

Notice relating to the findings of a review of the reconciliation of investment fund portfolio assets to the custodian's statement

Context

As part of its investment fund oversight program, the Autorité des marchés financiers (the "Authority" or "We") reviewed the reconciliation of investment fund portfolio assets to the custodian's statement (the "Review").

Under section 11.1 of Regulation 31-103 respecting Registration Requirements, Exemptions and Ongoing Registrant Obligations, CQLR, c. V-1.1, r. 10 ("Regulation 31-103"), a registered firm must establish, maintain and apply policies and procedures that establish a system of controls and supervision sufficient to (a) provide reasonable assurance that the firm and each individual acting on its behalf complies with securities legislation, and (b) manage the risks associated with its business in accordance with prudent business practices.

Reconciling portfolio assets to the custodian's statement is an activity essential to regulatory compliance and the management of risks, including the risk of accounting errors and appropriation of funds.

By this notice, the Authority wishes to share the principal findings of the review and also communicate identified areas for improvement.

Objectives and scope

The objective of this review was to verify, for a given date and a given sample of investment funds (individually, a "fund", and collectively, the "funds"), the existence, completeness and accuracy of cash balances and portfolio securities. The funds selected are managed by various investment fund managers headquartered in Québec (the "IFMs").

We validated each fund's portfolio assets appearing in the IFMs' systems by checking them against the custodian's statement, an information source external to the IFMs.

To achieve our objective, we analyzed the following attributes of each portfolio asset:

- Quantity and par value
- Recognized security identifier (CUSIP/ISIN)
- Description (including the type, currency, coupon rate and maturity date)

Another validation was performed to analyze the governance framework and the internal controls relating to the asset reconciliation activities of certain IFMs. The application of existing controls and procedures was also evaluated.

Summary of findings

Observations and/or recommendations were provided to certain IFMs when deficiencies were found.

Statistics based on the analyzed sample include:

- No significant differences were detected between the positions appearing in the custodians' records and those appearing in the IFMs' records;
- Deficiencies were identified in the reconciliation processes of **30%** of the IFMs;
- Deficiencies were identified in the written policies and procedures of **25%** of the IFMs;
- Insufficient supervision of functions outsourced to custodians was identified in the case of **15%** of the IFMs.

Principal findings

I. Deficiencies in the fund reconciliation process

A. Supporting documents and frequency of controls

We sometimes noted the absence of audit trails demonstrating the controls performed by the IFMs in regard to reconciliations between the positions appearing in the custodian's records and those appearing in the IFM's records. Some reconciliations were unsigned by the preparer or reviewer or not dated.

Furthermore, some reconciliations provided to us by the IFMs did not include any analysis or supporting documents explaining identified differences. Any discrepancies between explanations and supporting documents must be documented to ensure follow-up and appropriate corrective action.

We also noticed in certain cases that the portfolio securities were reconciled weekly or monthly, whereas the net asset value was calculated daily. In such situations, we consider it appropriate for the IFM to have internal controls in place as well as sufficiently detailed procedures to demonstrate that, for each date of calculation of the net asset value is calculated, the portfolio assets are validated properly.

B. Attributes and unreconciled assets

In some cases, we found that key elements in the identification of a security, such as the CUSIP/ISIN number or the description of the security (including the type, home currency, coupon rate and maturity date), were not reconciled.

We also found some instances where the following portfolio assets were not reconciled:

- Cash balances
- Warrants
- Foreign currency forward contracts
- Securities held in affiliated funds
- Securities in a sub-portfolio where the most securities had nil fair value for a reason such as bankruptcy.

All assets held by the fund should be reconciled to, among other things, detect any changes in holdings of such assets.

II. Deficiencies in written policies and procedures

We noted that certain policies and procedures relating to the reconciliation process were incomplete, as they did not include pertinent details necessary to ensure a smooth process. For example, the following points were not always specified in the policies and procedures: documenting the control (signature, date, supporting documents to be attached), specifying the

reconciled attributes and the materiality threshold, the frequency of controls, the custodian statements or systems used, reviewing the reconciliation and reconciling cash.

Policies and procedures should also be updated regularly, particularly when a change is made to a key component, in order to reflect the actual process carried out.

As indicated in section 11.1 of Companion Policy 31-103 – Registration Requirements, Exemptions and Ongoing Registrant Obligations (“Policy Statement to Regulation 31-103”), policies and procedures are essential but do not make an acceptable compliance system on their own. An effective compliance system also includes internal controls, day-to-day and systemic monitoring, and supervision elements.

III. Insufficient IFM supervision of outsourced functions

The IFM is also responsible for ensuring that the custodian of its funds complies with the standard of care set out in subsection (1) of section 6.6 of Regulation 81-102 respecting Investment Funds, CQLR, c. V-1.1, r. 39, and in subsection (1) of section 14.3 of Regulation 41-101 respecting General Prospectus Requirements, CQLR, c. V-1.1, r. 14. Furthermore, as indicated in Part 11 of Policy Statement to Regulation 31-103, registered firms remain responsible for all outsourced functions.

We found that some IFMs outsource certain functions to third-party service providers, including net asset value calculation and portfolio securities valuation. In some cases, the IFM was not supervising the outsourced function by, for example, regularly verifying the net asset value calculation agent’s reconciliation of the fund’s portfolio assets.

The IFM was occasionally reconciling fund portfolio assets itself but was not including certain types of assets or was relying on the rationale provided by the third-party service provider to explain certain reconciliation discrepancies. As a result, some IFMs were unable to properly explain certain discrepancies.

The IFMs should follow prudent business practices and conduct due diligence on third-party service providers. Such due diligence includes assessing the service provider’s reputation, financial stability and relevant internal controls.

Conclusion

Based on this information, we have identified certain deficiencies in the compliance systems analyzed. We have asked the funds involved to take corrective action to promptly address the deficiencies.

The Authority expects the findings and areas for improvement set out in this notice to be considered as part of the continuous improvement of the compliance system in order to regularly ensure that investors’ assets are safeguarded.

As part of its investment fund oversight program, the Authority will continue to closely monitor how the issues identified during this review evolve.

Additional information

If you have any questions, please contact the Direction de la surveillance des fonds d'investissement of the Autorité des marchés financiers at the following address:

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