Dog Days of Summer

AUM LAW

Bulletin

July 30, 2015

As you enjoy your down time on docks and beaches, we are pleased to send you what we hope is a helpful summer update. Please contact your usual lawyer at AUM Law if you would like to discuss any of the topics in this bulletin.

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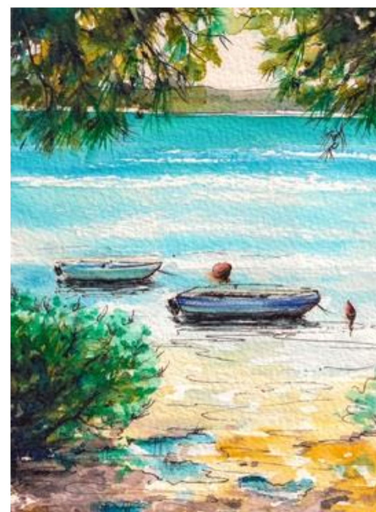

1. New Regulatory Notices

The Ontario Securities Commission (OSC) and the Canadian Securities Administrators (CSA) recently published the following notices relating to the filing of exempt distribution reports (Forms 45-106F1 and 45-106F6 in British Columbia):

- OSC Staff Notice 45-709 (Revised) Tips for Filing Reports of Exempt Distribution dated May 21, 2015
- CSA Staff Notice 45-308 (Revised) Guidance for Preparing and Filing Reports of Exempt Distribution under National Instrument 45-106 Prospectus Exemptions dated June 25, 2015

The notices highlight a number of deficiencies identified by OSC and CSA staff when reviewing these filings. While the notices generally do not contain new information (being revised versions of existing notices), they are useful quick reference guides that you may wish to keep at hand.

Some of the guidance may come as a surprise to market participants. In particular, market participants should note the statements in the notices relating to distributions in multiple jurisdictions (e.g., a distribution by an issuer in Alberta through an exempt market dealer based in Alberta to an investor resident in British Columbia) to the effect that:

- A distribution can occur in more than one jurisdiction. If a distribution occurs in multiple jurisdictions, the parties are generally required to comply with the law of all jurisdictions in which the distribution occurs.
- Not all exemptions are available in all jurisdictions. The issuer or underwriter may need to rely on multiple exemptions for the same purchaser in circumstances where the distribution is made in more than one jurisdiction and the same exemption is not available in those jurisdictions.
- If distributions are made in more than one jurisdiction, the issuer or underwriter must complete a single F1 identifying all purchasers, including purchasers that reside in the jurisdiction and those that do not, and file that report in each of the jurisdictions in which the distribution is made.

Although the statements in the notices are not new, they may not be consistent with some issuers' market practice. If you have any questions about the staff positions expressed in these notices, please contact [your usual lawyer at AUM Law](#).

2. Long-Awaited Anti-Money Laundering Regulations Released for Comment and Review

On July 4, 2015, the Government of Canada published for comment long-awaited amendments to regulations made under the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act*. These amendments implement certain legislative changes introduced in the 2014 omnibus budget bill.

The good news is that the proposed amendments provide for some much-needed updates to the manner in which reporting entities can perform client identification. The default model for identification procedures contemplates an in-person verification. Under the existing rules, doing non face-to-face identification, while possible, is difficult, cumbersome and fraught with the possibility of error – and is particularly problematic for online transactions. The amendments would see a more flexible approach to identification with a broader range of information sources that could be used. For example, a single piece of government-issued photo ID would be sufficient to ascertain identification. Equally, a combination of methods could be used where the information is obtained from an independent "reliable source". The commentary that accompanies the release indicates that FINTRAC will be providing guidance on the methods that could be considered for the dual-method identification procedures. Clearly though, one outcome will be that doing non face-to-face client identification will become easier.

A theme that runs through the proposals is the closing of gaps between the current Canadian regulatory requirements and the recommendations made by the international standard-setting body, Financial Action Task Force (FAFT). One such gap is in the area of due diligence on customers of reporting entities who are "politically exposed persons". Today, the requirement to take extra screening measures applies to politically exposed foreign persons. The proposed regulations would extend the rules to cover politically exposed domestic persons. Account openings and specified transactions involving such persons would be subject to enhanced due diligence, recordkeeping and reporting requirements.

Each reporting entity is currently required to make a risk assessment that serves to evaluate and document the money laundering and terrorist financing risks to which the entity is vulnerable. The proposed amendments would add another element to the assessment, requiring the reporting entity to consider the impacts of new developments and technologies (business relationships, products, delivery channels and geographic locations) on the existing assessment criteria.

The proposals also include housekeeping amendments. For example, they would clarify that a reporting entity that relies on an agent to verify client identity on its behalf could use identification measures that were previously undertaken by the agent on behalf of another reporting entity or for itself (i.e., where the agent is also a reporting entity in its own right). This would rid the system of some unneeded duplication. As well, a reporting entity would be able to recognize an existing customer through digital means or online, in addition to doing so visually or by voice. For securities dealers, the amendments clarify that for purposes of the anti-money laundering compliance rules, the reporting entity – not the dealing representative – is the dealer. A dealing representative of a dealer is not expected to have its own compliance program, and its obligations would be met by adhering to the compliance program of its sponsoring dealer.

The scope for administrative monetary penalties (AMPs) will be updated under the amendments to capture the full range of activity prohibited under the Act.

Interested persons may submit comments to the Department of Finance, Financial Systems Division until September 2, 2015. The amendments are expected to be in force later this year. These proposed amendments do not fully implement the legislative changes contained in the 2014 statute. A further round of implementing regulations are expected in the fall.

3. OSC Corporate Finance Branch Report on Prospectus Exemptions and Crowdfunding Regime

Offering Memorandum Exemption Coming to Ontario in the Fall of 2015

Over a decade after the “offering memorandum” prospectus exemption (the OM exemption) was first introduced elsewhere in Canada, the OSC has confirmed that the OM exemption will be coming to Ontario in the fall of 2015.

The OM exemption, which is already available in other Canadian jurisdictions, albeit with different parameters depending on the jurisdiction, allows businesses to raise capital from investors, including retail investors (i.e., investors who are not “accredited investors” as defined in NI 45-106 *Prospectus Exemptions* (NI 45-106)), based on an “offering memorandum” rather than a prospectus. While the offering memorandum is required to contain certain prescribed disclosure, be in a prescribed form (Form 45-106F2 or F3) and is subject to statutory liability in the case of a misrepresentation, it is not required to contain prospectus-level disclosure and is not subject to review by the securities regulators prior to an offering being made in reliance on the exemption.

When the OM exemption was first introduced in other Canadian jurisdictions, the OSC indicated that it was not proposing to introduce the exemption in Ontario due to investor protection concerns.

However, as explained in a series of concept proposals and updates published since November 2011, the OSC, together with its counterparts in the other Canadian jurisdictions (collectively, the CSA), have been engaged in a comprehensive review of the regulatory regime applicable to the Canadian exempt market with a view to facilitating capital-raising by small- and medium-sized business while maintaining appropriate levels of investor protection.

(For a description of the OSC exempt market review, see OSC Staff Consultation Paper 45-710 Considerations for New Capital Raising Prospectus Exemptions dated December 14, 2012, and OSC Notice 45-712 Progress Report on Review of Prospectus Exemptions to Facilitate Capital Raising dated August 28, 2013.)

In March 2014, the OSC and certain other participating jurisdictions published for comment a number of proposals relating to the exempt market, including the following:

- proposals in Ontario to introduce a version of the OM exemption to Ontario (see the Notice and Request for Comment relating to Proposed Amendments to NI 45-106 Prospectus and Registration Exemptions and related instruments dated March 20, 2014 (the March 2014 OSC Proposals))
- proposals in Alberta, Saskatchewan, Quebec and New Brunswick (see the Multilateral CSA Notice and Request for Comment re Proposed Amendments to National Instrument 45-106 Prospectus and Registration Exemptions Relating to the Offering Memorandum Exemption (the March 2014 CSA Proposals)), to amend the existing versions of the OM exemption in effect in these jurisdictions to address certain investor protection concerns these jurisdictions had identified with the existing model (for details of other jurisdictions’ experiences with the OM exemption, see Annex B: Background – Local Experience with OM Exemption to the March 2014 CSA Proposals)

The proposed version of the OM exemption contemplated by the March 2014 proposals would have resulted in a number of significant changes to the versions of the OM exemption in effect in these jurisdictions, including the introduction of a $30,000 investment limit for investors who were not “accredited investors”.

The comment period for these proposals ended in June 2014, with the participating CSA jurisdictions receiving more than 900 comment letters regarding the proposed amendments relating to the OM exemption.

On July 14, 2015, the OSC announced in its 2014–2015 Corporate Finance Annual Report (OSC Staff Notice 51-725 Corporate Finance Branch 2014–2015 Annual Report) that, following consultation with the other participating jurisdictions, advisory committees and other stakeholders, it plans to make changes to

respond to the concerns raised in the comment letters and publish the OM exemption in final form in the fall of 2015.

As explained in the report, the OSC anticipates that the final Ontario version of the OM exemption will include the following elements:

- comprehensive disclosure document at point of sale
- no limit on the amount of capital an issuer can raise
- investment limits for investors, other than those who would qualify as accredited investors or investors who would qualify to invest under the family, friends and business associates exemption, substantially along the following:
  - in the case of a purchaser that is not an eligible investor, $10,000 in a 12-month period
  - in the case of a purchaser that is an eligible investor, $30,000 in a 12-month period
  - in the case of a purchaser that is an eligible investor and that receives advice from a portfolio manager, investment dealer or exempt market dealer that an investment above $30,000 is suitable, up to $100,000 in a 12-month period
- risk acknowledgement form signed by investors
- ongoing disclosure made available to investors, including audited annual financial statements, annual notice regarding the use of the money raised and notice of a limited list of significant events.\

While the overall proposal is generally consistent with the March 2014 proposals published for comment, the ability of an investor who is not an accredited investor to exceed the $30,000 investment limit and make investments of up to $100,000 in a 12-month period based on suitability "advice" from a registered firm does appear to be a significant new element to the proposal. In view of the increased focus by the CSA on registered firms' compliance with suitability obligations (e.g., see CSA Staff Notice 31-336 Guidance for Portfolio Managers, Exempt Market Dealers and Other Registrants on the Know-Your-Client, Know-Your-Product and Suitability Obligations), any registered firm that provides suitability advice to allow a non-accredited investor to exceed the $30,000 investment limit will need to carefully ensure that an appropriate suitability review is conducted and fully documented.

It is not clear from the OSC Report whether the other participating CSA jurisdictions intend to proceed with corresponding changes to their versions of the OM exemption.

AUM Law will provide a full update when further developments are announced and the final version of the amendments are published.

Update on NI 45-108 Crowdfunding Regime

The OSC 2014–2015 Corporate Finance Annual Report also contained an update on the CSA proposals to introduce a new prospectus exemption and a regulatory framework for crowdfunding portals to facilitate retail crowdfunding as outlined in proposed Multilateral Instrument 45-108 *Crowdfunding* (Proposed MI 45-108). (In Ontario, see the OSC Notice and Request for Comment relating to Proposed Amendments to NI 45-106 *Prospectus and Registration Exemptions* and related instruments (including proposed MI 45-108 *Crowdfunding* and proposed Multilateral Policy 45-108CP Crowdfunding dated March 20, 2014 (the March 2014 OSC Proposals)). In the other CSA jurisdictions that published proposed MI 45-108 for comment, see the Multilateral CSA Notice of Publication and Request for Comment re Draft Regulation 45-108 respecting Crowdfunding (the March 2014 Multilateral CSA Crowdfunding Notice).

As explained in our nutshell on Equity Crowdfunding Portals, in March 2014, the OSC and its counterparts in Saskatchewan, Manitoba, Quebec, New Brunswick and Nova Scotia published for comment Proposed MI 45-108.

This proposed rule sets out a proposed prospectus exemption to facilitate capital raising by reporting and non-reporting issuers, other than investment funds, through online portals and a proposed regulatory framework for a new type of registrant, the "registered funding portal".

As with the OM exemption, the Corporate Finance Annual Report indicates that the OSC intends to publish a crowdfunding regime in final form and deliver the rules to the Minister of Finance for approval in fall 2015.

The OSC anticipates that the final version of MI 45-108 will include the following key elements:

- streamlined offering document at point of sale
- limit of $1.5 million on amount an issuer group can raise in a 12-month period
- all investments must be made through a funding portal that is registered with securities regulators
- low investment limits for investors who do not qualify as accredited investors ($2,500 in a single investment and $10,000 under the exemption in a calendar year) with higher investment limits for accredited investors and no investment limits for permitted clients
- risk acknowledgement form signed by investors
- ongoing disclosure made available to investors, including annual financial statements, annual notice regarding the use of the money raised and notice of a limited list of significant events

It is unclear based on the Annual Report what the “higher investment limits for accredited investors” will be or how they will be determined. For example, the participating CSA jurisdictions may be contemplating a higher investment limit calculated as a percentage of the accredited investor’s net income or net worth (which is generally the US approach under the JOBS Act crowdfunding regime) or alternatively may be contemplating higher numerical limits of, for example, $25,000 per investment and $100,000 per annum.

We look forward to reviewing the final version of the MI 45-108 crowdfunding regime in the fall and providing an update at that time.

Rights Offering Prospectus Exemption

Finally, the OSC 2014–2015 Corporate Finance Annual Report also contained an update on the CSA proposals to modernize and streamline the rights offering prospectus exemption. The Report indicates that currently, issuers do not appear to be using the existing rights offering process as a result of time and cost impediments. The OSC previously published for comment amendments to the prospectus-exempt rights offering regime intended to address these issues. The OSC is currently working with the CSA to develop final amendments to the existing exemption and the goal is to publish the amendments in the fall of 2015.

4. OSC Staff Notice 81-728 Use of “Index” in Investment Fund Names and Objectives

On July 9, 2015, the OSC released Staff Notice 81-728 setting out guidance with respect to Index Tracking Funds. The guidance provides, among other things, that:

- the methodology governing the indexes should generally not allow for material discretion by the index provider or any other party involved in the administration of the index, and
- the investment objectives of an Index Tracking Fund should set forth specific detailed disclosure regarding the index methodology or the constituents of the index, to help allow an investor to determine whether the Index Tracking Fund is a suitable investment for the investor.

If these two conditions are not satisfied, it is likely that the OSC would require references to the index in the fund's investment objectives and name be removed.

The guidance provided a reminder that an index that satisfies the above conditions may still not meet the definition of "index mutual fund" or "index participation unit" in National Instrument 81-102 *Investment*

Funds (NI 81-102); therefore, the exemptions provided to index mutual funds or index participation units under NI 81-102 may not be relied upon.

5. OSC Report on Mutual Fund Practices Relating to Portfolio Liquidity

Staff of the OSC recently released a report summarizing their findings from their targeted continuous disclosure review of a number of mutual funds. Staff examined funds investing in high-yield debt funds, emerging market funds, and small cap equity funds, since funds of those types may be more prone to liquidity concerns. The review focused on the policies and procedures of the funds – specifically, whether those policies identified potential illiquid assets and addressed the ability to manage higher levels of redemptions under different stress conditions, and whether the funds' valuation processes had taken liquidity into consideration. The theme of the report suggests that funds require robust policies to assess liquidity both at the time of investment and on an ongoing basis.

Staff emphasized that investment fund managers cannot take the view that equity investments are liquid solely because they are listed on an exchange, without any consideration of market conditions and activity (which would include volume metrics, bid/ask spreads and the outstanding issue size). The review found some examples where certain securities did not have the market activity needed to permit a sale if needed within the short period of time permitted for redemptions under NI 81-102. The report also described some good market practices, where managers have established committees to determine whether an asset is illiquid. The use of these committees, some of which included technical experts, are seen to add objectivity and expertise into the liquidity assessment process.

While most managers engaged in stress testing to assess their funds' ability to meet unexpected large redemptions, not all managers did. Of the managers that used scenario analysis, the analysis tended to incorporate only historical redemption rates and did not use higher levels than the funds' past experience, which staff encouraged. Staff also suggested that managers consider stress testing for portfolio performance, and that funds should provide additional disclosure of their risk management policies and investment restrictions used to mitigate liquidity risk.

With respect to valuation practices, staff indicated that closing market values were generally used for equity investments without further considering market activities and conditions. Managers did generally use ancillary information for fixed income investments, such as over-the-counter (OTC) broker quotes and data freshness reports. Interestingly, staff referred to IFRS 13 Fair Value Measurements, and indicated that a fund's determination of whether or not a security is quoted in an active market under IFRS 13 *must* be taken into consideration in determining whether or not the investment is illiquid under NI 81-102. If the security is not quoted in an active market, additional disclosure is required in the funds' financial statements with respect to fair value. Of interest to fund managers was the closing of the report, where it was noted that staff expects managers to obtain standing instructions from the funds' Independent Review Committee concerning their valuation policies and procedures.

6. CSA Staff Notice on Continuous Disclosure

The CSA recently published CSA Staff Notice 51-344 Continuous Disclosure Review Program Activities for the fiscal year ended March 31, 2015, which provides guidance to reporting issuers on common deficiencies identified by the regulators in their annual review of continuous disclosure by reporting issuers.

The CSA's report identifies common deficiencies in financial statements and Management Discussion and Analysis (MD&A), as well as other regulatory disclosure requirements, such as the mineral project disclosure.

- Financial statement deficiencies included inadequate disclosure about operating segments, business combinations and fair value measurement.
- MD&A deficiencies included inadequate disclosure about liquidity and capital resources, results of operations, forward-looking information/non-GAAP measures and REIT distributions.

- Other regulatory deficiencies included failure to file material contacts and material change reports, and selective disclosure of material non-public information.

Material deficiencies identified by the regulators could require issuers to provide additional disclosure or to refile the relevant documents, which may draw unwanted attention to the regulatory compliance of such issuers.

Please contact a member of our Corporate Finance Group if you have a question about your continuous disclosure obligations.

7. OSC to Review Compliance with OTC Derivatives Rules

On June 29, 2015, the OSC announced its intention to review compliance with over-the-counter (OTC) derivative trade reporting requirements as set out in OSC Rule 91-507 *Trade Repositories and Derivatives Data Reporting* (the TR Rule) in fiscal 2015/2016. (The TR Rule requires that all OTC derivatives transactions involving a local counterparty be reported to a designated trade repository in Ontario. For more information on the TR Rule please see our nutshell.)

OSC Staff Notice 91-704 Compliance Review Plan for OSC Rule 91-507 Trade Repositories and Derivatives Data Reporting (the Notice) indicates that the purpose of these planned compliance reviews is to reinforce the importance of derivatives data reporting, assess levels of compliance and identify obstacles to compliance, and help derivatives dealers to better understand their reporting obligations and the OSC's expectations.

A joint team from the OSC's Derivatives Branch and Compliance and Registrant Regulation Branch (OSC Staff) will carry out these compliance reviews. If selected, OSC Staff will notify the derivatives dealer in advance, request books and records, including policies and procedures relating to derivatives trade reporting obligations, and interview senior management and key employees in connection with the trade reporting obligations. OSC Staff may also attend the dealer's premises to review internal processes and compare trade records with reported data.

The Notice provides that the initial reviews will focus on "derivatives dealers" that are "most active" in the market and their compliance with requirements in Part 3 *Data Reporting* of the TR Rule. It is important to note that the term "derivatives dealer" is defined broadly in the TR Rule to mean:

> 'a person or company engaging in or holding himself, herself or itself out as engaging in the business of trading in derivatives in Ontario as principal or agent'.

Reporting obligations under the TR Rule have been in effect for certain market participants, including derivatives dealers and clearing agencies, since October 31, 2014. As of June 30, 2015, data reporting obligations became effective for a "reporting counterparty" that is not a derivatives dealer or a recognized or exempt clearing agency to make reports under certain circumstances. While the Notice states that the "initial reviews" will focus on derivatives dealers, OSC Staff may cast a wide net. Therefore, it would be prudent for all market participants with reporting obligations under the TR Rule to prepare for an OSC compliance review.

As part of these compliance reviews, the Notice indicates that OSC Staff will review the market participant's systems and documentation related to derivatives data reporting obligations to verify that:

- derivatives transactions are correctly identified, and reported accurately, completely and within prescribed timelines;
- reporting counterparties are determined in accordance with the TR Rule requirements;
- life cycle and valuation data is reported and updated in accordance with required timeframes; and
- a Legal Identity Identifier for each transaction counterparty is reported in accordance with regulatory expectations.

Please contact a member of our [Regulatory Compliance Group] to discuss the Notice, obtain further information about the application of the TR Rule or request our assistance in preparing for a compliance review.

8. CASL Year in Review

A year since *Canada's Anti-Spam Legislation* (CASL) came into effect, we have seen three enforcement cases publicized by the CRTC. The following is a snapshot of the penalties imposed and the breaches cited by the CRTC in the applicable notice of violation or undertaking:

Firm	Date	Financial Implications	Breach		
			Consent	Identification	Unsubscribe Mechanism
Compu.Finder	March 5, 2015	$1,100,000 penalty pursuant to a Notice of Violation	✓		✓
Plentyoffish Media Inc. (Plentyoffish)	March 18, 2015	$48,000 payment pursuant to a voluntary undertaking			✓
Porter Airlines Inc. (Porter)	June 26, 2015	$150,000 payment pursuant to a voluntary undertaking	✓	✓	✓

Back to Basics

As set out in [our nutshell], organizations need to ensure that the following key requirements are met before or at the time of sending a commercial electronic message:

1. Consent has been obtained (unless an exemption is available).
2. The sender's identification and contact information is provided.
3. An unsubscribe mechanism is in place with the following features: it is set out clearly and prominently; it is able to be readily performed; and it is effective within 10 business days of a recipient's indication that they wish to unsubscribe.

Implications

Based on the penalties imposed, the CRTC appears to be communicating the following:

- While much of the discussions in the industry before July 2014 surrounded the consent requirement, the cases suggest that meeting the content requirements is also important. For example, Plentyoffish was subject to a voluntary undertaking, including a payment of $48,000 for having an ineffective unsubscribe mechanism, even though it limited its electronic communications to its website subscribers (therefore meeting the consent requirement).
- Mitigating factors may help an organization that breaches CASL requirements, but will not necessarily save it. For example, the CRTC acknowledged that Porter "immediately" took steps to comply with CASL once it was made aware of the CRTC's investigation. However, Porter was still subject to a voluntary undertaking, including a payment of $150,000.
- Organizations should ensure that they have the following CASL-related items in place: a compliance policy, a robust compliance program, training and proper documentation of consents. For example, as part of their voluntary undertakings, Plentyoffish and Porter agreed to update their compliance programs to cover elements such as corporate compliance policies and procedures, training and education, monitoring, auditing and reporting mechanisms, and consistent disciplinary procedures.

Reminder: Private Right of Action

Starting in January 2017, firms will be exposed to civil lawsuits, many of which are expected to be in the form of class actions. It is unclear whether actions could be launched on a retroactive basis (i.e., between July 1, 2014, when CASL came into force, and January 1, 2017, when the provision on the private right of action will come into force).

Marking this CASL Anniversary

It is important to take the technical requirements of CASL seriously. More than 330,000 complaints have been submitted under CASL and the CRTC has emphasized that it will continue to enforce CASL provisions. Being subject to a CASL enforcement action may involve not only financial penalties, but also time and costs of an investigation, and unwelcome publicity. First-time offenders do not necessarily get a free pass.

We encourage you to review your CASL compliance program and assess how you are protecting your firm against a regulatory action or civil lawsuit.

AUM Law primarily serves the asset management sector, with specific expertise in the regulatory space. We strive to provide the most practical, forward-thinking advice and services, using a business model geared to efficiency, responsiveness and excellence. We are pleased to send you this summary of recent developments that may affect your business.

This bulletin is an overview only and it does not constitute legal advice. It is not intended to be a complete statement of the law or an opinion on any matter. No one should act upon the information in this bulletin without a thorough examination of the law as applied to the facts of a specific situation.