AUM LAW

July 2020 Bulletin

Dive-in Edition

As summer peaks and we head into a long weekend, we invite you to dive into this month's bulletin. We'll highlight some of the interesting recommendations made by Ontario's Capital Markets Modernization Task Force, discuss the CSA's new guidance on flexible CCO arrangements, and talk about the OSC's recent settlement of enforcement proceedings with Coinsquare, a crypto asset trading platform, and its principals. Read about these developments and more, below.

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1. Ontario's Capital Markets Modernization Task Force Releases Consultation Report

Inventions, apologies, clean water and comedians. Canada is great at many things. Add to that list our tolerance for studies of our securities regulatory system. Here at AUM Law, we've been dipping into the initial consultation report (Report) of the Ontario government's Capital Markets Modernization Task Force (Task Force). Like ice wine, the Report is better sipped than guzzled and so in this month's bulletin we've highlighted a handful of proposals that we think will be of particular interest to readers of this newsletter.

Background: The Task Force began its work in February 2020 and since then has engaged with over 110 stakeholders to learn more about the challenges that businesses and investors face in Ontario's capital markets. Now, the Task Force is seeking feedback on 47 proposals to supplement the policing function of Ontario's capital markets regulatory framework with a public policy imperative to grow those markets.

Self-Regulatory Organizations (SROs): SRO reform is a hot topic. Adding to the proposals we discussed last month, the Task Force has its own recommendations, including those outlined below, to transform the regulatory framework for SROs and registered firms.

- Create a single SRO to regulate both investment fund dealers and mutual funder dealers and conduct national market surveillance.
- In the longer term, transfer all registration functions and oversight of all firms distributing products and providing advice to investors from the OSC to the SRO.
- Increase the OSC's oversight over the existing SROs and any future SRO. For example, the OSC would approve SRO annual business plans and be able to veto significant publications (including rules and guidance) and key appointments.
- Link SRO executives' compensation and incentive structures to their public interest and policy mandate, require SROs boards to include directors with investor protection experience, require a greater proportion of directors (including the chair) to be independent, and introduce cooling-off periods between working for a member firm and becoming an independent director of an SRO.
- The Task Force also is considering whether to recommend an ombudsperson service to address complaints that SRO member firms have about the services received from their SRO.

Capital-Raising: Many of the Task Force's proposals, including the recommendations set out below, focus on making Ontario capital markets more attractive to issuers and investors:

- Expand the definition of accredited investor (AI) so that distributions under the AI exemption can be made to individuals who hold the CFA Charter or have completed other relevant proficiency requirements such as the Canadian Securities Course (CSC) exam, Exempt Market Products exam, or the Series 7 Exam plus the New Entrants Course Exam.
- Allow exempt market dealers (EMDs) to participate as selling group members in prospectus offerings and sponsor reverse takeovers (RTOs).
- Develop a regulatory framework for retail private equity investment funds, such as the "interval fund" concept in the United States. (An interval fund is a type of unlisted, closed-end fund that periodically offers to buy back a stated portion of its shares.)
- In the Report, the Task Force discusses the phenomenon of angel investor groups assisting with early stage financing of start-ups. According to the Report, angel investor groups consist of AIs who professionalize and share due diligence, domain knowledge, and expertise as they consider investing in early stage issuers. Some angel investor groups seek to be structured to earn a fee from working with their members to collaboratively finance these start-ups and such arrangements could, in some circumstances, trigger registration requirements. The Task Force recommends that the registration rules be changed so that angel groups can work with their AI members.
- Liberalize reporting issuers' ability to pre-market transactions to institutional investors before filing a preliminary prospectus. This regulatory change would be combined with increased monitoring and compliance examinations by regulators of the trading of those who might have advance knowledge of an offering.

Ownership Transparency: The Task Force sets out several proposals that may be of particular relevance to institutional investors who hold securities of reporting issuers. For example:

- Decrease the ownership threshold for early warning reports decrease from 10% to 5%. Feedback is requested on, among other things, whether requiring passive investors to report ownership at the 5% threshold would create undue burden relative to the disclosure benefits.
- Require institutional investors whose investments exceed a certain dollar threshold to disclose on a quarterly basis their holdings in Canadian reporting issuers whose market capitalization is above a certain threshold.

A Bigger Sandbox: The Task Force recommends that the OSC Launchpad and the Financial Services Regulatory Authority (FSRA) create an Ontario Regulatory Sandbox to serve innovative start-ups operating across Ontario's financial services sector. Ideally, the Ontario Regulatory Sandbox would expand into a Canadian Super Sandbox involving all provincial and federal financial sector regulators.

Other Recommendations: The summary above highlights only a handful of the Task Force's recommendations. The Report also includes potentially high-impact proposals such as:

- Separating the OSC's regulatory and adjudicative functions;
- Expanding the OSC's investigative and enforcement powers;
- Providing greater rights for persons or companies affected by the OSC's examinations and investigations, such as introducing a mechanism to ensure that the OSC's questions or requests for documents are subject to a "reasonable and proportionate" threshold and enabling affected persons to apply to an OSC adjudicator to clarify investigation and examination-related orders; and
- Empowering the Ombudsman for Banking Services and Investments (OBSI) to issue binding decisions requiring a registered firm to pay compensation to harmed investors and increasing the limit on OBSI's compensation recommendations;

What's Next? The deadline for comments on the Report is September 7. The Task Force plans to deliver its final report to the Minister of Finance before the end of the year. After that, the Task Force's proposals will become part of the mix of Ontario and Canada-wide reform proposals, including the OSC's regulatory burden reduction initiative, establishment of the Cooperative Capital Markets Regulatory System, and the Canadian Securities Administrators' agenda. We think that initiatives that can be implemented by Ontario authorities on their own could move forward fairly quickly, especially if no legislative or rule changes are required. Other proposals (such as SRO reform) will require coordinated, cooperative and determined actions by multiple parties across the country and are therefore likely to take much more time to achieve, if they are achievable at all.

AUM Law will continue to monitor the Task Force's work and update you on significant developments. If you are interested in submitting a comment letter or wish to discuss the Report's implications for your business, please do not hesitate to contact us.

2. CSA Publishes Guidance on Flexible CCO Arrangements

On July 2, the Canadian Securities Administrators (CSA) published Staff Notice 31-358 Guidance on Registration Requirements for Chief Compliance Officers and Request for Comments (SN 31-358), which outlines and provides guidance on three optional models for employment of chief compliance officers (CCOs). We highlight key features of the three models below.

Under the shared CCO model, an individual could become the CCO for two or more registered firms. Although larger firms likely need a full-time CCO, SN 31-358 acknowledges that some smaller firms might be able to operate an effective compliance system with a shared CCO. The shared CCO model also would enable firms with only one individual to separate the CCO function from that of the ultimate designated person (UDP) and director. CSA staff emphasized that the shared CCO model is not an "outsourced CCO" model, with services provided by a compliance consultant. The shared CCO will become an officer of each firm sharing their services.

According to SN 31-358, staff considering an application for a shared CCO will want to see how the sponsoring firms and the individual applicant plan to address potential conflicts arising from the arrangement and protect clients' confidential information. Staff also will consider the individual applicant's capacity to fulfil their obligations as CCO in light of their commitments at all the firms where they would serve as CCO, as well as any other commitments (such as their outside business activities). SN 31-358 also indicates that applicants to serve as a shared CCO typically will already have a track record as an effective CCO evidenced by, for example, the outcomes of compliance reviews at firms where they served as the CCO.

Under the multiple CCO model, a firm will employ more than one CCO, with each individual responsible for a different business line or registration category. According to SN 31-358, a firm seeking to implement this model will need exemptive relief and have to demonstrate, among other things, that each CCO will have their own responsibilities and that no CCO will delegate or transfer their prescribed responsibilities to another CCO.

Under the specialized CCO model, staff will consider an individual's relevant business experience in assessing whether the individual has the proficiency and experience required to serve as the CCO of a non-traditional or specialized firm. For example, experience developing financial products or services might be relevant in a CCO application for a firm that operates an online platform for innovative products or services. SN 31-358 notes that, in some circumstances, exemptive relief might be required.

CSA Wants Feedback: Somewhat unusually, SN 31-358 incorporates a request for comments even though the guidance on CCO models already appears to be in effect. CSA members want to hear from registrants about whether these CCO models meet their needs and their experience in implementing them, so that the CSA can determine if further policy initiatives are needed. This suggests that the CSA might be open to tweaking the models or proposing others, as needed. The deadline for comments in September 30.

Our Takeaways: SN 31-358 reflects a change in regulatory practice, not a change in the rules. We expect that the process to register a CCO under one of these models will be more time-consuming and complex than a typical application, potentially involving an application for exemptive relief and/or incorporation of terms and conditions on the CCO's registration. AUM Law has extensive experience helping firms prepare applications to register CCOs and engaging with regulators on firms' during the application process. If you are interested in exploring a non-traditional CCO arrangement, please contact us to discuss how we can help.

3. Watch Out or Wash Out: Coinsquare Executives Learn That Innovation Isn't a Free Pass to Violate Securities Laws

On July 21, the Ontario Securities Commission (OSC) approved a settlement agreement (Settlement) with Coinsquare Ltd. (Coinsquare) and several of its current and former executives

(collectively, the Individual Respondents) concerning inflated trading volumes, misleading statements, and reprisals against an internal whistleblower. We think that the Settlement and related decision approving the settlement (Decision) are interesting for several reasons:

- **It's the first time the OSC has settled a case involving market manipulation on a crypto asset trading platform.** According to the Settlement, Coinsquare substantially inflated the trading volume on its platform between July 2018 and December 2019.
- **Senior executives directed, implemented and/or acquiesced in the misconduct.** Coinsquare's then chief executive officer (CEO) Cole Diamond directed Virgile Rostand (Coinsquare's founder, president and chief technology officer) to develop and implement the algorithm that inflated the reported trading volumes.
- **Coinsquare misrepresented its trading volume** through its website and application programming interface (API), as well as in statements to existing and future customers even as people questioned the reasons for the sudden increase in trading volume beginning in July 2018.
- **The illegal activity occurred while Coinsquare was engaging with regulators** to register Coinsquare Capital Markets Ltd. (CCML) as an investment dealer and operator of an alternative trading system (ATS). Coinsquare representatives did not disclose the wash trading activity to OSC staff and instead, asserted that the company was taking steps to prevent market manipulation.
- **Breach of prohibition on reprisals against whistleblowers.** This is the first finding (albeit in a settlement agreement) by the OSC that a firm breached the prohibition in the Ontario *Securities Act* (Act) on taking reprisals against an internal whistleblower. According to the Settlement, an employee who played a key role on the automated trading strategies team repeatedly escalated concerns about the wash trades to senior management, including Messrs. Diamond and Rostand. He was told that the issue wasn't open for discussion and that continuing to raise such concerns would impact his employment. He took a stress leave in October 2019 and was formally terminated in early December 2019. The Settlement also includes a finding that Coinsquare's CEO breached the Act by authorizing, permitting or acquiescing in Coinsquare's breach of the whistleblower provision.
- **Coinsquare's Chief Compliance Officer (CCO) acted contrary to the public interest.** Felix Mazer held the title of CCO from May 2018 until he resigned in June 2020. Although he wasn't acting in a registered capacity in his role as the CCO of Coinsquare, he was held out as the CCO within Coinsquare and to the general public. According to the Decision, although he became aware of the wash trading activity in March 2019, he failed to take steps that a reasonable CCO would have taken in the circumstances, contrary to the public interest.
- **Enforcement orders designed to quash and deter misconduct, not innovation.** The Settlement provides for a package of administrative penalties and contributions to the OSC's investigation costs, while also outlining a path forward for Coinsquare to tap into the Individual Respondents' expertise and for CCML to become a registrant in the future. The Settlement provides for $2.25 million in penalties and costs, with the lion's share ($2 million) payable by Messrs. Diamond and Rostand. The Individual Respondents are also subject to bans on serving as officers or directors of issuers or registrants for varying periods, but the Settlement makes it clear that the boards of Coinsquare and CCML can request information from them, provided that the independent directors determine that the information is needed to fulfil their duties and is in the best interests of the relevant company, and provided that

appropriate records of the information requested and received are maintained. The Settlement also includes undertakings by Coinsquare and CCML relating to their firms' governance, whistleblower, compliance, and internal control functions and provides for CCML to resubmit its application for registration as an investment dealer and ATS.

The Settlement and Decision, read together with guidance from the Canadian Securities Administrators (CSA), serve as a reminder for participants in Canada's crypto asset industry that, if securities laws apply to their activity, they are expected to meet the same high standards of honesty and responsible conduct that apply in traditional capital markets. With our extensive experience assisting firms with registration and ongoing regulatory compliance matters and our knowledge of the crypto asset space, AUM Law can help you get it right the first time and stay on course as your business develops. Please don't hesitate to contact us for a free consultation.

FAQs

How does a registered firm's UDP certify their firm's 2020 RAQ responses if the UDP doesn't have online access to the survey?

As we mentioned in our May 2020 bulletin, Ontario-registered firms must submit online their 2020 Risk Assessment Questionnaire (RAQ) responses and supplementary COVID-19 survey responses to the Ontario Securities Commission (OSC) by August 6. The OSC introduced additional security measures this year for the RAQ process, including a requirement that each firm's chief compliance officer (CCO) register and create an online account before accessing the firm's 2020 RAQ.

Since many people are working remotely, it might not be possible for the firm's ultimate designated person (UDP) to access their firm's 2020 RAQ responses online and provide the required certification. OSC staff, therefore, sent an email in mid-July to UDPs describing the steps that they and the CCO should take in such circumstances. In particular:

- The UDP should certify the firm's 2020 RAQ by sending an email to the ComplianceSurvey@osc.gov.on.ca and copy the CCO on this email.
- The email must include the specific language set out in the email that the firm's CCO should have received from the OSC in mid-July.
- The CCO must copy that same email into the Final Overall Feedback section at the end of each section of the 2020 RAQ.

If you have any questions about the certification process described above or want us to review your draft responses to the 2020 RAQ or COVID-19 Survey, please contact us as soon as possible, so that we help you get your responses submitted by the August 6 deadline.

Do registered individuals (and applicants for registration) have to disclose offenses they have been charged with, if the matter hasn't been adjudicated yet?

Item 14.1 of Form 33-109F4 *Registration of Individuals and Review of Permitted Individuals* (Form 33-109F4) requires individual applicants to indicate whether there are any outstanding or stayed charges against them alleging that a criminal offense was committed. Once an individual is registered or approved, subsection 4.1(1) of National Instrument 33-109 *Registration Information* (NI 33-109) requires them to disclose to the regulator within ten days any change in the information previously submitted in respect of Item 14 - Criminal Disclosure on their Form 33-109F4.

Even though Form 33-109F4 makes it clear that criminal charges must be disclosed, some people might be embarrassed or otherwise reluctant to disclose such facts in the hope that no one will notice, especially if they think there is a good chance that the charge ultimately will be dismissed. There is no shortage of case law, however, indicating that this "stick your head in the sand" approach is very risky.

For example, in the recent Director's decision Re Tams published by the Ontario Securities Commission (OSC), the Director agreed with staff's recommendation not to re-activate an individual's registration as a mutual fund dealing representative due to concerns about his integrity. As part of OSC staff's routine criminal records check, they learned that while the applicant was registered with another firm, he had failed to disclose to the OSC that he had been charged with an impaired driving offense under the *Criminal Code*. Later, he quadrupled down on that non-disclosure by failing to disclose the outstanding charge to the OSC or his sponsoring firm when he applied for registration as a mutual fund dealing representative at that other firm, failing to respond to OSC staff's inquiries about the non-disclosure, and making false statements to staff during a voluntary interview to consider his registration.

Even though the applicant was ultimately acquitted for the criminal charge, OSC staff and the Director viewed his pattern of withholding information as problematic. In the decision, the Director refers to CSA Staff Notice 33-320 The Requirement for True and Complete Applications for Registration (SN 33-320), which stresses the importance of applicants for registration being willing and able to complete the application form for registration with candour.

AUM Law has extensive experience assisting individuals and their sponsoring firms with applications for registration, preparing updates to Form 33-109F4, training staff on their obligations to update this form when circumstances change, and engaging with regulators to address any concerns that might arise regarding an individual's fitness for registration. Please do not hesitate to contact us if you have questions about the application or update process.

In Brief

Are You Prepared to Deal with Colleagues Experiencing Diminished Capacity?

The Senior Issues and Diminished Capacity Committee (Committee) of the North American Securities Administrators Association (NASAA), which usually focuses on issues relating to senior and vulnerable investors, recently published a research report (Report) examining the issues that arise when diminished capacity affects financial professionals. Although the Report does not include specific policy recommendations for regulators or detailed guidance, we nevertheless believe it is a useful resource for registered firms. The Report, which is based in part on the Committee's consultations with firms, outlines the kinds of regulatory compliance and other challenges that firms face in dealing with individual representatives with cognitive impairment, describes the tools and kinds of information some firms have used to identify representatives experiencing diminished capacity, and the steps these firms have been taking to address situations where they identify representatives with diminished capacity. Not surprisingly, the Report notes that resources developed to help firms identify and engage with senior and vulnerable investors also may help firms identify and engage with employees experiencing similar difficulties.

AUM Law can help you review your policies, procedures and succession plan to determine whether enhancements are needed to address issues arising from diminished capacity among your staff.

We can also help coordinate the retention of employment or other specialized counsel should the need arise.

OSC Issues Interim Prospectus and Registration Exemptions to Facilitate Crowdfunding

In our February 2020 bulletin, we reported on proposed National Instrument 45-110 Start-up Crowdfunding and Registration Exemptions (NI 45-110), which is intended to create a nationally harmonized regime. The comment period for that proposal ended on July 13. On July 30, the Ontario Securities Commission (OSC) adopted an interim class order (Order) that provides prospectus and registration exemptions for start-up crowdfunding that are substantially similar to the local exemptions already in place in Alberta, British Columbia, Manitoba, New Brunswick, Nova Scotia, Québec, and Saskatchewan (collectively, the Crowdfunding Orders).

In the news release accompanying the Order, the Canadian Securities Administrators (CSA) noted that start-ups and other small businesses are facing significant funding challenges due to COVID-19 and might benefit from more unified regulatory requirements to expand their access to capital. The Order will remain in place until the earlier of the date that NI 45-110 is adopted or January 31, 2022. If you wish to learn more about the Crowdfunding Orders and their potential usefulness for your business, please contact us.

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AUM Law focuses on serving the asset management sector in the areas of regulatory compliance and investment funds. We also support clients in this sector by providing legal advice and services for structuring entities, raising capital, business combinations, and compliance with reporting issuers' and investors' disclosure obligations. Our clients include investment fund managers, portfolio managers, dealers, public and private investment vehicles including real estate funds, alternative funds and private equity funds, investors, and private and public companies.

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.

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