Wants and Needs

Like the Rolling Stones, this month at AUM Law we are thinking about wants and needs. Despite further delays, the participating governments in the Cooperative Capital Markets System hope that if they try really hard, Canada will get the unified capital markets regulatory system that many people believe the country needs. In other news, clients of prospectus-exempt investment funds will benefit from new custody rules coming into force on June 4, the OSC got the appellate ruling it needed on whether promissory notes are securities, and an IIROC hearing panel finally got the information it wanted, so National Bank Financial Inc. got the settlement it needed.

In this bulletin:

1. CMRA Delay
2. New Custody Rules for Prospectus-Exempt Funds Come into Force on June 4
3. *Tiffin* Ruling on Promissory Notes as Eagerly Anticipated as the Royal Wedding
4. Synchronized (Crypto) Sweeping
5. You Can't Always Get What You Want … Even in a Settlement Agreement
6. CCIR, CISRO and FSCO Propose Guidance on Fair Treatment of Customers
7. Tell the MFDA What You Think about Expanded Cost Reporting

In Brief: CSA Proposes to Extend the Post-Trade Transparency Requirements for Debt Securities ● MFDA Proposes Principles-Based Sanction Guidelines ● Good Riddance…One of These Days: CSA Gives an Update on Project RID for Investment Funds

> News & Events

1. CMRA Delay

The Canadian, British Columbia, Saskatchewan, Ontario, New Brunswick, Prince Edward Island, and Yukon governments continue working toward the launch of the Capital Markets Regulatory Authority (CMRA). In that respect, on May 8, 2018 they published for comment draft prospectus and related registration exemption regulations under the proposed provincial-territorial *Capital Markets Act*. The comment period is open until August 7, 2018.

Concurrent with the publication of these draft regulations, however, the participating governments acknowledged that the CMRA will not be ready for launch by the end

In Brief

CSA Proposes to Extend the Post-Trade Transparency Requirements for Debt Securities

On May 24, the Canadian Securities Administrators (CSA) published for comment proposed changes to National Instrument 21-101 - *Marketplace Operation* (NI 21-101) that, if adopted, will introduce post-trade transparency requirements for government debt securities, expand transparency requirements for corporate debt securities, and align the post-trade transparency regimes for government and corporate debt securities. The new requirements will apply to any person or company trading in corporate or government debt securities.

of 2018, as previously hoped. Due to the significant hurdles faced by the CMRA, this latest in the series of launch delays likely does not come as a surprise to industry participants.

For one thing, it remains uncertain whether certain fundamental aspects of the CMRA's proposed regulatory system are constitutional. Although the Supreme Court of Canada will be the final arbiter of this question, the Quebec Court of Appeal ruled in May 2017 that the proposed system is unconstitutional in certain respects, particularly with respect to the establishment of a pan-Canadian securities regulator under the authority of a centralized regulator. The Supreme Court heard an appeal from the Quebec decision on March 22, 2018 and likely will release its judgment by the end of September.

Also, unless at least Alberta and Quebec (with their large capital markets) opt into the system, there are concerns that the CMRA could further fragment securities regulation in Canada. For example, the C.D. Howe Institute's September 2017 report concluded that the CMRA's inability to achieve participation from all jurisdictions would constrain its ability to, among other things, meet its harmonization and enhanced enforcement objectives.

While we familiarize ourselves with the draft CMRA regulations that have been published to date, we are in wait-and-see mode. If the Supreme Court of Canada overturns the Quebec Court of Appeal's decision, then the CMRA will gain momentum and a push could be made to bring additional provinces on-board. Until then, the proposed CMRA continues to tread water.

2. New Custody Rules for Prospectus-Exempt Funds Come into Force on June 4

On June 4, amendments to National Instrument NI 31-103 – *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103) that affect the custody of clients' assets, including investment funds offered pursuant to prospectus exemptions, come into force. Unless an exemption is available, the new custody rules require registrants to ensure that a qualified custodian holds a non-prospectus investment fund's or client account's assets in a prescribed manner. In addition, registrants subject to the new rules must include disclosure about custody arrangements in the relationship disclosure information that they provide to their clients.

AUM Law can help you comply with the new rules effectively, *e.g.*, by:

1. Reviewing your custody arrangements to determine whether your clients' assets are being held by a "qualified custodian", as needed;
2. Drafting or reviewing written agreements with qualified custodians to confirm that the cash and securities of the investment fund or managed account are held in the prescribed manner;
3. Updating your compliance manual to reflect the new custody rules;
4. Drafting or reviewing relationship disclosure documents to determine if they contain the new, prescribed disclosure relating to custody arrangements; and
5. Advising you on a program for periodic review of your custodial arrangements.

Please reach out to your usual AUM Lawyer for assistance.

In Brief cont'd

The CSA also recommends that the Investment Industry Regulatory Organization of Canada (IIROC), which currently serves as the information processor (IP) for corporate debt securities trades, become the IP for trades in government debt securities. Initially, IIROC would disseminate information about trades in government securities executed by dealers, marketplaces, interdealer bond brokers, and Schedule I, II and III banks.

The proposed reforms will be implemented in stages, with the first phase commencing on April 1, 2019 and uniform post-trade transparency for corporate and government debt securities being achieved by December 31, 2019. Comments on the proposed rules are due by August 29, 2018.

•

MFDA Proposes Principles-Based Sanction Guidelines

On May 23, the Mutual Fund Dealers Association (MFDA) published for comment proposed changes to its Sanction Guidelines. The amendments reflect industry trends away from recommended fine amounts and penalties for specific violations of MFDA By-laws, Rules and/or Policies and toward a principles-based approach to sanctioning. The revised Sanction Guidelines also have expanded the list of "key factors" to consider in determining sanctions to include, among other things, whether the respondent:

- voluntarily implemented corrective measures after the misconduct;
- voluntarily engaged in acts of compensation, restitution or disgorgement; and

3. *Tiffin* Ruling on Promissory Notes as Eagerly Anticipated as the Royal Wedding

While most people spent the last few months counting down the days until the wedding of Ms. Markle and His Royal Highness Prince Harry, at AUM Law we were eagerly awaiting the appeal court's decision in *Ontario Securities Commission v. Tiffin* (*Tiffin*). The case turned on whether promissory notes issued by Tiffin Financial (TFC) to some of Daniel Tiffin's investment clients were securities. In 2016, the trial judge ruled that the notes weren't securities and acquitted Tiffin and TFC of charges under the Securities Act (Ontario) (the Act). Earlier this month, however, the Ontario Securities Commission (OSC) won its appeal to the Ontario Superior Court of Justice, and Tiffin and TFC were convicted of trading in securities without registration, distributing securities without filing a prospectus, and trading in securities while subject to a cease-trade order.

Seriously, there is nothing that securities lawyers love more than a discussion about what constitutes a "security". It takes us back to law school, when we could sleep in, stay up late and debate each other for fun.

We wouldn't waste your time telling you about this case, however, unless we thought it had practical significance for our clients. We often come across situations where someone has issued or is thinking of issuing promissory notes and does not believe that securities laws apply to the transaction. The confusion may arise because the definition of "security" in the Act is exceptionally broad. It includes, among other things, a "note or other evidence of indebtedness", unless the instrument fits into a long list of exceptions, such as evidence of a deposit issued by a regulated bank, credit union, loan corporation or trust company. In other words, the Act takes a "catch and exclude" approach to the definition of "security" and securities regulation generally.

In this case, Daniel Tiffin was a financial advisor who, from 1983 to 1999, had been registered with the OSC to trade in securities. In 2009, the OSC issued a temporary cease-trade order against him and his firm TFC in relation to promissory notes that had been issued as part of an investment scheme that purported to engage in foreign exchange trading. Five years later, the OSC issued its final decision and imposed sanctions against Tiffin and TFC that included a five-year prohibition on trading in securities or relying on exemptions in Ontario securities law.

After those sanctions were issued, Tiffin solicited funds from his insurance investment clients for personal use and to keep his business running. Six clients agreed to lend funds totaling $700,000 to TFC on terms set out in promissory notes.

Not surprisingly, these transactions attracted the attention of OSC enforcement staff. This time, the OSC sought to have Tiffin and TFC convicted of offences under the Act. At trial, however, Justice Kenkel dismissed the charges, having accepted the defendants' argument that the broad definition of "security" cast "too wide a net" and was "inconsistent with the purpose" of the Act. Instead, Justice Kenkel applied a test applied by U.S. courts that have considered whether notes are securities within the meaning of U.S. securities legislation. Kenkel J. concluded that the promissory notes issued by TFC were similar to one "family" of "non-security" notes in U.S. case law and that neither the statutory goals of the Ontario legislation nor the circumstances of the particular transactions required that the promissory notes in this case be regulated as securities.

The OSC successfully appealed this ruling. We believe that the appellate court judge's comments about the scope of securities legislation are particularly instructive for those who are tempted to test the boundaries of the Act:

> "Where a legislature acts to protect vulnerable segments of society it often casts its net widely to ensure that it captures all targeted activity. This

In Brief cont'd

- gave proactive and exceptional assistance to the MFDA in connection with the investigation.

Comments are due on August 20, 2018.

•

Good Riddance…One of These Days: CSA Gives an Update on Project RID for Investment Funds

On May 24, the Canadian Securities Administrators (CSA) published an update on its Rationalization of Investment Funds Disclosure Project (Project RID). Phase 1, consisting of information-gathering and prioritization of reform proposals, is complete. Phase 2 will involve developing rule proposals to:

- remove redundant information requirements in select disclosure documents;
- use web-based technology to provide certain information about investment funds;
- codify exemptive relief that is routinely granted; and
- minimize the filing of forms that may contain duplicative information, such as Personal Information Forms.

The CSA expects to publish proposed rules for comment by March 2019. Certain other potential reforms dealing with matters such as financial continuous disclosure requirements require further analysis and will be addressed at a later date.

AUM Law will monitor these initiatives and keep you informed of substantive developments and timelines for implementation.

•

> breadth is deliberate, and consistent with the remedial purpose of the [Securities] Act. In the absence of a constitutional challenge for overbreadth, this is not an invitation for the creation of judicially crafted criteria to scale back the scope of the law."

The OSC (and other Canadian securities regulators) are aware that Canadian securities legislation can be very broad in scope, and they have demonstrated a willingness to craft exemptions (in the form of rules or *ad hoc* exemptive orders) when there is a good business reason and it is not contrary to the public interest to do so. The fact that regulators are willing to consider requests for exemptive relief in appropriate circumstances, however, does not mean that market participants can ignore the letter of the law and ask for forgiveness after the fact.

AUM Law has extensive experience in the interpretation of Ontario securities laws, as well as insight into how securities regulators have exercised their discretion to grant exemptive relief from broadly worded legislation. Please do not hesitate to contact us if you wish to discuss how the laws apply to the activities you are contemplating.

4. Synchronized (Crypto) Sweeping

Securities regulators across North America continue to be concerned about potentially fraudulent activity involving crypto-currency products. In April, the North American Securities Regulators (NASAA) organized a task force of its member state and provincial securities regulators to begin a coordinated crackdown on fraudulent initial coin offerings (ICOs) and cryptocurrency-investment products (Operation Cryptosweep). In late May, both the British Columbia Securities Commission (BCSC) and Ontario Securities Commission (OSC) announced that they are participating in the task force and provided links to Investor Alert pages and educational materials about cryptocurrencies and the signs of investment fraud. Not only does this news emphasize regulators' continued focus on cryptocurrency, it illustrates how securities regulators work with their counterparts across borders to address emerging risks in capital markets.

5. You Can't Always Get What You Want … Even in a Settlement Agreement

The Investment Industry Regulatory Association of Canada (IIROC) recently published a decision where a Hearing Panel (Panel) initially had balked at approving a settlement agreement (Settlement) between National Bank Financial Inc. (the Bank) and IIROC's Enforcement Department. The case is instructive both for the substantive issue it addresses (inadequate supervision) and the procedural snag that arose, when the Panel concluded at the end of the hearing that it didn't have enough information to determine if the Settlement was reasonable.

This case begins in 2009, when the Bank issued an internal communiqué regarding the risks of leveraged, exchange-traded funds (ETFs) and conducted training so that representatives were aware that such products weren't suitable for certain clients. Soon afterward, the Bank detected that one of its registered representatives (Cloutier) had a number of clients who held exchange-traded ETFs even though they didn't meet the Bank's prescribed profile for such investments. Over the next 28 months, the Bank then took various steps to resolve the problem and, ultimately, terminated Cloutier's employment. When he was terminated, Cloutier still had some clients who held leveraged ETFs even though they didn't meet the Bank's prescribed profile for such investments.

It is unclear from the case exactly how the non-compliance came to IIROC's attention, and so our summary will skip forward to the Settlement agreed to by the Bank and IIROC's Enforcement Staff. The Settlement stated that the Bank had failed to establish and maintain a system that allowed adequate supervision of the business activities of one of its registered representatives. The Bank agreed to pay a fine of $110,000 and costs of $16,000. The Settlement was presented to the Panel for approval in December 2017.

At this point, the proceedings took an unusual turn. After analyzing the Settlement and hearing arguments from counsel for the parties, the Panel concluded that it did not have enough information to determine whether the proposed Settlement was reasonable and not contrary to the public interest. Among other things, the Panel wanted to know whether and to what extent any clients suffered losses as a result of the non-compliance.

The Panel, however, faced with a challenging situation. By law, its role was limited to approving or rejecting the Settlement based solely on the facts set out in that document. The Panel noted:

> “[To] … encourage parties to settle their differences and protect the integrity of the settlement process, the latter must have assurance that any negotiations that result in a settlement agreement being signed will remain confidential and cannot be used against them subsequently.”

However, the Panel also emphasized that:

> “IIROC … must not become a kind of ‘old boys’ club’ where outsiders would find it impossible to know the nature and scope of the misconduct that led to the settlement agreement.”

The Panel couldn’t require the parties to present more information, but it could encourage them to do so. With the Settlement was at risk, it is not surprising that the parties agreed to provide the additional information. Once the Panel got what it wanted (information), the parties got what they needed (an approved Settlement).

The Reasons for Decision are worth reading because they offer some interesting lessons about the measures that a firm might need to take when faced with persistent non-compliance by an individual employee, as well as factors to consider in negotiating a settlement with a regulator’s enforcement counsel. For reputational or other reasons, a firm might wish to limit the facts disclosed as part of a settlement agreement. But limiting that disclosure carries with it the risk that a settlement will unravel before the adjudicators.

AUM Law can assist you in developing escalation and resolution procedures for situations where non-compliance is detected, and we also can assist you in discussions with staff of the regulators if your firm is audited or investigated. Please do not hesitate to contact us.

6. CCIR, CISRO and FSCO Propose Guidance on Fair Treatment of Customers

Of interest to our clients who are involved in insurance products or interested in governance, the Canadian Council of Insurance Regulators (CCIR) and Canadian Insurance Services Regulatory Organizations (CISRO) have published for comment principles-based guidance on the conduct of insurance business and fair treatment of customers. The proposed guidance covers a wide range of topics, including conflicts of interest, disclosure to clients, outsourcing, dispute-handling and the provision of advice. The consultation paper also discusses the responsibilities of insurers, distributors, agents and representatives.

Comments will be accepted until June 18. Once the guidance is finalized, regulators will decide individually on the next steps in their jurisdictions.

In Ontario, the Financial Services Commission (FSCO) also published principles-based guidelines for fair treatment of customers in April. Until it is replaced by the Financial Services Regulatory Authority, FSCO oversees the insurance, pension plan and mortgage broker industries in Ontario. FSCO’s proposed guidelines stress that fair treatment of consumers should be a core component of a licensee’s business and governance. The guidelines also clarify FSCO’s expectations with respect to matters such as promotional activities, the need for training programs focusing on ethics and integrity, know-your-client (KYC) and suitability obligations, conflicts of interest, complaint-handling and privacy.

7. Tell the MFDA What You Think about Expanded Cost Reporting

On April 19, the Mutual Fund Dealers Association (MFDA) published a discussion paper (2018 Paper) on expanded cost reporting for investment funds. This initiative follows up on its December 2015 consultation on the same topic, as well as its 2017 CRM2 review of integrated members’ charges and compensation reports. The 2018 Paper asks the investment fund industry to consider whether investors should receive additional reporting on the total costs of investment fund ownership, including items such as management fees, fund operation costs, redemption fees and short-term trading fees, none of which are paid to dealer members. Other costs that could be disclosed include transaction costs such as custodial fees and portfolio management fees.

Although the 2018 Paper is primarily of concern to MFDA members, other investment fund industry participants should pay attention. This is because 2018 Paper also asks if regulators should expand cost

reporting for other investment products. The MFDA has indicated that will share the results of its consultation with other regulators. Comments are due on July 20, 2018.

News & Events

AUM Law is pleased to have worked with the Practices & Standards Committee of the Portfolio Management Association of Canada (PMAC) to revise its *Guide to Compliance with Anti-Money Laundering and Anti-Terrorist Financing Requirements* (Guide). The Guide has been updated from the 2015 version to reflect regulatory amendments, new methods to satisfy client identification requirements, and recent guidance from the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC). If you would like to have a copy of the Guide, you can access it from the Members' section of PMAC's website or request one from your usual lawyer at AUM Law.

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

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