Dam It!

It's that time of year when everyone is, or wants to be, soaking up the last rays of summer sunshine at the cottage. Back in Toronto, though, staff of the Ontario Securities Commission's Compliance and Registrant Regulation Branch have been working like busy beavers to finalize Staff Notice 33-749 *Annual Summary Report for Dealers, Advisers and Investment Managers*.

All kidding aside, we are grateful that the OSC publishes this annual summary of key issues and future areas of focus. That's why we have devoted most of this month's bulletin to a discussion of the report. Read on below.

In this bulletin:

1. Our Takeaways from the 2017-18 CRR Annual Report

Staff of the Compliance and Registrant Regulation Branch (CRR) encourage registrants to read and use their Annual Summary Report for Dealers, Advisers and Investment Managers (Report) to learn more about recent and proposed regulatory initiatives, the OSC's expectations for registrants, and how Staff interpret initial and ongoing requirements for registration and compliance. Although we hope you find our discussion helpful, it doesn't replace the Report or consultation with your counsel about the Report's implications for your business.

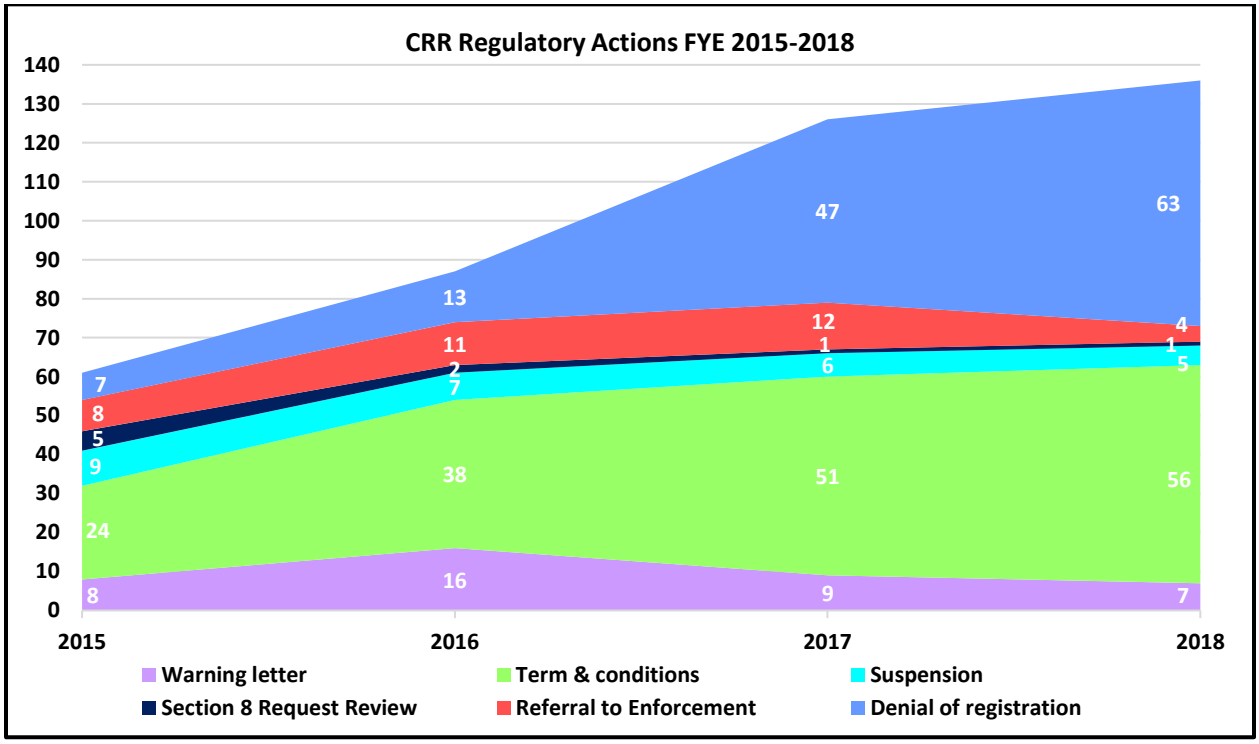
A. Compliance Reviews and Regulatory Actions: Looking Back

In 2017-18, Staff focused on seven areas for compliance reviews:

- Client disclosure and reporting
- Compliance systems
- Conflicts of interest and referral arrangements
- Financial condition and custody
- Know-your client (KYC), know-your-product (KYP) and suitability policies, procedures and practices
- Marketing
- Registration and compliance filings

Overall, the largest number of deficiencies related to compliance systems (38% as a percentage of overall deficiencies) and client disclosure and reporting (18%). The largest number of significant deficiencies concerned: (1) compliance systems (10%); and (2) KYC, KYP and suitability policies, procedures and practices (8%).

Regulatory actions taken by Staff against firms or individuals for the fiscal years ended 2015-2018 are summarized below.



(Section 8 Request Reviews are reviews by the OSC of decisions of the Director of CRR.)

B. Looking Ahead: Focus Areas for Upcoming Compliance Reviews

Staff expects upcoming compliance reviews in to focus on the following areas:

- Section 5.6 of National Instrument 81-105 *Mutual Fund Sales Practices* (NI 81-105) relating to promotional items and business promotion activities (see also section C(3) below);
- Conflicts of interest created by compensation practices;
- Firms that participated in "Registration as the First Compliance Review" program and have been operating for at least one year;
- Assessing the accuracy of responses from firms that completed the 2018 Risk Assessment Questionnaire (RAQ); and
- High-risk registrants identified through the 2018 RAQ process.

Our compliance risk assessment reviews can save you time and money by enabling you to pro-actively identify and address issues before they flare up into problems or you are audited by the OSC. But if the OSC calls you for an audit before you call us, we can conduct a strategic and expedited review (a "911 Review") so that you know what to expect in the audit process, are better-positioned to make a good first impression with OSC staff in the initial meeting, and can begin identifying and addressing any material issues. Contact us to learn more about these services.

C. Spotlight on 2017-18 Compliance Deficiencies

This year, Staff organized the discussion of compliance deficiencies by theme, instead of by registrant type. This means that readers may have to wade through more pages to find content that is relevant to them. Below, we have highlighted topics that we believe will be of particular interest to our clients.

1) Best Execution – EMDs / PMs

EMDs' and PMs' obligations to achieve best execution for their clients continue to be an important theme in compliance reviews. Although the Report's list of "shoulds" won't surprise anyone, the "should nots"

makes interesting reading this time. Among other things, EMDs and PMs should not:

- Give misleading or inadequate disclosure to clients about the firm's processes to achieve best execution (obviously);
- Rely on a dealer's best execution obligation or its policies and procedures when executing client trades to satisfy their own best execution obligation (perhaps less obviously); or
- Unnecessarily interpose another party between the PM and dealer or marketplace, for example by directing commissions to a dealer not involved in executing the trade to compensate them for referred clients.

Please contact us if you would like to discuss what your firm can do manage its compliance risks relating to best execution.

2) Client Disclosure and Reporting – EMDs / PMs

During Staff's CRM2 review, Staff observed that some firms were not delivering the required client statements and reports, including:

- EMDs that hold client assets;
- EMDs that do not hold client assets but receive trailing commissions related to the client's ownership of securities that they purchased for clients; and
- PMs that believe that they had met their statement delivery obligation because their clients' custodians were carrying out these tasks. (Staff reminds PMs to review CSA Staff Notice 31-347 *Guidance for Portfolio Managers for Service Arrangements with IIROC Dealer Members*.)

Common deficiencies in the required client statements and reports include:

- Client statements that consolidate all accounts owned by a client or family group;
- Compensation reports with inadequate disclosure about operating or transaction charges where clients with multiple accounts designate one account to pay for all the fees; and
- Performance reports that are missing information (*e.g.*, the definition of total percentage return and associated notification), do not include text, tables and charts to illustrate the content of the report, and/or do not provide adequate disclosure when discussing benchmarks.

We can review your post-trade client reports to determine whether you are meeting your disclosure and reporting obligations, and advise you on amendments to standard documentation as needed.

3) Conflicts of Interest: Retail Mutual Fund Sales Practices - IFMs

Staff address three topics in Section 2.2.5 concerning conflicts of interest:

- Assessing and addressing conflicts of interest
- Ineffective use of independent review committees
- Retail mutual fund sales practices

The discussion of the first two topics does not break any new ground. Staff's discussion of sales practices, however, is worth careful consideration and we would be happy to discuss it with you. The Report summarizes key findings from Staff's compliance reviews and identifies resources (such as the recent sales practices settlement agreements) that IFMs should use to enhance their compliance systems, internal controls and supervision for sales practices. The Report also includes several tables comparing examples of compliant and non-compliant sales practices and promotional activities, and it discusses prohibited solicitation by participating dealers and representatives. Finally, the Report

In Brief

FINTRAC Updates Its Guidance on Beneficial Ownership

On August 20, the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC) issued updated guidance on the means that can be used to determine beneficial ownership of entities. Previously, FINTRAC took the position that although various means could be used to obtain beneficial ownership information, only official documentation could be relied upon to confirm the accuracy of the information obtained. The new guidance indicates that, once beneficial ownership information is obtained, various reasonable measures may now be used to confirm the accuracy of that information.

FINTRAC's guidance emphasizes that what constitutes reasonable measures will depend on the circumstances. For example, the measures used must be in line with the assessed risk of a money laundering or terrorist financing offence for the entity, as well as taking into account the complexity of the entity whose beneficial ownership is being determined. The measures are discussed in more detail here.

OSC and AMF Join the Global Financial Innovation Network

On August 7, the Ontario Securities Commission (OSC), Quebec Autorité des marchés financiers (AMF) and eleven other financial sector regulators and related organizations announced their intention to establish a collaborative, global

includes a flowchart that can be used to assess whether the provision of a non-monetary benefit complies with section 5.6 of National Instrument 81-105. Of particular note, Staff indicate that exceptions to an IFM's own policies and procedures would be considered non-compliance with NI 81-105.

4) Employment-Related Agreements: Are Yours Offside the OSA's Prohibition on Reprisals? EMDs / IFMs / PMs / SPDs

It is an offence under section 121.5 of the Securities Act (Ontario) (Act) to take reprisal against an employee who reports or plans to report potential violations of securities law to the OSC, a recognized self-regulatory organization (SRO), or a law enforcement agency. Staff followed up on the 2016 enactment of this provision by conducting a desk review of thirty registered firms to see whether their agreements with employees, as well as their policies and procedures, were consistent with this prohibition. They found that a significant number of the firms reviewed had employment, severance and/or confidentiality agreements (Employment-Related Agreements) that restricted or purported to preclude employees from reporting securities law violations to the OSC, SROs or law enforcement agencies, contrary to subsection 121.5(3). In addition, some firms had policies, procedures and other documents that purported to stop whistleblowers from coming forward.

According to Staff, Employment-Related Agreements should not include language that:

- Prohibits any and all disclosure of information, without an exception for reporting potential violations of securities law;
- Allows disclosure "only as required by law";
- Permits disclosure only for "good faith" reports but is silent as to how the firm will assess that a report is made in good faith;
- Limits the type of information that an employee may report;
- Requires representations that an employee has not assisted in any investigation involving their employer; or
- Requires notification to or consent from an employer prior to reporting information.

Staff recommend that firms review their Employment-Related Agreements to determine whether they contain provisions that preclude or purport to preclude whistleblowers from reporting securities law violations. If they find any such provisions, firms should address the problems, *e.g.*, by:

- Revising agreements to bring them into line with Section 125.1; and
- Notifying current and former employees who signed restrictive agreements that they have the right to contact the OSC, an SRO or a law enforcement agency regarding potential violations of securities law, and to receive a whistleblower reward.

Registered firms also should:

- Implement policies and procedures to review and approve all Employment-Related Agreements to confirm that they do not preclude or purport to preclude whistleblowers from coming forward; and
- Review their compliance systems to assess the availability and appropriateness of employee reporting channels to encourage potential whistleblowers to report misconduct internally and allow the firm to investigate and remediate as appropriate.

5) Expenses Charged to Investment Funds – IFMs

Staff expect the portfolio management fee paid to the PM as an advisory fee to cover all of the expenses associated with executing the portfolio management function. Separate fees for, *e.g.*, research and analysis or software due diligence should not be charged to investment funds.

Other inappropriate expenses mentioned in the Report include investment level penalties, upfront fees charged when the funds are created to subsidize the funds' future expenses, reimbursements to the IFM

In Brief continued

network to help innovative firms seeking to operate in multiple countries. The organizations involved with GFIN have published a consultation paper on its proposed mission statement, functions and focus areas. GFIN's proposed functions are to:

- Act as a network of regulators to share knowledge of emerging innovation trends and liaise with firms;
- Function as a joint forum for policy work and regulatory trials in a manner that complements, rather than duplicates, work done at the national level; and
- Offer firms an environment in which to navigate multi-jurisdictional regulatory issues and test cross-border solutions.

The deadline for comments is October 14, 2018.

to compensate the IFM for subsidizing certain of the fund's expenses in prior periods, and overcharging on performance fees.

Taking into account these and other deficiencies, Staff emphasize that IFMs should, among other things:

- Have written policies and procedures on expenses and fees to ensure consistency in the IFM's practice;
- Review the performance fee charged to each fund to confirm that the calculation is accurate and that any changes to the high watermark are reasonable and appropriately disclosed;
- Review the nature and type of expenses charged to each fund to confirm that the expenses are attributable to the fund's daily operations;
- Use a fair methodology to allocate expenses;
- Review the costs relating to termination, restructuring and mergers to determine whether these costs are being charged to the investment funds and, if so, if it is appropriate to do so;
- Communicate with the IRC, if applicable, on expenses arising from the termination, restructuring or merger of funds; and
- Provide adequate and accurate disclosure about expenses and fees.

Expense allocation can be a difficult area for fund managers to navigate since every situation is different. AUM Law has experience engaging with Staff on our clients' behalf with respect to expense allocation issues. We also can help you by drafting or reviewing your expense allocation policies and procedures.

6) Fund Financial Statements – IFMs

According to Staff, some IFMs are not applying the appropriate accounting standards or have not maintained documentation to support the appropriateness of the standards they have used. If securities regulation does not specify a required accounting framework, the IFM should:

- Determine whether a fund meets the definition of "publicly accountable enterprise" (PAE) in the CPA Canada Handbook – Accounting (Handbook);
- If the fund is a PAE, prepare its financial statements in accordance with International Financial Reporting Standards (IFRS);
- If the fund isn't a PAE, prepare its financial statements in accordance with IFRS or Accounting Standards for Private Enterprises (ASPE); and
- Maintain documentation to support the appropriateness of the framework used, if the financial statements are not prepared in accordance with IFRS.

7) IFMs Outsourcing Their Responsibilities – How Much Is Too Much?

a) Outsourcing to Unrelated Third Parties

Over-outsourcing (we just made that term up) isn't just a problem for the outsourcing firm. It can also be a problem for the outsourcee (yes, we made up that word, too). For example, Staff are concerned that some IFMs have entered into arrangements with unrelated, registered firms to distribute funds managed by the IFM where the distributing dealer appeared be operating as the funds' "mind and management". They mentioned one example where the distributing dealer undertook numerous activities to direct the funds' business, operations and affairs including:

- Preparing the offering memorandum with external counsel;
- Directly providing seed capital for the investment funds;
- Indirectly making decisions on fund investments and managing the status of the funds;
- Having and exercising signing authority over the investments funds' bank accounts;
- Engaging service providers for the investment funds' daily fund administration;
- Engaging an auditor to prepare the funds' year-end, audited financial statements; and
- Collecting the majority of the fees related to investing in the fund.

IFMs must be careful not to enter into arrangements that delegate too much authority to other parties. Not only could this be an inappropriate delegation of the IFM's responsibilities, it could result in the other party

itself requiring registration as an IFM. Staff stress that IFMs must be involved in the daily operations of every fund they manage, including the following activities:

- Any engagement of service providers required to fulfill key responsibilities of an investment fund;
- Establishing and implementing policies and procedures to actively oversee all service providers;
- Overseeing the service providers to confirm that all duties outsourced to them are conducted in accordance with securities law;
- Drafting and approving legal documentation relating to the investment funds;
- Reviewing and approving all aspects regarding fund administration; and
- Validating that each party involved with the fund is adequately executing their duties within the parameters of their registration category.

b) Outsourcing to Related Party Service Providers

Staff also remind IFMs that if they outsource fund administration functions to related parties, they must not rely solely on that service provider and/or assume that all the IFMs' obligations under securities law have been met. IFMs are expected to employ the same level of oversight for related and unrelated service providers.

Where an IFM is part of a global conglomerate and using a related party service provider to allow for common compliance resources, IFMs should, at a minimum:

- Maintain a service level agreement with the affiliate that clearly lists each party's responsibilities;
- Implement a formal line of reporting between the affiliate and registrant;
- Have officers or directors of the affiliated service provider attend and report to committees within the registrant (including the risk management committee and valuation committee);
- Tailor oversight procedures to the IFM's business and outsourcing arrangement to meet their regulatory obligations; and
- Compare the fees charged by a related service provider to those charged by third parties to confirm that the selection of the service provider is in the investment funds' best interests, with referral of the matter to the IRC, if applicable, for consideration.

We can assist IFMs and other firms by drafting or reviewing service provider arrangements, as well as related policies and procedures, to confirm that IFMs aren't offside the rules governing IFMs' fulfillment of their obligations as registrants and service providers haven't inadvertently taken on responsibilities that could require registration as an IFM.

8) Issuers Directly Offering Securities

The "business trigger" test for registration can be a murky one to apply. In the Report, Staff remind entities that offer their own or an affiliate's securities that they must continually reassess whether they are in the business of trading in or advising on securities. The Report lists some factors to consider in determining whether an issuer has met the "business trigger" for registration:

- How frequently Form 45-106F1 *Report of Exempt Distribution* filings are made without reference to a registered dealer (since this may suggest trading activity conducted with repetition, regularity or continuity);
- Entities directly soliciting trades by advertising their securities offerings;
- Using the internet, including public websites and discussion boards, to reach a large number of potential investors;
- Employees actively soliciting the public for the purpose of selling their employer's securities, possibly with employees dedicated to capital-raising; and
- Entities that raise large capital sums from the general public through the distribution of securities.

9) Misleading or Inaccurate Marketing Materials - EMDs / IFMs / PMs / SPDs

Staff expressed concern about the following practices that they observed in their reviews of marketing materials provided to prospective clients:

- Using hypothetical performance data without first determining whether that information is fair and not misleading;
- Unbalanced sales presentations that omit or understate commissions, fees or risks; and
- Unsubstantiated statements in marketing and sales materials.

AUM Law can support your compliance efforts by reviewing your marketing materials, updating your policies and procedures for marketing materials, and/or conducting training for your staff in this area.

10) Offering Memorandum Exemption: Delivery of Offering Documents - EMDs

For an issuer to rely on the offering memorandum (OM) exemption from the prospectus requirements, a dealer must deliver to the investor (where the issuer has not) an OM at the same time as or before the purchaser signs the purchase agreement. Staff are concerned that some dealers are delivering OMs electronically without following the guidance in National Policy 11-201 *Electronic Delivery of Documents*. Staff reminder dealers that:

- If they make an electronic version of the OM available on their website, they must provide recipients with a separate notice about the OM's availability;
- They must take reasonable steps to ensure that access in a particular electronic format is neither burdensome nor overly complicated;
- They should not permit dealing representatives to determine for themselves how and when an OM will be delivered to an investor; and
- They must maintain documentation of how and when the OM was delivered to the investor.

AUM Law can help you develop, assess, and/or revise policies and procedures for delivery of OMs and train your staff on securities law requirements and your firm's policies and procedures this area.

11) Participation Fee Calculation – EMDs / IFMs / PMs / SPDs

Registered firms must remit, by December 31 each year, a participation fee calculated with reference to their "specified Ontario revenues". Under OSC Rule *13-502 Fees* (Fee Rule), firms can deduct certain revenues not attributable to "capital markets activities". According to the Report, some firms are improperly deducting fees that fall within this definition, such as origination fees and renewal fees paid to registered firms in connection with mortgage financings. Staff emphasize that although there are exemptions from the registration requirements for trades in mortgages or real property by persons or firms registered or licensed under mortgage broker legislation in Canada, to the extent a registered firm engages in such activities, those activities are considered to capital markets activities. Therefore, they cannot deduct revenues from those activities when they calculate their "specified Ontario revenues".

We can help you prepare and file the relevant forms that include your calculation of the participation fees due each year. The relevant forms are due on December 1.

12) Safeguarding Client Assets – IFMs

As we mentioned earlier this year, new custody requirements came into force in early June. Although IFMs understand that it is important to safeguard client assets, questions often arise about exactly which measures should be taken in other contexts. In the Report, Staff indicated that IFMs should, among other things:

- Decline to accept client assets unless they have clear policies and procedures for handling such assets;
- Ensure that reconciliations and the corresponding activity within trust accounts are reviewed, signed and dated by an individual independent of the preparer;
- Require that disbursements from trust accounts be authorized by multiple, approved persons; and
- Implement adequate compensating controls to address the increased risks when there is a lack of segregation of duties.

We can review your policies, procedures and internal controls, and conduct training for your staff, to help you ensure that you are complying with all the requirements for safekeeping of client assets.

13) Senior and Vulnerable Investors – EMDs / PMs / SPDs

Staff's sweep of firms with substantial numbers of senior and vulnerable investors revealed some significant compliance weaknesses, including the following:

- Approximately 90% of the firms lacked written policies and procedures for such clients;
- Approximately 57% of the firms did not collect and document sufficient KYC information;
- Generally, firms used the same KYC process (*e.g.*, as to the frequency of updates and types of information updated) and the same supervision and review procedures for suitability determinations for their senior clients as they did for other clients; and
- Approximately 23% of the firms reviewed did not maintain adequate documentation to support suitability determinations for their senior clients.

During the sweep, some firms reported that they are having difficulty serving clients who may have diminished capacity. For example, they may find it hard to detect clients with potential cognitive impairment issues or clients who may be victims of financial abuse, even in circumstances where the firms have known the clients and family members for a long time. Some firms also find it hard to share sensitive information with clients' family members, given existing privacy legislation.

The Report does not offer any specific solutions for overcoming these challenges. We likely will have to wait for further work to be done, as outlined in the OSC's Seniors Strategy, which we discussed in March 2018.

In the meantime and despite these challenges, Staff are recommending that firms should develop, or enhance, their policies, procedures and employee training with respect to senior and vulnerable investors. AUM Law has experience in this area. We can help you develop or fine-tune your policies and procedures to address the evolving expectations of regulators and investors and provide training to your staff.

D. Policy Initiatives

As in prior years, the Report summarizes policy initiatives affecting registrants and provides links to the relevant publications. This year, this section of the Report covers:

- Proposed registration and business conduct requirements for over-the-counter derivatives dealers and advisers (see our bulletin articles here and here);
- Multilateral Instrument 91-102 *Prohibition of Binary Options* (see our bulletin article here);
- Proposed amendments to the regulatory framework for syndicated mortgages (see our bulletin article here);
- Activities of the Ombudsman for Banking Services and Investments (OBSI) Joint Regulatory Committee (JRC) (see our bulletin articles here and here);
- New custody requirements for IFMs and PMs (see our bulletin article here); and
- Amendments to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Requirements* (NI 31-103) to clarify restrictions on EMD participation in prospectus offerings and brokerage activities (see our bulletin article here).

Surprisingly, the Report does not summarize the proposed, client-focused reforms to NI 31-103. However, in their discussion of compliance deficiencies relating to conflicts of interest, Staff remind registrants (at p. 53) to review the proposed reforms together with Staff's guidance on addressing conflicts of interest. See our summary of the proposed amendments here.

2. The Northwest Exemption for Prospectus-Exempt Trades Is Being Revoked

On August 15, the securities commissions of British Columbia, Manitoba, Nunavut, the Northwest Territories, and Yukon announced that they will be revoking their registration exemption orders, commonly known collectively as the "Northwest Exemption", effective April 30, 2019. The Northwest

Exemption deals with registration exemptions for trades in connection with prospectus-exempt distributions in each of the relevant jurisdictions.

At the same time, the Alberta Securities Commission (ASC) announced that it will consult on whether to revoke its related order, and the Saskatchewan Securities Commission (SSC) said it is considering whether to revoke its related exemption, too. In addition, the British Columbia Securities Commission (BCSC) said that it will not renew BC Instrument 32-517 dealing with dealer registration relief for mortgage investment entities and that it will expire effective February 15, 2019.

Transition periods will be apply for those jurisdictions where the Northwest Exemption is revoked. Parties currently relying on the Northwest Exemption may continue to rely on the exemption if they file Form 33-109F6 - *Firm Registration* and the filer is in compliance with the terms of the exemption. Commission staff will consider appropriate interim relief for individuals that have difficulty meeting the registration proficiency requirements by the expiry dates.

If you conduct securities activities in British Columbia, Manitoba, Nunavut, the Northwest Territories, Yukon, Alberta or Saskatchewan, and think you might be impacted by the revocation of the Northwest Exemption, please contact your usual AUM Lawyer for further guidance.

3. CSA Issues Guidance on Bail-in-Debt Regime

On August 23, the Canadian Securities Administrators (CSA) published two notices outlining staff's views about the securities law implications for Canada's implementation of the bail-in debt regime for domestically, systemically important banks (D-SIBs). Under Canada's new bail-in debt regime, which comes into force on September 23, 2018 the Office of the Superintendent of Financial Institutions (OSFI) may turn control over a D-SIB to the Canada Deposit Insurance Corporation (CDIC) if OSFI concludes that the D-SIB is no longer viable. The CDIC will have the authority to convert some or all of the D-SIB's debt (D-SIB Bail-in Debt) into common shares to recapitalize the bank. Subject to certain exclusions, D-SIB Bail-in Debt generally includes all unsubordinated unsecured debt of a D-SIB that is tradeable and transferable with an original term to maturity of over 400 days.

CSA Staff Notice 46-309 *Bail-in Debt* states, among other things, that, subject to certain exemptions, the trading or distribution of bail-in debt by persons or companies in the business of trading in securities to investors located in Canada must be done through a registered dealer and in accordance with National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Requirements* (NI 31-103). CSA Staff Notice 81-331 *Investment Funds Investing in Bail-in Debt* clarifies that D-SIB Bail-in Debt is an eligible investment for a money market fund only if such debt continues to meet the prescribed eligibility requirements applicable to money market funds. Investment fund managers also are expect to fully understand and take into consideration key features and risks of any D-SIB Bail-in Debt that they hold.

News & Events

PMAC Toronto Regulatory & Compliance Forum – September 27th

AUM Law is a proud sponsor of the Toronto Regulatory & Compliance Forum organized by the Portfolio Management Association of Canada (PMAC) on September 27. Click here to see the agenda and register.

Stay Tuned for Our Real Estate Investment Vehicles Brochure

Are you thinking about establishing an investment vehicle to invest in real estate or mortgages on real estate? AUM Law can help. We're putting the finishing touches on a new brochure that highlights key considerations in structuring real estate investment vehicles and the types of services we offer. Sign up for our bulletins to receive a copy.