BLG BEYOND™ AUM® LAW Bulletin

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Investor Education Month (AKA October) Edition

More people may associate the month of October with Halloween than Investor Education Month, but there is nothing scary about raising awareness of the importance of financial literacy and empowering people to make informed investment decisions. Many organizations in Ontario, including the Ontario Securities Commission, have been designing workshops and events to help more people understand investment products and recognize financial fraud. Similarly, many of the proposals and research reports described below are aimed at increasing investor protection. Just like Halloween ghosts, a lack of awareness of these regulatory priorities can haunt you over the long-term.

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BLG Resource Corner

1. From Concepts to Compliance: OSC Consults on Long-Term Asset Funds

The Ontario Securities Commission (**OSC**) has released an interesting discussion paper with respect to a potential new type of public investment fund that could hold long-term assets. In *Consultation Paper 81-737 Opportunity to Improve Retail Investor Access to Long-Term Assets through Investment Fund Product Structures*, the OSC sets out a framework proposal relating to investment funds (to be known as Ontario Long-Term Funds (**OLTF**s)) that would allow investments in long-term illiquid assets. In addition to potentially providing benefits to investors such as increased diversification, these structures could lead to more investment in capital-intensive assets such as infrastructure and natural resource projects.

For the purposes of the framework, long-term assets would be considered "illiquid assets" under National Instrument 81-102 *Investment Funds* (**NI 81-102**), which may be difficult to value, can not be disposed of readily, and generally have longer investment time horizons. Examples provided include venture capital, private equity, private debt, mortgages, and real estate.

As these investment funds would be publicly offered reporting issuers in Ontario, the funds would be required to have a registered investment fund manager and a registered portfolio manager, and the funds

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would be required to calculate a net asset value (**NAV**). Depending on the redemption terms of the funds, these could either be a mutual fund or a non-redeemable investment fund. The funds could also be either fixed-term or evergreen funds if liquidity risks are effectively managed. It is proposed that many of the requirements in NI 81-102 would not be applicable to OLTFs, such as the illiquid asset restriction. Instead, OLTFs would be required to hold a minimum and maximum percentage of long-term assets to ensure sufficient liquidity to meet redemption requests.

OLTFs would be required to invest through the securities of underlying collective investment vehicles (**CIV**s). Each CIV would be required to have a “cornerstone investor,” such as a pension fund or other institutional investor that qualifies as a “permitted client”. Ownership by OLTFs in a CIV would be limited to 10% of a CIV’s equity, and a cornerstone investor would be required to hold at least 10% of the CIV’s equity. It will be interesting to follow comments on this aspect of the proposal, as the consultation paper notes that the right to exit investments in CIVs by cornerstone investors should be proportional to the exit rights of the OLTF, meaning that some redemption rights might be more constrained under this framework.

The funds would still need to address issues such as liquidity, volatility, concentration, duration, and informational asymmetries through the potential means addressed in the consultation paper. The OSC is seeking comments on these attributes. For example, the OSC indicates that redemption restrictions should be allowed, to the extent the OLTF needs them to manage liquidity and reporting needs. The initial view is that redemptions should be no more frequent than monthly and no less frequently than annually, with NAV calculations being aligned with the timing of redemptions. Several potential redemption restrictions are noted as being permissible under the framework, such as discounts to NAV, advance notices, caps as a percentage of NAV, and a requirement to wind up an OLTF if annual redemption requests exceed the cap for two consecutive years. Alternative redemption restrictions are suggested for fixed-term OLTFs. The funds would be subject to a requirement to obtain an independent valuation at least annually.

Despite the fact that assets of the funds could be held outside Ontario, the funds themselves would only be available to Ontario investors, and as such, they would not have any securities listed and traded on a marketplace in Canada. The initial proposal considers the securities of the funds would be made available through investment dealers, portfolio managers, and mutual fund dealers that distribute alternative mutual funds (for OLTFs that would qualify as a mutual fund under securities legislation).

To help manage some of the atypical risks these funds present, initially OSC staff think that OLTF requirements would include:

- A corporate structure with an independent board of directors;
- The IFM disclosing how they manage the portfolio in the best interests of the fund and its security holders; and
- The IFM disclosing its assessment of whether the assets in the fund are fairly valued for purposes of the NAV calculation.

The next phase of the consultation is expected to include a publication for comment that would implement the framework, if supported by stakeholders. Several specific questions are posed, which range from broad

questions on the benefits to retail investors from increased access to long-term assets, to the proposed CIV requirement, to questions about valuation and liquidity. Comments will be accepted on the consultation until **February 7, 2025**. As this would be an entirely new framework for public funds in Ontario, interested parties should strongly consider providing their views on the consultation.

2. What's New for Dealers - CIRO Releases Phase 4 of the Rule Consolidation Project

On October 17, 2024, the Canadian Investment Regulatory Organization (**CIRO**) published for comment Phase 4 of its Rule Consolidation Project proposal (**Proposal**) relating to the consolidation of the two sets of rules currently applicable to investment dealers and mutual fund dealers into one set of rules. These Phase 4 changes relate to rules that are mostly unique to the investment dealer and mutual fund dealer rules that have been assessed as having differences deemed to be significant with potential material impacts on stakeholders. Our assessment is that the Proposal will have significant implications for mutual fund dealers.

This phase involves the adoption of rules relating to approval and proficiency for individuals, managing significant areas of risk, and business conduct and client account rules. The Proposal also relates to CIRO review procedures for approvals and membership.

The consultation notes that the following decisions have already been made by CIRO with respect to account types and services offered by mutual fund dealers (subject to any further approvals necessary):

- Mutual fund dealers will **not** be permitted to offer discretionary or managed accounts;
- Mutual fund dealers will be able to offer margin accounts; and
- Mutual fund dealers will be permitted to use free cash credit balances in their operations.

The following is a summary of some of the significant changes in the Proposal.

Approved Person Regime

Currently, the Ultimate Designated Person (**UDP**), Chief Compliance Officer (**CCO**) and dealing representatives of a mutual fund dealer are registered pursuant to the requirements of the Canadian Securities Administrators under National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*. This will continue to be the case under the Proposal. However, in addition, CIRO proposes to regulate the approval, experience and proficiency requirements for mutual fund dealer directors, executives, Chief Financial Officers (**CFO**s) and supervisors (formerly known as branch managers), as well as approved investors.

Mutual fund dealer stakeholders should review these specific provisions of the Proposal carefully and consider the impact on their firms, particularly with respect to the requirement to appoint a CFO given the potential scarcity of candidates (which has been expressed as a concern by some industry members). The

consultation also asks whether it is appropriate to allow the continuation of existing directors of mutual fund dealers into the approved person regime.

Delegation and Automation

The current Investment Dealer and Partially Consolidated Rules (**IDPC Rules**) concerning the delegation of tasks will be extended to apply to mutual fund dealers. The applicable IDPC Rule is more permissive than the current Mutual Fund Dealer Rule (**MFD Rules**), in that it permits delegation of tasks, **except** where expressly prohibited. The current MFD Rule approach prohibits delegation, unless expressly permitted.

There is also a proposed rule clarifying the requirements for individual human tasks which are automated. Automated tasks will be subject to specific supervision and controls to ensure the automated tasks are properly performed.

Definition of "Investment Product"

The current definition of "investment" in the MFD Rules is not being adopted, and instead the term "investment product" will be used in rules relating to key regulatory obligations, including know-your-product (**KYP**) and suitability. The new definition describes an "investment product" as a product that is a security, derivative, precious metal bullion or a product approved by CIRO as an investment product.

Risk Management

The IDPC Rules regarding risk management will be adopted, which will be a new set of obligations for mutual fund dealers. Among other things, there will be a requirement to identify significant areas of risk and to assign an executive (as defined in the IDPC Rules) to be responsible for significant areas of risk.

Conflicts of Interest

The current MFD Rules regarding conflicts of interest are general in nature. CIRO proposes the adoption of more precise conflict rules which are currently found in the IDPC Rules. More specifically, the current IDPC Rules regarding conflict policies and procedures and personal financial dealings will be applied to mutual fund dealers, which would among other things, extend the restriction from engaging in any personal financial dealings with clients to employees (and not just approved persons). There will also be a new restriction on approved persons accepting beneficiary status or a bequest from a client's estate, with an exception for immediate family members. This could present a material difference from current mutual fund dealer representative practices, and CIRO is specifically seeking comments on these new restrictions.

The current MFD Rules regarding referral arrangements will be adopted in the proposed new consolidated rules.

KYC, KYP, Suitability

Generally, the requirements concerning know-your-client (**KYC**) and client accounts that are currently in the IDPC Rules will be adopted in the proposed rules. The MFD Rules and IDPC Rules are similar in this area, and the changes proposed are not considered material.

The product due diligence and KYP requirements have been amended to clarify that the obligation applies to all products which fall within the new definition of “investment product” described above. The MFD Rules and IDPC Rules are similar is this area, and again the changes proposed are not considered material.

The requirements concerning suitability determination that are currently in the IDPC Rules are generally proposed to be adopted in the consolidated rules. The MFD Rules and IDPC Rules are also similar in this area. By adopting the IDPC Rule framework, mutual fund dealers will be able to designate accounts as institutional (instead of only retail). Dealers will also be required to have specific policies and procedures to determine the suitability of leveraged accounts and to detect and prevent unsuitable leveraging.

Supervision

With respect to governance, the Proposal adopts the IDPC Rules, which require a dealer to maintain a governance document and if the document is changed, file an updated copy with CIRO.

The IDPC Rule will be adopted with respect to both account supervision policies and daily/monthly trade supervision requirements. For account supervision, the IDPC Rule is the same as the MFD Rule, except for additional requirements to identify high risk clients and establish controls for accessing and amending records. With respect to daily and monthly trade supervision, CIRO proposes to remove some of the prescriptive requirements regarding thresholds for review found in the MFD Rule, believing that those detailed requirements would be better situated in guidance. The current mutual fund dealer requirements regarding the designation of certain account types for supervision will be adopted.

For supervision of new registrants, the IDPC Rule providing for six months of close supervision is proposed to be adopted, and for mutual fund dealers, this would replace the current program which consists of two consecutive 90-day segments of supervision.

Review Procedure for Approvals and Membership

CIRO has proposed a streamlined review process for all decisions of CIRO staff regarding individual approvals, exemptions from proficiency or continuing education requirements, and terms and conditions on approved persons. These decisions will be subject to an opportunity to be heard by a CIRO senior decision officer and may be subsequently reviewed by a CIRO hearing panel.

Membership applications are to be received and analyzed by CIRO staff and approved by the CIRO board. The CIRO board will provide an opportunity to be heard in advance of its decision, which will be final and not subject to review by a hearing panel.

Comments Sought

CIRO has asked stakeholders to comment on seven specific questions in addition to seeking general comments on the Proposal. The questions relate to items such as the definition of “investment product”, applying the CFO requirements to mutual fund dealers, and the application and implementation of the proficiency regime to mutual fund dealers.

The Proposal is wide ranging and touches many of the existing rules impacting investment dealers and mutual fund dealers. CIRO dealer members and other stakeholders should carefully review the changes and CIRO's questions and consider commenting, and we would be pleased to assist. The comment period expires on **February 4, 2025**.

3. OSC Examines AI-Enhanced Scams: Investing Smartly

Last month, the Ontario Securities Commission (**OSC**) released a report on research performed in conjunction with the Behavioral Insights Team (the **BIT**) into the role that artificial intelligence (**AI**) plays in supporting retail investor decision making. The OSC then published a follow-up report with the BIT with the assistance of the consultancy firm Behavioural Insights Team Canada entitled Artificial Intelligence and Retail Investing: Scams and Effective Countermeasures. The newest report explores how malicious actors are increasingly exploiting AI capabilities to deceive investors and orchestrate fraudulent schemes.

The OSC collaborated with the BIT to provide a research-based overview of:

- The use of AI to conduct financial scams and other fraudulent activities, including how:
  - Scammers use AI to increase the efficacy of their financial scams;
  - AI distorts information and promotes disinformation and/or misinformation;
  - Effectively people distinguish accurate information from AI-generated disinformation and/or misinformation;
  - The promise of AI products and services are used to scam and defraud retail investors; and
- The mitigation techniques that can be used to inhibit financial scams and other fraudulent activities that use AI at both the system and individual levels.

To achieve this, the teams employed two research streams:

- A literature and environmental scan to understand current trends in AI-enabled online scams, and a review of mitigation strategies to protect consumers.
- A behavioural science experiment to assess the effectiveness of two types of mitigation strategies in reducing susceptibility to AI-enhanced investment scams.

The report concluded that AI-enhanced scams pose significantly more risk to investors, with participants investing **22% more** in these scams compared to conventional ones. Malicious actors are effectively deceiving investors by:

- Using generative AI technologies to 'turbocharge common investment scams' by increasing their reach, efficiency and effectiveness;
- Developing new types of scams that would have otherwise been impossible without AI, like deepfakes and voice cloning; and
- Exploiting the promise of AI through false claims of 'AI investment opportunities.'

To address these heightened risks, the report identified promising strategies that could mitigate the harms associated with AI-related investment scams:

- **System-level mitigations** which limit the risk of scams across all (or a large pool of) investors; and
- **Individual-level mitigations** which help individual investors in detecting and avoiding scams.

Some platforms already use mitigation techniques, including by filtering content, and disabling accounts that spread disinformation. The report found that preventative techniques, including both system-level mitigations and individual-level mitigations, may be needed for retail investor protection. On an individual level, techniques such as the inoculation technique and web browser plug-ins that flag potential 'high-risk' opportunities, proved effective in significantly reducing the impact of these scams. The 'inoculation technique' involves providing users with high-level guidance on scam awareness before they encounter specific investment opportunities. The use of the web-browser plug-in reduced investment in fraudulent investment opportunities by a statistically significant 31%.

A related report, entitled Gamification Revisited: New Experimental Findings in Retail Investing, summaries research conducted by the OSC with the BIT into the effects of digital engagement practices on investor behaviour. The intent of the experiment was to measure the influence of non-expert, social information on the trading behaviour of Canadians. The experiment indicated that participants in the social interactions feed, which enable platform users to interact with other users, made 12% more of the total volume of their trades in promoted stocks compared to the control group. Participants exposed to copy trading conditions, where functionality of the platform allows users to copy the trades of other profiled users, made 18% more of the total volume of their trades in the promoted stocks. The findings could mean that socially based engagement techniques can influence behaviour by encouraging trading in specific assets.

The report recommended that regulators consider whether to limit digital trading platforms from using digital engagement practices that can compromise investor protection, potentially including points, top traded lists, social interaction feeds and copy trading, and to continue gathering data to measure the impact of these types of practices.

Reports such as these may be good indicators of areas where future regulation, additional guidance or consultations may be forthcoming.

In Brief

Building Up CIRO's Proficiency Proposals

Earlier this month, CIRO released an Amendment regarding individual Approved Person proficiencies. The purpose of the amendment is to eliminate a conflict between National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* and the Investment Dealer and Partially Consolidated Rules concerning the proficiency required for mutual fund only registered representatives who change jobs and are sponsored by a dual registered dealer who wish to continue to transact in exempt market products. The amendment clarifies that mutual fund only licensed individuals sponsored by a dual

registered dealer must have the proficiencies to transact in **all** securities in order to transact in exempt market products.

The change is expected to impact only a small number of individuals, however, the impact on those individuals will be significant. To help mitigate this impact, CIRO advised they are willing to consider granting exemptive relief to give affected individuals sufficient time to upgrade their proficiencies.

What Every Investor Should Know: CIRO's Enhanced Cost Reporting

On October 10, 2024, CIRO released Enhanced Cost Reporting – Proposed Rule Amendments. These amendments seek to harmonize CIRO member investment dealer and mutual fund dealer cost reporting requirements with the Total Cost Reporting Enhancements recently introduced in National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*. The changes would expand a dealer member's responsibility to report on ongoing investment fund expenses and charges incurred by their clients. The proposed changes also aim to resolve some of the existing differences in client reporting requirements and practices of investment dealers and mutual fund dealers. Stakeholders are encouraged to comment by **January 8, 2025**. The consultation notes that it is likely that these proposed amendments will be implemented before the dealer consolidated rule project is completed.

Disgorged Funds as Part of an Investor's Toolkit

For a second time, CIRO recently released for comment its proposal regarding Distributing Funds Disgorged and Collected through CIRO Disciplinary Proceedings to Harmed Investors (Phase II) (**Proposal**).

Responses to comments made on the original February 2023 proposal are included in an appendix. The object of the Proposal is to provide for the distribution of disgorged funds collected through CIRO's enforcement processes to harmed investors. Since the original proposal was drafted prior to several developments including to CIRO rules, it has been republished for comment unamended.

Certain aspects of the Proposal have been clarified, such as the fact that the eligible investor class will be open to all investors harmed by the misconduct (and not just those who participated in the enforcement proceedings). The comment period is open until **January 20, 2025**.

Staying Ahead of OSC Staff's Approach to Sustainable Finance

Earlier this month, the OSC released a report entitled *Insights on the OSC Staff's Approach to Sustainable Finance* (the **Report**). Under the three main pillars of **(i)** investor protection and thriving capital markets; **(ii)** thought leadership; and **(iii)** anticipating what's next, the Report delves into staff's holistic approach, which is intended to among other things address the risks of Ontario not keeping pace with international developments around sustainable finance.

In the Report, sustainable finance is described as "the process of incorporating ESG factors into decisions related to financial processes, risk management and capital flows that may prompt sustainable economic growth, capital formation and long-term stability of the financial system".

Staff's vision is to build trust in the sustainable finance ecosystem with effective, appropriate, and timely regulation and oversight. It is noted that ESG-related risks have become a mainstream business issue, with a consensus that investors need more consistent, comparable, and decision-useful information, and issuers are at risk of being shut out of global markets if they provide insufficient information.

The Report notes that being mindful of the capacity of public companies of varied sizes, staff will utilize robust regulatory impact analyses as part of their work. Among other priorities, the OSC will focus its efforts on several areas, including climate-related disclosures, assurance of sustainability-related disclosures, governance-related work, engagement with Indigenous communities and organizations, and will continue to review sustainable finance products, such as ESG-related investment funds and sustainability bonds.

Demystifying OBSI's Loss Calculation for Unsuitably Sold Illiquid Exempt Market Securities

The Ombudsman for Banking Services and Investments (**OBSI**) released a consultation relating to its approach to calculating investor loses where there has been an unsuitable sale of illiquid exempt market securities. The consultation reviews OBSI's fundamental approach to financial harm calculation, which is to identify an amount of compensation that puts an investor in the position they would have been had the error not occurred, and that such amount will be reduced when it is fair to do so (e.g. where an investor contributed to the harm).

Currently, if the evidence shows the investor would have invested in suitable investments, OBSI will compare the portfolio performance with the performance of a hypothetical comparative portfolio of suitable investments. Calculating the value of actual investments made as at the end of the relevant period becomes complicated for certain illiquid exempt market securities if there is no market or if there are so few arms-length transactions that a market price can not be determined. If there is insufficient evidence about the value of the security, OBSI will assign a value of zero to such securities for purposes of the loss calculation and require the investor to return the exempt market security to the firm. OBSI seeks formal industry views on this methodology, and poses two questions relating to the current approach, and whether there are circumstances where such an approach should not be used. Comments on the proposal are sought by **November 21, 2024**.

BLG Resource Corner

Our colleagues at BLG have provided a variety of insights we thought might interest our readers:

- Private real estate investment trusts: A smart plan for business growth
- Goodbye MRFP, Hello Fund Report: Proposed changes to continuous disclosure rules for investment funds
- Howdy limited partner: Six key features of Ontario limited partnerships

For more information, please visit the BLG website.

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