compliance is about making those rules and requirements live in the business.

Counsel often does not have a working knowledge of operations and technology, and therefore, cannot readily integrate control and audit concepts. Furthermore, Counsel's proper (and expected) role is typically risk avoidance rather than risk management.

Hence, getting advice from counsel on compliance matters can sometimes feel like getting tips on skiing from an instructor who has never been to the slopes and is also afraid of heights.

Industry seminars, conferences and other similar types of events are excellent forums for learning more about regulatory rules and concepts. However, they can't solve a firm's fundamental challenge, which is creating and managing a compliance structure appropriate for the CCO's specific firm needs and circumstances.

For small and mid-size firms, we believe the CEO or another senior person that operates in the business is the most appropriate individual to hold the CCO title. That individual would not only have an in-depth understanding of their business, but also a genuine interest in ensuring their firm operates in a compliant and controlled manner. What they lack is ready access to compliance knowledge experience and judgment for their type of firm, on an ongoing basis.

## **Ara Compliance Support**

The Ara Compliance Support Program serves to bridge the gap between a CCO's desire to do a great job in compliance and access to the ongoing compliance knowledge, experience and judgment they need.

Ara Compliance Support is a team of professionals that perform like a head office compliance department for small and mid-size registrants. Like any head office compliance department, we help the firm design and maintain an appropriate compliance structure, conduct periodic on-site reviews, conduct compliance seminars and stand ready to provide ongoing analysis and guidance on compliance and registration matters.

Along with operations and technology support, the Ara Support Program allows an independent firm to fully replicate the support services enjoyed by their national and regional competitors.

To learn more about Ara Compliance Support and our offering, please contact us at 416-941-1263 or [info@aracompliance.com](mailto:info@aracompliance.com).