AUM LAW

August 2019 | Bulletin

Back to School Edition

The days are getting shorter, and at AUM Law we're experiencing a mysterious urge to buy school supplies. Meanwhile, staff of the OSC's Compliance and Registrant Regulation (CRR) Division have already sharpened their coloured pencils and used them in their annual Summary Report on Dealers, Advisers and Investment Fund Managers to draw registrants' attention to compliance deficiencies, good practices and regulatory trends.

In this bulletin:

1. CRR Publishes Its Annual Report Card on Registrants

CRR staff at the Ontario Securities Commission (OSC) encourage registrants to 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 takeaways from the Report useful, the discussion below doesn't replace the Report or consultation with your counsel about the Report's implications for your business.

A. Looking Ahead: Focus Areas for 2019-20 Compliance Reviews

Staff expects their upcoming compliance reviews to focus on:

- Suitability assessments, including concentration and prospectus exemptions;
- The compliance structure of firms that have recently completed acquisitions; and
- High-impact and high-risk firms.

High-impact firms are those that could have a significant impact on capital markets if there were a breakdown in their compliance structure or key operations. High-risk firms include firms identified as high-risk either through the 2018 Risk Assessment Questionnaire (2018 RAQ) process or the "Registration as the First Compliance Review" process.

In Brief

CSA Publishes Guidance on Compliance Consultants

Securities regulatory authorities sometimes require registered firms to engage compliance consultants (Consultants) when a compliance review or enforcement investigation identifies significant non-compliance with securities law. On August 22, the Canadian Securities Administrators (CSA) published a staff notice (Notice) that describes why such engagements are typically required and the responsibilities that Consultants may be asked to undertake. The Notice is intended, among other things, to help firms evaluate and engage appropriate Consultants, as well as provide insight into CSA staff's criteria for approving or accepting a Consultant proposed by a firm.

AUM Law has experience serving as a Consultant (including experience with the monitoring function). Please do not hesitate to contact us for a consultation if you need assistance in this area.

OSC Publishes Study on Tactics to Improve Fee Disclosure

On August 19, the Ontario Securities Commission (OSC) published Staff Notice 11-787 *Improving Fee Disclosure through Behavioural Insights* (Report). The OSC Investor Office partnered with the United Kingdom's Behavioural Insights Team (BIT) to conduct research and a

B. Use Your Words (Carefully)

According to the Report, staff are using data analytics, text mining and reporting tools such as Natural Language Processing in their reviews of filings, comment letters and other documents to identify common themes, assess sentiment, and identify trends and risks. Staff intend to use these data strategies to enhance their decision-making and efficiency as well as to reduce regulatory burdens. We can also imagine how these tools could be used to identify and then act on red flags in registrants' filings, websites, client communications, and correspondence with regulators.

C. Looking Back: Compliance Reviews and Regulatory Actions

Compliance Reviews: Like last year, the Report includes a summary of compliance deficiencies, classified by topic and severity. The largest number of deficiencies related to compliance systems (38% of all deficiencies, the same percentage as in 2017-18). The second largest number of deficiencies related to know-your-client (KYC), know-your-product (KYP), and suitability matters (17%). The largest number of significant deficiencies in 2018-19 also concerned compliance systems (12%) and KYC, KYP, and suitability (9%).

Regulatory Actions: The Report also includes data on CRR regulatory actions, including data comparing the different kinds of regulatory actions taken in the past five fiscal years. We noted with interest that staff highlighted CRR referrals to the Enforcement Branch of mortgage investment entities (MIEs), mortgage brokers, administrators and their principals involved in trading in securities without registration. Given Ontario's bubbly real estate market and the upcoming changes to the regulatory framework for syndicated mortgages, we expect this industry sector to continue attracting regulatory scrutiny.

It doesn't take a lot of trading activity to trip the "business trigger" for registration. If you are involved in, or thinking about getting involved in, this sector and want to understand how the evolving regulatory framework may affect your business, please contact us for a free consultation.

D. Spotlight on Compliance Deficiencies

Like last year, staff have organized their discussion of compliance deficiencies by theme. Below, we have highlighted topics that we think will be of particular interest to our readers.

1) Referral Arrangements – EMDs , PMs and SPDs

Referral arrangements continue to raise regulatory concerns, so we are not surprised that staff conducted a referral sweep this year. Staff's commentary in the Report focused on the challenges and regulatory risks associated with the strong, continuing relationships that many referral agents maintain with clients referred to registrants. For example:

- Where such long-standing relationships exist, staff found that referred clients primarily communicated with referral agents, even on topics that should have been discussed with the registered individual, such as

In brief cont'd

randomized, controlled trial (Trial) to test which tactics might improve Canadian investors' understanding of their annual fee reports (Fee Reports).

The Report discusses twenty-four tactics designed to overcome barriers to engagement, comprehension and/or action. The BIT, with OSC input, also developed four prototype Fee Reports that incorporated some of these tactics and then tested these prototypes in the Trial. According to the OSC, the most effective Fee Report included all of the prescribed information but packaged it into a "summary" page and a "detail" section. The OSC is encouraging registrants to review the Report, consider testing some or all of the tactics and, if any of the tactics are proven effective, integrating them into their current practices. If you want to discuss the Report or assess your firm's compliance with CRM2 and related disclosure requirements, please do not hesitate to contact us.

- questions about portfolio holdings or changes in KYC information.
- Registered individuals, who may deal with referred clients infrequently (and primarily through phone and email), can find it difficult to "truly establish a relationship" with referred clients.
- Some registered individuals relied unduly on referral agents to transfer client information on matters that required the registered individual's involvement.
- Referred clients might not understand the differing responsibilities of the referral agent and registered individual.
- Some referral agents were conducting (and/or representing themselves as being able to perform) registrable activities, without being registered under *National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103).

The Report also includes some trend analysis on referral arrangements derived from the 2016 and 2018 RAQ responses. We expect this data as well as the compliance review findings to influence the OSC's position on the proposed restrictions on referral arrangements outlined by the Canadian Securities Administrators (CSA) in the client-focused reforms published for comment in June 2018. (See our discussion of those proposals here.) We will monitor developments in this area and keep you informed.

2) Registrable Activity by Non-registered Issuers and Finders

OSC staff continue to be concerned about issuers engaging in significant capital-raising without involving a registered dealer or relying upon an appropriate exemption. (See our discussion of this issue in our August 2018 bulletin and October 2018 bulletin.) The Report covers similar ground this year.

The Report also discusses staff's concerns about issuers who are distributing securities in supposedly "non-brokered" private placements or public offerings while paying compensation to finders, referral agents, investor relations consultants or similar third parties (collectively, Finders). Staff generally consider Finders to be engaged in registrable activities, and these activities raise various regulatory concerns, including the following.

- A person engaging in a registrable activity as a dealer and/or underwriter might not be registered.
- A person performing a function, and being compensated in a manner, similar to an underwriter in a public offering might be seeking to avoid underwriter liability. And if that person is an exempt market dealer (EMD), they might be seeking to avoid the restrictions on EMDs participating in prospectus offerings.
- An investment dealer (ID) or Portfolio Manager (PM) who purchases securities from the issuer for the client's managed account while also taking a finder's fee from the issuer may have a significant conflict of interest and be in breach of other obligations to their client.

AUM Law has substantial experience advising issuers and registrants on compliance with exempt market requirements. Subscribe to our bulletin to receive a copy of our handy Exempt Market Roadmap and please don't hesitate to contact us to discuss your fundraising plans.

3) Employees Offside the Registration Requirements

In the Report, staff remind registered firms that if they have employees engaging in registrable activities, those individuals must be registered in the appropriate categories. The past year's compliance reviews revealed that:

- Some employees of registered firms conducted trading/dealing activities for the firm without being registered to do so; and
- Some registered individuals were conducting activities without being registered in the appropriate category, *e.g.* advising representatives (ARs) soliciting clients without being registered as dealing representatives or dealing representatives collecting KYC information or discussing portfolio performance without being registered as ARs.

Staff caution firms to ensure that they:

- Have adequate internal controls to prevent non-registered individuals from conducting registrable activities;
- Review the role and nature of interactions between the firm's clients or potential clients and non-registered employees; and
- Provide adequate training to employees on the kinds of activities they can perform based on their registration category.

AUM Law can assist you in this area by conducting a focused compliance review, updating your policies and procedures as needed, and providing training to your employees.

4) Concentration Risk, Suitability and Client-Directed Trades – EMDs / SPDs

According to the Report, some dealers aren't adequately assessing concentration risk and may be using client-directed trade instructions to avoid having a meaningful discussion about suitability with affected clients. The Report reminds dealers that:

- Their policies and procedures should address concentration risk, including provisions about the KYC information collected to assess concentration risk, how the risk is calculated, and the thresholds that would cause a client to be over-concentrated.
- If there are concerns that a client has a high concentration in a single issuer, group of related issuers or single industry, the dealer should have a meaningful dialogue with the client about diversification and the risks of over-concentration, consider a lower investment amount to reduce concentration risk, and if necessary, document why a particular transaction is considered suitable despite the client's concentration risk.

We think client-directed trade instructions can be effective investment management tools when they are used responsibly. We can help you draft appropriate policies and procedures for client-directed trades that provide, among other things, for:

- How to conduct and document your discussion with the client about concentration risk and the transaction's unsuitability; and
- A signed, client-directed trade instruction that specifically explains the unsuitability of the transaction.

5) Supervision of Dealing Representatives Who Speak Multiple Languages – EMDs / SPDs

Employing dealing representatives who can communicate with clients in their native language (other than English or French) presents benefits and challenges. On the one hand, the representative's capabilities can help ensure that the firm knows its client and that the client understands the products and services they are being offered. It also means that language capability isn't a barrier to investment opportunities. The Report emphasizes that it is acceptable for representatives to communicate with their clients in whichever language best serves the client.

On the other hand, if clients receive disclosure documents in English or French but the representative explains the product's key features, risks and fees in a different language, there is a risk of misinformation because clients might rely solely on what the representative communicates to them. Registered firms also must be able to effectively supervise those communications as part of the firm's overall obligation to supervise each dealing representative's activities. The Report recommends that registered firms:

- Identify dealing representatives who use multiple languages;
- Have a process to supervise such representatives; and
- Document any special supervisory needs for such representatives.

6) Illiquid Asset Inadequacies – IFMs / PMs

Staff observed some deficiencies in how investment fund managers (IFMs) treat illiquid assets, such as publicly traded securities that do not necessarily trade at their quoted trading price because of market or other conditions. The Report reminds IFMs and PMs to, among other things:

- Review publicly traded securities held by investment funds to determine if the publicly quoted trading price reflects fair value;
- Determine an adequate valuation methodology, periodically review it to confirm that it's still appropriate, and verify that market inputs have been appropriately updated at each valuation date;
- Maintain adequate documentation to support the valuation of thinly traded, restricted and private securities; and
- Establish and comply with a process to monitor the investment fund's compliance with liquidity requirements, including any concentration or other restrictions set out in its offering documents or imposed by National Instrument 81-102 *Investment Funds* (NI 81-102), if applicable.

IFMs are also reminded that they shouldn't rely on the PM's pricing of an illiquid security without performing their own verification of the stated price.

7) Have You Fully Implemented the New Custody Rules? – IFMs / PMs

Some firms haven't fully implemented the June 2018 amendments to NI 31-103 (2018 Custody Rules). For example:

- Some IFMs and PMs are still using relationship disclosure documents that haven't been updated to describe:
  - Where and how the client's (including an investment fund's) assets are held; and/or
  - The risks and benefits arising from the assets being held at that location and in that manner;

- Some IFMs are using outdated custodial and prime brokerage agreements that do not address matters such as the location of portfolio assets, any appointment of a sub-custodian, custody methods, the custodian's standard of care, and responsibility for loss; and
- Some IFMs are not holding cash-in-transit in accordance with the 2018 Custody Rules.

We can help bring your relationship disclosure documents and relevant agreements into alignment with the 2018 Custody Rules, as well as the derivatives-related amendments to the custody rules that took effect in June 2019.

8) Investments in Related Entities – IFMs / PMs

There might be good reasons for an individual at a registered firm to become involved with an investee issuer (such as taking a seat on the issuer's board of directors). But such arrangements present potential compliance risks. Among other things, the firm will have to be mindful of the prohibitions in section 13.5(2) of NI 31-103 on investments in related entities, which can be as tricky to work through as trigonometric identities.

This year, staff commented that some advisers aren't taking appropriate steps, before buying securities of related entities for their managed account clients (including investment funds), to comply with the disclosure and written consent requirements in section 13.5(2)(a) of NI 31-103. For private investment funds, each security holder of the fund must receive the required disclosure and provide consent.

If individuals in your firm are contemplating becoming involved with investee issuers, please contact us to discuss the potential compliance risks and how we can help you manage those risks appropriately.

9) Inter-Fund Trades – IFMs and PMs

Staff reported that some firms breached section 13.5(2)(b) of NI 31-103, which prohibits inter-fund trades between private investments funds, or between a public and a private investment fund, where the funds are managed and advised by the same registrant. If you believe that there are good reasons to engage in such trades (*e.g.* to rebalance portfolios), we recommend that you speak to us before implementing the strategy. We can advise you on your options, including alternatives to inter-fund trades (such as redemptions and reinvestments) and/or the criteria for obtaining exemptive relief.

10) Sales Practices

Staff conducted a sales practices desk review to see if IFMs had absorbed the lessons laid out in the 2017-18 sales practices settlement agreements and recent staff guidance. (See, for example, our discussion of sales practices in our analysis of the 2018 Summary Report.) Although staff found that a majority of the 25 IFMs reviewed had improved their policies and procedures, they still observed a number of deficiencies, including the following:

Policies, Procedures and Internal Controls	Non-Compliant Practices
Inadequate written policies and procedures for: ▪ Provision of non-monetary benefits; and ▪ Solicitation of non-compliance monetary and non-monetary benefits	Provision of: ▪ promotional items of non-minimal value; ▪ excessive business promotion activities; ▪ non-promotional items and activities; ▪ non-monetary items on a frequent basis; and

Policies, Procedures and Internal Controls	Non-Compliant Practices
Inadequate internal controls to monitor provision of non-monetary benefits	▪ monetary support to non-educational events (e.g., holiday parties, activity days, client dinners and appreciation dinners for dealing representatives).

In our experience, staff expect IFMs to follow the detailed, published guidance to the letter and they are running out of patience for deficiencies in this area. AUM Law can help you reduce your compliance risks in this area by conducting a focused sales practices review, advising on potential enhancements to your policies, procedures and internal controls, and training your employees.

11) For Extra Credit

We've briefly summarized below some additional staff recommendations and commentary that we think our readers will find relevant.

Topic	Staff Recommendations and Comments
Compensation and incentive practices – everyone	The Report outlines some good practices in this area, including the following: ▪ Using product-neutral grids (e.g. for commission rates); ▪ Reviewing accounts with similar mandates to identify performance outliers (which may point to representatives chasing performance to increase their compensation); ▪ Using quantitative and qualitative factors to determine bonuses; and ▪ Using claw-back provisions to address non-compliance and client complaints.
National Registration Database (NRD) – data protection	Firms should review their information technology security processes and controls against the CSA's Authorized Firm Representative (AFR) Account Management Best Practices Checklist (AFR Guide) to ensure that they are adequately protecting the data maintained in NRD.
Short-term trading by unitholders – IFMs	If you sometimes waive short-term trading fees for unitholders: ▪ Your policies and procedures should address the circumstances when the fee can be waived, who can waive the fee, and the waiver process; ▪ You should document the firm's rationale for the waiver (including consideration of the potential impact on the fund's other unitholders); and ▪ You should be prepared for any inconsistent practices (e.g. waiving fees for certain unitholders or their dealing representatives but not others) to attract scrutiny in a compliance audit.

E. Policy Initiatives

As usual, the Report summarizes certain policy initiatives affecting registrants and provides links to the relevant publications. This year, the Report covers:

- Derivatives regulation (see our bulletin articles here and here);

- Alternative funds regulatory framework (see our bulletin article here and subscribe to our publications to get a copy of our alternative funds brochure);
- Syndicated mortgages (see our bulletin articles here and here); and
- Custody-related amendments to NI 31-103 that came into force in June 2019 (2019 Custody Amendments).

The Report doesn't discuss several high-profile initiatives, such as the proposed client-focused reforms affecting NI 31-103, the September 2018 proposals that would affect embedded commissions, initiatives affecting financial planners and the use of titles, and the Cooperative Capital Markets Regulatory System. We think that the CSA's and OSC's recently published statements of priorities, which we discussed in June and July, respectively, are more comprehensive sources of information on the status of various regulatory initiatives.

2. Crypto Kerfuffles Continue

Cryptocurrency-related products and services continue to attract investors like ants to picnic leftovers. And so we aren't surprised that North American securities regulators are continuing to publish investor alerts and take enforcement action against firms that they believe have breached securities laws. On August 7, the North American Securities Administrators Association (NASAA) published an update on Operation Cryptosweep, which we reported on when it was launched in 2018. Since then, provincial and state securities regulators in Canada and the United States have opened 130 investigations into questionable cryptocurrency-related investment offerings. According to NASAA, there have been 35 pending or completed enforcement actions since the beginning of 2019.

As well, the U.S. Securities and Exchange Commission (SEC) enforcement action against Canada-based crypto-currency issuer Kik Interactive Inc. (Kik) is generating controversy as well as pun-loaded commentary. In June of this year, the SEC sued Kik, claiming that it had offered and sold one trillion tokens known as Kin in violation of the Securities Act of 1933 (Securities Act). The SEC claims that the sale of Kin constituted an unregistered offering of securities. Kik's August 9 response to the SEC complaint challenges many of the facts and legal opinions articulated by the SEC. Among other things, Kik is challenging the inferences that should be drawn from its interactions with Ontario Securities Commission (OSC) staff in 2017 and Kik's decision not to make Kik available to Canadian investors.

This case, and the regulators' continued focus on this area highlight the importance of obtaining legal advice if your business plans contemplate the use of crypto-currency. AUM Law has experience in this area, and we can help you navigate the regulatory challenges in this area.

3. FSRA Focuses on High-Risk Syndicated Mortgages

Since July 2018, mortgage brokers who deal with non-qualified syndicated mortgages have had to comply with expanded know-your-client (KYC) and suitability obligations, enhanced disclosure requirements, and a 12-month, $60,000 investment limit for sales of non-qualified, syndicated mortgages to any investor or lender who isn't a "Designated Investor". (Read more about these requirements in our March 2018 bulletin.)

Now, the Financial Services Regulatory Authority (FSRA) is proposing additional requirements for high-risk, syndicated mortgage investments (High-Risk SMIs). Generally, High-Risk SMIs meet one or more of the following criteria:

- Loan-to-value (LTV) ratios that exceed 100%;

- A subordination clause (where the syndicated mortgage's priority could be lowered without the lender's consent); and/or
- Conflicts of interest involving the borrower or developer being related to the mortgage administrator.

The proposals encompass:

- A supplementary disclosure form to be provided investors other than Designated Investors; and
- A supervisory approach that includes real-time review of High-Risk SMIs and outreach to firms that have brokered High-Risk SMIs in the past, to ensure that they're complying with the new requirements.

Timing is everything: The 30-day comment period for FSRA's proposal ends on September 6. And this request for comment has landed just as market participants in this industry are counting down to December 31, 2019, when proposed changes to the securities regulatory framework proposed by the Canadian Securities Administrators (CSA) are supposed to come into effect. In very general terms, the non-qualified, syndicated mortgage market will become subject to oversight by CSA members. (See our March 2019 bulletin for more details.)

FSRA has indicated that it will re-consider its proposal if it is made redundant by the transfer of the regulation of High-Risk SMIs to the Ontario Securities Commission (OSC), as contemplated under the CSA proposal. But if FSRA moves swiftly and the CSA proposal gets bogged down, FSRA's new regime could be operational for some time.

AUM Law has been facilitating discussions between some of our clients in the syndicated mortgage market, on the one hand, and staffs of the OSC, FSRA and the Ministry of Finance, on the other. If you want to discuss how the CSA's proposal, FSRA's proposal and related initiatives might affect your business or be connected with our clients who are in discussions with the regulators, please contact us.

FAQ Corner

Does an employee who executes trading instructions (Trader) provided by a registered advising representative (AR) have to be registered?

Answer: No, but of course there are caveats! In our view, if an AR makes the decisions regarding such elements as which security to buy or sell, the number of shares to buy / sell and at what price / terms, and which client accounts to include in the trade, then the Trader who executes those instructions by contacting registered dealers to execute the trades is not engaging in a registrable activity. If, however, the Trader exercises any discretion, then they must, at a minimum, be registered as an associate advising representative (AAR) and supervised by an AR.

The AR must supervise the Trader to confirm that all trades are made in accordance with instructions. And of course, the registered firm remains responsible for the conduct of individuals acting on the firm's behalf, including the Trader. It would need to be able to demonstrate in a compliance audit that it has an appropriate level of training and oversight over such activities and that it is complying with, among other things, the best execution requirements in National Instrument 23-101 *Trading Rules*. This would include having a system in place to monitor for (and minimize) trade errors, as well as systems for rectification of trading errors.

News and Events

PMAC Toronto Regulatory & Compliance Forum – September 19th

AUM Law is a proud sponsor of the Toronto Regulatory & Compliance Forum organized by the Portfolio Management Association of Canada (PMAC) on September 19. Our very own Richard Roskies will be participating as a panelist in a session focused on private clients. Click here to see the agenda and register.