January 2017

Bulletin

Washington Upset

No, we're not talking about Denzel Washington's recent upset of Casey Affleck in their fierce battle for the SAG Best Actor award (though that was quite a moment). In a month that has been marked by a U.S. inauguration, historic protests, and political turmoil, it is difficult not to feel a little overwhelmed. While there is much to discuss in this month's Bulletin, we at AUM Law find that reviewing the OSC's Investment Fund Practitioner is a reliable way to lower our resting heart rates in times of stress. And so we will begin there. Please take some deep cleansing breaths and enjoy.

In this bulletin

In Brief: OBSI Explores Use of New Enforcement Powers ● OSC's New Fintech Advisory Committee

1. Highlights From OSC's December 2016 Investment Funds Practitioner

The OSC released the December 2016 edition of the Investment Funds Practitioner, which provides, among other things, an overview of recent issues arising from Staff's review of mutual fund sales practices and applications for exemptive relief.

Of note, OSC Staff has recommended relief from the requirement to deliver an information circular in connection with an investment fund securityholder meeting, which would allow an investment fund to deliver a notice-and-access document providing basic information about the subject matter of the meeting and instructions on how to access the information circular online or request a copy.

In Brief

OBSI Explores Use of New Enforcement Powers

The Ombudsman for Banking Services and Investments (OBSI) just released a five year strategic plan wherein it outlined plans to explore and evaluate alternatives to its existing "name and shame" enforcement power, including the use of binding compensation recommendations. Stay tuned.

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OSC's New Fintech Advisory Committee

The Ontario Securities Commission (OSC) recently announced the membership of its new Fintech Advisory Committee (FAC), which will advise OSC staff on developments in the fintech

Staff has also recommended expanding existing relief granted to allow mutual funds to use OTC swaps that are cleared on a voluntary basis, provided the same procedures apply as with swaps that are subject to mandatory clearing. The Staff also provides fresh clarification for investment fund managers (IFMs) with respect to the organization of conferences and seminars by IFMs for the benefit of participant dealers' salespersons. The CSA's position continues to be that IFMs who invite conference participants from participating dealers should generally be dealing with the dealers and not with individual salespersons.

OSC Staff also reminded Independent Committee Members of their duty to balance and consider the varied interests of different investor groups when being asked by IFMs to provide direction on a conflict of interest.

In Brief cont'd

space as well as the unique challenges faced by fintech businesses in the securities industry. The FAC will meet quarterly, with members serving one-year terms, and will be chaired by Pat Chaukos, Chief of OSC LaunchPad.

Finally, OSC Staff has commenced an issue-oriented review of scholarship plans registered as Registered Education Savings Plans, to obtain further information on their operational practices. RESP sponsors should be prepared to address concerns that will be reported by Staff later this year.

2. Employment Law Expertise – We Have It!

As a reminder to our clients, AUM Law offers advice and services in the area of employment law, including wrongful or constructive dismissals, human rights, occupational health and safety, and employment standards. We can also provide assistance in the drafting of employment contracts and employment-related workplace policies.

Please contact us to discuss your employment needs further.

3. Embedded Commissions - Soon to be Dislodged?

On January 10, 2017, the Canadian Securities Administrators (CSA) published CSA Consultation Paper 81-408 – *Consultation on the Option of Discontinuing Embedded Commissions* (the Paper). The Paper seeks input on the option of discontinuing embedded commissions and the potential impacts of such a change on Canadian investors and market participants. Here are six key takeaways from the Paper:

1. **Embedded commissions would be banned with transition to "direct pay" model**. The CSA is proposing to ban embedded commissions (see #3 below) in favour of "direct pay" arrangements (e.g., up-front commissions, flat fees, hourly fees, fees based on a percentage of assets under administration or other arrangements). The direct pay arrangements contemplated by the CSA would require that (i) the arrangement is negotiated and agreed to exclusively by the investor and the dealer (through the representative) pursuant to an explicit agreement, and (ii) the investor exclusively pays the dealer for the services provided under the agreement. Note that investment fund managers could facilitate investors' direct payment of dealer compensation through payments taken from the investor's investment (e.g., deductions from purchase amounts or periodic redemptions from the investor's account).
2. **The ban would apply to all investment funds and structures notes, public and private**. The ban would apply to all investment funds under securities legislation, as well as structured notes, whether sold under a prospectus or in the exempt market under a prospectus exemption.
3. **What would be banned?** The CSA envision a prohibition of any payment of money to dealers in connection with an investor's purchase or continued ownership of an investment fund or structured note that is made directly or indirectly by any person or company other than the investor. The rule would preclude compensation to dealers that is paid or funded by the investment fund (or its IFM) or structured note issuer out of fund assets or revenue, and would include/ban, at a minimum:
    - Ongoing trailing commissions or service fees; and
    - Upfront sales commissions for purchases made under a DSC option.
4. **What would be allowed?** Direct pay arrangements (discussed above) would be allowed. In addition, the rule would likely allow the following types of dealer compensation payments:

- referral fees paid for the referral of a client to or from a registrant;
- dealer commissions paid out of underwriting commissions on the distribution of securities of an investment fund or structured note that is not in continuous distribution under an initial public offering;
- payments of money or the provision of non-monetary benefits by investment fund managers to dealers and representatives in connection with marketing and educational practices under Part 5 of NI 81-105; and
- internal transfer payments from affiliates to dealers within integrated financial service providers which are not directly tied to an investor's purchase or continued ownership of an investment fund security or structured note.

5. **The ban would be complementary to other recent CSA initiatives**: The CSA consider that a ban on embedded commissions compliments other recent policy initiatives (e.g., CRM2, best interest and targeted reforms, point of sale) but that such initiatives do not (and were not designed to) address most of the concerns identified in the Paper.
6. **What transition options are being considered?**: The CSA are considering either a three-year transition period or a "phase-in" approach by transitioning dealers' accounts over multiple periods.

Although the CSA has stated it has not yet decided whether to ban embedded commissions, the amount of detail and analysis provided in the Paper suggests that such a ban is likely and that "direct pay" arrangements will be the new normal governing investor-dealer relationships. In the interim, the CSA is also calling on the fund industry to create market-driven solutions and innovations that address the concerns raised in the Paper.

We strongly encourage our clients impacted by the Paper to carefully review the Paper (including the 36 specific questions posed to stakeholders) and to submit their views to the CSA (including comments on the regulatory impact that the Paper's proposals have on their businesses). The decisions made as a result of this consultation will reverberate within Canada's capital markets for decades to come. The CSA has prepared a helpful Backgrounder that summarizes the Paper – it can be found here.

In light of the significance and complexity of the issues raised in the Paper, the CSA is holding a longer than normal comment period of 150 days; comments should be submitted in writing by **June 9, 2017**. Finally, some CSA members also plan to hold in-person consultations in 2017 to facilitate additional feedback.

Please contact us if you have any questions regarding this Paper or would like assistance with providing input to the CSA.

4. *Dōmo arigatō*, Mr. Roboto

In a move that has captured the attention of many in the industry, Toronto-based online-advisor Wealthsimple Inc. is seeking regulatory approval of a "no-call" or "robo-advisor" model when onboarding new clients.

As we have previously discussed, while the U.S. has seen a rise in robo-advisors, or web-based "no call" investment services that use electronic questionnaires to gather know-your-client (KYC) information online and then use algorithmic software to match clients to a model portfolio, Canadian online advisors are generally considered "hybrid" models. These hybrid models still use registered individuals who interact with clients to answer questions and confirm know-your-client (KYC) information as they would in a face-to-face model. Canadian regulators have been clear that online advisors who don't initiate contact with clients and operate under the U.S. "no call" model may be subject to terms and conditions and/or have registration limited to a restricted category.

In particular, the CSA outlined regulatory expectations for how the online advice industry should grow in CSA Staff Notice 31-342: *Guidance for Portfolio Managers Regarding Online Advice* (CSA Notice 31-342), and clarified that online brokers that want to be exempted from having personal contact with each prospective client must have a satisfactory system in place for identifying circumstances when personal contact would be required. It further established that such brokers may also be restricted to offering more

basic investment products such as low-cost mutual funds and other redeemable investment funds, and unleveraged exchange-traded funds.

AUM Law is uniquely qualified to provide guidance in the online advisory and dealer space. We have registered and continue to work with a number of firms that use online platforms, and our qualified team of legal experts can guide you through the registration and approval process.

Please contact a member of our Regulatory Compliance Group if you would like to discuss online platforms and the "robo-advisor" model further.

5. MFDA Provides Guidance on Suitability

The Mutual Fund Dealers Association of Canada (MFDA) has published a research paper on suitability, in particular providing guidance on how regulators have addressed issues of suitability through previous enforcement proceedings. This paper will be updated every two years.

Though the paper does not establish new regulatory obligations or standards, it is a useful resource for mutual fund industry participants as it canvasses, amongst other things, know-your-client (KYC) and know-your-product (KYP) obligations, as well as recommendations and disclosure.

Importantly, the MFDA emphasizes in this paper that the disclosure of material negative factors to a client is not enough to satisfy the suitability requirement, and that advisors must ensure that the client understands the risks involved, particularly where the client has relatively little investment experience.

Please contact our Regulatory Compliance Group if you would like to discuss this paper further.

6. New Record-Keeping Requirements for Ontario Corporations that Own Real Property

As of December 10, 2016, a corporation incorporated or continued under the Ontario Business Corporations Act (OBCA) must maintain at its registered office a register of its "ownership interests in land" in Ontario, together with supporting documentation, such as copies of any deeds, transfers or similar documents. As the OBCA is silent on the meaning of "ownership interests", there is confusion at present whether the requirement applies to legal and registered interests only, or also to beneficial interests such as leaseholds, options, mortgages, easements and other interests.

Corporations incorporated or continued under the OBCA prior to this date have a two-year transition period and must comply with the provisions as of December 10, 2018. For Ontario corporations with interests in many properties, we recommend starting the process of collecting the required information and records now to ensure they are in compliance by the December 10, 2018 deadline. Non-compliance with these provisions may result in the corporation and its directors or officers being subject to fines or other penalties under the OBCA.

Please contact our Corporate Group for more information.

7. Deadlines, Deadlines…

Once again, AUM Law was busy working with our clients to ensure that they met their 45-106F1 obligations by the deadline of January 30th. This was a particularly challenging year because of the new obligation to create SEDAR profiles to facilitate filings in certain jurisdictions.

Please note that if you are undertaking these filings yourself but have missed the January 30th deadline, late fees of $100 apply for every business day past the deadline (up to a max of $5,000 per issuer).

8. AML Obligations – The Gift that Keeps on Giving

AUM Law would like to remind our clients about their ongoing anti-money laundering (AML) risk assessment obligations. Specifically, the following two risk assessment functions are considered by the Financial Transactions and Reports Analysis Center of Canada (FINTRAC) to be fundamental to a registrant's AML program:

- Performance of an independent review of their AML program every two years.

- Documentation of an annual internal risk assessment. Please note that in light of FINTRAC's recent Risk-Based Approach Guidelines released in April 2016 and other related guidance, this annual internal risk assessment requires a more robust approach as compared to past years.

If you are unsure of whether you have met the above obligations or wish to inquire about our services in this area, please contact your usual lawyer at AUM Law.

Frequently Asked Questions

> Can a firm provide account statements to its clients under Section 14.14 of NI 31-103 on a "trade-date" basis, taking into account that certain securities may not settle by the end of the reporting period?

A firm should exercise caution when including pre-settlement trades in an account statement. If (a) there is any ambiguity regarding which securities have settled and which have not, or (b) a trade fails to settle, then the PM may be subject to a misrepresentation claim. It must also be very obvious that the security subject to the provisional trade is on the statement on a provisional basis only. Otherwise, the confirmation could arguably misrepresent the true state of the client's holdings.

We also suggest considering what the subsequent account statement will look like. For example, assuming a client has requested monthly statements, will the firm need to repeat the information required by s. 14.14(4) in the following month's statement (i.e., the month that the trade actually settles)? If so, care must be taken to ensure this does not prove confusing for the client.