June 2018

Bulletin

Heatwave Edition

Is Bananarama right? Will it be a cruel, cruel summer for the asset management industry as it digests proposed changes to the registrant-client relationship, Canada's anti-money laundering regime, and the registration and compliance framework for OTC derivatives?

At AUM Law, we promise not to leave you here on your own to deal with these initiatives. In the meantime, we hope you enjoy what promises to be a sunny, Canada Day long weekend, and we look forward to speaking with you soon about developing a solid and realistic plan to deal with the changing regulatory landscape ahead.

In this bulletin:

1. Fundamental Changes Coming to Registrant-Client Relationship, if the CSA Has Its Way

On June 21, the Canadian Securities Administrators (CSA) published two notices regarding regulatory initiatives intended to reform client-registrant relationships. AUM Law plans to publish a special comment on these initiatives in the coming weeks, so our summary below just touches on the highlights.

First, the CSA is proposing changes (Client-Focused Reforms) to National Instrument 31-103 – *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103) relating to the know-your-client (KYC), know-your-product (KYP), suitability, conflicts of interest, and relationship disclosure information (RDI) requirements. The proposed changes represent a fundamental shift toward a best interest standard, without actually imposing an all-encompassing

In Brief

OSC Report Sheds Light on Financial Consumers' Understanding of Cryptoassets

On June 28, the Ontario Securities Commission (OSC) published the research study Taking Caution: Financial Consumers and the Cryptoasset Sector. According to the study, about 1.5% of Ontarians have participated in an initial coin offering (ICO). Of concern to the OSC, over half of the past and present cryptoasset owners surveyed for the report either don't know who regulates initial coin offerings (ICOs) or believe that the offerings are unregulated. One third said that they wouldn't know where to go if they had a complaint about a cryptoasset service provider.

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obligation for registrants to act in the best interests of their clients. Instead, specific obligations are incorporated into various provisions in NI 31-103, with some representing new requirements and others codifying what regulators consider to be good practice.

The proposed Client-Focused Reforms will, among other things:

1. Require registered firms to address all existing and reasonably foreseeable conflicts of interest (not just material conflicts), including conflicts arising from compensation arrangements and incentive practices, in the client's best interest;
2. Impose on registered individuals the same obligation to address conflicts of interest as described in (1) above, as well as prohibiting a registered individual from proceeding with an activity relating to an identified conflict of interest unless:
   a. That conflict has been addressed in the client's best interest; and
   b. The registered individual has received consent from their sponsoring firm;
3. Require registrants to put the client's interest first when making suitability determinations;
4. Amend the KYC and KYP requirements to:
   a. support the enhanced conflict of interest and "clients first" provisions described above;
   b. clarify regulators' expectations about the information that they expect registrants to collect about their clients; and
   c. increase transparency and rigour around the products and services that registrants offer to clients;
5. Explicitly require registrants to consider certain factors, including costs and their impact, in determining the suitability of investments, and make the determinations on a portfolio basis;
6. Impose restrictions on referral arrangements, including a prohibition on paying referral fees to non-registrants;
7. Strengthen the prohibitions on misleading marketing and advertising;
8. Expand the RDI requirements to address any restrictions on the products or services that a registrant will make available to a client, including when the registrant uses proprietary products, and address the potential impact on a client's investment returns and the costs and fees that the client incurs resulting from such restrictions;
9. Introduce a new requirement to make certain information publicly available so that potential clients can use that information in selecting a registrant who meets their expectations; and
10. Make corresponding changes to requirements and guidance concerning training of representatives and maintenance of policies, procedures, controls and documentation to support internal compliance systems.

The comment period on these proposed changes to NI 31-103 closes on October 19, 2018.

Staff also indicated that, over the longer term, they intend to propose for comment additional reforms relating to:

- Proficiency standards;
- Titles and designations, including the use of "advisor" to describe individuals who are not registered in the category of advisor;
- The need for a statutory fiduciary duty when a client grants discretionary authority in jurisdictions that do not currently have this provision; and
- The roles of ultimate designated persons and chief compliance officers.

In Brief cont'd

MFDA Publishes 2018-2022 Strategic Plan

On June 19, the Mutual Fund Dealers Association (MFDA) published a five-year strategic plan. In light of the key themes and regulatory priorities that we have seen other regulators focus on, we are not surprised to see that the MFDA's strategic plan includes the following elements, among others:

- Support for innovation by, *e.g.*, encouraging members to collaborate with the MFDA if they want to implement new technology and assessing MFDA requirements to ensure they are relevant and applicable to emerging technologies and new business models;
- Introducing a continuing education requirement for all MFDA advisors;
- Exploring alternatives to improve transparency of costs for mutual fund investors; and
- Developing a cybersecurity plan to identify risks within the membership and provide information and guidance on threats, breaches and best practices.

In a separate notice, CSA staff announced their policy decision on mutual fund embedded commissions. They expect to publish proposed rules in September 2018 that, if adopted, will prohibit:

- all forms of deferred sales charge options for purchases of prospectus-qualified mutual fund securities; and
- the payment of trailing commissions to, and the solicitation and acceptance of trailing commissions by, dealers who do not make a suitability determination in connection with the distribution of prospectus-qualified mutual fund securities.

AUM Law's extensive experience with NI 31-103 means that we can help you navigate these tectonic shifts in the regulatory framework for registrants. Please do not hesitate to contact us to discuss the implications of the proposed changes for your business.

2. CSA Consults a Second Time on Business Conduct Rules for OTC Derivatives

On June 14, the Canadian Securities Administrators (CSA) published for comment proposed National Instrument 93-101 *Derivatives: Business Conduct and its Companion Policy* (Business Conduct Instrument). The Business Conduct Instrument complements National Instrument 93-102 *Derivatives: Registration* (Registration Instrument), which we wrote about when it was published earlier this spring. The two instruments are intended to create a comprehensive investor protection framework for the regulation of people and companies who are in the business of dealing in or advising on over-the-counter (OTC) derivatives.

The proposed Business Conduct Instrument will apply to any person or company who meets the definition of "derivatives adviser" or "derivatives dealer" (collectively, a Derivatives Firm) for OTC derivatives, unless they qualify for an exemption, such as those applicable to:

- certain end-users who trade derivatives for their own account for commercial purposes; and
- certain foreign derivatives advisers and derivatives dealers (Foreign Derivatives Firms).

The Business Conduct Instrument takes a two-tiered approach to regulation by tailoring many requirements according to the nature of the person or firm (Derivatives Party) with whom the Derivatives Firm is interacting. Some obligations (*e.g.*, relating to fair dealing) will apply regardless of the Derivatives Party's sophistication or financial resources. Other obligations will not apply, or can be waived in some circumstances, by Derivatives Parties that meet the definition of "eligible derivatives party" (EDP).

The revised Business Conduct Instrument takes into account comments that were made on the proposed instrument published in 2017. For example, "commercial hedgers" have been added to the definition of EDP. In addition:

- **Managed accounts of EDPs** will not be treated as non-EDPs.
- **Annual compliance report to board:** The original draft rules called for an individual designated as responsible for the firm's derivatives business unit (Senior Derivatives Manager) to, among other things, report at least annually to the firm's board of directors on compliance with the Business Conduct Instrument, applicable securities legislation, and the policies and procedures required under the Business Conduct Instrument. The revised Business Conduct Instrument permits this reporting function to be carried out by the Senior Business Manager or the firm's chief compliance officer.

In addition to seeking comments on all aspects of the Business Conduct Instrument, the CSA is seeking specific feedback on several issues, such as:

- The definition of EDP;
- The definition of "affiliated entity" (*e.g.*, whether the test should be based on the concept of control or the accounting-based concept of consolidation);
- The scope of certain exemptions for anonymous transactions executed on a derivatives trading facility; and
- Potential issues with implementing the requirement to have policies, procedures and controls that are sufficient to ensure that an individual who transacts or advises on derivatives for a Derivatives Firm conducts themselves with integrity.

The comment period for both the Business Conduct and the Registration Instruments closes on September 17, 2018. Then on September 20, the Ontario Securities Commission (OSC) will hold a roundtable to discuss both proposed instruments. The OSC will publish registration details for the roundtable in August.

Given AUM Law's depth of experience in advising on NI 31-103 and related matters, we are ideally suited to help firms navigate the proposed derivatives registration and business conduct regime. Please contact us if you would like to discuss the proposals and their potential impact on your business.

3. Pursue Best Execution for Your Clients, or Else

In July, the Ontario Securities Commission (OSC) is scheduled to hear staff's case against Caldwell Investment Management Ltd. (CIM) for allegedly failing to provide best execution for its clients. Regardless of the final outcome in this case, we believe that the Statement of Allegations is worth reading now since it reflects OSC staff's interpretation of the best execution requirements.

In the Statement of Allegations, staff describe CIM's best execution obligations as follows:

> "Advisers … are required to make reasonable efforts to achieve best execution of orders when acting for clients. Best execution is defined as the most advantageous execution terms reasonably available under the circumstances. In order to meet the reasonable efforts standard, an adviser must have, and abide by, policies and procedures that outline the process it has designed toward the objective of achieving best execution. The policies and procedures should describe how the adviser evaluates whether best execution was obtained and should be regularly and rigorously reviewed."

CIM acted as an investment fund manager (IFM) and portfolio manager (PM) for a number of Caldwell-related mutual funds and performed portfolio management services for clients under separately managed discretionary accounts (SMAs). According to OSC staff, CIM:

- Breached its best execution obligation under section 4.2 of National Instrument 23-101 - *Trading Rules* (NI 23-101) by placing most of its trades for execution through Caldwell Securities Ltd. (CSL), a related investment dealer, without having adequate policies and procedures or an adequate written process in place to ensure that CIM's best execution obligation was being met;
- Had inadequate policies and procedures relating to its best execution obligation, contrary to section 1.1 of National Instrument 31-103 – *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103); and
- Made one or more misleading misrepresentations to its investment review committee (IRC) and did not provide it with sufficient information to carry out its responsibilities, contrary to section 2.4(1)(a) of National Instrument 81-107 – *Independent Review Committee for Investment Funds* (NI 81-107).

The allegations have not been proven, so we will need to wait and see how the case proceeds before the OSC. Please contact us if you would like to discuss what your firm can do manage its compliance risks relating to best execution.

4. CSA Staff Publish Follow-up Guidance on Token Offerings

To follow up on guidance regarding cryptocurrency offerings published last year, on June 11 the Canadian Securities Administrators (CSA) published Staff Notice 46-308 – *Securities Law Implications for Offerings of Tokens* (SN 46-308*)* to address inquiries that they have been receiving about whether and how securities laws apply to offerings of tokens, including "utility tokens". A "utility token" is a token that has one or more specific functions, such as allowing its holder to access or purchase securities or assets based on blockchain technology. Many business have been offering tokens to raise capital for the development of their software, online program, or application.

In SN 46-308, CSA staff discuss a series of examples to illustrate how they analyze token offerings in light of the definition of "security". As we mentioned in last month's bulletin article on the *Tiffen* ruling, "security" is defined very broadly. One sub-category of "security" is an "investment contract". The term has been interpreted to mean: (1) an investment of money (2) in a common enterprise, (3) with the expectation of profit (4) to come significantly from the efforts of others.

Some of the market participants contacting CSA staff believe that, because their proposed offering involves a utility token, the offering isn't a distribution of an investment contract. CSA staff, however, have indicated that the existence of a utility function is not determinative of whether the token offering involves a distribution of a security. For example, an issuer may suggest to investors that the tokens which it is offering will have a utility beyond the issuer's platform. However, when these suggestions are made, the issuer cannot show that the tokens are widely used or accepted. According to CSA staff, this could indicate a common enterprise because investors must rely on management to take key actions to establish uses for the tokens beyond the platform.

SN 46-308 also discusses token offerings that are structured in multiple steps. For example:

- In step one, a purchaser agrees to contribute money in exchange for a right to receive tokens at a future date. Staff note that generally, this step involves the distribution of a security (*i.e.*, the right to a future token), often made under a prospectus exemption such as the accredited investor exemption.
- In step two, a token is delivered (*e.g.*, when the issuer has represented that the software, online platform or application is built, or the goods or services are available, and the token is functional).

Some issuers have taken the position that the token itself is not a security. As discussed above, however, CSA staff believe that the token's utility function isn't determinative and that prospectus and registration requirements in securities legislation must be considered at all stages in a multi-step transaction. Moreover, if a security is distributed in breach of securities laws at the first step, the issuer will remain in default even though subsequent steps have occurred. They also stress that the examples listed in SN 46-308 should not be used to conduct a mechanical "tick-the-box" assessment of the proposed offering because the legal analysis is very fact-specific and focuses on the economic realities of the offering.

As SN 46-308 indicates, the cryptocurrency industry is evolving quickly. AUM Law has experience advising clients on transaction structures in this field, and we also can assist you in engaging with securities regulators if you believe that your proposed transaction or business model calls for a flexible approach to compliance with securities laws.

5. Federal Government Proposes Changes to AML/ATF Regime

On June 9, 2018, the Government of Canada published proposed amendments to the regulations for the Canadian Anti-Money Laundering and Anti-Terrorist Financing (AML/ATF) regime. The changes are intended to help address deficiencies that the Financial Action Task Force (FATF) identified in its 2015-16 assessment of Canada's AML/ATF regime and operationalize some of the legislative changes to Canada's regime that were enacted in 2017.

Changes of significance to the asset management sector include the following:

- **Reliance on Third Parties and Foreign Affiliates:** If you work with either an affiliate or third party that is also subject to the Canadian AML/ATF regime, the proposed amendments recognize that you should not have to duplicate their work when verifying an investor. You may rely on identify verification performed by either:
  - A third party that is also a reporting entity under the Canadian AML/ATF regime; or
  - A foreign affiliate.
- **Scans and Photocopies:** We have heard that the new, remote identification regime (also called the "dual process" method) presents challenges because some investors have found it difficult to present original forms of identification. It appears that the regulators have recognized this concern and are changing the requirement for identity verification documents from "original, valid and current" to "authentic, valid and current". That should mean that if you reasonably believe that a photocopy of the listed identification documents under the dual process method is authentic, then you can accept that document.
- **Currency of corporate status documentation:** Historically, when verifying the existence of a corporation, firms collected a corporation's articles of incorporation. The existing Regulations do not set any parameters on the date of issuance for such documents. The proposed amendments will require that documents used to establish proof of a corporate client's existence be no more than one year old for the certificate of corporate status and "most recent" for other permissible documents, such as audited, annual financial statements.

- **Keeping beneficial ownership information up-to-date:** Reporting entities already have to verify the beneficial owners of an investing client, take reasonable measures to confirm the information's accuracy, and keep the information up-to-date on an ongoing basis. For example, for an investor that is a corporation, the reporting entity must determine and list all individuals who own 25% or more of that investing corporation (along with all directors and officers of that corporation). However, the Regulations do not explicitly state what reporting entities must do to confirm the accuracy of new information as it comes in or is updated over time. The proposed amendments will expressly require the relevant information to be confirmed as it comes in or is updated by the client.
- **Dealers in virtual currencies to be regulated as money service businesses:** Canada's existing AML/ATF framework was designed for traditional financial services and "bricks and mortar" institutions. Some of the proposed amendments are designed to close perceived loopholes (*e.g.* relating to virtual currency) that could be exploited by criminals. Under the proposed amendments, persons and entities that are "dealing in virtual currency" (*e.g.* by providing virtual currency services or value transfer services) will be regulated as money services businesses (MSBs). Among other things, they will have to register with FINTRAC and implement a full compliance program.

The comment period on the proposed amendments closes in early September. The Government has not specified a target date for implementation of the proposed amendments. However, it has acknowledged that businesses will need time to implement the changes and intends to provide a 12-month transition period that runs from the date the Regulations are registered. Once the proposed amendments are approved, FINTRAC will update its guidance so that reporting entities are aware of the new obligations.

If you wish to discuss this changes or what it means for your business, please contact your usual lawyer at AUM Law.

6. Why Invest in Investment Policy Statements?

National Instrument 31-103 – *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103) requires advisers to take reasonable steps to know their clients (KYC) and ensure that trades in securities for a client are suitable for the client. Advisers that are portfolio managers also may owe a fiduciary duty to their clients.

One manner in which an adviser can help ensure that they are meeting these obligations is to develop an investment policy statement (IPS) for each client. Typically, portfolio managers that have full discretion to manage a client's money use IPSs to help ensure that they are managing the client's money as desired by the client.

The Canadian Securities Administrators' 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* indicates that CSA staff expect every PM to:

> "…develop a tailored investment policy statement (IPS) for each managed account. The IPS should document the client's investment needs and objectives and set out a planned asset allocation. PMs should provide a signed (and dated) copy of the IPS to each client at the time the IPS is first signed and when it is updated."

In addition to helping a portfolio manager meet its regulatory and fiduciary obligations, creating an IPS is simply good client service. The IPS helps ensure the clients' expectations are clearly communicated to the portfolio manager and that the portfolio managers' responsibilities are clearly communicated to the client. This provides for a higher level of confidence between the client and the portfolio manager and helps reduce the likelihood of any miscommunications.

AUM Law has extensive experience assisting advisers draft and review IPSs and providing advice on related matters. Please contact us for assistance.

7. OSC Approves No-Contest Settlement with IPC Dealers

On June 7, 2018 the Ontario Securities Commission (OSC) approved a no-contest settlement with IPC Securities Corporation and IPC Investment Corporation (collectively, the IPC Dealers) regarding excess fees paid by some of their clients. Although enforcement matters are often resolved through settlement agreements between OSC staff and market participants, no-contest settlements, where the respondent

makes no admissions of fact or liability, are relatively unusual. This case, therefore, provides insight into the steps a registrant can take if it identifies potential non-compliance with securities law to increase the likelihood that a no-contest settlement can be reached.

In this case, OSC Enforcement Staff alleged that certain of the IPC Dealers' clients paid excess fees because the firms failed to establish, maintain and apply a sufficient system of controls and supervision, as required under National Instrument 31-103 – *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103). In concluding that the proposed Settlement Agreement, including the no-contest element, should be approved, the OSC emphasized the following elements, among other things:

- The IPC Dealers promptly reported the inadequacies that they had detected in their systems to their respective self-regulatory organizations and soon afterward began discussions with OSC staff.
- The IPC Dealers promptly began to address the underlying causes of the alleged inadequacies once they were identified.
- Throughout the process, the IPC Dealers provided prompt, detailed and candid cooperation to OSC staff, and there was no allegation or evidence of dishonest conduct on the part of the IPC Dealers.
- The IPC Dealers committed to pay compensation totaling $11 million to affected clients, under OSC staff's supervision. They also committed to take implement enhanced procedures, controls and monitoring systems to prevent a recurrence of the alleged inadequacies, and to have those revised procedures reviewed and approved by OSC staff.
- The IPC Dealers also made a voluntary payment of $460,000 for allocation or use by the OSC as well as $30,000 to reimburse the OSC for costs.

AUM Law has substantial experience engaging with securities regulators on behalf of registered firms, including in situations of alleged non-compliance with securities laws. We also have experience in helping firms develop remediation plans, including enhanced compliance policies and systems. Please do not hesitate to contact us if you need assistance in a similar situation.

News & Events

We're Moving This Fall!

AUM Law is pleased to announce that we have secured premises in Toronto's financial district. We will relocate to 110 Yonge Street (at Adelaide Street) this fall. Our new office will be closer to many of our clients, with excellent access via public transit and the PATH system for visitors to the firm. We also will be closer to regulators like the Ontario Securities Commission, as well as industry associations that we support, like the Portfolio Management Association of Canada.

Our new office will be configured to support growth in our services, and it will offer comfortable and functional space to meet with existing and potential clients. We expect to move in the second half of October.