July 2016

AUM LAW **Bulletin**

Regulatory Rush

Did you know… Canadian musician and national treasure Geddy Lee was born on this day in 1953? As the vocalist, bassist, and keyboardist for the iconic rock group Rush, Lee is known for his progressive, synthesizer-laden rock.

In tribute to Geddy, this month's AUM Law bulletin "synthesizes" key recent regulatory developments.

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1. 2016 OSC Compliance and Registrant Regulation Report

On July 21, 2016, the Compliance and Registrant Regulation (CRR) Branch of the Ontario Securities Commission (OSC) released its annual report entitled OSC Staff Notice 33-747 Annual Summary Report for Dealers, Advisers and Investment Fund Managers (the Report). The Report outlines the activities of the CRR Branch in the previous fiscal year and provides insight into its priorities for the upcoming year.

More specifically, the Report reviews the CRR Branch's approach to registrant outreach, provides updates on registration initiatives (e.g., online business models), identifies current trends in compliance deficiencies (both general and by firm registrant category), and affirms that compliance reviews in the year ahead will focus on high risk firms, conflicts of interest relating to sales incentives and compensation practices, and compliance with new regulatory requirements (e.g.,

In Brief

Securities regulators in Alberta, New Brunswick, Newfoundland and Labrador, Northwest Territories, Nova Scotia, Nunavut, Prince Edward Island and Yukon (the Other Provinces) recently announced amendments to Multilateral Instruments that govern over-the-counter (OTC) derivative data reporting in those provinces and territories, that substantively harmonizes them with OTC derivative reporting rules in Ontario (amended in May 2016). These amendments are expected to come into force in Ontario on July 29, 2016, and in the Other Provinces on September 30, 2016.

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new prospectus exemptions). The Report also outlines regulatory action taken by the OSC in response to registrant misconduct, provides an overview of key policy initiatives impacting registrant and re-affirms that regulatory requirements apply to *all* business models, including crowdfunding portals, online advisers and lending platforms. Firms seeking to operate online portals and trading platforms should review the registration considerations contained in the Report in order to understand the OSC's expectations.

The OSC strongly recommends that the Report be used by registrants along with the advice of professional compliance advisors as a self-assessment tool to strengthen and enhance their systems of compliance, internal controls and supervision.

For your convenience, we have created a reference document outlining the key areas of the Report with corresponding page references.

If you have any questions regarding the Report, please contact your usual lawyer at AUM Law.

The OSC announced earlier this month the official launch of the first Canadian whistleblowing policy, with one critical addition since its release for comment.

Policy 15-601 now indicates that the *Securities Act* has been amended to include anti-reprisal provisions, which aim to protect employees wishing to report misconduct from potential reprisal by their employers.

2. Adding an Online Platform to Your Existing Registrant

The emergence of crowdfunding portals, online advisers and lending platforms has had an impact on the financial industry in Canada and around the world. The CRR Branch of the OSC recently acknowledged the challenges these evolving technologies pose to regulators in its *Annual Summary Report for Dealers, Advisers and Investment Fund Managers* (detailed above), stressing that open lines of communication with registrants is critical to effectively addressing these challenges. Firms looking to adopt an online platform must be cognizant of this increased regulatory scrutiny.

There have been a bevy of media reports recently about the rise of so-called "robo-advisors," particularly in the U.S. Simply put, these are web-based "no call" investment services that use electronic questionnaires to gather know-your-client (KYC) information online and then use algorithmic software to match clients to a model portfolio. Clients' managed accounts are typically invested in relatively simple and lower-risk investment products such as exchange-traded funds (ETFs), low-cost mutual funds, cash and cash equivalents. Riskier investment strategies such as the use of leverage or short-selling, individual securities such as equities or commodity pools are typically not permitted. However, unlike their American cousins, Canadian online advisors are generally hybrid models, as registered individuals interact with clients to answer questions and confirm KYC information as they would in a face-to-face model. They are also ultimately responsible for the suitability of the investments. Canadian regulators have been clear that online advisors who don't initiate contact with clients and operate under the U.S. "no call" model may be subject to terms and conditions and/or have registration limited to a restricted category.

We have also seen the rapid growth of "crowdfunding", an umbrella term for raising funds or capital over the internet from members of the public (the crowd).

Equity crowdfunding involves the sale of securities through online investment platforms or portals that connect investors with private companies seeking capital on a prospectus-exempt basis. These approved internet funding sites are typically registered in Canada as an investment dealer, an exempt market dealer (EMD) or a restricted dealer, and like robo-advisors, can be new registrants that build their presence digitally or existing registrants that move some or all of their business online.

A funding portal is a dedicated website and intermediary that makes issuer offering materials available online to prospective investors and fulfills certain gatekeeper functions such as ensuring self-certifications of eligible investors, reviewing issuer disclosure, performing background checks on the issuer and its officers and directors and enabling related online communication.

As noted, these technological developments have not gone unnoticed by the regulators:

- As discussed in our June 2016 Bulletin, the Competition Bureau recently launched a market study that will look at technological innovation in the Canadian financial services "FinTech" industry including robo-advisers and crowdfunding and will publish their results in the Spring of 2017.

- As discussed in our November 2015 Bulletin, in January of this year, five Canadian provinces including Ontario came together to publish Multilateral Instrument 45-108, which builds a regulatory regime around crowdfunding. However, its strict monetary limits, such as a 1.5 million annual cap for companies, has limited its use.
- As discussed in our November 2015 Bulletin, the CSA published Staff Notice 31-342 (the Notice) which provides guidance to portfolio managers (PMs) regarding online advice. The CSA clarified that the Notice was limited to PMs and that dealers may have additional regulatory requirements.

Firms wanting to adopt an online platform should be prepared to submit a business plan or a revised business plan to the regulators as part of Form 33-109F6 and F4s (for new registrants) or Form 33-109F5 (for existing registrants). As well, firms should provide a process map or workflow, copies of webpages or an online demonstration, and copies of the KYC questionnaire, investor profiles and model portfolios (in the case of an online advisor).

AUM Law is uniquely qualified to provide guidance in the online advisory and dealer space, having worked with several market leaders in the industry. We have registered and continue to work with a number of firms that use online platforms and our qualified team of legal experts can guide you through the registration and approval process whether you are an existing registrant looking to add an online distribution platform to your traditional “bricks and mortar” operation or a new registrant that will focus primarily on operating through an interactive website. Please contact a member of our Regulatory Compliance Group if you would like to discuss online platforms in greater detail.

3. Proposed Amendments to NI 31-103 and NI 33-109

On July 7, 2016, the Canadian Securities Administrators (CSA) released for comment proposed amendments to NI 31-103 – *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103) and NI 33-109 – *Registration Information Requirements* (NI 33-109), aimed at enhancing custody requirements for certain registrants, clarifying activities that may be conducted by EMDs and incorporating relief from certain CRM2 requirements.

The proposed amendments to NI 31-103 will not significantly impact registered dealers which are members of the Mutual Fund Dealers Association of Canada (MFDA) or the Investment Industry Regulatory Organization of Canada (IIROC) since they are exempted from many of the obligations in NI 31-103 in light of substantially similar requirements under MFDA and IIROC member rules.

Custody Amendments

The proposed custody amendments will:

- Require registered firms to ensure that a "qualified custodian" is used to hold securities and cash of a client or an investment fund in certain circumstances
- With some exceptions, prohibit self-custody by registered firms and prohibit the use of a custodian that is not functionally independent of the registered firm
- Require registered firms to confirm how the securities and cash of a client or an investment fund are being held by a qualified custodian
- Require registered firms to disclose to clients where and how client assets are held or accessed

Proposed exceptions to these custodial requirements include:

- Permitted clients if such clients (i) are not individuals or investment funds, and (ii) waive (in writing) the custodial requirements
- Investment funds subject to National Instrument 81-102 - *Investment Funds* or National Instrument 41-101 *General Prospectus Requirements*
- Certain types of assets, such as client name securities, certain mortgages and customer collateral subject to specified custodial requirements under derivatives regulation

The CSA propose a six-month transition period for impacted firms to meet these new custody requirements.

EMD Amendments

The proposed EMD amendments re-affirm that EMDs may not participate in distributions of securities under prospectuses in any capacity, including as underwriters and selling group members, and provide further clarification around permissible EMD activities, including trades of securities distributed under a prospectus exemption and certain resale trades. Significant additional guidance has been added to the Companion Policy for NI 31-103 (31-103CP) regarding this restriction. EMDs should review their internal procedures to ensure they have sufficiently robust processes in place to stay onside these strict requirements.

The proposed amendments also expand the exemption from the dealer registration requirement in section 8.6 of NI 31-103 so that registered advisers may trade in the securities of investment funds (including, as is the case today, those distributed under a prospectus) if the adviser *or an affiliate of the adviser* manages the investment fund and certain conditions are met.

CRM2 Relief Amendments

The proposed amendments relating to CRM2 aim to make permanent certain temporary blanket-like relief granted by the CSA in May 2015 in relation to CRM2 amendments made in 2013 (2013 Amendments). The proposed amendments also address various matters that have arisen in the course of implementing the 2013 Amendments, including adding guidance to 31-103CP regarding the delivery of information to clients required by the 2013 Amendments. Impacted registrants should review their current CRM2 templates and internal procedures to determine whether they align to these proposed amendments.

Housekeeping Amendments

The CSA are proposing certain minor amendments of a housekeeping nature to NI 31-103 and 31-103CP that include clarifying drafting changes or addressing matters in specific jurisdictions (e.g., Alberta and Québec).

Finally, the CSA also propose changes to National Instrument 33-109 that:

- Would eliminate the requirement, in Form 33-109F6, for firms to provide information on exemptions from registration or licencing to trade or advise in securities or derivatives that the firm is currently relying on if the firm has already notified the regulator in accordance with the applicable exemption.
- Clarify that registered or permitted individuals would be required to complete an updated Form 33-109F4 (as part of a reactivation procedure), rather than the more streamlined Form 33-109F7 (and related reinstatement procedure), if the individual is moving to another registered firm and there have been certain changes to the individual's registration or licencing to trade in or advise on securities or derivatives (other than an approved recorded through NRD), or in the case of registrations or licences when dealing with the public in a non-securities or derivatives context, disciplinary actions or refusals to register or license the individual.

Comment Period

The comment period for the CSA's proposed amendments to NI 31-103 and NI 33-109 closes on October 5, 2016. Please contact a member of our Regulatory Compliance Group if you have any questions or require assistance with your comment letter.

4. OSC Proposes New Rule for Out-Of-Province Distributions

On June 30, 2016, the OSC published for comment Proposed Rule 72-503 and Proposed Companion Policy 72-503CP (collectively, the Proposed Rule). The Proposed Rule aims to provide Ontario-based issuers and dealers with greater certainty about the applicability of Ontario's prospectus and dealer registration rules when securities are distributed to investors outside Ontario. The Proposed Rule would replace OSC Interpretation Note 1 *Distributions of Securities Outside Ontario* (Interpretation Note), which was adopted in 1983. The Interpretation Note formalized the OSC's view that neither a prospectus nor a prospectus exemption is required to issue securities to investors outside Ontario if the issuer and its intermediaries take reasonable steps to ensure that such securities come to rest outside of Ontario.

However, with the increasing globalization of capital formation over the past 33 years, the Interpretation Note's guidance as to what reasonable steps would prevent outbound securities from flowing back into Ontario became less helpful.

The Proposed Rule would replace the Interpretation Note with four clear prospectus exemptions, three of which would require an issuer to file a relatively simple report with the OSC within 10 days of the distribution. The Proposed Rule also provides an exemption in certain circumstances from the dealer and underwriter registration requirements, which should facilitate greater access for Ontario issuers to the services of foreign dealers and their access to the global capital markets.

Comments on the Proposed Rule are due by September 28, 2016. If you have any questions or require assistance with your comment letter, please contact a member of our Regulatory Compliance Group.

5. Additional Consultations on Non-Centrally Cleared Derivatives

On July 7, 2016, the CSA Derivatives Committee (the Committee) released another consultation paper with respect to derivatives, CSA Consultation Paper 95-401 – *Margin and Collateral Requirements for Non-Centrally Cleared Derivatives*. The paper is the latest in a series of consultations, proposals and published rules resulting from G20 summits held subsequent to the 2008 financial crisis, and deals with the higher risks of non-centrally cleared derivatives and promotes central counterparty clearing. The recommendations of the Committee are based on the standards set by the Basel Committee on Banking Supervision and the International Organization for Securities Commissions, and are similar to guidelines published in Canada by the Office of the Superintendent of Financial Institutions (OSFI) applicable to federally regulated financial institutions.

The Committee has recommended that, subject to limited exceptions, counterparties to a non-centrally cleared derivative transaction would be required to exchange initial margin and deliver variation margin. The requirements would apply where the counterparties are financial entities (which would include pension funds, investment funds and persons registered or exempt from registration as a result of trading in derivatives) with an aggregate month-end average notional amount under outstanding non-centrally cleared derivatives above Cdn $12 billion. A counterparty could choose to calculate the amount of initial margin based on either a quantitative margining model or a prescribed standardized schedule.

Initial margin would have to be exchanged by a counterparty in circumstances where the total amount of initial margin required to be delivered under all outstanding non-centrally cleared derivatives using the formula chosen exceeded Cdn $75 million, and the specific amount to be exchanged would be only the amount required over and above the $75 million threshold. Initial margin is intended to protect counterparties during the time it takes to close out a position in the event of a counterparty default, and variation margin is intended to mitigate risks from the fluctuations in the value of a derivative. Variation margin would be calculated using an appropriate valuation method and should be sufficient to fully collateralize the exposure of the derivatives transaction. Initial or variation margin would not have to be delivered if the sum of the two is less than $750,000. In addition to other requirements, entities to whom a final rule applied would be required to enter into agreements with each other counterparty that is subject to the rule, to establish rights and obligations in relation to matters such as exchange of margin, use of collateral (including segregation) and the process to resolve defaults.

A number of specific questions are asked in the paper, and comments will be accepted to September 6, 2016. If you have any questions on how these requirements might impact your derivatives activities, please contact us.

6. CRTC Publishes Enforcement Advisory on CASL Consent Records

Canada's anti-spam legislation (CASL), enacted in 2014, requires businesses and individuals to obtain either express or implied consent to send commercial electronic messages (CEMs) to recipients. As the onus of proving consent is on the individual or business sending the CEMs, the maintenance of adequate consent records is imperative to responding to CRTC production notices in a satisfactory manner and avoiding possible enforcement proceedings for failure to do so.

The CRTC has shed light on what it considers to be adequate proof of consent in an Enforcement Advisory released on July 27, 2016. In particular, it encourages senders of CEMs to consider keeping a hard copy or an electronic record of, among other things:

- All evidence of express and implied consent (e.g., audio recordings, copies of signed consent forms, completed electronic forms) from consumers who agree to receive CEMs
- Documented methods through which consent was collected
- Policies and procedures regarding CASL compliance
- All unsubscribe requests and resulting actions

The CRTC also outlines what it considers to be benefits of proper record keeping, including the ability to:

- Identify potential non-compliance issues
- Investigate and respond to consumer complaints
- Identify the need for corrective actions
- Demonstrate that these corrective actions were implemented
- Establish a due diligence defense in the case of a violation of CASL

Though this Enforcement Advisory is not binding, it would be foolhardy to disregard the guidance contained therein, especially as the CRTC explicitly connects these record keeping practices to the successful establishment of a due diligence defense in the case of a CASL violation. In addition to proper record-keeping, it is clear that businesses should have proper CASL Compliance Programs in places, including CASL-specific policies and procedures, training and audits to ensure that internal practices align with those policies and procedures.

Please contact us if you would like to further discuss this topic.

7. Help Us Help You

As we have previously discussed, registered firms have ongoing obligations under securities legislation to inform the OSC of the following changes to a firm or a registered individual's information. Failure to notify the OSC within 10 calendar days of most of these changes may lead to a $100 late fee per day, up-to a maximum of $5,000 per year:

Changes to Firm	Changes to Registered and Permitted Individuals	Changes to Operations
• Operations (e.g., organizational structure, officers and directors) • Ownership or anticipated acquisition of securities of another entity • Insurance, auditors and constating documents (e.g., articles of amendment)	• Individual Forms 33-109F4 • Outside activities*	• Offering of new products/business lines

*The OSC has been imposing late filing fees for failure to disclose all outside activities of individuals (e.g., directors, officers, trustees, shareholders and other roles). If you are unsure what to disclose, please contact us for further analysis and potential filing.

An ounce of prevention is worth a pound of cure. Contact a member of our Regulatory Compliance Group to ensure that you are compliant.

Frequently Asked Questions

> What is the deadline for filing your investments fund's 45-106 F1 Report of Exempt Distribution?

Many investment funds typically have a December 31 or June 30 year-end. Historically, the requirement was to file within 30 days of the fund's year-end. However, recent amendments to NI 45-106 have standardized the filing deadline to 30 days after December 31, regardless of the year-end of the fund.

So… if your fund's year end is June 30 and you are frantically scrambling to file your report today (why are you reading this bulletin?) we hope this is some welcome good news as you head into the long weekend!

News & Events

Best Interest Standard Seminar

AUM Law hosted a seminar on July 19 on **Proposed CSA Reforms Impacting Dealers, Advisers and their Representatives**. Jeff Scanlon, Deputy Chief Regulatory Counsel, walked attendees through highlights of CSA Consultation Paper 33-404, including the best interest standard and proposed reforms to NI 31-103.

Jeff offered his experience as an ex-regulator to shed some light on the potential impact of the proposed reforms, which include changes to KYC, KYP, relationship disclosure, and proficiency requirements.

We remind our clients that the deadline to submit comments to the CSA **has been extended from August 26, 2016 to September 30, 2016**.

2016 PMAC Toronto Compliance Forum

Alan Sinclair has joined the lineup of speakers for this year's Portfolio Management Association of Canada's Toronto Compliance Forum, taking place September 22 at the Toronto Board of Trade. Alan will be discussing key issues that registrants should have on their "compliance radar" in 2016. For more details and to register for the conference, please visit the event page.

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.