Trees and Triffids

With all the tinselly and lit-up trees at this time of year, at AUM Law we find it hard to hear the word MiFID (aka the European Markets in Financial Instruments Directive) without thinking of Triffids - the murderous, stinging plants in John Wyndham's apocalyptic novel *The Day of the Triffids* and its movie adaptation. In this issue of our Bulletin, MiFID II (the sequel to MiFID) makes an appearance, without the sting, in our "In Brief" section.

In this bulletin:

1. For Best Execution, Good May Not Be Good Enough

The OSC recently considered the issue of best execution with respect to trading by a portfolio manager. In a decision by the Director of the Compliance and Registrant Regulation Branch (**CRR**) of the OSC, the OSC ordered a Portfolio Manager (**PM**) to retain the services of an independent compliance consultant to assist in comparing trade execution options, and determine the most advantageous terms for the PM's clients. The order stems from a compliance review conducted by CRR where the OSC found that the PM placed all trades for individual clients with either a related dealer or a single third party dealer, and placed all trades for its affiliated funds with its related dealer. The OSC found that the PM's clients paid higher commissions when trades were placed with the related dealer than with the third party dealer.

NI 23-101

In the decision, the OSC referred to the requirements in National Instrument 23-101 *Trading Rules* (**NI 23-101**) and Companion Policy 23-101CP to National Instrument

In Brief

Outside Business Activities: A Few Instances to Remember

The Ontario Securities Commission (**OSC**) has often imposed conditions on registered representatives who are members of a religious or charitable organization where the registered representative volunteers or is otherwise involved in the organization. The OSC has viewed such outside business activities, where the registered representative is in a position of potential influence, to give rise to possible conflicts of interest. Accordingly, the OSC has imposed conditions on the registered individual with respect to dealings with those specific clients or prospective clients, including a recent decision.

•

23-101 (**23-101CP**). Section 4.1(2) of 23-101CP requires that dealers or advisers, including portfolio managers, use "*reasonable efforts*" to achieve best execution. Section 4.1(3) of 23-101CP indicates that to meet the reasonable efforts test, a dealer or adviser should be able to demonstrate that it has, and has abided by, policies and procedures that outline the process it has designed toward the objective of achieving best execution. An adviser should consider a number of factors when selecting appropriate dealers and marketplaces and monitor the results on a regular basis.

The OSC reviewed the PM's policy and found that it did not describe the process it used to evaluate best execution. The policy did not include any provisions about selecting dealers or marketplaces, and the policy did not provide details how to review trading to determine if best execution had been achieved. The PM also did not have a system to monitor results of trading on a regular basis.

The OSC acknowledged that the provisions of NI 23-101 make it clear that one must consider a number of factors, including, but not limited to price, when considering whether the best execution obligation of an adviser has been met. The PM argued that it met its best execution obligations as a result of: (a) the related dealer's good execution; (b) continuous access to its related dealer's system database; (c) access to the related dealer's portfolio management software; and (d) freedom of delivery against payment problems which may exist at other institutions. The OSC submitted that the PM did not provide sufficient evidence to support the assertion that the higher price charged by the related dealer when compared to the price charged by the third party dealer was explained by the value of the research goods and services supplied by the related dealer.

In the face of the contradictory submissions and evidence, the OSC could not find that PM's clients sustained an adverse monetary impact as a result of the PM's failure to comply with its best execution obligations. The OSC stated that the lack of review and analysis completed by the PM made it necessary for the OSC to impose terms and conditions requiring the PM to engage a consultant to assist the PM in comparing trade execution options and arrangements. If the review found that PM's clients sustained an adverse monetary impact, then the PM would have likely been required to take steps to remediate the adverse impact.

NI 31-103

The OSC also argued that the PM's practice of directing client trades to a related dealer, and paying higher commissions to the related dealer than would otherwise be payable to a dealer operating at arm's length from the PM, represented a failure on the part of the PM to respond to conflicts of interest with its clients. The OSC referred to section 13.4 of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**NI 31-103**) that requires registered firms to take reasonable steps to identify and respond to existing and potential material conflicts of interest that may arise between the firm and a client. Based on the evidence provided, the OSC was not satisfied that the PM had effectively responded to the material conflict of interest and found that the PM failed to comply with section 13.4(2) of NI 31-103.

In Brief cont'd

Form 33-109F5 Requirement for Cryptocurrencies

On December 5, 2017, staff of the Ontario Securities Commission reminded firms that they are required to report changes in their business activities by filing Form 33-109F5 *Change of Registration Information* if they plan on establishing, managing, advising and/or trading in securities of investment funds that deal in cryptocurrencies and related offerings. Staff also reminded registrants that in such instances, firms should also update their Form 33-109F6 *Firm Registration* to include these products and/or services.

•

MiFID II Unbundling Requirements: Impact (or lack thereof) in the Canadian Markets

On December 14, 2017, staff of the Canadian Securities Administrators (**CSA**) published an update on their consultations with industry and other regulators regarding the potential impact on the Canadian regulatory framework of the European Union's new requirements for the unbundling of research inducements from trading fees under MiFID II. These new unbundling requirements will apply to all EU and third country investment firms that provide investment services or activities in the EU, beginning on January 3, 2018.

Since the summer of 2016, CSA staff have been consulting with market participants and other regulatory authorities to determine whether these new requirements are consistent with the Canadian regulatory framework set out in National

OSC Rule 31-505

The OSC also submitted that, by directing client account trades to a related dealer that appears to charge a higher commission for the same services as other dealers, the PM failed to comply with its obligation to deal fairly, honestly and in good faith with its clients as required by subsection 2.1(1) of OSC Rule 31-505 *Conditions of Registration*. Based on the evidence presented and findings related to NI 23-101 and NI 31-103, the OSC concluded that the PM did not comply with its obligation to deal fairly with its clients. There was insufficient evidence to conclude whether the PM dealt honestly and in good faith with its clients.

This decision is instructive as it sets out what may or may not constitute best execution for a portfolio manager, discusses the related issues around conflicts of interest and conditions of registration.

We can assist you in developing or enhancing your policies and procedures concerning best execution. We can also assist you in identifying conflicts of interest and with respect to complying with conditions of registration.

2. A Stern Warning to Registrants Regarding OBSI Obligations

In an infrequent joint notice published by the Canadian Securities Administrators (**CSA**), the Investment Industry Regulatory Organization of Canada (**IIROC**), and the Mutual Fund Dealers Association of Canada (**MFDA**), staff indicated a number of concerns with practices that seem to be developing among a few registrants in relation to their obligations (outside of Quebec) to utilize the services of the Ombudsman for Banking Services and Investments (**OBSI**) as an independent dispute resolution service.

As a reminder, National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**NI 31-103**) requires registered firms to use OBSI to deal with client complaints, under a specific time frame and process. While OBSI's compensation recommendations are not currently binding on a complainant or registrant, staff note that if a registrant does not pay the compensation recommended by OBSI, or settles for lower amounts on a frequent basis than the recommended amount, such decisions may indicate that the firm has issues with respect to its complaint handling practices. In addition, staff note that such practices may raise questions as to whether the registrant is complying consistently with its standard of care, or participating in OBSI's services in good faith. Other examples of potential failures in complaint handling practices are described, including not fully assisting OBSI with its investigation.

Staff also note their concerns about potential confusion for clients if registrants make the services of an "internal" ombudsman available during the OBSI process without clear disclosure of the OBSI procedures.

It seems clear from the notice that staff of the CSA and the SROs are taking a close look at the public record for refusals to comply with OSBI recommendations, are speaking with OBSI closely through the Joint Regulators Committee and are looking at the number of settlements occurring. Staff may make further inquiries of a registrant, and/or take more serious action where warranted, up to and including referring files to enforcement.

In Brief cont'd

Instrument 23-102 *Use of Client Brokerage Commissions* **(NI 23-102**). CSA staff concluded that there is no immediate need to amend the Canadian framework. In particular, CSA staff believe that a market participant can comply with both MiFID II and NI 23-102 without conflict, and that compliance with MiFID does not appear to require any additional requirements for market participants that are subject to NI 23-102.

AUM Law will monitor further developments regarding the CSA's approach to MiFID II's unbundling requirements.

- **Less CASL Hassle**

In a sign of hope, the Federal Government has twigged to certain head-scratching elements of CASL and recently released a report with 13 recommendations for improvement, which can be found at:

http://www.ourcommons.ca/content/Committee/421/INDU/Reports/RP9330839/421_INDU_Rpt10_PDF/421_INDU_Rpt10-e.pdf

- **Update on CCIR Segregated Fund Working Group Position Paper**

The Canadian Council of Insurance Regulators (**CCIR**) recently released their recommendations following extensive industry consultations and a prior consultation paper released in May 2016 on potential amendments to rules regarding segregated funds. Segregated funds may resemble mutual funds, but are seen by some as a distinct asset class in that they are purchased under insurance contracts and are

In a footnote to the joint notice, the CSA notes that it is continuing to consider options to strengthen the ability of OBSI to gain compensatory redress for clients. If you have any questions or require clarification about the OBSI requirements, please reach out to your regular AUM lawyer.

3. Cybersecurity: Why Director Involvement is so Important

Given the number of financial service firms that hold, and work with, confidential information obtained from their clients, the threat of a cybersecurity breach has been in the spotlight as an ongoing business risk throughout 2017. As directors seek ways to address this risk, they should be mindful of *CSA Staff Notice 33-321* released in October 2017 by the Canadian Securities Administrators which provides guidance in this area (summarized in our November Issue of the Bulletin). Directors should also be mindful of one of the leading privacy law cases: Townsend v. Sun Life Financial ("**Townsend**") which discusses a firm's obligations regarding the protection of private and confidential information.

In *Townsend*, the plaintiff alleged that Sun Life failed to safeguard his personal information by accidentally sending information to a third party and mailing certain letters to incorrect addresses. The Federal Court did not award any damages to the plaintiff and found that: (a) the breach was relatively minor; and (b) "Sun Life had a detailed protocol [for dealing with private information] before the occurrence of what can only be considered human error" and "Nobody should be held to a standard of perfection".

The Court's finding in (b) above is significant because it suggests that taking reasonable measures to protect private information may lessen or absolve culpability in the event of a data breach (including a cybersecurity incident) at a firm. Reasonable measures may include using certain cybersecurity measures that are currently being used by the financial services industry, including:

- The National Institute of Standards of Technology Cybersecurity Framework
- The 10 principals of Cyber Resilience from a report issued by the World Economic Forum entitled "Advancing Cyber Resilience Principles and Tools for Boards"
- The IIROC Cybersecurity Best Practices Guide

Although we recommend that you speak to your usual lawyer at AUM Law to discuss what measures makes sense for your firm, a common thread on all cybersecurity standards that we have seen is that directors are required to play an *integral* part of the management process and be active in the oversight of cybersecurity risk. In short, cybersecurity is not an IT department problem and those firms that delegate the management of their cybersecurity risk to their "tech people" may be seen to fall short of the "reasonable measures" expectation described above.

Director involvement requires that firms maintain and document proof that they have reviewed and promoted their cybersecurity policies, and that they have the technical proficiency to understand the policies and/or they have consulted experts that can explain it to them. After a cybersecurity policy is created, directors must still ensure that they are actively reviewing the policy and asking questions of their experts to ensure that their policy remains effective and current.

There are a number of ways to show director involvement in your firm's cybersecurity framework. We advise that you speak to your usual AUM Lawyer if you have any questions.

In Brief cont'd

traditionally sold by insurance companies. Of note, despite the fact that the CCIR found no statistical evidence that regulatory arbitrage was occurring as between the segregated funds and mutual fund sector, they have made a number of recommended changes to ensure fair treatment for the end customer and minimize conflicts of interest. Some of the recommendations include the use of the dollar-weighted methodology to calculate performance, aligning the risk classification with the CSA's methodology for risk classification of mutual funds, as well as additional disclosure of fees for segregated funds. The CCIR is developing a form of client account statement for consumer focus group testing. Further consultation with industry on all the recommendations is expected. We will continue to monitor progress in this area.

4. Prohibiting Cluster Munitions Act: A Cause for Concern?

In order to implement its commitments under the 2008 international Convention on Cluster Munitions, the federal government enacted the *Prohibiting Cluster Munitions Act* (the "**Act**"), which came into force in March 2015. The Act prohibits the use, development, production, acquisition, possession, importation or exportation of cluster munitions, explosive submunitions and explosive bomblets (collectively, "**cluster munitions**"). The Act also prohibits attempting to commit, or aiding, abetting, counselling or conspiring to commit, such a prohibited action or providing assistance after a prohibited action.

While federal government representatives have previously asserted that direct and intentional investments in entities that engage in an action prohibited by the Act would be caught under the Act's aiding or abetting prohibitions, the Act does not, in its current form, explicitly prohibit financial investments in cluster munitions. However, amendments to the Act have been proposed which, if enacted, would explicitly prohibit individuals and organizations from providing financing or acquiring, whether as a shareholder or partner or otherwise, any pecuniary interest in an organization that has committed, or that has aided or abetted in the commission of, any act towards the development, production, acquisition, possession, importation or exportation of cluster munitions.

The bill containing the proposed amendments passed its third reading in the House of Commons earlier this year and, after passing its second reading in the Senate, was referred to the Senate's Standing Committee on Foreign Affairs and International Trade. We will continue to monitor and report on the proposed amendments to the Act. In the interim, we encourage all of our portfolio and fund manager clients to assess whether any potential investments on their horizon may be impacted by the proposed amendments.

5. European Privacy Laws Are Changing: Do They Apply to Your Firm?

On May 25th 2018, the General Data Protection Regulation (**GDPR**) legislation will come into force. This legislation, adopted by the European Union (**EU**) in 2016, will bring a single cohesive system of privacy regulation to Europe. The GDPR has higher privacy obligations and required procedures as compared to the standards set out by Canadian legislation and if the GDPR applies to your firm, a degree of work will be required to ensure compliance.

The GDPR is intended to have a wider reach than just European countries and may impact Canadian firms if:

1) the Canadian firm is processing personal data on a site in the territory of a state that is a signatory to the GDPR ("**Member State**");
2) the Canadian firm is established in a place where the Member State's national law applies; or
3) the Canadian firm processes data using equipment located in the territory of the Member State, unless it is only used for transit through the territory.

If the Canadian firm has an establishment in the EU, then the GDPR will apply if:

a) the Canadian firm offers goods or services to EU residents; or
b) the Canadian Firm monitors the behavior of EU residents within the EU (i.e. internet tracking activities).

If you believe that the GDPR may apply to your firm, please contact your usual lawyer at AUM Law to assist you.

6. *Re: Marek* – Who is Your Client?

In early December, the Ontario Securities Commission (**OSC**) published reasons for its decision in *Re Marek*, a case examining, among other things, when a registrant-client relationship is created between two individual investors and a registered representative of a firm. The case is an important reminder to

registrants that if they are interacting with investors who might reasonably believe that they are clients, the registrant should make clear to such investors whether or not that belief is correct.

Background

The OSC decision flows from a request by Earl Marek for a review of a decision by a hearing panel of the Investment Industry Regulatory Organization of Canada (**IIROC**). The IIROC panel decided that Marek had contravened an IIROC rule when he facilitated off-book share purchases in Facebook for two investors (the "**L Brothers**") without the knowledge or approval of Mr. Marek's employer ("**M Co**"), an IIROC member firm. Their decision turned on whether the L Brothers were clients of Mr. Marek at the relevant time.

In brief, the L Brothers were referred to Mr. Marek by his son, who told them that Mr. Marek had a block of pre-IPO Facebook shares and wanted to sell some of them. The OSC found that, among other things, at the first meeting between Mr. Marek and the L Brothers in January 2012, he discussed the merits of investing in Facebook and recommended that they buy shares at the pre-IPO price, including instructing for payment of proceeds.

Following a hearing into their complaint, the IIROC panel fined Mr. Marek $50,000 and ordered that his registration be suspended for a year. He then applied to the OSC for a review of that decision.

The OSC's Decision

The OSC noted that Ontario securities laws and IIROC rules do not define the term "client" or expressly answer the question when a client relationship arises. (As an aside, this missing definition has created problems in other areas of the securities law regime, including aspects of CRM2.)

The OSC concluded that a context-specific analysis was appropriate and found that all of the relevant factors pointed to the conclusion that the L Brothers were in fact Mr. Marek's clients at the time of the Facebook transaction. In particular:

- At his first meeting with the L Brothers, Mr. Marek engaged in a registrable activity by giving advice as to the merits of a specific securities transaction;
- He told the L Brothers that the transaction would go through M Co. (his employer) and that M Co. would be paid an administrative fee;
- He orchestrated all steps of the transaction, including giving direction as to the payment of funds;
- He told the L Brothers that he hoped this was the beginning of a longer-term client relationship; and
- The L Brothers reasonably believed that they were clients of Mr. Marek, and there was no evidence that he did anything until June 2013 to disabuse them of that belief.

The OSC upheld the IIROC panel's decision.

Takeaways

The OSC stressed that, when dealing with a registrant, an investor typically is at a disadvantage with respect to matters that are within the registrant's expertise, including the processes involved in completing trades in securities. Investors, therefore, are vulnerable to unfair, improper and fraudulent practices. The principle of investor protection dictates that the investor should receive the benefit of any reasonable uncertainty in determining when a client relationship arises.

Although this case involved an IIROC Member firm, OSC's approach and reasons are relevant for non-IIROC firms and individuals as well. It is important for registrants to know when someone becomes a client, since numerous protections for investors and responsibilities for registrants attached to that relationship.

If you have questions about these issues, please do not hesitate to contact us for assistance.

News & Events

AUM Law Team Member Announcements

We are very pleased to announce that we will soon be joined by **Stacey Hoisak**. Stacey recently spent the last 4 years as general counsel at Birch Hill Equity Partners, advising on fund formation and general legal matters. Prior to Birch Hill, she worked for over 6 years at Alpha Trading Systems until its purchase by the TMX Group, gaining valuable insight into regulated exchanges. Stacey got her start at Stikeman Elliott in 2000-2009, where her practice included private equity, private/public M&A and providing advice to investment fund issuer clients. We look forward to Stacey's arrival in early January.