OSC Staff Notice 33-738

2012

OSC Annual Summary Report for Dealers, Advisers and Investment Fund Managers

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Introduction

This report provides information for dealers that are directly regulated by the OSC (primarily exempt market dealers (EMDs) and scholarship plan dealers (SPDs)), advisers (portfolio managers or PMs) and investment fund managers (IFMs) (collectively, registrants). The main purpose of this report is to assist registrants in complying with their regulatory obligations under Ontario securities law. It was prepared by the OSC's Compliance and Registrant Regulation (CRR) Branch, which registers and oversees approximately 1,300 firms and 66,000 individuals in Ontario that trade or advise in securities or commodity futures, or act as IFMs. Although the OSC registers firms and individuals in the category of mutual fund dealer (MFD) and firms in the category of investment dealer, these firms and individuals are directly overseen by their self-regulatory organizations (SROs), the Mutual Fund Dealers Association of Canada (MFDA) and the Investment Industry Regulatory Organization of Canada (IIROC), respectively.

This report summarizes new and proposed rules and initiatives impacting registrants, current trends in deficiencies from compliance reviews of registrants (and suggested practices to address them), and current trends in registration issues. We also focus on know-your-client (KYC), know-your-product (KYP) and suitability obligations to clients for dealers and PMs, and what we are doing to assess compliance with these obligations.

This report also provides a summary of some key registrant misconduct cases, provides guidance on preparing for an OSC compliance review, explains how registrants can get more information about their obligations, and provides OSC contact information.

We strongly encourage registrants to use this report to improve their understanding of

- initial and ongoing registration and compliance requirements,
- OSC staff expectations of registrants and our interpretation of regulatory requirements, and
- new and proposed rules and other regulatory initiatives.

We also suggest registrants use this report as a self-assessment tool to strengthen their compliance with Ontario securities law, and to improve their systems of internal controls and supervision.[1]

[1] The content of this report is provided as guidance for information purposes and not as advice. We recommend that you seek advice from a qualified professional advisor before acting on any information in this report, or on any website to which this report is linked.

1. Key policy initiatives impacting registrants

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ONTARIO SECURITIES COMMISSION

1. Key policy initiatives impacting registrants

1.1 Cost disclosure, performance reporting and client statements

The Canadian Securities Administrators (the CSA), along with IIROC and the MFDA, have been working to develop requirements in a number of areas related to a client's relationship with a registrant. This initiative was previously referred to as the Client Relationship Model project, which, as part of the new regime for registrants, developed requirements on relationship disclosure information delivered to clients at account opening, and comprehensive requirements for managing conflicts of interest.

On June 14, 2012, we published for a second round of public comment proposed amendments on cost disclosure, performance reporting and client statements (Client Relationship Model Phase 2 or CRM2). We regard this as an important investor protection initiative. If adopted, CRM2 will introduce performance reporting requirements and enhance existing cost disclosure requirements in National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103).

We conducted investor research during the second half of 2011 and consulted with four industry organizations in the early part of 2012. The reports on the investor research are available on the OSC's website at Investor Research Reports and Document Testing. We have amended the proposals in response to public comments after the first publication, investor research and industry consultation.

CRM2 includes, among other things, requirements for dealers and advisers to provide their clients with annual reports that show them

- in dollars, what the dealer or adviser was paid for the products and services it provided; and
- in dollars and percentages, how the client's investments performed during that year and over longer periods.

The purpose of the cost disclosure requirements is for investors to be made aware of all the costs, and dealer and adviser compensation, associated with the products and services they receive from registrants.

The purpose of the performance-reporting requirements is for investors to get clear and meaningful information that will enable them to evaluate how well their investments are doing. To that end, dealers and advisers would be required to provide clients with annual performance reports that cover

- deposits into, and withdrawals from, the client's account;

- the change in value of the account; and
- the percentage returns for the previous year; the previous three, five and ten years; and for the period since the account was opened.

CRM2 contains a model performance report to provide guidance to registrants.

CRM2 also includes proposals for

- the disclosure of some fixed income commissions to provide more clarity about embedded costs;
- an expanded “client statement”, replacing the existing account statement, that includes reporting on securities whether they are held in nominee name or client name;
- a new hierarchy of steps for determining the market value of securities; and
- new disclosure requirements for SPDs that are tailored to the unique risks associated with investments in scholarship plans.

IIROC and the MFDA have worked with the CSA on the CRM2 project. If adopted, CRM2 would apply in all CSA jurisdictions. We would expect the requirements for members of IIROC and the MFDA to be materially harmonized.

For more information, see Proposed Amendments to NI 31-103 on *Cost Disclosure, Performance Reporting and Client Statements*. Also, see section 5.5.1 of this report on *Inappropriate expenses charged to funds* for staff’s views on IFMs charging CRM2 costs to their investment funds.

1.2 Potential best interest standard for dealers and advisers

We are re-evaluating the advisor-client relationship by considering whether an explicit statutory fiduciary or best interest standard should apply to dealers and advisers in Ontario and on what terms. A fiduciary duty is essentially a duty to act in a client’s best interest.

In Ontario, section 116 of the *Securities Act* (the Act) applies a best interest standard to IFMs in their dealings with the investment funds they manage. However, there is no equivalent provision under the Act that explicitly applies a best interest standard to dealers and advisers in their dealings with their clients (but there is a requirement to deal fairly, honestly and in good faith with their clients[2]). Although there is no statutory fiduciary duty for dealers and advisers in Ontario, Canadian courts can find that a given

[2] Section 2.1 of OSC Rule 31-505 *Conditions of Registration*

dealer or adviser owes a fiduciary duty to his or her client depending on the nature of their relationship. This may be the case, for example, if:

(a) the client is vulnerable and places significant trust and reliance on the dealer or adviser and the dealer or adviser accepts this responsibility, and

(b) where the dealer or adviser has explicit (as in the case of a managed account) or implicit (as in the case of a non-managed account where the client essentially always follows the advice provided) discretion or power over the client.

Recently, there have been important international developments on the issue of a best interest standard. In the United States, staff of the Securities and Exchange Commission recommended introducing a common statutory best interest standard for investment advisers and broker-dealers when they are providing personalized advice to retail customers. They are currently conducting extensive cost-benefit analysis on this recommendation as a prelude to publishing a draft rule for comment. In Australia, the government recently passed legislation that will make advisers subject to a best interest duty when providing personal advice to retail clients. In the United Kingdom and the European Union (EU), firms are already required to act honestly, fairly and professionally in accordance with the best interests of their clients.

In accordance with the OSC's 2012-2013 Statement of Priorities, we participated in the publication on October 25, 2012 of CSA Consultation Paper 33-403 *The Standard of Conduct for Advisers and Dealers: Exploring the Appropriateness of Introducing a Statutory Best Interest Duty When Advice is Provided to Retail Clients*, and encourage interested stakeholders to participate in this consultation process. We are also continuing to monitor the fiduciary duty debate internationally, as well as related policy developments in the US, Australia, the UK and the EU.

1.3 OTC derivatives regulation

Working with the CSA, we are continuing to develop proposals for the regulation of over-the-counter (OTC) derivatives to meet Canada's G20 commitments made following the recent global financial crisis. The proposals cover the regulation of derivatives market participants, trading, clearing, margin, capital and collateral, and trade reporting to a trade repository. The OSC, led by our Derivatives Branch, has been a key participant in developing these proposals.

Since the CSA published its high-level consultation paper on OTC Derivatives Regulation in Canada in late 2010, the CSA has also published the following consultation papers on these specific areas:

- reporting trades to a trade repository
- surveillance and enforcement of trades
- segregation and portability of collateral in OTC derivatives clearing
- exemptions from the regulatory requirements (the end-user exemption), and
- central counterparty clearing.

See the Derivatives section on our website to view these consultation papers.

Over the next few months, the CSA plans to publish three additional consultation papers for comment. These papers will address

- the registration and regulation of derivatives market participants,
- exchange and platform trading, and
- capital and collateral.

Dealers and advisers in OTC derivatives should particularly monitor the proposals for the registration and regulation of derivatives market participants.

The CSA will consider the feedback from the consultation process when it develops rules for OTC derivatives regulation in Canada.

1.4 Review of prospectus exemptions

We recognize that the exempt market in Canada has become increasingly important for investors and issuers. Accordingly, as part of a CSA policy review, we continue to assess whether the existing minimum amount and accredited investor prospectus exemptions remain appropriate or whether changes should be made. OSC Staff has also broadened the scope of this review to consider

- the exempt market regulatory regime more generally, and
- whether we should introduce other prospectus exemptions to facilitate capital raising for business enterprises.

For example, we are looking at the experience of other CSA jurisdictions with prospectus exemptions not currently available in Ontario and relevant developments in other jurisdictions.

We intend to publish a second consultation note (to follow November 2011's CSA Consultation Note 45-401 *Review of Minimum Amount and Accredited Investor Exemptions*) about the proposed introduction of any new prospectus exemptions and, if so, under what circumstances or terms. We will also hold public consultation sessions and reach out to investors and other stakeholders to obtain their feedback. We also established an Exempt Market Advisory Committee to provide advice on these issues. Although this initiative is being led at the OSC by our Corporate Finance Branch, the CRR Branch is also involved since this initiative may have important implications for EMDs and other registrants.

For more information, see OSC Staff Notice 45-707 *OSC Broadening Scope of Review of Prospectus Exemptions*.

2. Focusing on KYC and suitability assessments by registrants

ONTARIO SECURITIES COMMISSION

2. Focusing on KYC and suitability assessments by registrants

One of the cardinal rules under securities law is for dealers and advisers to know their clients and to recommend suitable investments for them. We continue to identify significant deficiencies in compliance by some registrants with their KYC and suitability obligations and unsuitable investments are a common subject of investor complaints. Accordingly, we continue to focus our resources on assessing whether registrants are meeting their KYC and suitability obligations.

2.1 Highlights of recent enforcement case on KYC and suitability of recommendations

In April 2012, the OSC approved a settlement agreement between Staff and Trapeze Asset Management Inc. (Trapeze), a firm registered as a PM and EMD, and two of its advising representatives, for breaching KYC and suitability obligations owed to clients between September 2006 and August 2010.

At certain points in time over the period, many clients experienced substantial declines in the market values of their accounts at Trapeze. Trapeze admitted in the settlement that, in some cases, they did not adequately ascertain the client's investment needs and objectives and risk tolerance. Further, Trapeze admitted that they inaccurately assessed the risk associated with many of the investments purchased on behalf of clients in managed accounts resulting in a failure to ensure that investments Trapeze made on behalf of clients were suitable for all clients. The settlement required Trapeze to hire an independent consultant to review its practices and procedures regarding its KYC and suitability obligations (including for determining risk levels of individual securities and portfolios of securities), to conduct client account reviews for all clients in accordance with those new practices and procedures, and to ensure that the investments in each clients' accounts are suitable. Trapeze also agreed to an administrative penalty of $1 million and to pay $250,000 towards investigation costs.

This is an important case that demonstrates the serious implications for registrants that fail to comply with their KYC and suitability requirements. We encourage PMs and dealers to review the details of this settlement, and to ensure that their KYC and suitability processes and practices are in compliance with Ontario securities law.

For more information, see Trapeze settlement.

2.2 Suitability sweep and new initiative to contact investors

In addition to Trapeze, our compliance reviews continue to identify significant deficiencies with respect to some dealers' and PMs' compliance with their KYC, KYP, and suitability obligations to clients. For example, KYC information such as the client's investment needs and objectives, financial circumstances and risk tolerance is not always collected and documented, or the information is not kept current. Further, at some dealers there is inadequate product knowledge among dealing representatives that recommend products to clients. For both dealers and PMs, we found that some investments were not suitable for clients based on the KYC information that was collected and documented. We also found some PMs that did not adhere to the clients' asset mix or investment instructions for their investment portfolios.

We have also found cases where registrants were improperly relying on the accredited investor exemption for the distribution of prospectus-exempt securities to clients. A registrant is required to determine, before a client purchases prospectus-exempt securities, that the client qualifies as an accredited investor or that the client can rely on another prospectus exemption. This is a key part of the registrant's KYC and suitability obligations. It is also important for registrants who recommend that their clients borrow money to purchase securities to determine that the use of leverage is suitable for the clients.

To address these concerns, in June 2012 we started a targeted review (sweep) of over 85 EMDs and PMs to assess their compliance with their KYC, KYP and suitability obligations under sections 13.2 and 13.3 of NI 31-103.

This sweep introduced our new approach of contacting a sample of a dealer's or adviser's clients as part of our normal course compliance reviews. Although we've contacted investors in the past as part of for-cause reviews, this was the first time we contacted investors as a routine part of our compliance review process. Clients who are contacted may be asked a number of questions about their registrant firm and dealing or advising representative, including the completeness and accuracy of their KYC information obtained by the firm and the investment recommendations and advice provided to them. Clients' participation in this process is voluntary. We've found that investor contact is a valuable method to assess if their registrant is complying with Ontario securities law. Our new approach of contacting investors will be used for our ongoing reviews of dealers and advisers. For more information, see OSC new review procedure of calling investors.

Although our suitability sweep is ongoing, at this time, we have identified the following preliminary findings:

Findings for both EMDs and PMs:

- some registrants inadequately collect and/or document KYC information which is required to confirm a client's identity, ascertain if the client is an insider of a reporting issuer and to assess the suitability of proposed investments

- some registrants made unsuitable investments for clients. For example, a PM invested in the securities of only three companies for its smaller managed accounts resulting in a non-diversified and higher risk portfolio that was unsuitable based on the clients' KYC information

- some registrants have inadequate or no written policies and procedures on their KYC, KYP and/or suitability obligations

- some registrants did not meet the relationship disclosure information obligations (in section 14.2(2)(k) of NI 31-103) because the document provided to clients did not state that the firm has an obligation to assess whether a purchase or sale of a security is suitable for a client prior to executing the transaction or at any other time.

Findings for EMDs:

- some EMDs improperly relied on the accredited investor exemption when distributing prospectus-exempt securities to investors. For example, some EMDs documented in their client files that investors were accredited investors. However, our review indicated that the information collected about the investors' net income or net financial assets was not consistent with the test for their status as accredited investors

- some EMDs did not collect specific KYC information to demonstrate compliance with their use of the accredited investor exemption. For example, the EMD's KYC form collects information on the client's "net worth" rather than their "net financial assets", when the "greater than $1 million in net financial assets" test was used to determine the client's status as an accredited investor

We encourage EMDs to review section 5.2.1 of this report for suggested practices on KYC, KYP and suitability obligations, and on the use of the accredited investor exemption.

Findings for PMs:

- some PMs did not update KYC information at least annually, or met with their clients at least annually to update KYC information but did not maintain any record of the meeting or document any KYC updates
- some PMs improperly delegated their KYC and suitability responsibilities to another party. See discussion of this deficiency in section 5.2A of OSC Staff Notice 33-736 *2011 Annual Summary Report for Dealers, Advisers and Investment Fund Managers* (OSC Staff Notice 33-736)

We also noted some best practices during our reviews of PMs, which we encourage all PMs to consider:

Best practices for PMs:

- An advising representative has meaningful discussions with a prospective client at a number of in-person meetings to fully understand the client and their circumstances and to explain to them the PM's investment philosophy and strategies. To assist in this process, the advising representative uses a financial planning questionnaire.
- The advising representative uses the information obtained from the in-person meetings and questionnaire to develop a tailored investment policy statement (IPS) for each client which is used as a plan to manage the client's portfolio. The IPS documents the client's investment needs and objectives, risk tolerance, financial circumstances, time horizon, liquidity requirements, tax considerations, and any legal, regulatory or other requirements or information. The IPS also sets out a planned asset allocation. Each client signs and receives a copy of his or her completed questionnaire and IPS to ensure it is complete and accurate.
- At least annually, the advising representative meets with the client to discuss the IPS and their portfolio, or as soon as possible after their circumstances change. If the advising representative revises the IPS, the client signs and receives a copy. If there is no change to the IPS, the client confirms in writing that their IPS remains current and valid.

If we identify significant deficiencies in compliance by dealers or advisers with their KYC, KYP and suitability obligations (such as unsuitable investments), we will take appropriate regulatory action, including referrals to our Enforcement Branch. Once our sweep is completed, we will review the results to assess if further guidance is needed about KYC, KYP and suitability obligations. In the meantime, we strongly encourage firms to review the above findings and perform their own self-assessment for compliance with the KYC, KYP and suitability obligations.

2.3 "Online" delivery platforms: KYC and suitability obligations

From time to time, we are presented with new business models developed by industry participants. Recently, an investment dealer sought relief for a novel business model: a full service brokerage service including suitability recommendations delivered through an online security trading platform with involvement by registered representatives.

In August 2012, the OSC granted relief to this investment dealer from the obligation to register as an adviser in order to provide suitability advice (i.e., investment recommendations to clients) in the ordinary course of its dealer business. Providing suitability advice via a hybrid online platform is novel but this model otherwise fits within the existing regulatory framework. Section 8.23 of NI 31-103 allows a registered dealer to provide suitability recommendations without also having to register as an adviser, so long as the client does not have a managed account. As an IIROC member, this investment dealer also required and obtained relief from certain IIROC rules.

This relief relates to the ability of an IIROC member to provide investment dealer services through an online platform with registered representative involvement. This business model is not a new type of service outside of existing registration categories, nor does it represent a lowering of the suitability standards (it is not, for example, "discount brokerage plus advice", "discount advice" or "advice-lite"). The element of suitability advice here is consistent with the suitability advice that a traditional individual registered representative, without having to be registered as a PM, is expected and obliged to provide in his relationship with a client.

We continue to support innovative business models developed by industry that can benefit investors. For more information, see the decision *In the matter of BMO InvestorLine Inc.*, dated August 1, 2012.

3. Acting on registrant misconduct

3. Acting on registrant misconduct

3.1 Registrant misconduct cases of interest

We stay alert for signs of potential registrant misconduct or fraud and when we find evidence of this we take appropriate steps. The CRR Branch works together with the Enforcement Branch to maintain an effective compliance-enforcement continuum for registrants, and to take appropriate regulatory actions when justified. These include sanctions such as the suspension or termination of the registration of a registered firm and/or its registered individuals, administrative penalties, and disgorgement of monies.

In addition to the Trapeze case, some notable registrant misconduct cases from the past year are summarized below. Please note that some cases are still ongoing. To get more information on a particular case, click on the respondent's name. Documents related to OSC proceedings before the Commission and before the Courts are available on our website under OSC Proceedings. Further, Director's Decisions from the CRR Branch are also available under the Information for Dealers, Advisers and IFMs section of our website.

Roger Rowan, Watt Carmichael Inc., Harry Carmichael, and Michael McKenney v. Ontario Securities Commission (March 29, 2012). Mr. Rowan was a director of Biovail Corporation (Biovail), and a registered representative with Watt Carmichael Inc., an investment dealer with discretionary trading authority over a number of trust accounts that held securities of Biovail. The trust accounts were set up by Eugene Melnyk, the former chairman of Biovail. The Commission had previously found that Mr. Rowan had traded millions of Biovail shares, generating over $2.3 million in commissions for Watt Carmichael Inc. over a two-year period, and that he breached Ontario securities law by failing to file insider reports in respect of these trades. The Commission also found Watt Carmichael Inc., Mr. Carmichael (the firm's ultimate designated person), and Mr. McKenney (the firm's chief compliance officer) had failed to adequately supervise Mr. Rowan's trading activities in Biovail shares. The Commission assessed administrative monetary penalties against the registrants under section 127(1)9 of the Act. In addition, the Commission rejected the registrants' challenge to the constitutionality of section 127(1)9. The registrants appealed the Commission's decision before the Divisional Court, which upheld the Commission's decision, and then to the Court of Appeal for Ontario, which upheld the provision. The Court rejected the arguments by the firm, Mr. Carmichael and Mr. McKenney that the Commission's finding that they had failed to adequately supervise Mr. Rowan was unreasonable.

Re Daniel Sternberg, Parkwood GP Inc., and Philco Consulting Inc. (April 26, 2012). Mr. Sternberg, who was not registered, was the principal of the general partner of a limited partnership which operated as an investment fund. The fund had retained a registered PM, but Mr. Sternberg provided advisory services to this PM in respect of the fund, and the PM remitted most of the management fees it received from the fund to Mr. Sternberg. Mr. Sternberg also acted in furtherance of trades in units of the fund. When we discovered what Mr. Sternberg was doing, he undertook in writing to cease performing registrable activities, but he failed to do so and continued to perform registrable activities. The Commission subsequently approved a settlement agreement between Staff and Mr. Sternberg to settle proceedings brought by the Enforcement Branch. The terms of the settlement agreement included a prohibition on Mr. Sternberg becoming a registrant for a period of one year.

Re Swift Trade Inc., Peter Beck, and others (June 21, 2012). Swift Trade Inc. was registered as an EMD until it dissolved in December 2010. Swift Trade Inc. and the other respondents were involved in a large-volume day-trading business. The operation involved several thousand traders located in Ontario and around the world, none of whom were registered in Ontario, placing orders on marketplaces in Canada, the US, the UK and elsewhere. In March 2009, the CRR Branch conducted a compliance review of Swift Trade Inc. that identified conduct which, in its view, constituted breaches of Ontario securities law, including failing to establish proper supervisory processes, not properly recording business transactions, employing compliance personnel with an insufficient understanding of Swift Trade Inc.'s complicated business structure, failing to detect questionable trading, and trading being conducted through unregistered entities. On June 21, 2012, a hearing panel of the Commission approved a settlement agreement between staff of the Commission, Swift Trade Inc., Peter Beck, and the other respondents in which the respondents agreed, among other things, to a statement of facts relating to their conduct, to pay an administrative monetary penalty, costs, and also to prohibitions, specific to each respondent, pertaining to trading securities, and becoming registrants for varying lengths of time.

Re M.H. (January 5, 2012), *Re Pyasetsky* (February 28, 2012), and *Re Couto* (April 20, 2012). Each of these cases involved an applicant for registration as a mutual fund dealing representative who omitted to disclose a material fact on their application; or who otherwise made misleading statements to Staff during the course of the application process. In each case, the Director refused the application for registration after offering the applicant an opportunity to be heard. Ms. Pyasetsky is currently seeking a review of the decision of her case by a Panel of the Commission.

Re Blueport and Hare (December 13, 2011, with written reasons issued January 12, 2012) and *Re Morgan Dragon Development Corp., John Cheong, and Herman Tse* (January 27, 2012, with written reasons issued February 10, 2012). Each of these cases involved an EMD in respect of which serious deficiencies were identified following a compliance review, including the inappropriate use of investor money. In both cases the firm and its registered individuals were suspended by the Director after an opportunity to be heard. Because the Director considered the registrants' ongoing registration to be a significant risk to investors, the registrants were suspended at the conclusion of the opportunity to be heard, with written reasons being issued a short time later. The registrants in *Morgan Dragon* were also referred to the Enforcement Branch, and a Statement of Allegations was issued on March 22, 2012. A hearing before the Commission into the allegations contained in the Statement of Allegations has not yet occurred.

David Phillips and John Wilson. On June 4, 2012, the Enforcement Branch issued a Statement of Allegations against David Phillips and John Wilson arising out of their involvement with First Leaside Securities Inc., an investment dealer, and F.L. Securities Inc., an EMD. Both companies are members of the First Leaside Group, and in February 2012 both companies had their registration suspended and also obtained protection from creditors under the *Companies Creditors Arrangement Act.* The Statement of Allegations alleges that Phillips and Wilson directed and oversaw the sale of First Leaside Group equity and debt offerings which raised approximately $19 million from investors. The Statement of Allegations also alleges that Phillips and Wilson did not properly disclose the fact that an independent accounting firm had recently issued a report commenting negatively on the financial status of the First Leaside Group. A hearing before the Commission into the allegations contained in the Statement of Allegations has not yet occurred.

Gentree Asset Management Inc. Gentree Asset Management Inc. was registered as a PM and EMD. A compliance review of this firm identified serious issues, including that the firm planned to correct a large working capital deficiency by selling securities of itself. The matter was referred to the Enforcement Branch, and the firm had its registration suspended by way of temporary orders dated August 17, 2011 and September 26, 2011. On March 27, 2012, a Statement of Allegations was issued alleging that the firm sold securities on a prospectus-exempt basis to individuals who did not qualify for an exemption, that some investor proceeds were used in a manner not disclosed in the offering memorandum, that the firm failed to meet the minimum working capital requirements of NI 31-103, and that the firm did not maintain proper books and records. A hearing before the Commission into the allegations contained in the Statement of Allegations has not yet occurred.

Colby Cooper Capital Inc. Colby Cooper Capital Inc. (Colby Cooper) was a registered EMD until its registration was suspended by the Director on January 31, 2012 because it did not have a properly qualified chief compliance officer. Following a compliance review, on March 27, 2012, the Enforcement Branch issued a Statement of Allegations against Colby Cooper, several related companies and their directing mind, Lee Mason. The Statement of Allegations alleges that Colby Cooper engaged unregistered individuals to conduct a high-pressure telephone sales campaign selling securities of a related issuer which falsely represented that it would use investor funds to develop oil and gas properties in Alberta and Texas, when in fact the funds were put to other uses, including financing Mr. Mason’s lifestyle. A hearing before the Commission into the allegations contained in the Statement of Allegations has not yet occurred.

Re Sextant Capital Management Inc., Otto Spork, and others (June 1, 2012). In May 2011, a hearing Panel of the Commission found that Sextant Capital Management Inc., formerly a PM and EMD, had engaged in fraud by falsely inflating the value of its investment fund, and receiving performance fees and management fees based on those inflated values. This matter had been referred to the Enforcement Branch as a result of the concerns identified from a compliance review of this firm in the fall of 2008. On June 1, 2012, the Commission released its decision on sanctions, which included, among other things, suspensions of corporate and individual registrations, and orders for the payment of administrative monetary penalties, disgorgement, and costs. The Commission’s decision is being appealed.

Re New Solutions Capital Inc., Ron Ovenden, and others. New Solutions Capital Inc. was formerly registered as an EMD, and Ron Ovenden was its ultimate designated person. As a result of the findings from a compliance review of this firm, the matter was referred to the Enforcement Branch, which obtained a temporary order on April 11, 2012 ceasing all trading by New Solutions Capital Inc. in a number of related issuers. (This order was subsequently extended). The basis for the temporary order was that it appeared to the Commission that New Solutions Capital Inc. may have failed to deal fairly, honestly, and in good faith with its clients, may have made misrepresentations to clients, and may have contravened the anti-fraud provisions of the Act. On April 12, 2012, we notified the registrants that we had recommended to the Director that their registrations be suspended, and on April 13, 2012, the firm’s chief compliance officer resigned. On April 26, 2012, the Director suspended the registrants on the basis that their ongoing registration would be objectionable in light of the temporary order against it, and on the basis that the firm did not have a chief compliance officer.

Re Sawh and Trkulja. (August 1, 2012). Sawh and Trkulja were formerly dealing representatives in the categories of MFD and EMD, and were the principals of a dealer named The Investment House of Canada. In 2009, Sawh and Trkulja settled disciplinary proceedings brought against them by the MFDA on terms that included their firm's resignation from membership in the MFDA, which also resulted in the suspension of their individual registration under the Act. In the settlement agreement with the MFDA, Sawh and Trkulja admitted to misconduct pertaining to the sale of certain prospectus-exempt securities. After entering into the settlement agreement, Sawh and Trkulja applied for a reinstatement of their registration as mutual fund and exempt market dealing representatives. On November 2, 2010, an opportunity to be heard was held, following which the Director issued a written decision refusing to grant either individual's application. Sawh and Trkulja then applied to the Commission for a hearing and review of the Director's decision under section 8 of the Act. In comprehensive reasons issued August 1, 2012, the Commission reviewed the general legal principles relating to suitability for registration under the Act, as well as the duties imposed on registrants by Ontario securities law relating to their dealings with clients. The Commission explained how Sawh and Trkulja failed to properly discharge their duties with regards to KYC and suitability, reliance on the accredited investor exemption, KYP requirements, and conflict of interest disclosure. As a result, the Commission dismissed the application for hearing and review, and refused to register either applicant. Sawh and Trkulja have appealed the Commission's decision to the Divisional Court.

4. Registration of firms and individuals

ONTARIO SECURITIES COMMISSION

4. Registration of firms and individuals

The registration requirements under securities law helps to protect investors from unfair, improper or fraudulent practices by participants in the securities markets. The information required to support a registration allows us to assess a firm's and individual's fitness for registration, including whether a firm is able to carry out its obligations under securities law and an individual's proficiency, integrity and solvency. These fitness requirements are the cornerstones of the registration requirements.

4.1 New registration requirements

4.1.1 Registration of non-resident IFMs

The new regime for registrants introduced a registration requirement for every firm that directs the business, operations or affairs of an investment fund. All IFMs operating in Canada prior to September 28, 2009 were required to apply for registration in the jurisdiction where their head office is located by September 28, 2010.

On July 5, 2012, we published Multilateral Instrument 32-102 *Registration Exemptions for Non-Resident Investment Fund Managers* (MI 32-102) on the registration requirements that apply in Ontario, Quebec and Newfoundland and Labrador to non-resident IFMs, which includes

- international IFMs who carry out investment fund management activities outside of Canada, and
- domestic IFMs who do not have a place of business in the province.

Under MI 32-102, we require registration of all non-resident IFMs that have a significant connecting factor to Ontario unless they can rely on one of the available exemptions. This initiative will enhance our regulatory oversight of IFMs and provide greater protection to Ontario investors from the ongoing operational risks associated with investment funds regardless of where the IFM is located.

Non-resident IFMs will not be required to register in Ontario if

- there are no Ontario security holders in an investment fund that is managed by the non-resident IFM,
- the non-resident IFM does not actively solicit Ontario residents after September 27, 2012, or
- an investment fund managed by the non-resident IFM only has "permitted clients" and other conditions are met (only for international IFMs).

MI 32-102 and the exemptions came into force on September 28, 2012. If a non-resident IFM does not intend to rely on one of the exemptions, then it must apply for registration by December 31, 2012.

For more information, see MI 32-102.

4.1.2 Registration and oversight of foreign broker-dealers

Since publishing CSA Staff Notice 31-327 *Broker-Dealer Registration in the Exempt Market Dealer Category* on September 2, 2011, we have undertaken a consultation process with stakeholders. We distributed a survey to all EMDs to determine which firms are engaging in brokerage activities (trading securities listed on an exchange in foreign or Canadian markets). We met with stakeholders including IIROC member firms and Financial Industry Regulatory Authority (FINRA) member firms. The results of the survey showed that this issue is specific to US broker-dealer firms who are FINRA members. We worked collaboratively with IIROC and involved FINRA.

On July 12, 2012 we published CSA Staff Notice 31-331 *Follow-Up to Broker-Dealer Registration in the Exempt Market Dealer Category* (CSA Staff Notice 31-331). The notice introduced an IIROC concept paper developed in response to the CSA's and IIROC's concerns. The IIROC concept paper, also published on July 12 as IIROC Notice 12-0217, proposes a framework for the oversight of these firms under a new class of IIROC member called a "Restricted Dealer Member". Based on the proposal, firms would surrender their EMD or restricted dealer registration and apply for investment dealer registration as well as seek IIROC membership.

As next steps, we will review any comments received on the IIROC proposal. At the conclusion of the consultation period, IIROC may make changes to its by-laws and rules. We may also propose changes to NI 31-103 to expressly limit the types of activities that EMDs can conduct.

For more information, see CSA Staff Notice 31-331.

4.2 Current trends in registration issues

Internet platforms and other unregistered entities engaged in registrable activities

Over the last year, we have considered a number of situations involving market participants that, although not dealers or advisers in the traditional sense, appear to be engaged in registrable trading or advising activities. In these cases, we have assessed whether these entities should be considered "in the business" of trading or advising and therefore subject to the dealer or adviser registration requirement under the Act.

To assist these entities in determining their status, we will generally refer them to the guidance in section 1.3 of Companion Policy 31-103CP *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (31-103CP). We also remind these entities that the definition of "trade" is very broad and includes "any act, advertisement, solicitation, conduct or negotiation directly or indirectly in furtherance of" a trade.

The question of whether these entities satisfy the "business trigger" will generally be fact-specific and may not apply to all entities engaged in such activities. Some examples of entities that we consider to be in the business of trading or advising include

- an internet platform that seeks to showcase investment opportunities to investors in return for fees from issuers and dealers that advertise on the platform;
- an angel investor organization or investment club that identifies investment opportunities for members, assists with due diligence on investments, and provides updates on the performance of investments in return for membership fees and, in some cases, fees and/or broker warrants granted as compensation on investments (collectively broker-type compensation);
- an issuer that filed a final prospectus that indicated that an offering would be made through an agent but subsequently marketed the offering through active client solicitation and sold 87% of the offering itself; and
- "finders" and "investor relations" entities who participate in private placements and prospectus offerings in return for broker-type compensation.

We continue to support innovative business models developed by industry that can benefit investors. In the case of entities that seek to advertise investment opportunities to investors through the internet, depending on the business model, we are open to considering exemptive relief from certain dealer requirements if these requirements are not appropriate for this type of entity, and if investor protection concerns can otherwise be adequately addressed.

Mortgage investment entities (MIEs)

In February 2011, we issued guidance on the registration requirements that apply to MIEs in each CSA jurisdiction in CSA Staff Notice 31-323 *Guidance Relating to the Registration Obligations of Mortgage Investment Entities* (CSA Staff Notice 31-323). However, we have identified a number of MIEs doing business in Ontario that have not applied for registration. We have sent these MIEs a letter requesting a response to our registration questions and concerns, and are assessing their responses. We are also considering additional measures for these identified MIEs and any other firms that are performing registrable activities in Ontario without registration, which may involve regulatory action. Therefore, MIEs, or firms which provide services to MIEs, which are carrying out registrable activities in Ontario should review and act on the information in CSA Staff Notice 31-323.

Designating a chief compliance officer (CCO)

From time to time, we receive a notification from a registered firm that their CCO has left unexpectedly, and that they do not currently employ an individual who meets the proficiency requirements for registration as a CCO.

We remind registered firms of the requirement under section 11.3 of NI 31-103 to designate an individual as CCO who meets the conditions for registration, including the required proficiency. Registered firms should therefore consider how they would be able to fulfill this requirement if their registered CCO were to suddenly resign or be unable to execute his or her responsibilities. For example, a firm may wish to ensure that it has one or more individuals who have the required proficiency and are familiar with the firm's compliance system so that the individual may step in as the CCO on a temporary or ongoing basis if the need arises.

If firms are not able to register a replacement CCO within a reasonable period of time, we may recommend regulatory action such as the imposition of terms and conditions or suspension of the firm’s registration.

Outside business activities

We have noted that some CCOs and dealing representatives of EMDs, MFDs and SPDs have employment or other business activities outside the registrant. In a number of cases, we have found that these outside business activities (OBAs) create a potential conflict of interest or place the registrant in a position of power or influence.

For example, we have seen situations where

- lawyers who are employed with law firms apply as CCOs or dealing representatives of registered firms or seek to register their own EMD or PM firms and register themselves as Ultimate Designated Persons (UDPs), CCOs, and in some cases, dealing or advising representatives of the firm, and

- dealing representatives sponsored by MFDs and SPDs who are also employed as teachers or healthcare workers, who are involved with organizations that have a religious affiliation, or who are employed by or affiliated with childcare providers.

To address these situations, in some cases, we have imposed terms and conditions on a firm's or a representative's registration, including restricting them from dealing with individuals over whom they have power or influence. For example, lawyers would be restricted from dealing in securities with clients of their law firm, and teachers would be restricted from dealing with their students and their students' close family members.

We have also noted a trend with small firms that are registered or seeking registration as EMDs, hiring a CCO that has other full-time or part-time employment. Many of these individuals appear to be a CCO "in name only" and are being offered the CCO position mainly because they meet the proficiency requirements under NI 31-103. Sometimes, such individuals may not truly be part of the registrant's compliance function and organizational structure. For example, we have found that some of these CCOs are not physically located at the office of the EMD and only work a few hours per week in their role at the EMD. Sometimes, these individual applicants act as consultants to other registrants. All successful CCO applicants must demonstrate that they can effectively maintain and oversee the registrant's compliance system. This means that CCO applicants must have the appropriate amount of involvement, time and resources to fulfill their regulatory obligations, and must be able to manage any conflict of interest issues that may exist in a dual employment situation.

We remind registered firms of their obligation to ensure the OBAs of the individuals they sponsor do not impair or impede the performance of their regulatory obligations. See CSA Staff Notice 31-326 *Outside Business Activities* for issues to consider when reviewing the circumstances of an individual's OBAs.

We also wish to remind registrants that all OBAs must be disclosed in Form 33-109F4 (or Form 33-109F5 for changes in OBAs after registration). Required disclosure includes

- having a paid or unpaid role with a charitable or religious organization,
- serving as an officer or director, and
- being a significant owner of a holding company.

Misrepresentations in registration applications

We have been conducting a more in-depth review of applications for registration from firms and individuals involved or proposing to be involved in higher-risk activities (e.g., firms that intend to deal in securities of related or connected issuers, and individuals that are officers or directors of a reporting issuer). We find that some applicants appear to be making material misrepresentations in their applications, including not disclosing full-time employment outside the registrant;

- not disclosing the failure to meet a financial obligation of $5,000 or more as it came due; or
- in cases where the firm does not have a Chief Executive Officer, the designated UDP is not the most senior decision-maker in the firm.

We also noted omissions after registration has been granted, such as new shareholders, officers or directors not filing the required application form as a permitted individual.

We remind firms of their obligations under section 5.1 of National Instrument 33-109 *Registration Information* (NI 33-109) to ensure applications include truthful and complete information and that the information is updated as required under sections 3.1 and 4.1 of NI 33-109.

Late filings

We have also seen a trend in registrants incurring late fees for failing to meet the filing deadlines set out in NI 33-109. For example, registered and permitted individuals do not disclose their OBAs or information related to criminal, civil or financial disclosure. This non-disclosure may occur either at the initial application stage or after a change takes place after they have been registered and we are not notified on a timely basis. For example, on October 1, 2012, a firm files a late Form 33-109F5 which updates information on a Form 33-109F4. That firm must pay a late fee within 30 days (by October 31, 2012) or be automatically suspended.

Also, many registered firms incur late fees because they fail to file their Form 13-502F4 *Capital Markets Participation Fee Calculation* by December 1 of each calendar year.

We remind registrants that when late fees remain unpaid for more than 30 days after they are due, the firm's registration is automatically suspended in accordance with section 29(1) of the Act.

Common deficiencies from registration applications

In last year's report, we outlined common deficiencies from our review of firms' and individuals' registration applications, along with actions to be taken to avoid the deficiencies. From our review of this year's common deficiencies, we found many similar deficiencies, and as such do not repeat them here. To access last year's guidance (which continues to apply), see section 4.3 of OSC Staff Notice 33-736.

4.3 Common deficiencies from notices on proposed ownership changes or asset acquisitions of a registrant and suggested practices

Under sections 11.9 and 11.10 of NI 31-103, an acquirer and/or a registered firm must give notice in the case of certain acquisitions of a registered firm's assets or securities. If we notify the registered firm or person making the acquisition that we object to the acquisition within 30 days of the receipt of such notice, then the acquisition must not occur until the objection is withdrawn.

To decide whether or not to object, we examine whether the acquisition is:

- likely to give rise to a conflict of interest,
- likely to hinder the registered firm in complying with securities legislation,
- inconsistent with an adequate level of investor protection, or
- otherwise prejudicial to the public interest.

We often find that the notice filed does not provide sufficient information for us to make this determination. Accordingly, we have to request additional information, which may result in further delays before we can make a final decision.

The following are suggested practices to prepare a section 11.9 or 11.10 notice. We acknowledge that some of these suggested practices may not be relevant depending on the type of transaction or specific facts.

Suggested practices

- Provide details about the business reasons for the transaction.
- Set out details about the registered firm's operations and business plan after closing. The information regarding any changes to business operations should include details required in Item 3.1 of the Form 33-109F6 *Firm Registration* (i.e., primary business activities, target market, and the products and services it provides to clients).
- Include any significant changes to business operations and any changes to the CCO, the UDP, key management, directors, officers, permitted individuals or registered individuals. If no changes are contemplated, confirm this is the case.
- Discuss whether the registered firm has written policies and procedures in place to address any conflicts of interest that may arise.

- If there is a potential conflict of interest because of the transaction, explain how this conflict of interest has been addressed.
- Discuss whether the parties to the transaction have adequate resources to ensure compliance with all applicable conditions of registration.
- Discuss whether directors, officers, partners, advising representatives and dealing representatives of the registered firm, if applicable, will be in compliance with section 4.1 of NI 31-103 (restrictions on acting for another registered firm).
- Provide details of any client communications in connection with the transaction that have been made or are planned. If you do not propose to communicate with clients about the transaction, advise us and explain why.
- Provide a copy of the press release announcing the transaction. If you do not plan to issue a press release, advise us and explain why.
- Confirm the proposed closing date.
- Provide corporate charts (before and after the closing of the transaction) that include all affiliated companies and subsidiaries of the registered firm.
- On the charts provided, identify any companies or affiliates which are registered under the Act and/or the *Commodity Futures Act* and specify their category of registration.
- Where any individuals are shown on the corporate charts as holding an interest in a company, partnership or trust, confirm whether the individual holds that interest directly or through a holding company, trust or other entity (a Holdco). If ownership is through a Holdco, provide the name of the Holdco and its ownership structure.

Acting on the above suggested practices will help us to assess a proposed transaction while minimizing the exchange of correspondence that can sometimes cause additional delays.

4.4 New initiatives

Enhanced transparency of communications with registrants

In the past, when we recommended that an individual's registration be refused or be subject to terms and conditions or amendment, a letter that provided written notice of the recommendation and brief reasons for it was provided only to the individual (and not also to their sponsoring firm). The sponsoring firm was sent a written notice outlining our recommendation and informing them of the individual's right to be heard and that the reasons were provided to the individual. As a result, the sponsoring firm was not always aware of the reasons for the recommendation.

We now also provide the individual's sponsoring firm with the reasons underlying the recommendation. This will improve the transparency of our communications with registrants and will assist sponsoring firms in ensuring the accuracy and completeness of information that they provide to us for individuals that they sponsor. For more information, see OSC Staff Notice 33-737 *Enhanced Transparency of Communications with Registrants*.

5. Information for dealers, advisers and investment fund managers

ONTARIO SECURITIES COMMISSION

5. Information for dealers, advisers and investment fund managers

The information in this section includes the key findings and outcomes from our ongoing compliance reviews of the registrants we directly regulate. We highlight deficiencies from our reviews and provide suggested practices to address those deficiencies. The suggested practices are intended to give guidance to registrants to help them comply with their regulatory obligations, as they provide our interpretations of the legal requirements and our expectations of registrants. We also discuss new or proposed rules and initiatives impacting registrants.

This part of the report is divided into five main sections. The first section contains general information that is relevant for all registrants. The other sections contain information specific to EMDs, SPDs, PMs and IFMs, respectively. This report is organized to allow a registrant to focus on reading the section for all registrants and the sections that apply to their registration categories. However, we recommend that registrants review all sections in this part, as some of the information presented for one type of registrant may be relevant to other registrants.

5.1 All registrants

This section outlines our compliance review process and its outcomes, current trends in deficiencies and suggested practices to address them, and details new and proposed rules and initiatives impacting all registrants.

5.1.1 Compliance review process and its outcomes

We conduct compliance reviews of selected registered firms on a continuous basis. Generally, we select registrants for review using a risk-based approach. However, we occasionally select firms for review on a random basis to help us evaluate the effectiveness of our risk-based approach. Compliance reviews of registered firms generally focus on their conduct, practices, operations and capital adequacy. The risk-based approach is intended to identify those registrants that are most likely to have material issues, including risk of harm to investors. We normally conduct compliance reviews on-site at a registrant's premises, but may also perform reviews from our offices, which are known as desk reviews. The majority of reviews are proactive in nature, but we also perform reviews on a for-cause basis where we are aware of a potential compliance issue, for example, from a complaint or a referral from another OSC branch, an SRO or another regulator. We also conduct sweeps, which are compliance reviews of a sample of registered firms on a specific topic or in an industry sector over a short period of time. Sweeps allow us to respond on a timely basis to industry-wide concerns or issues.

The purpose of compliance reviews is to assess compliance with Ontario securities law. In most cases, the deficiencies noted are raised with the firm reviewed so that appropriate corrective action can be taken. However, we stay alert to any signs of potential registrant misconduct or fraud and will take appropriate steps if we identify these signs. In fiscal 2012, 18% of our compliance reviews resulted in a combination of the following: terms and conditions placed on the firms' registration, referrals to OSC Enforcement for further regulatory action, or the suspension of the firms' registration.

The outcomes of our compliance reviews in fiscal 2012, with comparables for 2011, are presented in the following table and are listed in their increasing order of seriousness. The percentages in the table are based on the registered firms we reviewed during the year and not the population of all registered firms.

Outcomes of compliance reviews (all registration categories)	Fiscal 2012	Fiscal 2011[3]
Enhanced compliance	34%	31%
Significantly enhanced compliance	47%	55%
Terms and conditions on registration	8%	3%
Surrender of registration	1%	1%
Referral to the Enforcement Branch	6%	7%
Suspension of registration	4%	3%

Each outcome is explained in Appendix A. In some cases, there may be more than one outcome from a review. In these cases, the review is counted only under its most serious outcome.

Sweep of higher risk registrants

In June 2011, we sent out an updated and integrated risk assessment questionnaire (RAQ) to all PMs, IFMs and EMDs registered in Ontario. The RAQ included questions on various areas of a firm's operations such as their business activities, financial condition, custody, fee arrangements, marketing practices, and compliance systems. The registrant's responses to each question generated a risk score that was used to rank similarly registered firms. For example, firms registered as IFMs and PMs were ranked against other firms registered as IFMs and PMs. We used the risk scores to help us allocate our resources to higher risk registrants and higher risk activity. Starting in late 2011, we began conducting on-site compliance reviews of firms that had higher risk scores compared to their peers. Our reviews focused on the higher-risk activities of

[3] Percentages for 2011 have been revised to conform to our new reporting method for 2012.

the selected firms. Most reviews resulted in a report issued to the registrant that outlined the deficiencies we found, and that required corrective action by the registrant. Registrants were required to respond to us in writing on how they addressed deficiencies identified as significant, such as an inadequate compliance system. We then assessed whether each registrant had addressed all significant deficiencies. Although our sweep of the higher risk registrants is complete, we continue to use the information we collected on the RAQ to help us decide which firms to review in the future, which areas of their business to focus on, and to identify compliance trends.

What to expect from, and how to prepare for, an OSC compliance review

When a registered firm is selected for an on-site compliance review, we contact the firm's CCO to make arrangements. We explain the focus or scope of the review and the time period that the review will cover. We normally give several business days advance notice before starting a review. However, when appropriate, we may give a shorter or longer advance notice period. We will not defer the start of a review unless there are exceptional circumstances and there is no known risk of harm to investors.

We next send the CCO a list of the registered firm's books and records that we would like to be compiled or made accessible for the start of the review. See Lists of Books and Records for examples. Our books and records requests are often customized based on the type and nature of the review. We prefer that registrants provide us with copies of their documents, and when appropriate, that they be made available in an electronic format (e.g., for a record of all trades in securities for clients over the past year). We also request additional books and records after we start the review (e.g., samples of client files).

When we attend a registered firm's offices, we present the CCO with a written designation under section 20 of the Act authorizing us to enter the firm's business premises and inquire into, examine, and copy the firm's books and records. At the start of the review, we usually have a two-to-three hour meeting with senior management of the registrant to obtain a high-level understanding of the firm. We normally expect the UDP, CCO and other senior management to attend this meeting. In general, at least two accountants and sometimes a lawyer will attend all or part of the review for the OSC. The length of time that we are on-site varies depending on the scope and nature of the review, the issues we find, and other factors (including size and complexity of the firm), but is generally between one day and three weeks.

Unless our review is a sweep that is targeting a specific topic only, we generally assess the adequacy of each registrant's compliance system, its internal controls and systems, marketing and sales practices, financial condition, dealing with clients and handling of client accounts. For dealers and advisers, we also generally focus on how they meet their KYC and suitability obligations, including how they research and make investment recommendations for clients. For IFMs, we also generally focus on their fund accounting, transfer agency and trust accounting functions, and oversight of any service providers if these functions are outsourced. We also examine other ongoing obligations of registrants. At the end of each review, we normally communicate any deficiencies with Ontario securities law that require corrective action by the registrant in a report to the CCO. The registered firm is expected to address all matters identified in the report on a timely basis, but must respond to us in writing within 30 days on their actions to address all deficiencies identified as significant. When all significant deficiencies have been satisfactorily addressed, we normally send the CCO a letter stating that our review is closed. However, this letter does not necessarily mean that the registrant is in compliance with all aspects of Ontario securities law. For example, reviews are often focused on a particular area of a firm's business and are therefore not comprehensive, and our reviews test for compliance on a sample basis, and using a risk-based approach.

The best way to prepare for an OSC compliance review is by having an effective compliance system that is appropriate to the registered firm's business. An effective compliance system enables registrants to understand their regulatory obligations, to assess if they are complying with them, and to take corrective action when necessary. In most reviews we aim to help registrants improve their understanding and compliance with Ontario securities law. However, it is not acceptable for registrants to rely on us to inform them of their legal responsibilities and to identify non-compliance. We expect registrants to know and to comply with the law.

For more information, see the compliance review section on the OSC website.

The following are suggested practices to prepare for an OSC compliance review.

Suggested practices

- Periodically perform a self-assessment of your firm's compliance with Ontario securities law, or engage a compliance consultant to perform a mock regulatory review, and take corrective action in any areas that are deficient.

- Compile books and records requested for review on a timely basis, organize them in a logical format, and make copies of the materials for us and you (unless we only requested access to the records).

- If applicable, review your firm's most recent OSC RAQ, and any past compliance review deficiency reports and your responses.

- Be prepared to explain your firm's business, including, but not limited to, your corporate and organizational structure, products, services, types of clients, compliance and risk management systems, investment process (including KYC, KYP, and suitability), marketing practices and financial condition.

- Inform relevant persons that the OSC is conducting a compliance review, and that they may need to be available for interviews during the review.

- Appoint a contact person (e.g., the CCO) to answer our questions, schedule meetings, and request and collect additional documents.

- Provide us with use of a private meeting room or office to review the books and records and conduct meetings with your staff.

- Maintain an ongoing dialogue with field review staff so that you are aware of the status and progress of the review.

5.1.2 Current trends in deficiencies and suggested practices

Inadequate compliance systems and CCOs not adequately performing responsibilities

Our compliance reviews have identified a number of registered firms that do not have an adequate compliance system in place and CCOs who are not adequately performing their responsibilities.[4] For example, we found that some CCOs lacked knowledge of key requirements in NI 31-103 and had limited involvement in the compliance function.

When we find deficiencies of this nature, we consider this a serious matter and will take appropriate regulatory action. This may include

- requiring registered firms to self-correct their deficiencies through a concerted effort to review and apply securities law to their operations;

- requiring firms to hire an external compliance consultant to correct the deficiencies; or

- being subject to strict regulatory action, including suspension of their registration where warranted.

[4] Since we use a risk-based approach to select a sample of registered firms for compliance reviews over the year, we expect to find more issues at firms we review than are likely to be present in our overall population of registered firms.

In May 2012, we communicated our concerns to all CCOs and UDPs of registered firms that we directly regulate. We also provided examples of inadequate compliance systems and CCOs not adequately performing their responsibilities, and outlined our regulatory approach when we identify concerns in this area. We also clarified our expectations and made suggestions on how a CCO or UDP can improve a firm's compliance systems.

Registered firms are required to register a CCO who meets the education and experience requirements in Part 3 of NI 31-103. Although the CCO's responsibilities are to be fulfilled on an ongoing basis, we recognize that many CCOs of small and mid-sized firms may also have other duties and responsibilities. A CCO must have the appropriate amount of involvement, time and resources to fulfill his or her responsibility to monitor and assess compliance with regulatory requirements. In performing his or her duties and responsibilities as CCO, the CCO must have a good understanding of the regulatory requirements applicable to the firm and individuals acting on its behalf. On an ongoing basis, the CCO must demonstrate that he or she can effectively maintain and oversee the compliance system of the registrant firm. It is also important that firms allocate adequate staff and resources to the compliance function, by taking into account the size, nature, complexity and risk of their business. For example, at larger, higher risk or more complex firms, it is generally appropriate for the firm's CCO to dedicate most of their time to compliance responsibilities and for the firm to have other staff employed in a compliance role.

Registered firms and their CCOs should also perform ongoing self-assessments of their compliance with Ontario securities law and take action to improve their internal controls, monitoring, supervision and policies and procedures when necessary. Where appropriate, firms should consider engaging external legal counsel or a compliance consultant to provide advice, including making recommendations to improve the firm's compliance system. When we require a registered firm to engage a compliance consultant to improve its compliance system through terms and conditions of registration, we consider the following factors when assessing the acceptability of the consultant:

- their knowledge, resources and staff
- their experience with the type of registrant that the engagement relates to, and
- any conflicts of interest.

We may also consider factors in addition to those listed above. We also encourage CCOs to attend compliance-focused seminars and participate in compliance officer associations. For more information, see OSC Message to CCOs and UDPs on Inadequate Compliance Systems, which includes guidance from us and the SROs that may also be applicable to non-SRO registrants.

Inadequate relationship disclosure information

In November 2011, we participated in a desk review (sweep) with several other CSA members to assess the type of relationship disclosure information (RDI) dealers and advisers provide to clients to meet the requirements under section 14.2 of NI 31-103.

The RDI requirements were established to provide clients with increased transparency and a better understanding of the registrant-client relationship. The information that is required to be disclosed includes

- the nature and type of the client's account
- the products or services the firm offers to clients
- the types of risks a client should consider in making investment decisions
- costs to a client for the operation of an account
- costs the client will pay in making, holding and selling investments
- the content and frequency of reporting to clients.

We reviewed and assessed the RDI for 40 firms in Ontario, out of a total of 120 firms that were selected across the participating CSA jurisdictions. Our sample included firms that were registered as sole PMs, sole EMDs, or registered in multiple categories of registration. Our purpose was to review and understand how registrants were meeting the RDI requirements.

We have completed our review of the 40 Ontario firms. Deficiency letters were delivered to registrants who failed to adequately meet the RDI requirements. The most common deficiencies identified related to inadequate disclosure of

- the types of risks a client should consider when making investment decisions
- the information a registered firm must collect about the client under section 13.2 of NI 31-103 (KYC)
- the risks to a client of using borrowed money to invest, or
- the content and frequency of reporting for each account or portfolio of a client.

We anticipate that the CSA will provide registrants with further guidance on compliance with the RDI requirements.

Inaccurate calculations of excess working capital

We continue to identify instances where registered firms are not accurately calculating their excess working capital on Form 31-103F1. Inaccurate reporting on Form 31-103F1 may result in a firm failing to meet the capital requirements set out in section 12.1 of NI 31-103.

To address this, we have listed in the table below the significant deficiencies identified from our reviews of Form 31-103F1s over the last year. The deficiencies have been separated out by each line item on Form 31-103F1. In order to reduce errors when calculating their excess working capital, registered firms should avoid these deficiencies and follow the actions to be taken when preparing their Form 31-103F1s.

Form 31-103F1 *Calculation of Excess Working Capital*

Deficiency noted	Action to be taken
Line 1 *Current assets*	
(a) Inclusion of accounts receivables, especially from related parties, that are not readily convertible to cash.	(a) Any receivables that are included on Line 1 and that cannot be converted into cash in a prompt and timely manner should be deducted on Line 2 *Less current assets not readily convertible into cash (e.g., prepaid expenses)*. Firms should be able to provide evidence to us that if the related party receivable was called upon by the firm, the amount could be promptly received. Evidence may include, among other items, a copy of the most recent audited financial statements of the related party or a bank statement supporting the amount of cash available.
(b) Inclusion of cash that is committed to serve a specific purpose (e.g., for collateral or as a security deposit).	(b) Any cash that is not readily available for use by the registrant for its current business purposes or to settle its current liabilities is considered to be restricted cash and should be deducted on Line 2.

Deficiency noted	Action to be taken
Line 5 *Add long-term related party debt* (a) Failure to add back 100% of long-term related party debt.	(a) All long-term related party debt is required to be added back on Line 5 unless the firm and the lender have executed a subordination agreement in the form set out in Appendix B to NI 31-103 and the firm has delivered a copy of the agreement to its principal regulator. Preferred shares issued to related parties and classified as a financial liability are considered to be long-term related party debt.
(b) Failure to deliver a copy of the subordination agreement to the regulator when subordination agreements have been executed.	(b) Firms are required to deliver a copy of all subordination agreements to their principal regulator. Refer to Appendix B of NI 31-103 for a copy of a subordination agreement template. Only subordination agreements executed in the format outlined in Appendix B comply with the requirements of Line 5. Related party debt subordinated in any other format is not considered to be subordinated for the purposes of determining excess working capital.
(c) Repayment of subordinated debt is made without prior notice to the regulator.	(c) As indicated on Clause 4 of the subordination agreement template in Appendix B of NI 31-103, firms must notify their principal regulator 10 days before the full or partial repayment of the loan. Further documentation may be requested by the principal regulator after receiving the notice from the firm. Firms are also required to provide an updated subordination agreement or a schedule indicating the outstanding balance after a partial repayment of the loan.

Deficiency noted	Action to be taken
Line 9 *Less market risk*	
(a) The market risk calculation is omitted.	(a) For all securities whose values are included in Line 1 current assets, the market risk for each security must be determined based on its fair value and the applicable margin rates set out in Schedule 1 of Form 31-103F1. Refer to section 1(1) of the Act for the definition of the term "security". See Schedule 1 of Form 31-103F1 for instructions on calculating market risk. Firms may be asked to provide evidence of the market risk calculation.
(b) In determining market risk for US-registered money market funds, 1% or 5% margin rates are being applied to the value of these securities.	(b) A margin rate of 100% must be applied to the value of US-registered money market funds as these securities meet the criteria outlined in Schedule 1(g) of Form 31-103F1 For all other securities. Any securities that do not meet the exact criteria outlined in Schedule 1 clauses (a) to (f) require a 100% margin rate to be applied to their fair value.
Line 11 *Less guarantees* Failure to include the amount of a liability of another party that is guaranteed by the registered firm.	If the registered firm is guaranteeing the liability of another party, regardless of whether there are other guarantors to the liability, the total amount of the guarantee must be included on Line 11 (unless the amount of the guarantee is already included on Line 4 Current liabilities).

Inappropriate sale of registrants' securities to their clients

We have concerns when a registered firm sells securities in itself to its clients. We have noted a number of cases recently where a registered firm was directly selling securities (such as notes, common or preferred shares) of the registered firm itself to its clients. In these cases, the investors were not taking control or direction over the firm, were not sophisticated investors, and were arm's-length from the registrant and its principals. Where this occurs, we have identified a number of serious issues, including

- registrants raising money from investors to fund their operations when the registrant was in financial difficulty, or had negative cash flow. Investors were not adequately informed of the financial difficulty of the registrant, and its associated risks, and were not provided with current and ongoing financial statements of the firm. Rather, the interest rate or dividend yield of the security was emphasized;
- the securities that were sold to investors were not suitable based on their investment needs and objectives, risk tolerance and financial circumstances, and the securities comprised a large percentage of the investor's financial assets;
- the securities were sold by improperly relying on a prospectus exemption. For example, the registrant relied upon the accredited investor exemption when the investor did not meet any of the definitions for an accredited investor;
- the money raised by the security offering was not used for the purposes told to investors or outlined in offering documents;
- the risks of the investments were not disclosed or they were inaccurate or understated, or other misrepresentations were made to the investors.

In each of these cases, the matters were referred to our Enforcement Branch for appropriate action.

It is a material conflict of interest when a registered firm sells securities in itself to clients. Section 13.4 of NI 31-103 requires registrants to identify and respond to existing or potential material conflicts of interest between the registered firm (including each individual that acts on its behalf) and a client.

Section 13.4 of 31-103CP identifies three ways to respond to conflicts of interest:

- avoidance
- control, and
- disclosure.

If the risk of harming investors or the markets is high, the conflict needs to be avoided. If a registered firm does not avoid a conflict of interest, it should take steps to control or disclose the conflict, or both.

Further, section 2.1 of OSC Rule 31-505 *Conditions of Registration* (OSC Rule 31-505) obligates dealers and advisers to deal fairly, honestly and in good faith with their clients. This fair dealing obligation must be met when a registrant sells securities in itself to clients, and may be difficult to meet given the fundamental conflict of interest from this practice.

Suggested practices

- Given the fundamental conflict of interest, registrants should avoid selling securities in themselves to clients.
- Registrants who think they are able to address the conflict of interest through control and disclosure should first obtain legal advice before engaging in this practice.
- Registrants that need to raise working capital should obtain it from the firm's existing owners, financial institutions or sophisticated investors, or engage independent dealers to raise the money for them.

Failure by CCO to submit an annual compliance report

In last year's report, we discussed how we often found no evidence that a registered firm's CCO submitted an annual report to the firm's board of directors (or its equivalent) to assess the firm's, and its registered individuals', compliance with securities law. Since we continued to see this deficiency during many of this year's reviews, we emphasize it again.

Section 5.2 of NI 31-103 outlines the responsibilities of a registered firm's CCO. These include submitting an annual report to the firm's board of directors, or individuals acting in a similar capacity for the firm, for the purposes of assessing compliance by the firm, and individuals acting on its behalf, with securities legislation.

When the CCO has not submitted an annual compliance report to the registrant's board, this raises questions about the adequacy of the registrant's compliance system, and whether the CCO is adequately performing his or her responsibilities. See the *Inadequate compliance systems and CCOs not adequately performing responsibilities* section of this report.

Suggested practices

- A CCO should prepare and maintain a *written* annual report that the CCO provides and presents to the firm's board of directors. The report should outline the CCO's assessment of the firm's and its registered individuals' compliance with securities law for the period of the report.
- Where appropriate, a CCO should provide and present a report more frequently than annually. This may be appropriate:
  - at larger firms
  - when there are external members on the firm's board of directors, or
  - when there are significant compliance deficiencies at the firm.
- The CCO should describe in the report the steps that were taken to perform the assessment, the results of the assessment (including any significant instances of non-compliance such as those that create a risk of harm to a client or the capital markets), and what has been done or will be done to address the non-compliance.
- The CCO may also want to discuss in the report:
  - the status and effectiveness of the firm's internal controls, monitoring and supervision; the firm's commitment to compliance, resources and training; and changes to the firm's policies and procedures;
  - any deficiencies identified in the firm's or its individuals' compliance with securities law;
  - the status and outcome of any regulatory reviews, internal audits, inquiries or investigations involving the firm or its individuals;
  - complaints or lawsuits against the firm or its individuals where there is potential non-compliance with securities law;

- proposed changes to securities law that materially impact the firm;
- key compliance risks facing the firm and how they are being addressed; and
- an overall assessment of the firm's and its individuals' compliance with securities law.

- In cases where the CCO has decided not to prepare a written report, but instead provides an oral presentation of his or her report to the firm's board of directors, the minutes to the board meeting should document the discussion, and describe the same information as outlined in the suggested practices for a written report above. An oral presentation without a written report may be appropriate, for example, in the case of a small firm with limited business lines that did not have any significant instances of non-compliance.

These suggested practices apply to all registered firms, including one-person firms and when the CCO is the sole member of the registered firm's board of directors.

Acting on the above suggested practices will help us to assess if a CCO has fulfilled his or her responsibilities under section 5.2 of NI 31-103.

5.1.3 New and proposed rules and initiatives impacting all registrants

Update on independent dispute resolution services for registrants

We have extended the transition period (except in Québec) for certain registered firms to make available to their clients independent dispute resolution or mediation services to September 28, 2014 (unless we implement amendments before this date). If a firm was registered for the first time after September 28, 2009, then this extension does not apply and we expect the firm to comply with the independent dispute resolution requirements.

On November 15, 2012 we proposed amendments to NI 31-103 to require all registered dealers and advisers to utilize the services of the Ombudsman for Banking Services and Investments for their dispute resolution or mediation services obligations (except in Québec). For more information, see Proposed Amendments to NI 31-103 on Dispute Resolution Service.

We remind registrants that we expect them to have internal complaint handling policies to ensure that any client complaints are addressed.

On-line submission process for Form 31-103F1, financial statements and other information

We are currently developing, and plan on implementing, an on-line submission process that requires all registered firms whose principal regulator is the OSC to electronically complete and submit Form 31-103F1 *Calculation of Excess Working Capital* (Form 31-103F1).

Firms would also be required to attach and submit audited financial statements, interim financial information and other information that is relevant to the financial condition of the firm.

The implementation of an electronic submission process is in line with the Commission's priorities to modernize our regulatory systems and approaches.

Registered firms would benefit from the convenience of filing through a centralized submission point, receiving instant filing receipt information, as well as assisting in reducing the environmental impact of printing.

Upcoming desk review on accuracy of Form 31-103F1 filings

We will be conducting a targeted desk review of a sample of registered firms to assess the accuracy of Form 31-103F1 filings.

This desk review will complement our on-going reviews of Form 31-103F1s, audited financial statements and other financial information that are required to be filed with us.

The desk review will focus on the line-by-line calculation of Form 31-103F1. We plan to commence the desk review this fall. The purpose of the desk review is to assess compliance with the capital requirements in section 12.1 of NI 31-103 and to assess whether further guidance in this area is needed.

5.2 Exempt market dealers

This section contains information specific to EMDs, including current trends in deficiencies and suggested practices to address them, and new and proposed rules impacting EMDs.

5.2.1 Current trends in deficiencies and suggested practices

Our EMD reviews focused on areas that we found to be problematic in recent years, including

- inadequate compliance systems and supervision
- inadequate collection and documentation of KYC information
- failure to assess the suitability of trades and selling unsuitable investments

- insufficient product due diligence (KYP)
- failure to identify and respond to conflicts of interest, and
- improper reliance on the accredited investor exemption.

We will continue to focus our compliance resources on these areas.

In addition to the matters discussed at section 5.1.2 of this report on *Inadequate compliance systems and CCOs not adequately performing responsibilities*, the following are trends in deficiencies identified during this year's reviews of EMDs. Where relevant, we also highlight some recent regulatory proceedings brought against EMDs to demonstrate our response when we identify registrant misconduct and the consequences when EMDs fail to comply with securities law.

Conflicts of interest when selling securities of related or connected issuers

EMDs that distribute the securities of related or connected issuers[5] continue to be an area of focus and concern for us due to the disproportionate rate of compliance deficiencies found in many of these firms.

In particular, some EMDs failed to identify and respond appropriately to the conflicts of interests that arise from these relationships. There are significant potential conflicts of interest when the mind and management of the issuer and the EMD are the same. These potential conflicts of interest include the EMD sponsoring dealing representatives that are also employees of, or related to, various issuers whose securities the EMD distributes. These include, for example, dealing representatives that:

- perform investor relations services for the issuers
- perform consulting services for the issuers, or
- act as officers or directors (or in an equivalent position) for an issuer.

Among our concerns is that dealing representatives may put their personal interests or the interests of the issuers ahead of their investor clients. *In the Matter of Staff's Recommendation to Suspend the Registration of Carter Securities Inc.* is a recent Director's Decision involving the suspension of an EMD based on a repeated failure to disclose material conflicts of interest to its clients. This EMD failed to inform investors that it directed investor funds into a related party loan from the related issuer it was distributing. The firm's failure to disclose the conflict demonstrated a lack of the integrity required of registered firms.

[5] See definition of related and connected issuer in section 1.1 of NI 33-105 *Underwriting Conflicts.*

As previously discussed, section 13.4 of NI 31-103 requires EMDs to identify and respond to existing or potential material conflicts of interest between the EMD (including each individual that acts on its behalf) and a client. Section 13.4 of 31-103CP identifies three ways to respond to conflicts of interest:

- avoidance
- control, and
- disclosure.

If the risk of harming investors or the markets is high, the conflict needs to be avoided. If a registered firm does not avoid a conflict of interest, it should take steps to control or disclose the conflict, or both. For example, the registered firm could require an independent audit of the issuer's financial statements to mitigate the potential conflicts.

EMDs who are making prospectus-exempt distributions of related or connected issuers must also meet their disclosure obligations of the relationship as required under National Instrument 33-105 *Underwriting Conflicts* (NI 33-105). In particular, section 2.1(1) of NI 33-105 imposes a disclosure obligation applicable to a distribution in which a non-independent underwriter participates. This obligation is designed to require full disclosure of the relationship and specifies the disclosure requirements in Appendix C to NI 33-105.

Suggested practices

EMDs should

- have a process in place to identify and respond to any conflicts of interest that could impact clients' decisions to purchase an investment product, such as providing examples of material conflicts of interest to their dealing representatives and requiring them to timely inform the CCO if any actual or potential conflicts of interest arise;
- avoid the conflict if the risk of harm to clients is high;
- have a process in place to provide prominent, specific and clear disclosure to clients that explains any conflicts of interest, how the firm is dealing with the conflict, and how conflicts of interest could affect clients; and
- have a process in place to inform investors of a conflict before or at the time they recommend a security transaction that gives rise to the conflict, and what controls are in place to deal with the conflict.

Misuse of the accredited investor exemption

Some EMDs continue to misuse the accredited investor exemption. These EMDs are selling prospectus-exempt securities to investors without ensuring that investors qualify as accredited investors within the meaning of National Instrument 45-106 *Prospectus and Registration Exemptions* (NI 45-106). For example, some EMDs simply rely on a statement from the investor stating that he or she meets the accredited investor definition without collecting any other information to support this statement. As we explained in OSC Staff Notice 33-735 *Sale of Exempt Securities to Non-Accredited Investors* (OSC Staff Notice 33-735), we are concerned that individuals who are purchasing securities as "accredited investors" do not meet the required minimum income or asset thresholds. Many EMDs continue to incorrectly interpret the definition of "financial assets" by including non-financial assets such as precious metals, the investor's primary residence, and other real estate as "financial assets" for purposes of determining if an investor satisfies the financial assets test in paragraph (j) of the accredited investor definition in section 1.1 of NI 45-106.

As set out in section 7.1(2)(d) of NI 31-103, an EMD can trade a security only where the trade is exempt from the prospectus requirement. Section 1.9 of the Companion Policy to NI 45-106 states that it is the responsibility of the person distributing or trading securities to determine whether an exemption is available. EMDs must ensure the information collected from investors supports the use of the accredited investor exemption. If the client is not an accredited investor (and another prospectus exemption is not available), a prospectus is required, and the EMD is acting outside of its registration category.

Recent decisions that illustrate some of the potential consequences of an EMD's failure to comply with this requirement include *Re Morgan Dragon Development Corp., John Cheong, Herman Tse*, and *Re Blueport and Hare*. See section 3.1 of this report for more information.

Suggested practices

EMDs and their registered individuals should confirm that they

- have a process in place to collect and document sufficient information for each prospective investor to determine whether the product can be sold pursuant to the accredited investor exemption; and

- understand the criteria that must be met to qualify under the accredited investor definition.

EMDs should also refer to OSC Staff Notice 33-735 for additional guidance.

Unsuitable investments and failure to meet KYC, KYP and suitability obligations

We continue to identify issues in the areas of KYC information, assessment of suitability, and knowledge of products recommended to clients. We are now performing targeted reviews of EMDs to further assess compliance with their KYC, KYP and suitability obligations. See section 2.2 of this report for more information.

During this year's reviews, we noted

- inadequate collection and documentation of KYC information for clients necessary to assess the suitability of trades and to ascertain investors' eligibility for securities traded under a prospectus exemption;
- some products sold to investors were unsuitable based on the clients' risk tolerance, financial situation and other client information;
- inadequate assessment of suitability of investment for clients; and
- insufficient due diligence and knowledge of an investment product prior to recommending it to investors. Many EMDs did not have a process in place to understand (or were unable to demonstrate) the structures and key features, including risks, of their product offerings. Some EMDs relied solely on the information provided by the issuer to satisfy their KYP obligations without further assessing the product, including the financial viability of the issuer and the use of investor proceeds.

We remind EMDs of their obligations under section 13.2 of NI 31-103 to take reasonable steps to ensure they have sufficient and current KYC information for clients, including their investment needs and objectives, financial circumstances and risk tolerance. Also, EMDs are required under section 13.3 of NI 31-103 to take reasonable steps to ensure that all securities recommended to clients are suitable. To meet this suitability obligation, EMDs should also understand the structure and features of each investment product they recommend, including features such as costs, risks and eligibility requirements.

The KYC and suitability requirements are a critical element in protecting investors. An EMD's failure to comply with these requirements is taken very seriously. Two recent examples of regulatory proceedings that illustrate the potential consequences of an EMD's failure to comply with these requirements include *Re Blueport and Hare* and *Re Morgan Dragon Development Corp, John Cheong, and Herman Tse*.

Suggested practices

EMDs and their registered individuals should

- have a process in place to collect and document sufficient KYC information for each client (for example by using a standard KYC form) so they can properly assess the suitability of investment products they recommend;
- have clients sign-off on their completed KYC forms;
- have an in-depth understanding of
  - the general features and structure of the product,
  - the product risks including the risk/return profile and liquidity risks,
  - the management and financial condition of the issuer,
  - the intended use of investor proceeds,
  - costs, and
  - any eligibility requirements for each product

  before recommending a product to clients;
- perform adequate due diligence of products before recommending them to clients;
- perform ongoing due diligence of the issuers and products to assess changes to their structure or features and determine the impact on their clients' investments;
- develop and use documented criteria and guidelines for assessing the suitability of investment recommendations to clients; and
- have a trade review process in place that includes having a proficient individual in a supervisory capacity to review and approve the suitability assessments made by dealing representatives that recommend investment products to clients.

EMDs should also refer to CSA Staff Notice 33-315 *Suitability Obligation and Know Your Product* for additional guidance.

Inappropriate use of investor monies

We continue to be concerned about EMDs using investor proceeds for their related or connected issuers for purposes other than those set out in the offering documents provided to investors. We will take regulatory action when we identify evidence of inappropriate use of investor monies. See, for example, the Statement of Allegations for *Re Colby Cooper Capital Inc.*

Section 2.1 of OSC Rule 31-505 requires EMDs to deal fairly, honestly and in good faith with their clients. We expect EMDs to apply this principle to all areas of their activities, including handling of client monies in accordance with the use of proceeds disclosed to investors.

Suggested practices

EMDs should:

- provide clear and adequate disclosure to investors regarding the use of investor proceeds,
- have policies in place to ensure investor monies are used in accordance with the stated investment objectives, and
- disclose any related parties and appropriately deal with existing or potential conflicts of interest, including fees and payments to related parties.

Inadequate supervision of dealing representatives

We continue to see that some EMDs are not adequately supervising their dealing representatives, especially when representatives are working in different locations from their supervisor. Among our concerns are that dealing representatives, who are the primary contact for investors, are not being adequately trained in relevant securities law obligations, on their sponsoring firm's policies and procedures, and on the investment products that they are recommending. Further, we have concerns that some EMDs are sponsoring dealing representatives solely for the purpose of distributing securities of a particular issuer and are "renting out" their firms' registration, rather than providing the necessary training and required supervision.

We remind EMDs of their ongoing obligation to monitor and supervise their registered individuals in an effective manner. Supervision of dealing representatives should be performed by an individual who has adequate training, knowledge and authority. EMDs should establish and maintain procedures for supervising their dealing representatives, and maintain evidence of their supervisory reviews.

Section 32(2) of the Act requires registrants to establish and maintain systems of control and supervision for controlling their activities and supervising their representatives. Also, section 11.1 of 31-103CP, under the heading "Day-to-day supervision", states that anyone who supervises registered individuals has a responsibility on behalf of the firm to take all reasonable measures to ensure that each of these individuals

- deals fairly, honestly and in good faith with their clients,
- complies with securities legislation,
- complies with the firm's policies and procedures, and
- maintains an appropriate level of proficiency.

Section 3.4 of NI 31-103 requires that a registered individual must not perform an activity that requires registration unless the individual has the education, training and experience that a reasonable person would consider necessary to perform the activity competently, including understanding the structure, features and risks of each security the individual recommends.

Suggested practices

EMDs should provide ongoing training for their dealing representatives so that they

- are aware of the securities law requirements impacting their activities,
- understand and comply with their sponsoring firm's policies and procedures,
- have an in-depth understanding of the products they recommend to clients, and
- are informed of any changes to the above on a timely basis.

EMDs should develop written policies and procedures to supervise the activities of their dealing representatives, including

- the activities to be supervised and by whom,
- the frequency of supervision, and
- how the supervision will be evidenced and enforced by the firm.

Not disclosing outside business activities

We continue to note that many EMDs do not disclose to clients, or provide notice to the Commission, of their OBAs. These include

- acting as an officer, director or in an equivalent position for a company other than their registered firm, and
- employment with a company other than their registered firm.

EMDs must disclose existing and potential material conflicts of interest to investors in accordance with section 13.4(3) of NI 31-103.

EMDs must also notify the Commission of OBAs. Section 4.1(1)(b) of NI 33-109 requires a registered or permitted individual to notify the Commission of changes to information previously submitted in a Form 33-109F4 *Registration of Individuals and Review of Permitted Individuals* (Form 33-109F4), within 10 days of the change, including the information in item 10 of Form 33-109F4. Item 10 requires a list and description of all current business and employment activities, including all business-related officer or director or equivalent positions.

For additional guidance on a registrant's obligation to disclose all OBAs, see CSA Staff Notice 31-326 *Outside Business Activities*. Failure to comply can result in the firm incurring significant late fees for failing to meet the filing deadlines set out in NI 33-109. See section 4.2 of the report for more information on late filings.

Suggested practices

EMDs and their registered individuals should confirm that they:

- have policies and procedures in place that requires all registered individuals to disclose new OBAs to the OSC and deal with any potential conflicts of interest, and
- provide clients with clear, adequate and timely disclosure of OBAs.

5.2.2 New and proposed rules impacting EMDs

Review of prospectus exemptions

See section 1.4 of this report for a discussion on the review of prospectus exemptions.

Broker-dealer registration in the EMD category

See section 4.1.2 of this report for a discussion on registration and oversight of foreign broker-dealers registered as EMDs.

Electronic report of exempt distribution on Form 45-106F1

On June 21, 2012, we published OSC Staff Notice 45-708 *Introduction of Electronic Report of Exempt Distribution on Form 45-106F1* to notify issuers, underwriters and their professional advisers that an electronic version (the E-form) of Form 45-106F1 *Report of Exempt Distribution* is being made available on the OSC's website. Issuers and underwriters are required to prepare and file a report of exempt distribution in connection with certain prospectus exemptions (including the accredited investor exemption under NI 45-106) on Form 45-106F1 (the Report). Filers may prepare and file the Report using the E-form, instead of in a paper format.

At this time, filing the Report electronically is voluntary, although we anticipate moving towards mandatory electronic filings in the future. Until this time, filers may continue to prepare and file the paper version of the Report. However, we encourage filers to use the E-form whenever possible, as we anticipate that it will be faster and more efficient.

To provide guidance for preparing and filing the Report, the CSA published *CSA Staff Notice 45-308 Guidance for Preparing and Filing Reports of Exempt Distribution*. We also separately published OSC Staff Notice 45-709 *Tips for Filing Reports of Exempt Distribution* which provides tips to help filers avoid common deficiencies in completing and filing the Report.

5.3 Scholarship plan dealers

This section contains information specific to SPDs, including the results of our review of SPDs, and new and proposed rules impacting SPDs.

5.3.1 Review of SPDs

We recently conducted compliance reviews of all five firms registered solely as SPDs. SPDs may act as a dealer in securities of scholarship plans, education plans or educational trusts (collectively referred to as education savings plan products or ESP products in this section). We have performed several reviews of SPDs in past years, both on our own and jointly with other CSA members. During past years' reviews, we identified a number of significant deficiencies at certain firms, including failings with respect to their

- compliance structure
- KYC and suitability of investments
- dealing representatives' knowledge of ESP products sold to investors
- supervision of branch locations and dealing representatives
- marketing and sales practices, and
- conflicts of interest.

As part of this year's reviews, we performed an on-site review at each SPD's head office, visited a sample of 25 branch offices in Ontario, and interviewed over 70 dealing representatives.

We found that some of the issues identified in previous reviews continued to be a problem. In many instances, we identified issues which had been brought to the attention of SPDs in previous reviews. Key areas of concern from our recent reviews included

- CCO and UDP not adequately performing their responsibilities;
- failure to meet KYC and suitability requirements;
- failure to meet KYP obligations;
- use of misleading marketing materials;
- use of high-pressure sales tactics to enroll investors in an ESP product; and

- inadequate oversight of branches and dealing representatives, including
  - inadequate trade review of enrolment applications for ESP products,
  - inconsistent or inadequate training of dealing representatives, and
  - failure to identify and rectify compliance issues at the branch level.

Outcome of recent SPD compliance reviews

We referred four SPD firms to our Enforcement Branch after identifying serious concerns with sales practices during the compliance reviews of these firms. To address investor protection concerns and, in particular, concerns on the suitability of specific ESP products recommended to investors, interim terms and conditions were imposed on consent on the registrations of these four SPDs. The terms and conditions vary, but require each of these SPDs to

- retain an OSC-approved independent consultant to develop and implement a compliance enhancement plan (Compliance Plan);
- retain an OSC-approved independent monitor to review new clients, including calling certain clients to confirm accuracy of their KYC information, confirm that the ESP product is suitable and affordable, confirm that the investor understands the ESP product's fees, and unwind any unsuitable investments, until the Compliance Plan has been approved;
- require the monitor to provide regular reports and have an ongoing role during the implementation of the Compliance Plan; and
- not open any new branch locations or hire any new dealing representatives (unless replacing an existing dealing representative and certain conditions are met) until the Compliance Plan has been fully implemented.

For more information, see the interim orders for Children's Education Funds Inc., Global RESP Corporation, Heritage Education Funds Inc., and Knowledge First Financial Inc.

5.3.2 New and proposed rules impacting SPDs

Cost disclosure, performance reporting and client statements

As discussed in section 1.1 of this report, the CSA has recently published proposed rules on cost disclosure, performance reporting and client statements. The proposals will apply to SPDs, and have been tailored to recognize the unique features of ESP products that merit different disclosure and reporting requirements.

The proposals aim to provide investors with information relevant to investments in ESP products, including a specific discussion at the account-opening stage of the consequences to the client of (i) the client failing to maintain prescribed plan payments, or (ii) a beneficiary not participating in or completing a qualifying educational program.

Further, the proposal will require that an annual report be sent to clients that provides information on charges and other compensation, including information about any outstanding front-loaded fees.

Lastly, the proposal will require an investment performance report to be provided to clients that provides relevant information on their ESP product including

- how much has been invested,
- how much would be returned if the client stopped paying into the plan, and
- a reasonable projection of the income the client should expect to see if they stay invested to maturity and their designated beneficiary attends a designated educational institution.

For more information, see Proposed Amendments to NI 31-103 on *Cost Disclosure, Performance Reporting and Client Statements*.

5.4 Advisers (portfolio managers)

This section contains information specific to PMs, including current trends in deficiencies and suggested practices to address them. We also discuss our desk review of the client account statement practices of PMs, and new and proposed rules impacting PMs.

5.4.1 Current trends in deficiencies and suggested practices

Unfair allocation of investment opportunities

In a small number of cases, PMs are not fairly allocating investment opportunities to their clients. When a PM places an investment order to a dealer for more than one of its clients (a bunched or blocked trade), and the order is partially filled (such as for a new issue or illiquid security), some PMs allocate these securities to clients with a smaller portfolio size, or to clients whose portfolios are underperforming. We do not consider these to be fair allocation practices, as they favour certain clients based on their asset size or performance, to the disadvantage of others. Examples of other unfair allocation practices include allocations (i) based on compensation arrangements, such as favouring clients that pay performance fees, (ii) based on client types, such as favouring investment funds over private clients, (iii) to newer accounts over older accounts or vice versa,

(iv) based on client relationships or to obtain future business, and (v) to proprietary, employee or personal accounts over third-party accounts.

Since it may not be possible to treat clients equally for every investment opportunity, we acknowledge that there may be trades where one client or group of clients is allocated investments and not others. But over time, PMs should allocate suitable investment opportunities to their clients using a systematic and fair process, and not consistently favour one client or group of clients over others. Further, PMs do not meet their obligations to fairly allocate investment opportunities to clients through disclosure of an unfair allocation practice.

Section 14.10 of NI 31-103 requires advisers to ensure fairness in allocating investment opportunities among their clients. Section 11.1 of NI 31-103 requires advisers to establish, maintain and apply policies and procedures that establish a system of controls and supervision sufficient to provide reasonable assurance that they comply with securities legislation, including a policy to ensure fairness in allocating investment opportunities (Fairness Policy). Section 14.3 of NI 31-103 requires advisers to deliver a summary of the Fairness Policy to their clients when they open an account for the client and when there has been a significant change to the summary previously delivered.

Suggested practices

- An adviser's Fairness Policy should, at a minimum, disclose the method used to allocate the following:
  - price and commission among client orders when trades are bunched or blocked (such as average price per share and average commission rate per share),
  - block trades and initial public offerings (IPOs) among client accounts, and
  - block trades and IPOs among client orders that are partially filled, such as on a pro-rata basis. (A pro-rata allocation is when clients are allocated an amount of securities in proportion to their account size or the original trade order.)
- A Fairness Policy should also address any other situation where investment opportunities must be allocated (such as how private placements will be handled).
- A Fairness Policy should be sufficiently objective and specific to permit independent verification of the fairness of the allocation. A Fairness Policy that states that an adviser "uses judgment" to allocate investments does not meet this test.

- Advisers should use the pro-rata allocation method for partially filled trades. When this method is not practical (for example, if it would result in clients being allocated a very small number of shares), use another pre-determined formula that is fair and objective, such as a rotational allocation (when the adviser regularly changes the sequence in which orders are allocated to clients) or a statistically random allocation (when each client is given an equal chance to participate).

- Advisers should not allocate partially filled trades to proprietary, employee or personal accounts until all other accounts are completely filled.

- Any exceptions to the firm's Fairness Policy should be approved by the adviser's CCO and reasons for the exception should be documented.

Not reflecting all revenue for capital market activities

Some PMs are not reflecting all of the revenue earned from their portfolio management services on their firm's financial statements and on the form that is used to calculate their Ontario capital markets participation fees (Form 13-502F4) to the OSC. We are concerned that these firms' financial statements may not be accurate since revenues are not fully reflected and that they may not be paying the full amount of their fees.

We found that an Ontario-based PM earned performance fees from an associated investment fund that was attributable to its portfolio management services, but did not reflect these performance fees as revenue on its financial statements or as revenue on its Form 13-502F4. Further, another Ontario-based PM entered into an arrangement with its parent company so that all of the portfolio management fees earned by the PM firm were reflected as revenue on the financial statements of the parent company, rather than the PM firm. As part of the arrangement, the PM firm was then attributed revenue by the parent company that was based on recovery of costs plus a mark-up. The PM firm reflected this attributed amount as its revenue on its financial statements and as revenue on its Form 13-502F4.

Section 3.1 of OSC Rule 13-502 *Fees* (OSC Rule 13-502) requires PMs and other registered firms, unregistered IFMs, and unregistered exempt international firms to pay capital markets participation fees (as outlined in Appendix B of OSC Rule 13-502) to the OSC each year based on their specified Ontario revenues calculated in accordance with sections 3.3, 3.4 or 3.5 of OSC Rule 13-502.

The specified Ontario revenues must include all actual revenues from the firm's capital markets activities in Ontario, subject to certain deductions permitted on Form 13-502F4. Capital markets activities are activities for which registration under the Act or an exemption from registration is required. These include providing securities-related advice or portfolio management services.

Firms that have not appropriately reflected and paid their capital markets participation fees are subject to payment of the overdue fees along with late fees, and may also be subject to other regulatory action.

Further, market participants (which include registrants) must properly reflect all of their revenues on their financial statements in order to comply with their record-keeping obligations under section 19(1) of the Act.

This deficiency applies not only to PMs, but also to other registered firms, unregistered IFMs and unregistered exempt international firms.

Suggested practices

Registered firms, unregistered IFMs, and unregistered exempt international firms should

- assess which revenues of the firm are derived from Ontario capital markets activities, and
- have a process in place to ensure that all the firm's revenues from their Ontario capital markets activities are reflected on its financial statements and Form 13-502F4.

Use of consolidated account statements

Some PMs provide clients with "consolidated" account statements which combine the security holdings and/or transaction information for more than one account they manage for a client in a single summary statement. These PMs generally consolidate different types of accounts managed for one client (for example, taxable and tax-deferred accounts), along with accounts managed for client relationships, such as family accounts (for example, spouses and dependants) or accounts of affiliated parties.

We have concerns when PMs provide consolidated statements to clients, especially when the PM does not also provide them with a statement for each account that they manage for the client. Clients may not understand the information they are receiving, the grouping of accounts may be inappropriate or cause privacy concerns, and it may be difficult for clients to compare information from the PM with information on statements from their custodian (which is presented on an account-by-account basis).

PMs must deliver a statement for each account that they manage for their client to meet their account statement requirements in section 14.14(3) of NI 31-103. It may be appropriate for PMs to provide consolidated statements to a client when it is provided as supplementary information to the client's statements for each account managed by the PM. We recognize that consolidated statements can provide added value for clients by presenting a complete, summarized picture of a client's portfolio. If a PM provides clients with a consolidated statement as supplementary information, whether initiated by the PM or upon request of the client, they should consider the suggested practices below.

Suggested practices

A PM should only deliver a consolidated account statement to a client when

- it helps clients to better understand their overall investment portfolios managed by the PM;
- the accounts that are included in the consolidation are for an appropriate client relationship (which may be one or more persons) and have similar investment goals and objectives. For example, it may be appropriate to group accounts for spouses whose goals and objectives are saving for retirement, and exclude an account whose objective is to fund their child's education; and
- the client consents to, or requests, the delivery of a consolidated statement.

If the above criteria are met, the PM should provide adequate disclosure on the consolidated statement, such as

- a prominent heading on the statement noting that it is a "consolidated" statement (or another appropriate term, such as "summary" or "combined" statement), and then explain the term used and what information is being presented;
- the account numbers and the beneficial owner(s) for the accounts that were included in the "consolidated" statement;
- which entity holds the assets in the client's accounts; and
- a statement that clients should refer to their "account-by-account" statements to see their holdings and transactions for each account.

Lack of awareness of trade-matching requirements

A number of PMs were not aware of the institutional trade-matching (ITM) requirements in National Instrument 24-101 *Institutional Trade Matching and Settlement* (NI 24-101). As a result, they were not meeting the rule's ITM requirements. The ITM requirements apply to a PM who places a DAP/RAP trade (defined below) in an equity or debt security with a dealer for one or more of its clients with DAP/RAP trading privileges. Clients with DAP/RAP trading privileges typically include institutional clients such as investment funds and pension plans, but may also include clients that are individuals.

Under NI 24-101, a DAP/RAP trade is a trade that is:

(a) executed for a client trading account that permits settlement on a delivery against payment or receipt against payment basis through the facilities of a clearing agency (such as CDS), and

(b) for which settlement is made on behalf of the client by a custodian other than the dealer that executed the trade.[6]

Section 3.3(1) of NI 24-101 prohibits an adviser from giving an order to a dealer to execute a DAP/RAP trade on behalf of an institutional investor[7] unless they first establish, maintain and enforce policies and procedures designed to achieve matching as soon as practical after the trade is executed, but by no later than noon (Eastern Time) on the next business day following the trade date (T+1).

Section 3.4 of NI 24-101 requires advisers to have ITM policies and procedures in place to encourage each of their trade-matching parties (i.e., the dealers and custodians involved in processing trades executed with or on behalf of institutional investors) to enter into a *trade-matching agreement* with, or provide a *trade-matching statement* to, the adviser. This must generally be done before the adviser opens an account to execute a DAP/RAP trade for the account of an institutional investor or gives an order to a dealer to execute a DAP/RAP trade for the account of an institutional investor. Dealers have similar ITM requirements in section 3.2 of NI 24-101, so will also request trade-matching agreements or statements from PMs that are their trade-matching parties.

Section 4.1 of NI 24-101 is an exception reporting requirement. Advisers are required to deliver Form 24-101F1 *Registered Firm Exception Report of DAP/RAP Trade Reporting and Matching* to their principal regulator (via an on-line reporting tool on the CSA's website) no later than 45 days

[6] See the definition "DAP/RAP trade" in section 1.1 of NI 24-101.

[7] Section 1.1 of NI 24-101 defines an institutional investor to mean a client of a dealer that has been granted DAP/RAP trading privileges by the dealer.

after each calendar quarter-end if less than 90% of the equity or debt DAP/RAP trades executed for the adviser during the quarter are not matched by noon on T+1. The 90% test is determined both by number of trades and the aggregate dollar value of the securities purchased and sold in those trades. The percentage is also determined for transactions in equity and debt securities separately. On the exception report, advisers must provide a brief explanation as to why they did not meet the thresholds, and discuss their steps to address the delays.

Suggested practices

Determine if NI 24-101 applies to your firm by assessing if you give orders to a dealer to execute a DAP/RAP trade on behalf of an institutional investor.

If NI 24-101 applies, then

- Develop written ITM policies and procedures to ensure trades are matched as soon as practical after trades are executed (but by no later than noon on T+1). See the guidance on trade-matching policies and procedures in section 2.4 of the Companion Policy to NI 24-101 and section C of CSA Staff Notice 24-305 *Frequently Asked Questions About NI 24-101,*
- Determine who your trade-matching parties are (in order to exchange trade-matching statements or enter into trade-matching agreements),
- If you are unable to obtain a trade-matching agreement or statement from a trade-matching party, document your efforts to obtain this documentation in accordance with your policies and procedures (see section D of CSA Staff Notice 24-305), and
- At least quarterly, monitor your firm's trade-matching statistics to assess if your ITM policies and procedures are effective and to determine if you have to file an exception report. Where useful, you should be able to obtain trade-matching performance reports from your clients' custodians.

For more guidance, see the Companion Policy to NI 24-101 and CSA Staff Notice 24-305 for answers to frequently asked questions about NI 24-101. For guidance on filing an exception report on the CSA's website, see CSA Staff Notice 24-306.

5.4.2 PM client account statement practices

In last year's report, we discussed our in-progress desk review of the client account statement practices of a sample of Ontario-based PMs. The purpose of the review was to better understand their practices and to assess if further guidance was needed to help firms comply with their requirements. We have now completed our desk review, and this is what we found:

- About 33% of the PMs in our sample did not deliver account statements to their clients. Many of these firms do not send a statement because the clients' custodian sends a statement with the required information at the required times.
- Of the PMs that deliver quarterly account statements to their clients, about 30% do not disclose information on security transactions made for clients.

These findings indicate that many PMs are not in compliance with their client account statement obligations. Section 14.14(3) of NI 31-103 states that "Except if the client has otherwise directed, a registered adviser must deliver a statement to a client at least once every 3 months." Further, sections 14.14(4) and (5) require that the statements must include prescribed information on transactions made for each client during the period and prescribed information on security holdings in the client's account.

We also found that there are different views amongst PMs on what the term "Except if the client has otherwise directed" in section 14.14(3) of NI 31-103 means. Staff's view is that the client may request statements more frequently than once every 3 months. It does not mean that the client can consent to not receiving a statement at all from their adviser. To clarify this, proposed changes to section 14.14(3) have been made as part of the CRM2 proposals discussed in section 1.1 of this report. The proposed text clarifies that an adviser must deliver an account statement at least once every 3 months, unless the client requests monthly statements. For more information on potential changes to client account statement requirements as part of the CRM2 proposals, see Proposed Amendments to NI 31-103 on *Cost Disclosure, Performance Reporting and Client Statements*.

We are currently discussing with the CSA the client account statement obligations of PMs. This may result in us providing further guidance on these obligations in the future.

For information and suggested practices on the use of consolidated account statements, see section 5.4.1 of this report.

5.4.3 New and proposed rules impacting PMs

Update on direct electronic access (DEA)

In last year's report, we discussed proposed National Instrument 23-103 (then titled *Electronic Trading and Direct Electronic Access to Marketplaces*), which was relevant for PMs and EMDs who used DEA to directly send trade orders to marketplaces. The proposed rule permitted PMs to use DEA when it was provided by a participant dealer[8] for trading in their own accounts or the accounts of their clients. It was further proposed that the participant dealers that provided DEA to PMs would be subject to additional requirements including

- standards to be applied before granting DEA to a PM,
- specific elements to be included in a written agreement with the PM,
- training the PM, and
- assigning a unique identifier to each PM for each of their orders.

Since then, in June 2012, the CSA announced that the rules governing electronic trading in NI 23-103 (since re-titled as *Electronic Trading*) would be adopted[9] other than the requirements on the provision of DEA (as described above). The CSA decided that other forms of marketplace access, such as order execution service accounts and dealer-to-dealer routing, raise similar risks to DEA, and should be subject to similar requirements. To address these issues, the CSA published for comment on October 25, 2012 new proposed rules to provide a framework for the provision of DEA.

For more information, see Proposed Amendments to NI 23-103 *Electronic Trading*.

Potential regulation of proxy advisory firms

Most PMs have been authorized by their clients to vote proxies for securities held in their managed accounts. When PMs have this authority, we generally expect them to vote the proxies using guidelines that form part of their written policies and procedures, and to be able to justify the manner in which all proxies are voted.

PMs are increasingly engaging proxy advisory firms to analyze client proxies and to make recommendations on how to vote them, which they use to help formulate their voting decisions for clients.

8 A participant dealer is a marketplace participant that is a registered investment dealer and an IIROC member.
9 This rule sets out a regulatory framework to help ensure that marketplace participants and marketplaces manage the risks associated with electronic trading.

The increased use of and reliance on proxy advisory firms' recommendations by institutional investors (including PMs) has raised concerns, including a lack of transparency on how proxy advisory firms reach their voting recommendations, and how they address any conflicts of interest. As such, in June 2012, the CSA published for comment a consultation paper on the potential regulation of proxy advisory firms. The purpose of regulation would be to increase the accountability of proxy advisory firms and to make the process leading to vote recommendations more transparent.

For more information, see CSA Consultation Paper 25-401 *Potential Regulation of Proxy Advisory Firms*.

5.5 Investment fund managers

This section contains information specific to registered IFMs, including current trends in deficiencies and suggested practices to address them, new and proposed rules and initiatives, and IFM resources.

5.5.1 Current trends in deficiencies and suggested practices

Insufficient oversight of outsourced functions and service providers

Many IFMs choose to outsource aspects of their IFM operations (such as fund accounting and unitholder recordkeeping) to third-party service providers. Some IFMs rely solely on the third-party service provider and do not perform any oversight to ensure that these service providers are fulfilling their duties and responsibilities. As a result, these IFMs are not satisfactorily discharging their obligations to comply with applicable securities legislation.

Section 11.1 of NI 31-103 requires IFMs to establish a system of controls and supervision to ensure compliance with securities legislation and to manage their business risks in accordance with prudent business practices. Part 11 of 31-103CP, under the heading "General business practices – outsourcing", states that registrants that outsource aspects of their business operations to third-party service providers are responsible and accountable for all functions that have been outsourced. An IFM is required to oversee its service providers in order to meet its obligation of being responsible and accountable for the work performed by the service providers.

Suggested practices

IFMs should

- establish and implement policies and procedures to actively monitor the work of service providers,
- review the work performed by service providers; for example, by reviewing reports for the calculation of net asset value,
- conduct oversight of service providers on a frequent and as appropriate basis, taking into account the IFM's business operations, and
- ensure the monitoring of service providers is adequately documented.

Improper valuation of restricted securities

A number of investment funds invest in securities that are restricted from resale for a specified period of time. Some IFMs have been valuing these restricted securities using a quote from an active market for publicly listed securities of the same issuer that do not have a resale restriction.

An investment fund is required by section 2.6 of National Instrument 81-106 *Investment Fund Continuous Disclosure* (NI 81-106) to prepare its financial statements using generally accepted accounting principles which requires all securities to be valued using a fair value. Further, section 14.2 of NI 81-106 requires the net asset value of an investment fund that is a reporting issuer to be calculated using the fair value of the investment fund's assets and liabilities. A quoted price in an active market does not reflect the fact that a restricted security is illiquid for a specific period of time.

Suggested practices

IFMs should

- develop a valuation policy to determine the fair value of a restricted security, and
- if a quote from an active market is used to value a restricted security, the valuation policy should consider applying a discount to the value of the security to reflect the illiquid nature of the security during the restricted time period.

Inappropriate expenses charged to funds

In last year's report, we highlighted our concern that some IFMs are charging inappropriate expenses to the investment funds that they manage. Since we continued to identify this practice during this year's reviews, we emphasize this deficiency again. When this issue is identified, we require the IFM to reimburse the applicable fund(s) for the inappropriate expenses, and depending on the nature of the inappropriate expenses, we may take further action.

IFMs should only charge expenses to their investment funds that are related to the operation of the investment funds. Some IFMs are allocating to their investment funds expenses that are related to the operation of the IFMs' business and not the investment funds. Some examples of such inappropriately allocated expenses, which we identified when conducting compliance reviews, include capital market participation fees, premiums on their bonding or insurance, expenses relating to the wholesaling activities of the IFM, and expenses relating to social events and holiday parties.

If proposed requirements discussed at section 1.1 *Cost disclosure, performance reporting and client statements* are implemented, they would require IFMs to provide information to dealers and advisers of the dollar amount of the trailing commissions paid to dealers and advisers in respect of their client's investment. Consistent with the principle above, we would expect that compliance with this new requirement would be a business expense of the IFM relating to its choice of distribution method, and not an expense attributable to the operation of the investment funds.

Section 116 of the Act imposes a standard of care on IFMs for the investment funds they manage. In our view, to meet this standard of care, IFMs should ensure that the investment funds they manage are only paying for expenses that are related to the operation of the investment funds. The expenses listed above are related to the operation of the IFM. We consider these expenses to be the cost of running a fund management business and should therefore be borne by the IFM, and not their investment funds.

Suggested practices

An IFM should

- establish policies and procedures and a system of controls to ensure that its investment funds are only paying for expenses that are related to the operation of the investment funds, and
- review expense allocations on a regular basis to ensure that only appropriate expenses are charged to and paid by its investment funds.

Inadequate insurance coverage

Some IFMs are not maintaining adequate insurance when their assets under management increase during the year. Furthermore, some IFMs did not maintain insurance that provides for a "double aggregate limit" or "full reinstatement of coverage".

IFMs must maintain adequate levels of bonding or insurance as required under section 12.5 of NI 31-103. The amount of insurance required is based on calculations that take into account various factors, including assets under management. IFMs should take into account likely increases in their assets under management when assessing the level of insurance coverage they require.

IFMs should also ensure that their bonding or insurance provides for a "double aggregate limit" or a "full reinstatement of coverage" as explained under Division 2 – Insurance of Part 12 of 31-103CP.

Suggested practices

To ensure adequate insurance coverage, IFMs should

- factor in any likely increase in their assets under management, and
- regularly review the adequacy of their insurance coverage, especially when there is a material change in their business or circumstances.

Misleading marketing practices

Many IFMs are preparing marketing materials for investors with information about their investment funds that is outdated, misleading, or contain unsubstantiated claims. For example, some IFMs use terms such as "best", "exceptional" or "leading" to describe their services or the performance of their investment funds without also including disclosure containing evidence to support using these claims. Some IFMs are also comparing an investment fund's performance against the returns of benchmarks that are not comparable to the fund's investment strategy, without any explanation on why the comparison is relevant.

Section 116 of the Act imposes a standard of care on IFMs for the investment funds they manage. In our view, to meet this standard of care, IFMs should ensure that the marketing materials for their investment funds are fair and not misleading. Also, part 15 of National Instrument 81-102 *Mutual Funds* provides requirements on sales communications for mutual funds.

CSA Staff Notice 31-325 *Marketing Practices of Portfolio Managers* provides guidance to PMs to help them comply with securities legislation and best practices in the preparation and use of marketing materials. This guidance is applicable to other registrants, including IFMs.

Suggested practices

IFMs should:

- provide clear and adequate disclosure in marketing materials to ensure that the information is complete, accurate and meaningful;
- substantiate all claims made in marketing materials (adequate references to the information supporting the claim should be provided where the claim is made in the marketing material so that investors can easily assess the merits of the claim);
- review and update marketing materials regularly to ensure all information is complete, accurate and current;
- use benchmarks that are relevant and comparable to an investment fund's investment strategy; and
- if a non-comparable benchmark is used but is relevant since it is widely known and followed, disclose the relevance of the benchmark and the differences between the benchmark and the fund's investment strategy.

5.5.2 New and proposed rules and initiatives impacting IFMs

Registration of non-resident IFMs

For information on the new registration requirements for non-resident IFMs, see section 4.1.1 of this report.

Information on International Financial Reporting Standards (IFRS)

In March 2012, the CSA updated IFMs on the deferral of the mandatory changeover date to IFRS for investment funds in Canada to January 1, 2014. For more information, see CSA Staff Notice 81-320 (Revised) *Update on International Financial Reporting Standards for Investment Funds*.

Investment fund initiatives

The OSC, led by staff from the Investment Funds Branch, is working on a number of initiatives with the CSA that are applicable to IFMs. Some of the key initiatives are described below.

Investment funds modernization project

The purpose of this project is to modernize the product regulation of publicly offered investment funds.

Phase 1 of the modernization project was completed with the publication of final amendments to NI 81-102 on February 9, 2012. For more information, see Notice of Amendments to NI 81-102 *Mutual Funds* and Companion Policy 81-102CP.

As part of phase 2 of this project, the CSA is now working on amendments to NI 81-102 that would implement certain key restrictions and operational requirements for non-redeemable investment funds (also referred to as "closed-end funds"), consistent with similar requirements for mutual funds. For more information, see CSA Staff Notice 81-322 *Status Report on the Implementation of the Modernization of Investment Fund Product Regulation Project.*

Point of sale disclosure

On June 21, 2012, the CSA published for second comment changes to the proposed amendments to National Instrument 81-101 *Mutual Fund Prospectus Disclosure* aimed at implementing stage 2 of the point of sale initiative, to allow for the delivery of the Fund Facts document to satisfy the legislative requirement to deliver a prospectus within two days of buying a mutual fund. The proposed changes focus primarily on the presentation of risk in the Fund Facts document. The comment period ended on September 6, 2012.

For more information, see Implementation of Stage 2 of Point of Sale Disclosure for Mutual Funds.

New prospectus form for scholarship plans

Amendments to National Instrument 41-101 *General Prospectus Requirements* have been proposed to create a new, tailored prospectus form for scholarship plans. The proposed amendments were republished for a second comment period in late 2011 and reflect changes made as a result of comments received by the CSA after the initial publication in 2010.

For more information, see New Prospectus Form for Scholarship Plans.

5.5.3 Investment fund manager resources

Published guidance for IFMs

Various organizations publish industry guidance as suggested "best practices" for IFMs. These organizations include the Investment Funds Institute of Canada, the Alternative Investment Management Association and the Hedge Fund Standards Board. We encourage IFMs to review the guidance prepared by these organizations and assess the applicability of this guidance to the operations of their investment funds.

The Investment Funds Practitioner

The Practitioner is an ongoing publication prepared by the OSC's Investment Funds Branch that provides an overview of operational issues arising from applications for discretionary relief, prospectuses, and continuous disclosure documents that are filed with the OSC. It is intended to assist IFMs and their staff or advisers who regularly prepare public disclosure documents and applications for exemptive relief on behalf of investment funds.

The Practitioner is also intended to make IFMs more broadly aware of some of the issues the Investment Funds Branch has raised in connection with their review of documents filed with them and how these issues have been resolved. The Practitioner is intended to serve as a useful resource when preparing applications and disclosure documents.

Past editions of The Practitioner can be accessed on our website under Information for: Investment Funds.

Disclosure of portfolio holdings

The Investment Funds Branch published in August 2012 a staff notice outlining its findings and recommendations from its targeted review of the disclosure of portfolio holdings in financial statements, Management Reports of Fund Performance, and Fund Facts documents of investment funds.

For more information, see OSC Staff Notice 81-717 *Report on Staff's Continuous Disclosure Review of Portfolio Holdings by Investment Funds*.

More information for IFMs

In addition to the initiatives and resources summarized in this report, the Investment Funds Branch has also published a number of documents as guidance for IFMs. For a complete listing of available information, see the Information for: Investment Funds section of the OSC's website.

6. Additional resources

6. Additional resources

This section discusses how registrants can get more information about their obligations.

The CRR Branch works to foster a culture of compliance through outreach and other initiatives. We try to assist registrants in meeting their regulatory requirements in a number of ways.

We encourage registrants to visit the OSC's website at www.osc.gov.on.ca for more information regarding their obligations. The Information for Dealers, Advisers and Investment Fund Managers section provides firms and individuals with detailed information about the registration process and their ongoing obligations. It also includes information about compliance reviews and suggested practices, provides quick links to forms, rules and past reports and email blasts to registrants.

Registrants may also contact us. Please see Appendix B to this report for the CRR Branch's contact information. The CRR Branch's portfolio manager, investment fund manager and dealer teams focus on registration, oversight, policy changes, and exemption applications for their respective registration categories. The Registrant Conduct and Risk Analysis team supports the other teams in cases of potential registrant misconduct and reviews registrant submissions regarding financial reporting.

We also have an Investors section on our website that provides information to help investors. For example, investors can learn more about investing (such as the risks of borrowing to invest), help protect themselves against fraud and use tools and resources (such as checking the registration status of a person or company).

Appendix A – Explanation of compliance review outcomes

- **Enhanced compliance**: At the end of a review, we usually issue a report to the firm identifying areas of non-compliance that require corrective action. We work with the firm to facilitate the appropriate resolution of deficiencies. Compliance field reviews generally result in enhanced compliance at these firms following their actions to address the identified matters and to improve their compliance systems, internal controls, or policies and procedures.

- **Significantly enhanced compliance**: When the seriousness of the deficiencies identified during a review warrants it, in addition to the steps taken in the enhanced compliance outcome, we increase our monitoring of the registrant. For example, we may conduct a follow-up review of a registrant or require the registrant to provide additional evidence to assess whether it has appropriately addressed the identified deficiencies. The increased monitoring and the registrant's actions generally result in significantly enhanced compliance by the firm.

- **Terms and conditions on registration**: We may impose terms and conditions on a firm's registration to more actively monitor how a registrant is complying with securities law. We may also impose terms and conditions requiring a registered firm to take a specific action or to restrict its business activities. For example, terms and conditions may require the firm to submit information (such as financial statements and excess working capital calculations) to us more frequently, retain a consultant to improve its compliance systems, or prohibit the registrant from opening new client accounts.

- **Surrender of registration**: In some cases, a registered firm may decide to surrender its registration during or after a compliance review. However, we will not consent to the firm's surrender of registration unless our compliance review is completed and any significant deficiencies identified from the review (for example, those impacting the firm's clients) have been appropriately addressed.

- **Referral to the Enforcement Branch**: If we identify a serious breach of securities law, we discuss the findings with the Enforcement Branch, and together determine an appropriate course of action.

- **Suspension of registration**. If we identify a serious breach of securities law that causes us to conclude that a registrant's continued fitness for registration is no longer appropriate, CRR Branch staff will recommend to the Director that the firm's registration be suspended. The Director will decide to accept or reject staff's recommendations based on staff's submissions, and the registrant's submissions (when provided) at an opportunity to be heard.

Appendix B

Contact Information for Registrants

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For general questions and complaints, please contact the OSC Inquiries and Contact Centre at 1-877-785-1555 or (416) 593-8314 or inquiries@osc.gov.on.ca

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