March 2024 | Bulletin

Sweet Dreams Edition

As we collectively recover from the one-hour time loss earlier in March, it is an appropriate interval to reflect on the relatively recent introduction of National Sleep Awareness Week. This week of ZZZs has generally been celebrated the second week of March, since the 1990s. The week is intended to raise awareness about sleep related issues. Of note, the recommended amount of sleep for adults aged 18-64 is thought to range between 7-9 hours per night, which we are sure all our readers obtain consistently.

Based on the number of regulatory proposals, guidelines, and deadlines described in this March edition of our bulletin, however, the regulators never shut their eyes. Just as the right amount and quality of sleep impacts your overall health, we hope these summaries help with your sense of regulatory compliance well-being.

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1. Wakeup Call: CIRO Compliance Priorities for 2024

On March 13, 2024, the Canadian Investment Regulatory Organization (**CIRO**) released its compliance priorities for the year. There is much in the document for CIRO members to note. Dealers need to pay special attention to the emphasis on compliance with the Client Focused Reforms, and particularly the requirements concerning Conflict of Interest, Know-Your-Client (**KYC**), Know-Your-Product (**KYP**) and suitability. Dealers should also take note of the areas of focus for compliance examinations, and ensure they have the appropriate monitoring, controls, policies, and procedures in place.

The initiatives highlighted by CIRO include the following:

- **CIRO Framework** – CIRO will continue to consolidate and integrate the former MFDA and IIROC organizations.
- **Office of the Investor** – Established in 2023, the Office of the Investor will continue to conduct research and inform the development of regulation.
- **Crypto Asset Trading Platforms** – CIRO will continue to work with the Canadian Securities Administrators (**CSA**) and stakeholders to tailor its regulatory approach to the industry.
- **Compliance Program** – The compliance programs for mutual fund dealers and investment dealers will continue to be integrated, and the following changes are highlighted:
    - **Risk Models** – Work will continue to integrate the legacy risk models of IIROC and the MFDA.
    - **Examination Schedules** – The examination scheduling year for mutual fund dealers will be aligned with CIRO's fiscal year of April 1 to March 31.
    - **Examination Reports** – The format of examination reports will be aligned.
    - **Annual Risk Questionnaire** – The annual risk questionnaires used for both dealer types will be reviewed and aligned.
    - **Protocol for Compliance Referrals to Enforcement** – The framework governing referrals to enforcement will be reviewed and aligned.

Regarding conduct and supervision, the focus will include:

- **Client Focused Reforms (CFR) Phase II Sweep – KYC, KYP and Suitability** – CIRO and the CSA are currently conducting a sweep to evaluate compliance by dealers with the KYC, KYP and suitability requirements in the CFR. Guidance on the regulators' expectations on how dealers may comply with the CFR will be published. The focus of CIRO in dealer examinations will include:
    - **Reasonable Range of Alternatives** – Ensuring that dealers identify a reasonable range of alternatives when making investment recommendations. Attention will be paid to the scope of products considered, the timing of the assessment, the documentation required and the reasons for choosing a specific security.
    - **Risk Profile** – There will be a focus on the adequacy of the dealer's process for determining risk capacity, the dealer's process for determining risk profile based on the lower of risk capacity or risk tolerance, and the procedure for ensuring that KYC is reviewed in accordance with the mandated schedule (1 year for managed accounts and 3 years for advisory accounts).
    - **Product Due Diligence and KYP** – Firm level processes for product due diligence will be examined. Registrant level processes and procedures will be examined, and there will be a focus

on the process to ensure that previously approved products are monitored for significant changes and registrants are notified of the changes when their clients hold those products.

- **Memorandum of Understanding with FINTRAC** – Information sharing with FINTRAC has been enhanced, and the mutual fund dealer compliance examination program will be enhanced to include testing for compliance with AML requirements.
- **Advisor Ranking Contests/Lists** – Further to the notice provided in July 2023 regarding participation by registrants in ranking contests or lists, CIRO advises that during dealer examinations they will examine dealer policies and processes relating to participation in ranking contests or lists.

Regarding registration and proficiency, the focus will include:

- **Relevant Investment Management Experience (RIME) for APMs and PMs** – Registration staff expect dealers to clearly outline the RIME to support a PM or APM application. Doing so will promote timely approval.
- **Experience Requirement for Supervisors** – Firms are encouraged to carefully review a person's education and experience before applying for approval as a supervisor. Dealers are encouraged to contact registrations staff if they require clarification before making an application.
- **Competency Profiles and Proficiency Initiative** – CIRO plans to publish rule amendments related to the Proposed Proficiency Model during the summer of 2024. Since the contract with CSI will expire in December 2025, CIRO is also proceeding with a Request for Proposal and will update further in due course.
- **Dual Registered Dealers** – CIRO reminds dealers interested in dual registration to consult the material available on the CIRO website.
- **Québec Mutual Fund Dealers** – In September of 2023, the Government of Québec approved the delegation of registration and examination of mutual fund dealers in Québec to CIRO. CIRO plans to begin examining mutual fund dealers in Québec during the summer of 2024.
- **Continuing Education** – CIRO reminds dealers and registrants to complete their CE in a timely manner, and to avoid undue burden and the risk of non-compliance by not leaving the submission of CE credits until the end of the cycle.

Regarding dealer operations and risk management, the focus will be on:

- **T+1 Settlement** – Assessing dealer readiness.
- **Cybersecurity Risk** – Firms must have appropriate controls in place to manage cybersecurity risk. During regularly scheduled examinations, CIRO will look at how dealers comply with incident reporting requirements, and manage cybersecurity risk, and CIRO will incorporate its assessment into the dealer risk score. The report identifies numerous common deficiency findings regarding cybersecurity policies, procedures, and documentation.

- **Proposal to Modernize Back-Office Arrangements and Subordinated Debt Financing** – CIRO will undertake a review to identify opportunities to modernize the rules related to back-office arrangements and subordinated debt financing and create a detailed notice for dealer members.
- **Credit Risk Management** – CIRO will continue to review dealer credit risk policies and procedures and will focus on the management of counterparty risks.
- **Debt Securities Concentration** – CIRO notes that many dealers do not have adequate reporting to ensure that debt security concentration is monitored, supervised, and reported on the dealer's Form 1.

Regarding trading, the focus will include:

- **Order Marking and Client Identifiers** – CIRO notes staff reviews continue to identify issues with market participants not properly marking trades, or properly applying client identifiers.
- **Internal Risk Assessments** – Market participants are required to conduct and regularly review and update an assessment of the risks associated with their trading activity and focus compliance resources accordingly. CIRO will be requesting and reviewing these risk assessments.
- **Short Selling and Extended Failed Trades** – Before entering a short sale, order participants are expected to have a "reasonable expectation" to settle the resulting trade. Participants must also ensure that short sales are properly marked and extended failed trades are reported to CIRO. CIRO will be reviewing dealer policies, procedures, and internal testing to confirm that proper processes are in place to prevent improper short sales and to report extended failed trades.

Finally, regarding membership issues, CIRO reminds dealers of the requirement to inform them of any material changes to the dealers' business activities, and to use the new template form when submitting a business change request.

CIRO has published an ambitious priorities report. Dealers should take note of the areas of focus and ensure their compliance program is current and examination ready. Please contact us if you require any assistance updating your policies and procedures.

2. Avoiding Nightmares – Updates to CSA Staff Notice on ESG Guidance for Funds

The CSA published additional guidance on ESG investment fund disclosure practices on March 7, 2024. CSA Staff Notice 81-334 (Revised) ESG-Related Investment Fund Disclosure (**Staff Notice**) replaces and augments the guidance published in January 2022. The 2024 guidance summarizes key findings from the ESG sweeps, provides additional guidance on ESG fund characterization as well as disclosure in prospectus and sales communications for each fund characterization.

Of particular interest to those operating a publicly offered ESG fund, the Staff Notice categorizes **ESG-Related Funds** into the following three fund categories, dependent on the level of ESG inclusion in their investment process to help investment fund managers correctly identify an ESG-Related Fund:

1. **ESG Objective Funds** – funds whose investment objectives reference ESG factors.
2. **ESG Strategy Funds** – funds whose investment objectives do not reference ESG factors but that use ESG strategies, where the consideration of ESG factors plays a significant role in their investment process.
3. **ESG Limited Consideration Funds** – funds whose investment objectives do not reference ESG factors but that use ESG strategies, where the consideration of ESG factors plays a limited role in their investment process.

The CSA also lists one other fund type: the **Non-ESG Fund**. The CSA identified this type of fund as one that does not consider ESG factors in their investment process and would include a fund in an ESG-related asset class but that does not consider ESG factors, a fund that is subject to an exclusionary screen that has no impact on the investment selection process, and a fund that is subject to an investment fund manager's general proxy voting or engagement approach that addresses ESG matters.

The Staff Notice emphasizes that these classifications are not intended to be used as investor-facing labels or classifications in prospectuses, other disclosure documents, or sales communications.

The CSA also provided further guidance on their expectations regarding when a fund name can reference ESG, the appropriateness of ESG disclosure in a fund's suitability statement and what to include in a fund's investment strategies disclosure.

With respect to sales communications, the CSA continues to warn registrants against making misleading or inaccurate ESG-related statements, or statements that would otherwise conflict with prospectus disclosure. Staff did acknowledge that **Required ESG-Related Initiative Communications** could be excluded as a sales communication if they are explicitly required to be made public as part of the investment fund manager's commitment to a voluntary ESG-related initiative that is: **(a)** administered by an organization that is not affiliated with the fund or its investment fund manager, portfolio adviser or principal distributor; and **(b)** widely recognized.

3. Sleeping Soundly by Dealing with Fee Arrangement Conflicts

Since the CFRs in National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* came into effect the other year, firms have been making serious efforts to meet their enhanced conduct obligations. This includes taking reasonable steps to identify existing and reasonably foreseeable material conflicts of interest and to address those conflicts in the best interests of clients. If there is no way to address a material conflict in the best interest of clients using controls, the conflict must be avoided.

Last year, the CSA and CIRO staff (the **Regulators**) published further guidance outlining their expectations relating to identifying and addressing material conflicts of interest: *Joint CSA and CIRO Staff Notice 31-363* (**Notice**).

One specific conflict that was highlighted was "fees charged to clients", with the Regulators noting that that some firms had not identified that different / multiple fee schedules could be a material conflict of interest in certain circumstances as it could affect either or both decisions of the client or the services or products offered by the firm. The Regulators noted that where a client is charged more than other clients for the same or substantially similar products or services, there could be a breach of a registrant's duty to treat clients fairly, honestly and in good faith. Additionally, they reminded firms that disclosure alone is not sufficient to address this conflict, nor is disclosure alone sufficient to demonstrate that the firm has met its standard of care.

Our experience with clients has led us to observe that this conflict is amongst the most consequential that needs to be considered and addressed. In considering the impact of different / multiple fee schedules for the same services, firms should be cognizant that they will be expected to have acceptable measurable criteria in place to justify the fee differences among clients. This can include a client's account size, but likely should not include factors such as the geographic location of the firm's registered individuals or their seniority.

Additionally, amongst other considerations, if a firm has a standard fee schedule but allows some clients to negotiate fees or deviate from the schedule, the firm should be aware that the Regulators' guidance is that they expect the firm to: **(a)** implement guidelines or criteria for circumstances where a deviation from the standard fee schedule would be acceptable, **(b)** implement a process where deviations require prior approval from designated senior personnel, and **(c)** disclose to all clients and describe the circumstances under which the firm is prepared to negotiate fees or deviate from the firm's standard fee schedule.

We have also seen this conflict come to the fore in instances where a registered firm is acquiring or merging with another registered firm; i.e. as the firms move towards being one firm, how will they address their historically separate fee schedules so that their combined clients will be paying appropriate fees for the same or substantially similar products or services on a go-forward basis. We have seen required regulatory non-objections be delayed in instances where firms have not adequately addressed this consideration.

If you have any questions or would like to discuss any of the above further, please contact your regular lawyer at AUM Law. AUM Law regularly assists clients to consider their enhanced conflict of interest obligations, including advising firms on implementing disclosure and controls to address material conflicts in a manner consistent with regulatory expectations.

4. Keepin' up with KYP (or, How to Sleep Like a Baby)

Registrants are reminded that your basement is not the only thing that may need some spring cleaning – it may be time to dust off the product shelf and review your Know-Your-Product (**KYP**) documentation to ensure it is up to date.

With securities regulators likely entering the final stages of their Know-Your-Client (**KYC**), KYP and suitability sweep, we should be receiving additional guidance and feedback soon on what their specific expectations are regarding KYP, but until then, registrants should keep the following core obligations in mind.

As set out in National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**NI 31-103**), registered individuals are prohibited from trading or recommending securities to a client unless they have taken steps to understand the securities, including the securities' structure, features, risks, initial and ongoing costs, and the impact of those costs. Also, firms are prohibited from making securities that are approved and on their product shelf available to clients unless they have taken reasonable steps to monitor the securities for significant changes. Collectively, whether directly or by implication, these two requirements establish an obligation upon both firm and individual registrants to ensure their KYP documentation is periodically kept up to date.

A firm's KYP process should include monitoring for significant changes to securities that have been approved by the firm and that continue to be made available to clients. What constitutes an appropriate monitoring process may vary, depending on the type or complexity of the security, as well as the business model of the firm, the proficiency of its registered individuals, and the nature of the relationships the firm and its registered individuals have with clients. It is the responsibility of the firm to determine at what frequency the monitoring will take place.

Where there are significant changes to securities that the firm has approved and continues to make available to clients, firms should consider revisiting their approval of or controls on the securities, as appropriate. Firms and their registered individuals should consider whether such changes would require new suitability determinations for clients holding that security where appropriate, as required under NI 31-103.

We remind registrants of the requirement for periodic suitability determinations in connection with clients' accounts and the securities within those accounts. As an example, for firms offering managed accounts, KYC information is required to be refreshed every 12 months, and exempt market dealers are required to have updated KYC information within 12 months of trading or recommending a security to a client.

It is important to note that any KYP updates should be documented in the client's file, similar to how KYC or suitability updates should be documented.

The failure to keep KYP documentation up to date would not only be the type of deficiency that is likely to be identified in a regulatory audit, but it could also have the potential to negatively impact other regulatory obligations that rely on KYP, such as the suitability obligation. Given that these obligations are designed to better client outcomes, stale KYP documentation runs the risk of causing unsuitable investment actions and negative client outcomes.

If you have any questions regarding the KYP obligation or any other CFR related obligation, please contact us.

In Brief

Keeping the Lights on: FSRA Releases Proposed Mortgage Licensing Suitability Guidance

On March 6, 2024, the Financial Services Regulatory Authority of Ontario (**FSRA**) released proposed guidance (**Proposed Guidance**) outlining FSRA's interpretation of the licensing suitability requirements and FSRA's approach to assessing an applicant's suitability to hold a mortgage agent or mortgage broker license in Ontario. The Proposed Guidance also explains the oversight role of brokerages and principal brokers and can serve as a guide for screening applicants. In addition to setting out key factors FSRA considers when assessing licensing suitability, the Proposed Guidance sheds light on what FSRA considers to be a reasonable system for the oversight of broker and agent compliance. The Proposed Guidance is the first time FSRA has issued guidance to the sector on this topic. Members of this sector may be interested in tuning in to FSRA's webinar on April 17th to learn more about the Proposed Guidance. The consultation on the Proposed Guidance is open for stakeholder feedback until **May 6, 2024**.

No Time for a Power Nap: Additional FINTRAC Sanctions to Action

On February 24, 2024, the Ministerial Directive on Financial Transactions Associated with Russia (the **Directive**) took effect. The Directive applies to various entities regulated under the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* (the **Act**), including "securities dealers". As a reminder, under the Act a securities dealer is defined to include portfolio managers and exempt market dealers, and thus these firms are subject to the Directive. The Financial Transactions and Reports Analysis Centre of Canada (**FINTRAC**) has also issued guidance on the Directive. Some key requirements include the following:

- Firms must treat every financial transaction originating from or bound for Russia, regardless of its amount, as a high-risk transaction for the purposes of the compliance program provisions of the Act.
- Firms must verify the identity of any client (person or entity) requesting or benefiting from such a transaction in accordance with Part 3 of the Proceeds of Crime (Money Laundering) and Terrorist Financing Regulations.
- Firms must perform client due diligence in relation to any such transaction, including ascertaining the source of funds or virtual currency, the purpose of the transaction and the beneficial ownership or control of any entity requesting or benefiting from the transaction.
- A **record** must also be retained of any such transaction, in accordance with the Proceeds of Crime (Money Laundering) and Terrorist Financing Regulations, regardless of the monetary thresholds set out in those Regulations.

Even if the transactions noted above are not likely to arise for any particular firm in practice, portfolio managers and exempt market dealers should have related policies and procedures in their Anti-Money Laundering and Anti-Terrorist Financing compliance manual in place, as the lack of updates risks being classified as a deficiency. Registrants are reminded of the existing Ministerial Directive in place with respect to North Korea as well.

CSSB Proposed Disclosures for Night Owls

On March 13, the Canadian Sustainability Standards Board (**CSSB**) released Canadian Sustainability Disclosure Standards (**CSDS**) for public consultation. These standards are based on the standards released by the International Sustainability Standards Board (**ISSB**) last June.

Comments are requested by June 10, 2024 on the following materials:

- Exposure draft - CSDS 1, General Requirements for Disclosure of Sustainability-related Financial Information
- Exposure draft - CSDS 2, Climate-related Disclosures
- Criteria for Modification Consultation Paper

What does it all mean?

The only changes to the ISSB proposals in the exposure drafts relate to effective dates and transition relief. However, concerns have been raised on provisions within the global standards. Consequently, the CSSB has requested specific comment on the following topics:

- scope of proposed CSDS 1
- timing of reporting
- climate resilience
- Scope 3 greenhouse gas (**GHG**) emissions

The CSSB has published a very helpful and clear overview of the exposure drafts and the specific areas where they seek comment.

Will the Canadian Sustainability Disclosure Standards be mandatory?

No. The proposed standards would become voluntarily effective for annual reporting periods beginning on or after January 1, 2025.

To become mandatory in Canada, the CSSB standards would need to be incorporated into a CSA rule. In other words, once the CSSB consultation is complete and its standards are finalized, the CSA would need to seek comment on a rule setting out sustainability disclosure requirements. Moreover, the CSA has stated that it anticipates adopting only those provisions of the sustainability standards that are necessary to support climate-related disclosures.

From Pillows to Penalties – Requirements re WFH for Registrants

Back in the early (and dark) days of the pandemic, we published our April 2020 Bulletin Working From Home Edition. We followed that up with an article in our May 2020 Bulletin titled "May an associate advising representative work remotely or in a one-person branch office?". Although the pandemic may be something we all want to forget, we should not forget the important regulatory issues raised by working from home (**WFH**) - as many of us continue to do. Indeed, the regulators have not forgotten about these issues.

In recent regulatory audits of registered firms, the regulators have flagged issues regarding home offices. Under the heading of inadequate supervision and training, regulators observed that some individual registrants working from home permit their spouses or other individuals to have unrestricted access to their home offices, including client documents. The regulators noted that National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* requires registrant firms to keep their records in a safe location. This includes ensuring that no one has unauthorized access to information, particularly confidential client information. Where firms have policies and procedures regarding employees working from home and maintaining client confidentiality, the firms must also have evidence that they monitored the WFH arrangements of their registered employees. Where there is no such evidence, the regulators will have concerns about the firm's oversight over the books and records maintained by the individual registrant at their home offices. Of particular concern is the lack of security of confidential materials such as know-your-client forms and other client records, which could lead to breaches of other requirements including a firm's personal trading policy or misuse of material non-public information.

For more detailed regulatory guidance, see the December 2020 Canadian Investment Regulatory Organization (**CIRO**) publication Business locations — Registration and Compliance approach to work from home arrangements. There, CIRO noted that appropriate recordkeeping would include the following information: the date on which the regular and on-going WFH arrangement started; a description of the activities that occur at the individual's residence; the enhanced supervision assessed and/or introduced in order to address any oversight gaps that may be arising from the WFH arrangement; potential conflicts of interest arising from the WFH arrangement, and how they have been addressed; and the end date of the WFH arrangement, if applicable. In that publication CIRO also provided factors for considering whether a personal residence is a "business location" that must be reported to regulators.

If you have any questions regarding the regulatory expectations around working from home, please contact us.

Important Reminders

Filing Registrant Financial Statements by April 1 to Rest Assured

A friendly reminder to registrants of the requirement under Part 12 of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* to file the firm's annual audited financial statements with the firm's principal securities regulator. Firms that have a year end of December 31, 2023 are required to file their annual financial information with their principal securities regulator no later than March 30, 2024. As March 30th falls on a weekend this year, the due date is **Monday, April 1, 2024**.

Late filing fees may apply if this deadline is missed. The filing should include the firm's audited annual financial statements for the December 31, 2023, year-end, a completed Form 31-103F1 *Calculation of Excess Working Capital*, and if applicable for investment fund managers, a completed Form 31-103F4 *Net Asset Value Adjustments*. If the Ontario Securities Commission is your principal regulator, you can complete the filings using the following link.

Counting Sheep and Filing Fees: Follow Up re SEDAR+ Profile Updates

In our February bulletin, we wrote about the importance of updating your SEDAR+ profile if the information contained in the profile is inaccurate. Generally, information must be updated no later than 10 days after the date on which the transmitter knew, or reasonably should have known, that the information contained in the profile is inaccurate (or earlier, in certain circumstances). We noted that keeping the profiles up to date are not only a regulatory requirement but helps to ensure that regulators have the right information for fee calculation purposes.

We are aware that some issuers have been contacted by securities regulatory authorities with respect to the chosen category and type of investment funds on their SEDAR+ profile. It was noted that the selection of "other" should not be chosen unless there is no other suitable selection. In Alberta, the selection of "other" may result in a higher filing fee – for example, 0.025% of the gross proceeds instead of 0.02% when filing a report of exempt distribution.

When SEDAR+ profiles were migrated over from the legacy SEDAR system, many funds did not have a specific category checked, or were listed as "other", which has resulted in a higher fee calculation. We would be happy to assist you in updating your profiles if you believe your funds may have incorrectly been charged a higher fee because of their classification on SEDAR+.

BLG Resource Corner

Our colleagues at BLG have provided the following insights we thought might interest our readers:

- Responsible use of artificial intelligence: Best practices for Canadian asset managers
- Updated guidance on preparing a modern slavery report in Canada
- Canadian Securities Administrators release updated guidance on virtual shareholder meetings

For more information, please visit the BLG website.

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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.