

OSC Staff Notice 33-742

→ 2013

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

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# Introduction

## Introduction

This report provides information for registered firms and individuals (registrants) that are directly regulated by the Ontario Securities Commission (OSC). These registrants primarily include:

- exempt market dealers (EMDs)
- scholarship plan dealers (SPDs)
- advisers (portfolio managers or PMs), and
- investment fund managers (IFMs).

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 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.

In this report, we summarize 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 discuss our new registrant outreach program that will help strengthen our communication with registrants on compliance practices. We also provide a summary of some key registrant misconduct cases, explain where registrants can get more information about their obligations, and provide OSC contact information.

This report is a key part of our outreach to registrants. We strongly encourage registrants to thoroughly read and use this report to enhance 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 recommend registrants pro-actively use this report as a self-assessment tool to strengthen their compliance with Ontario securities law, and as appropriate, to make changes to enhance their systems of compliance, internal controls and supervision.<sup>1</sup>

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<sup>1</sup> The content of this report is provided as guidance for information purposes and not as advice. We encourage firms to seek advice from a professional advisor as they conduct their self-assessment and/or implement any changes to address issues raised in the report.



# 1. Key policy initiatives impacting registrants

- 1.1 Cost disclosure, performance reporting and client statements
- 1.2 Potential statutory best interest standard for dealers and advisers
- 1.3 Independent dispute resolution services for registrants
- 1.4 Registration of OTC derivatives market participants
- 1.5 Review of prospectus exemptions
- 1.6 Ongoing amendments to registration requirements, exemptions and ongoing registrant obligations

## 1. Key policy initiatives impacting registrants

### 1.1 Cost disclosure, performance reporting and client statements

Effective July 15, 2013, the Canadian Securities Administrators (CSA) amended National Instrument (NI) 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103), as well as its Companion Policy (31-103CP), implementing new requirements to ensure all investors receive essential information about the costs and performance of their investments. The amendments are relevant to all categories of registered dealer and registered adviser, with some application to IFMs. The amendments are commonly referred to as the “Client Relationship Model - Phase 2” or “CRM2”.

The amendments will be phased-in over three years. Beginning this July, minor clarifications to NI 31-103 took effect, such as enhancements to relationship disclosure information.

Beginning July 15, 2014, registered firms will need to:

- provide pre-trade disclosure of charges; and
- report on compensation from debt securities transactions

Beginning July 15, 2015, the new account statement /additional statement requirements take effect.

These include requirements to provide position cost information and to determine market values using a prescribed methodology.

Beginning July 15, 2016, registered firms will need to:

- provide an annual report on charges and other compensation that shows, in dollars, what the dealer or adviser was paid for the products and services it provided; and
- provide an annual investment performance report that covers
  - deposits into, and withdrawals from, the client’s account;
  - the change in value of the account; and
  - the percentage returns for the previous year; and the previous three, five and ten years.

Additional guidance about implementing the CRM2 requirements can be found in [CSA Staff Notice 31-334 CSA Review of Relationship Disclosure Practices](#) (CSA Staff Notice 31-334) and in an “FAQ” that we expect to publish this fall.

The CSA expects the IIROC and MFDA member rules to be materially harmonized with the CSA’s CRM2 requirements and to be implemented on substantially the same schedule.



For more information, see [CSA Notice of Amendments to NI 31-103 and to 31-103CP \(Cost Disclosure, Performance Reporting and Client Statements\)](#).

## 1.2 Potential statutory 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 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 \(Ontario\)](#) (Act) applies a best interest standard to IFMs in their dealings with the investment funds they manage. 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, although section 2.1 of [OSC Rule 31-505 Conditions of Registration](#) (OSC Rule 31-505) requires dealers and advisers to deal fairly, honestly and in good faith with their clients. While there is no statutory best interest duty for dealers and advisers in Ontario, Canadian courts can find that a given dealer or adviser owes a best interest duty to his or her client depending on the nature of their relationship.

[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](#) was published on October 25, 2012. With the CSA, we are reviewing over ninety comment letters and conducted three roundtable sessions to engage stakeholders on the issues raised in the paper.

Working with the CSA, we plan to publish an update on the consultation findings this fall.

## 1.3 Independent dispute resolution services for registrants

In November 2012, the CSA proposed rule amendments to NI 31-103 that would require all registered dealers and advisers, outside of Québec, to use the Ombudsman for Banking Services and Investments (OBSI) as the common dispute-resolution service for the securities industry. OBSI is an independent, not-for-profit organization with significant experience as a dispute-resolution service. The CSA has reviewed stakeholder comments on the proposal and is considering appropriate next steps.

Except in Québec, the transition period for dealers and advisers that were registered as of September 28, 2009 to make available to their clients independent dispute resolution or mediation services has been extended to the earlier of September 28, 2014 or the implementation of amendments to the requirement. If a firm became registered after September 28, 2009, then this extension does not apply and we expect the firm to immediately comply with the independent dispute resolution requirements.

For more information, see [Proposed Amendments to NI 31-103 on Dispute Resolution Service](#).





We remind all dealers and advisers of their existing requirements in section 13.15 of NI 31-103 to have internal complaint handling policies to ensure that all client complaints are addressed appropriately.

#### 1.4 Registration of OTC derivatives market participants

As part of the CSA's ongoing development of proposals for the regulation of over-the-counter (OTC) derivatives in Canada, the CSA's Derivatives Committee published on April 18, 2013 a consultation paper on the registration and regulation of derivatives market participants.

CSA Consultation Paper 91-407 *Derivatives: Registration* (CSA CP 91-407) proposes three categories of registration as follows:

- Derivatives dealer for persons carrying on the business of trading in derivatives (or holding themselves out as doing so),
- Derivatives adviser for persons carrying on the business of advising others in derivatives (or holding themselves out as doing so), and
- Large derivatives participant for entities (other than derivatives dealers) that have a substantial aggregate derivatives exposure.

The paper recommends that all derivatives registrants be subject to requirements on:

- Proficiency,
- Financial condition and solvency,
- Compliance systems and internal business conduct,
- Honest dealing, and
- Holding of client and counterparty assets.

In addition, the paper also recommends that derivatives dealers and advisers be subject to:

- Gatekeeper obligations (to ensure market integrity and to assess counterparty risks), and
- Business conduct requirements, including know your client (KYC) and suitability obligations, addressing conflicts of interest, and fair dealing obligations.

The paper also proposes exemptions from regulatory requirements (but not registration) for persons subject to equivalent requirements, and also exemptions from registration (such as for derivatives dealers that provide incidental advice from also having to also register as derivatives advisers).

The CSA is reviewing over 40 comment letters it received on the consultation paper (comments closed on June 17, 2013), which will be considered when it develops rules for an OTC derivatives regulatory framework.



For more information, see [CSA CP 91-407](#).

## 1.5 Review of prospectus exemptions

The OSC is actively involved in exempt market initiatives including the CSA policy review of the existing minimum amount and accredited investor prospectus exemptions and the OSC's expanded review of potential new prospectus exemptions. These initiatives will have important implications for EMDs and other registrants selling exempt market products.

We are evaluating whether any changes should be made to the existing accredited investor and minimum amount exemptions. The feedback from industry highlighted the need for greater access to the exempt market for issuers, particularly start-ups and small and medium sized enterprises. As a result of that feedback, on December 14, 2012, we published [OSC Staff Consultation Paper 45-710 Considerations for New Capital Raising Prospectus Exemptions](#), which sets out four concept ideas for new prospectus exemptions in Ontario. The comment period closed on March 8, 2013 and we received over 100 comment letters. We also held several town hall sessions and consulted with numerous stakeholders including SROs, foreign regulators, investor advocates, industry associations, portals, and academics.

To assist us in our review of potential new prospectus exemptions, we established the OSC's Exempt Market Advisory Committee to advise us on possible regulatory approaches to the exempt market. In addition, we considered the experience of other CSA jurisdictions with prospectus exemptions not currently available in Ontario, as well as international developments relevant to capital raising in the exempt market.

On August 28, 2013, we published OSC Notice 45-712 *Progress Report on Review of Prospectus Exemptions to Facilitate Capital Raising* (OSC Notice 45-712), which sets out the next steps in the OSC's exempt market review and consideration of the following prospectus exemptions:

- a crowdfunding exemption,
- a family, friends and business associates exemption,
- an offering memorandum exemption,
- a streamlined version of the existing rights offering exemption currently available across Canada, and
- amending the accredited investor exemption in Ontario to allow fully managed accounts to purchase investment fund securities.

This work is a priority for the OSC and any resulting proposals will be brought to the public for comment before making any final decisions. For more information, see [OSC Notice 45-712](#).



## 1.6 Ongoing amendments to registration requirements, exemptions and ongoing registrant obligations

Since the implementation of [NI 31-103](#) in September 2009, and amendments which came into force in July 2011, we have monitored this new regulatory regime for registrants and engaged in discussions with stakeholders about questions and concerns regarding their practical experience working with the regime. With the CSA, we have developed additional technical and substantive amendments to NI 31-103 and NI 33-109 *Registration Information* (NI 33-109) arising from this ongoing process.

This fall, we expect to publish for comment these proposed amendments to codify current exemption orders, refine certain exemptions, and provide guidance and clarifications that will enhance investor protection and improve the day-to-day operation of the registration regime for industry participants and regulators. In addition, we believe that the proposed amendments will further clarify our legislative intent.





## 2. Outreach to registrants

- 2.1 New outreach program
- 2.2 Registrant advisory committee

## 2. Outreach to registrants

### 2.1 New outreach program

In July 2013, the CRR Branch launched its new outreach program to registrants. The new program will strengthen our communications with Ontario registrants we directly regulate and other industry participants (such as lawyers and compliance consultants), and is intended to promote stronger compliance practices and enhance investor protection.

Our new outreach program is interactive and will enhance dialogue with registrants. It has the following features:

#### Registrant Outreach web page

We have set up a [Registrant Outreach web page](#) on the OSC's website, which has been designed to enhance awareness of topical compliance issues. Registrants are encouraged to check the web page on a regular basis for updates on regulatory issues impacting Ontario registrants.

#### Educational seminars

Beginning September 2013, we began hosting a series of targeted seminars to provide registrants with practical knowledge on compliance related matters, such as calculating regulatory capital, understanding KYC, know your product (KYP), and suitability obligations, and getting through an OSC compliance review. Interested registrants can find the seminar calendar, course descriptions, and how to register on the [Registrant Outreach web page](#).

#### Registrant Outreach Community

Registrants are also encouraged to join our Registrant Outreach Community to receive regular email updates on OSC policies and initiatives impacting registrants, as well as the latest publications and guidance on our expectations regarding compliance. To join, visit the [Registrant Outreach web page](#).

#### Registrant Resources

Our Registrant Outreach web page has a Registrant Resources section to provide registrants and other industry participants with easy, centralized access to recent compliance materials.

If you have questions related directly to the Registrant Outreach program or have suggestions for seminar topics, please send an email to [RegistrantOutreach@osc.gov.on.ca](mailto:RegistrantOutreach@osc.gov.on.ca).

## 2.2 Registrant advisory committee

The CRR Branch has formed a new committee to help us to consult with our stakeholders and to assist registrants in meeting their regulatory obligations. In December 2012, we established the Registrant Advisory Committee (RAC) to serve as a forum to discuss issues and challenges faced by registrants in interpreting and complying with Ontario securities law, including registration and compliance related matters. The committee's mandate is to assess these issues, discuss possible resolutions, consider the implication of each feasible option, and help to ensure that solutions are applied consistently across registrants. The committee also plays a consultative role by providing feedback to the CRR Branch on the development and implementation of policy and rule making initiatives that promote investor protection and fair and efficient capital markets.

The RAC is chaired by the CRR Branch's Director and consists of members representing the different registration categories and registrant business models, industry advisory groups and SROs. The RAC meets approximately four to six times per year, in addition to ad hoc meetings as required, with members serving two-year terms.



## 3. Registration of firms and individuals

- 3.1 Registration and oversight of foreign broker-dealers
- 3.2 Current trends in registration issues
- 3.3 Novel business activities potentially requiring registration
- 3.4 Relevant investment management experience for advising representatives
- 3.5 Amendments to calculation of capital markets participation fees

### 3. Registration of firms and individuals

The registration requirements under securities law help to protect investors from unfair, improper or fraudulent practices by participants in the securities markets. The information required to support a registration application allows us to assess a firm's and individual's fitness for registration. When assessing a firm's fitness for registration we consider whether it is able to carry out its obligations under securities law. For example, registered firms must be financially viable. We use three fundamental criteria to assess an individual's fitness; their proficiency, integrity and solvency. These fitness requirements are the cornerstones of the registration regime.

In this section, we discuss foreign broker-dealers registered as EMDs, current trends in registration issues, novel business activities potentially requiring registration, relevant investment management experience for advising representatives, and amendments to the fees rule.

#### 3.1 Registration and oversight of foreign broker-dealers

Following a public consultation process, the CSA and IIROC have concluded that IIROC should regulate all firms that conduct brokerage activities (trading securities listed on an exchange in foreign or Canadian markets), and that firms using the EMD registration category should not be permitted to conduct brokerage activities with accredited investors. We intend to publish proposed amendments to NI 31-103 later in 2013 as part of the ongoing amendments to that rule in order to prohibit EMDs from conducting brokerage activities. In our most recent notice, we suggest that impacted firms may wish to consider how they will conduct brokerage activities in the future, including transferring their brokerage activities to a Canadian incorporated IIROC firm, tailoring their activities to fit solely within the EMD registration category, or relying upon the international dealer exemption in section 8.18 of NI 31-103.

For more information, see the most recent notices published by the CSA and IIROC on February 7, 2013:

- [CSA Staff Notice 31-333 Follow-up to Broker-Dealer Registration in the Exempt Market Dealer Category](#)
- [IIROC Notice 13-0042 IIROC Concept Proposal Restricted Dealer Member Proposal – Summary of Comments](#)

#### 3.2 Current trends in registration issues

##### Outside business activities

Registrants sometimes have business activities in addition to those with their sponsoring firm. Registrants must ensure that these outside business activities (OBAs) do not impair or impede the performance of their regulatory obligations, including with the conflicts of interest provision in NI 31-103. We remind





registrants that all OBAs must be disclosed in Item 10 of [Form 33-109F4](#) (Form F4), or [Form 33-109F5](#) for changes in OBAs after registration.

Below, we list some of the inquiries we received on which OBAs must be disclosed and our interpretation of the requirements.

*What does “business related” mean in Form F4?*

Any activity that places the registered individual in regular contact with clients or potential clients can be considered “business related”.

*What does “officer or director positions and . . . any other equivalent positions” mean in Form F4?*

Equivalent positions to an officer or director include roles where the individual is in a position of power or influence over clients or potential clients. This may include non-leadership and/or unpaid roles. For example, some of the activities that we have required to be disclosed include:

- roles handling investments or monies of an organization, such as being on a charity’s investment or finance committee, as these roles are similar to activities performed by registrants,
- acting as a pastor, as this role places the individual in a position of influence over his or her congregation, and
- mentoring youth through an organization, as it places the individual in a position of influence over potential clients, including family members of the youth.

*Does being an owner of a holding company require disclosure?*

Yes. Having ownership in a holding company is a “business” activity that requires disclosure. This is because owning a holding company allows a person to perform, control or influence a business activity indirectly. However, where the ownership is at a negligible level of 1% or 2%, we generally do not require disclosure.

*Does an OBA have to be “material” in order to merit disclosure?*

No. Whether an activity is material is subjective. An OBA that falls under Form F4 must be disclosed, even if it is “immaterial” from the perspective of the firm or the registered individual. Once the activity has been disclosed, we will review the activity and take into account the potential conflicts of interest that may arise as a result of that activity.

**Return of (or requests to withdraw) incomplete or delayed applications**

In some instances, we receive applications for registration that are substantially incomplete. For example, required provincial business name registrations have not been obtained, audited financial statements



have not been prepared, an auditor has not been appointed, or firms are not prepared to file the individual registration applications on the National Registration Database (NRD). In these instances, we may return the applications without review for completion.

As well, in other cases when we review applications, applicants provide inadequate, incomplete or no responses to deficiencies we raise or to our requests for further information, despite multiple follow-ups. Also, applications for exemptive relief from certain registration requirements (such as proficiency) provided with registration applications are also sometimes deficient in the information they include or filers are slow to respond to questions. These deficiencies cause delays in the time to process these applications. In these instances, we may require the applicant to withdraw the application.

Applicants should be aware that when we return an application or require the withdrawal of an application, when the application is re-filed, we may require the filing fees to be paid again.

As such, to avoid processing delays and paying additional filing fees, applicants should ensure that applications are complete and contain all required information when they are filed and that they have the resources to respond to our deficiencies and questions within a reasonable time-frame.

### **Late filings**

We continue to see a trend in registrants incurring late fees for failing to meet deadlines to notify us of changes in registration information. In particular, we see numerous late filings relating to terminations, OBAs, and criminal, civil and financial disclosure. [NI 33-109](#) sets out the deadlines for these and other filings.

Also, many registered firms and exempt international firms fail to file their [Form 13-502F4 Capital Markets Participation Fee Calculation](#) by December 1, or in the case of unregistered investment fund managers, within 90 days of their fiscal year ends. Also, some registrants are filing late notices under section 11.9 of NI 31-103 (see section 4.1.2 on *Failure to provide notice of ownership changes or asset acquisitions*). We will charge late fees in applicable circumstances. The fees for late filings are outlined in Appendix D to [OSC Rule 13-502 Fees](#) (OSC Rule 13-502).

When late fees remain unpaid for more than 30 days after they are due, the firm's registration is automatically suspended pursuant to section 29(1) of the Act.

We remind firms that they are expected to have policies and procedures in place to ensure that required filings are made within the deadlines established under securities laws. Maintaining these policies and procedures will also help firms avoid incurring late fees. In addition, repeated late filings may impact our assessment of a firm's suitability for registration.



### 3.3 Novel business activities potentially requiring registration

Over the last year, we reviewed a number of cases involving persons and companies engaging in (or proposing to engage in) novel business activities that appeared to be registrable trading or advising activities. In these cases, we assessed whether these entities would be “in the business” of trading or advising and therefore subject to the dealer or adviser registration requirements under the Act.

To assist entities in determining whether their activities require registration, we generally refer them to the guidance in section 1.3 of [31-103CP](#) under *Business trigger for trading and advising*. 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 entities satisfy the “business trigger” will generally be fact-specific and may not apply to all entities engaged in similar activities.

Some recent examples of entities that we have found to be in the business of trading or advising include:

- an online platform that aims to bring together accredited investors and issuers,
- entities that offer “auto-trading”, “mirror investing” and “trade copying” services to clients,
- promoters and distributors of certain tax shelter products, particularly products that involve leveraged donations of property to charities in the expectation that clients will receive tax credits,
- finders, referral agents and investor relations entities who regularly participate in private placements and prospectus offerings in return for fees and/or warrants granted as compensation,
- an online portfolio management system for investors to use to build investment portfolios based on their investment needs and objectives, and
- unregistered firms in Ontario that were trading or advising in securities with investors located outside of Ontario.

Some of these examples are discussed in more detail below.

#### 1) Online platform to facilitate investing

We recently granted restricted dealer registration to a not-for-profit online platform (the Filer) that aims to facilitate “impact investing” by bringing together accredited investors in Ontario (and potentially elsewhere) and issuers that aim to solve social or environmental challenges in Ontario.

The Filer also obtained exemptive relief from certain KYC and suitability requirements (Client-Specific KYC and Suitability Requirements) in NI 31-103.

The decision states that, subject to certain investment limits and other terms and conditions, the Filer is exempt from the obligation to determine that sales of securities by issuers to accredited investors who are matched to the issuers through the Filer’s platform are suitable for the investors in light of the investor’s investment needs and objectives, financial circumstances and risk tolerance. The Filer continues to be



required to comply with customary gatekeeper KYC requirements, such as establishing the identity of a client, confirming that the client is an accredited investor and complying with anti-money laundering requirements. The Filer may not issue securities or have related or connected issuers and no transactions may be executed, settled or cleared through the Filer's platform.

The time-limited relief from the Client-Specific KYC and Suitability Requirements for the Filer's platform is based on the particular facts and circumstances of the application and on very specific, rigorous conditions relating to processes such as the criteria for selecting issuers and background checks. There is no assurance that a similar exemption from KYC and suitability requirements would be granted to others, including crowdfunding portals.

For more information, see the June 17, 2013 decision [\*In the Matter of MaRS VX\*](#).

2) Auto-trading, mirror investing and trade copying services

We have considered a number of situations involving “auto-trading”, “mirror investing” and “trade copying” services.

In one case, we considered a firm based in Ontario that provides auto-trading services to clients for a fee. The firm operates a website that allows investors to subscribe to one or more non-affiliated investment newsletter services that provide buy and sell recommendations for the trading of shares and options. The firm provides an automated trading service whereby the firm will, through the use of software and a power of attorney arrangement over the client's brokerage account, match newsletter recommendations with client instructions to create a trade order for each of its relevant clients which the firm electronically delivers to the client's investment dealer. Based on the nature of the services provided by the firm and the terms of the agreement between the firm and its clients, we concluded that the firm was in the business of advising in securities in Ontario.

We have also received enquiries from a number of individuals who proposed to set up “mirror investing” or “trade copying” arrangements for a fee. In one case, an individual claimed that he was an experienced trader who had developed a personal trading strategy that yielded consistent and positive returns. The individual wished to offer a service whereby other investors could benefit from his trading strategy by using “trade copying” software that would copy trades from his personal trading account to their trading accounts in exchange for a share of the profits. We asked this individual to seek appropriate legal advice before proceeding as we would likely take the view that these activities would be registrable advising activity.

3) Promoters and distributors of tax shelter products

We have recently reviewed a number of cases that involved promoters and distributors of tax shelter



products. Based upon our review of the products and how they were promoted, and the relevant caselaw, including the recent Synergy Group decision,<sup>2</sup> we concluded that the entities were engaged in registrable activity and were required to register as a dealer.

4) Online portfolio management system

An unregistered firm located in Ontario developed a web-based personal portfolio management system that investors could subscribe to, for a monthly fee, to enable them to build, design and manage an investment portfolio with securities using portfolio management tools and approaches. After investors input their portfolio needs, asset allocation and risk and reward preferences to the system, the firm's software (using algorithms) would provide them with a customized short-list of securities that the investor could consider for purchase through their on-line brokerage account at a registered investment dealer. The firm claimed that its system provided a research tool for self-directed investors and did not provide advice. We disagreed with this claim. Our view was that it would be in the business of providing tailored securities advice to investors based on their investment needs and objectives, and that the firm would need to register as an adviser if it launched its system in Ontario.

5) Trading or advising in Ontario with non-Ontario investors

We have recently seen a number of cases in which individuals and firms located in Ontario were engaged in registrable trading or advising activities with investors outside of Ontario without being registered in Ontario.

We remind market participants that registration in Ontario is generally required (unless a registration exemption is otherwise available) where registrable activities are provided to investors resident in Ontario or where registrable activities are conducted within Ontario, regardless of the location of the clients. If the trading or advising activity is taking place within Ontario, then to comply with section 25 of the Act the individual or firm is generally required to be registered as a dealer or adviser (as applicable) in Ontario, or rely on a registration exemption. Individuals and firms that conduct these activities may not avoid registration by informing prospective clients that they do not offer or provide their services to Ontario investors.

In the recent *Crowe* decision,<sup>3</sup> the Ontario Superior Court of Justice (Divisional Court) reaffirmed that provincial securities legislation is not limited to protecting the interests of investors located within the province from unfair, improper or fraudulent activities. Provincial securities legislation regulates individuals and firms within the province in order to protect investors both within and outside the province from unfair,

<sup>2</sup> See decision of the Alberta Court of Appeal in *Synergy Group (2000) Inc. v. Alberta (Securities Commission)*, 2011 ABCA 194.

<sup>3</sup> See *Crowe v. OSC* (2012) 108 O.R. (3d) 410 (Aitken J., Pardu J., Swinton J.) (December 5, 2011); leave to appeal to the Court of Appeal dismissed July, 2012.



improper or fraudulent activities. Where a trade has an extra-provincial character, the Commission's jurisdiction over the trade is not determined by the location of the investors; rather, the Commission will have jurisdiction over a trade where there is a sufficient connection between Ontario and the impugned activities and the entities involved.

The Commission has recently granted relief from the dealer and adviser registration requirements in a number of cases<sup>4</sup> where registrable services were being conducted in Ontario but were provided to clients resident in the US or another foreign jurisdiction and the firm was appropriately registered to provide such services in the US or other foreign jurisdiction. While staff would not necessarily consider these cases to be precedents, we will consider recommending exemptive relief by analogy to the principles reflected in these cases in appropriate circumstances.

### 3.4 Relevant investment management experience for advising representatives

An individual applying to register as an advising representative or associate advising representative with a PM needs to meet the "relevant investment management experience" and educational requirements to qualify for registration.

We receive many inquiries about the factors we consider in assessing what constitutes "relevant investment management experience." In response, on January 17, 2013 we published CSA Staff Notice 31-332 *Relevant Investment Management Experience for Advising Representatives and Associate Advising Representatives of Portfolio Managers* (CSA Staff Notice 31-332). While we assess each application on its facts, we expect prospective applicants to consider the information in this notice when deciding whether to apply for registration as an advising representative or associate advising representative.

The notice discusses decisions on experience relating to:

- client relationship management
- corporate finance/investment banking
- dealing representative with IIROC member
- consulting on portfolio manager selection and monitoring, and
- mutual fund sales

For more information, see [CSA Staff Notice 31-332](#).

<sup>4</sup> See, e.g., the following adviser registration cases: *Re Macquarie Private Wealth Inc. and Macquarie Private Wealth Corp.* dated October 19, 2012; *Re BMO Nesbitt Burns Securities Ltd.* dated April 11, 2012; *Re Manulife Asset Management (North America) Limited* dated October 28, 2011; *Re Goodman & Company N.Y. Ltd. and Goodman & Company, Investment Counsel Ltd.* dated October 25, 2011; and *Re Gavin Management Group, Inc.* dated June 3, 2011; and the following dealer registration cases: *Re NCP Northland Capital Partners Inc. and NCP Northland Capital Partners (USA) Inc.* dated March 11, 2011; *Re Stonecap Securities Inc. and SCS (USA) Inc.* dated February 18, 2011; and *Re Thomas Weisel Partners Canada Inc. and Thomas Weisel Partners (USA) Inc.* dated October 7, 2008. All cases are available on the OSC's website.



### 3.5 Amendments to calculation of capital markets participation fees

On April 1, 2013, amendments to OSC Rule 13-502 on fees came into force.<sup>5</sup> In the past, registrants and unregistered capital markets participants were required to calculate information on Form 13-502F4 *Capital Markets Participation Fee Calculation* (Form 13-502F4) based on their most recently completed fiscal year. However, as a result of the amendments to the fees rule, registered firms, exempt international firms relying on sections 8.18 [international dealer] and 8.26 [international adviser] of NI 31-103 and unregistered IFMs<sup>6</sup> will complete Form 13-502F4 for the required filings for 2013, 2014 and 2015 based on information from their financial statements for their “reference year”.

For most firms, the “reference year” will be their last fiscal year ending before May 1, 2012. Therefore, the specified Ontario revenues reported on most firms’ Form 13-502F4 should be the same in each of 2013, 2014 and 2015. However, in cases where a firm was not a registrant firm, exempt international firm or unregistered IFM at the end of its last fiscal year ending before May 1, 2012, the firm’s “reference year” will not be static. In these cases, registrant firms and exempt international firms will use their financial statements for their last fiscal year ending in the calendar year (or, in the case of unregistered investment fund managers, their last fiscal year) when completing Form 13-502F4. Therefore, the specified Ontario revenues reported on these firms’ Form 13-502F4 will likely be different in each of 2013, 2014 and 2015. This scenario might apply where a firm became registered in Ontario for the first time on or after May 1, 2012 or became registered for the first time before May 1, 2012 but had not yet experienced a full fiscal year before May 1, 2012.

For more information, see [OSC Rule 13-502](#). Also, see section 4.1.2 of this report on *Incorrect calculation of capital markets participation fees*.

<sup>5</sup> On April 1, 2013, amendments to OSC Rule 13-503 (*Commodity Futures Act*) Fees also came into force. This rule covers fees for persons or companies registered as dealers or advisers under the *Commodity Futures Act* (Ontario).

<sup>6</sup> See section 1.1 of OSC Rule 13-502 for the definition of an “unregistered investment fund manager.”



## 4. Information for dealers, advisers and investment fund managers

- 4.1 All registrants
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## 4. 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 current trends in deficiencies from our reviews and provide suggested practices to address the deficiencies. We also discuss new or proposed rules and initiatives impacting registrants.

This part of the report is divided into four main sections. The first section contains general information that is relevant for all registrants. The other sections contain information specific to dealers (EMDs and SPDs), advisers (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.*

### 4.1 All registrants

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

#### 4.1.1 Compliance review process

We conduct compliance reviews of registered firms on a continuous basis. The purpose of compliance reviews is primarily to assess compliance with Ontario securities law; but they also help registrants to improve their understanding of regulatory requirements and our expectations, and help us to learn about a specific industry topic or practice we may have concerns with.

#### Risk-based approach

Firms are generally selected for review using a risk-based approach. This approach is intended to identify firms that are most likely to have material compliance issues (including risk of harm to investors) or a significant impact to the capital markets if there is a compliance breach. To determine which firms should be reviewed, we consider a number of factors, including firms' responses to the most recent OSC risk assessment questionnaire, their compliance review history, complaints or tips from external parties and referrals from another OSC branch, an SRO or another regulator.

We frequently conduct compliance reviews on-site at a registrant's premises, but also perform reviews from our offices, which are known as desk reviews. For information on "What to expect from, and how to prepare for, an OSC compliance review" see section 5.1.1 of [OSC Staff Notice 33-738 2012 OSC Annual Summary Report for Dealers, Advisers and Investment Fund Managers](#) (OSC Staff Notice 33-738).



As part of our risk-based approach to reviews, we also assess which areas of a registered firm's business and operations to review and focus on. This means that on any given review, we may not review all aspects of a firm's business, but may focus on certain functions or risks. For example, we may decide to review a PM firm's portfolio management and trading practices, but not to review their marketing practices. But we always perform certain review steps for on-site reviews, including interviewing senior management of the registrant to obtain an understanding of their business, reviewing the firm's most recent financial statements and excess working capital calculations, reviewing regulatory reports (such as the annual compliance report to the board of directors), and assessing the firm's overall compliance and supervision structure.

### **Sweep reviews**

In addition to reviewing individual firms, we conduct sweeps which are compliance reviews of a sample of registered firms on a specific topic or in an industry sector. Sweeps allow us to respond on a timely basis to industry-wide concerns or issues. We regularly perform sweeps of newly registered firms to assess if they are off to a good start and to help them to understand their requirements and our expectations. We also regularly review large or "impact" firms to help ensure we allocate sufficient compliance oversight resources to firms that would have a material impact to investors and the Ontario capital markets if there was a significant failure in their systems of control and supervision.

Some of the sweep reviews we performed this year are high-lighted below:

- We reviewed a sample of newly registered PMs. See section 4.3.2 for a summary of this sweep and its findings.
- We started an on-site sweep review of a sample of "impact" PMs, IFMs and EMDs. We assessed a PM or IFM to be an "impact" firm if it had a high value of assets under administration or management and a high number of clients compared to other firms. We assessed an EMD to be an "impact" firm if it had a high number of dealing representatives compared to other firms.
- We performed a desk review of the custody practices of a sample of EMDs, PMs and IFMs that had custody of their client's assets. See section 4.1.3 *Review of custody requirements for non-SRO registrants* for a summary of this sweep and its findings.
- We performed a desk review sweep of a sample of firms' excess working capital calculations for periods during their financial year. This sweep complemented our ongoing reviews of firms' financial statements and other financial information that firms deliver to us for their financial year-ends. See section 4.1.2 on *Inaccurate calculations of excess working capital* for deficiencies identified from this sweep (and actions to be taken).
- We performed a desk review of a sample of firms' 2012 capital markets participation fees to the OSC. See section 4.1.2 on *Incorrect calculation of capital markets participation fees* for this sweep's findings and guidance.



## Outcomes of compliance reviews

In most cases, the deficiencies found in a compliance review are set out in a written report to the firm so that they can take appropriate corrective action. After a firm addresses its deficiencies, the expected outcome is that they have enhanced their compliance. If a firm had many significant deficiencies, once it addresses these, the expected outcome is that they have significantly enhanced their compliance.

In addition to issuing compliance deficiency reports, we take additional regulatory action when warranted (including when we identify signs of potential registrant misconduct or fraud).

The outcomes of our compliance reviews in fiscal 2013, with comparables for 2012, 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 2013	Fiscal 2012
Enhanced compliance	38%	34%
Significantly enhanced compliance	52%	47%
Terms and conditions on registration	3%	8%
Surrender of registration	1%	1%
Referral to the Enforcement Branch	2%	6%
Suspension of registration	4%	4%

For an explanation of each outcome, see Appendix A in [OSC Staff Notice 33-738](#). 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.

## Non-significant deficiencies

In August 2011, we changed our approach to compliance deficiency reports issued to registrants upon the completion of a review. Previously, we required that registrants respond to us explaining how they will address all deficiencies included in the report. With our new approach, we require registrants to only respond in writing to deficiencies that we have identified as being “significant.” This helps us to better allocate our resources and focus on higher-risk activities. However, we still expect registrants to address the non-significant deficiencies, even though there is no requirement for them to respond to us in writing. We informed registrants that on a sample basis we would follow up with them to assess that they have adequately addressed the non-significant deficiencies.



In November 2012 we conducted a desk review of a sample of EMDs, PMs and IFMs to assess if they had taken corrective actions regarding non-significant deficiencies identified from previous reviews. We required the selected registrants to provide us with the appropriate documentation to evidence that the non-significant deficiencies were addressed. Overall, we were satisfied with the corrective action taken for the non-significant deficiencies. Based on this sample, we believe that our new approach is effective and will therefore continue.

### **Contacting investors as part of compliance reviews**

As part of our ongoing, normal course reviews of dealers and advisers, we contact a sample of their clients by telephone. 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 registrants are complying with Ontario securities law. For more information, see [OSC New Review Procedure of Calling Investors](#) and [Frequently Asked Questions on Receiving Calls from the OSC](#) on the OSC's website.

### **Protection of registrant and investor information**

As part of our on-site compliance reviews, we examine the books, records and other documents maintained by registrants, including personal information concerning their clients. This is normally done at the registrant's offices. However, we may make copies of this information and take it back to our offices. We also obtain information from registrants and applicants for other purposes, such as reviewing registration applications and notices of the sale of a registrant's securities or assets.

The OSC is subject to the provisions of the *Freedom of Information and Protection of Privacy Act* (Ontario), which imposes obligations on how we collect, use, disclose, retain, secure and destroy personal information. In addition, OSC staff are also subject to the OSC's Code of Conduct which requires us to use and protect confidential information appropriately. For example, access to registrant and client information obtained from a compliance review is limited to OSC staff participating in the review or others who may be involved in performing their duties because of issues raised by the review.

We have a responsibility to protect the information we obtain from our stakeholders, and will take all necessary steps in the event of a security breach.

#### **4.1.2 Current trends in deficiencies and suggested practices**

In this section, we summarize key trends in deficiencies from recent compliance reviews of EMDs, PMs, and IFMs. For each deficiency, we summarize the applicable requirements under Ontario securities law



which must be followed. In addition, where applicable, we provide suggested practices. *The suggested practices throughout this report are intended to give guidance to help registrants address the deficiencies, and provide our expectations of registrants.*

We strongly recommend registrants review the deficiencies and suggested practices in this report that apply to their registration categories and operations to assess and, as needed, implement enhancements to their firm's systems of compliance and internal controls.

### **Non-compliance with KYC, KYP and suitability requirements and accredited investor requirements**

We continue to have concerns that some dealers and advisers are not adequately meeting their KYC, KYP and suitability obligations. We also remain concerned that some EMDs are selling securities to investors that do not qualify under a prospectus exemption (such as the accredited investor exemption).

In 2012, we conducted a targeted review (Suitability Sweep) of 87 firms registered in the categories of EMD and PM. Our Suitability Sweep identified a number of significant suitability compliance issues at the registrants we reviewed, which we think is unacceptable. On May 30, 2013, we published OSC Staff Notice 33-740 *Report on the results of the 2012 targeted review of portfolio managers and exempt market dealers to assess compliance with the know-your-client, know-your-product and suitability obligations* (OSC Staff Notice 33-740) which summarized the Suitability Sweep's findings. Some of the major findings are highlighted below.

#### Findings from reviews of EMDs

- Selling exempt securities to non-accredited investors
- Inadequate suitability assessment, including due to over-concentration in one investment and due to inadequate documentation to satisfy how a suitability determination was made
- Inadequate process for collection, documentation and maintenance of KYC information

#### Findings from reviews of PMs

- Inadequate relationship disclosure information
- Inadequate process on collection, documentation and maintenance of KYC information

For more information, see [OSC Staff Notice 33-740](#). For guidance to dealers on complying with the accredited investor exemption, see [OSC Staff Notice 33-735 Sale of Exempt Securities to Non-Accredited Investors](#) (OSC Staff Notice 33-735).

Later this year, we plan on issuing guidance (including suggested practices) in the areas of KYC, KYP and suitability to assist registrants in meeting their obligations. We will continue to focus on assessing if EMDs and PMs are meeting their KYC, KYP and suitability obligations, and if EMDs are selling exempt securities to non-accredited investors. Where we identify significant compliance issues in these areas, we



will take appropriate regulatory action. As well, we intend to pay particular attention to registrants relying on purported “client-directed trade instructions”, or selling investments using the \$150,000 minimum amount exemption when the investment represents more than 10% of the client’s net financial assets.

### **Inadequate compliance systems and UDPs and CCOs not meeting their responsibilities**

In a limited number of cases, we find that registered firms have an inadequate compliance system and that their Ultimate Designated Person (UDP) and Chief Compliance Officer (CCO) are not meeting their responsibilities. For example, we identified some firms with significant compliance issues, such as selling exempt securities to retail investors, dealing or advising in securities of related and connected issuers when it was not suitable or appropriate for clients, or having unregistered persons engage in dealing or advising activities on the firm’s behalf. We assessed these firms as having inadequate compliance systems and that their UDP and CCO (who in some cases were the same individual) were not meeting their responsibilities.

There are serious consequences when firms have deficiencies of this nature. In addition to requiring the firm to correct their deficiencies through a concerted effort to review and apply securities law to their operations, we may take further regulatory action including:

- requiring the firm to hire an external compliance consultant to correct the deficiencies and to strengthen the firm’s compliance system,
- requiring the firm to replace its CCO with a better suited individual, and
- referring the matter to the Enforcement Branch or suspending the firm’s registration.

Registered firms are required to maintain a control and supervisory system sufficient to ensure compliance with securities law and to manage business risks (see section 32(2) of the Act and section 11.1 of NI 31-103). A firm’s UDP and CCO have extremely important compliance roles. They are ultimately responsible for ensuring that a compliance system is in place to ensure that the firm, and its representatives, comply with securities law. It is critical that they understand and fulfill their required responsibilities and roles under sections 5.1 and 5.2 of NI 31-103.

The UDP is responsible to supervise the firm’s compliance activities and to promote compliance.

The CCO is responsible to establish and maintain policies for assessing compliance by the firm, and individuals acting on its behalf, with securities legislation. The CCO must also monitor and assess compliance by the firm, and individuals acting on its behalf, with securities legislation.

An effective compliance system is essential to a registered firm’s continued fitness for registration. Elements include day-to-day monitoring and supervision, overall systemic monitoring, identifying non-compliance at an early stage, and allowing for correction of non-compliant conduct in a timely manner.



Although the firm's UDP and CCO serve important roles, compliance is a responsibility that extends to everyone in the firm, whether they are registered or not.

### ***Suggested practices***

- UDPs should ensure that adequate staff and resources are allocated to their firm's compliance function, taking into account the size, nature, complexity and risk of their business.
- UDPs should communicate and reinforce to all staff that compliance with securities law is a firm-wide responsibility.
- CCOs should ensure that they have an appropriate amount of involvement, time and resources to fulfill their responsibility to monitor and assess compliance with regulatory requirements.
- Firms and their CCOs should 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.
- Firms should provide regular training to their staff so that they understand the firm's policies and procedures and applicable regulatory requirements.
- Firms should consider engaging external legal counsel or a compliance consultant to provide advice on compliance, including making recommendations to improve the firm's compliance system.
- CCOs should continuously educate themselves on compliance and regulatory topics, such as by attending compliance-focused seminars and participating in compliance officer associations.
- Firms should appoint individuals to act as alternates in the brief absence of the CCO or UDP (such as during vacations).
- Firms should keep detailed records of activities they conduct to identify compliance deficiencies and the actions taken to correct them.

For more guidance, see section 11.1 of 31-103CP and our May 2012 [OSC Message to CCOs and UDPs on Inadequate Compliance Systems](#).

### **Inadequate or no annual compliance report**

We continue to find cases where a registered firm's CCO does not provide an annual report to the firm's board of directors that assesses the firm's, and its registered individuals', compliance with securities law. In addition, we also find cases where a CCO submits a perfunctory report that concludes that the firm has



complied with securities law, but does not provide any support for how the CCO made his or her assessment.

One of the CCO's responsibilities is to submit an annual report to the firm's board of directors, or individuals acting in a similar capacity for the firm, for the purpose of assessing compliance by the firm, and individuals acting on its behalf, with securities legislation (see section 5.2 of NI 31-103).

When the CCO has not submitted an annual compliance report, or submits a perfunctory report, this raises questions about the adequacy of the registrant's compliance system, and whether the CCO is adequately performing his or her responsibilities.

We review firm's annual reports during all on-site compliance reviews and use it as a factor to assess the adequacy of the reviewed firm's compliance system and if the CCO is performing his or her responsibilities.

For suggested practices on the CCO's annual compliance report, see section 5.1.2 of [OSC Staff Notice 33-738](#) under the heading *Failure by CCO to submit an annual compliance report*.

### **Failure to provide notice of ownership changes or asset acquisitions**

Some registrants do not provide us with the required notice under sections 11.9 or 11.10 of NI 31-103 of proposed ownership changes in, or asset acquisitions of, registered firms. We have found a number of cases where:

- registered firms or registered individuals (including the UDP, CCO, advising representative, or dealing representative of the firm) have acquired 10% or more of the securities of another registered firm, or their sponsoring firm, without first providing us with the required notice
- registered firms or registered individuals have acquired a security or securities in addition to the 10% or more securities that they already own without first providing us with the required notice; or
- registered firms have not provided us with the required notice as soon as the registered firm knew, or had reason to believe, that 10% or more of its voting securities were going to be acquired by a non-registrant, including an officer, director, permitted individual or employee of the firm (barring exceptional circumstances, we expect to receive notice of these transactions at least 30 days prior to the transaction taking place).

We have also found that some IIROC or MFDA member firms did not file the required 11.9 or 11.10 notices based on the view that their SRO notice process was sufficient. This is not the case. The notice obligations apply to all registrants, including member firms of IIROC and the MFDA, and arise from the OSC's responsibility to register, among others, dealer firms.





If we notify the registered firm or person making the proposed acquisition that we object to the transaction (within 30 days of receipt of the notice), then the acquisition must not take place until our objection is withdrawn.

In the cases where registrants did not provide us with the required notice for their completed acquisitions, we required them to file the notice, pay the applicable filing fees and be subjected to our notice review process. So far, we have not objected to any of these transactions, but instead have issued a written letter to each firm warning them of the seriousness of their failure to provide notice. However, if we were to object to a completed transaction in the future, we would take regulatory action, including potentially having the transaction unwound. In the future, registrants that do not give us the required notice may also be charged late filing fees.

In last year's report, we provided guidance to assist firms in providing sufficient information to us on their section 11.9 or 11.10 notices. See section 4.3 *Common deficiencies from notices on proposed ownership changes or asset acquisitions of a registrant and suggested practices* in [OSC Staff Notice 33-738](#).

#### **Inaccurate calculations of excess working capital**

Registered firms must meet their capital requirements in section 12.1 of NI 31-103 to maintain their registration in good standing. Despite the importance of the capital requirements, our ongoing desk and field reviews continue to identify cases where firms are incorrectly calculating their excess working capital on [Form 31-103F1 Calculation of Excess Working Capital](#) (Form 31-103F1). An inaccurate calculation on Form 31-103F1 may result in a firm failing to meet its capital requirements once corrections are made.

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

Deficiency noted	Action to be taken
<p>Line 1 Current assets and Line 2 Current liabilities</p> <p>The amounts for current assets and current liabilities are accounted for on a cash-basis</p>	<p>Form 31-103F1 must be prepared using the accounting principles used to prepare the firm's financial statements in accordance with NI 52-107 <i>Acceptable Accounting Principles and Auditing Standards</i>. These accounting principles include using an accrual basis of</p>

Deficiency noted	Action to be taken
and not an accrual basis.	accounting.
<p data-bbox="237 369 493 401"><i>Line 1 Current assets</i></p> <p data-bbox="237 449 591 659">(a) Inclusion of accounts receivables, especially from related parties, that are not readily convertible to cash.</p> <p data-bbox="237 940 586 1150">(b) Inclusion of cash that is committed to serve a specific purpose (e.g., for collateral or as a security deposit).</p>	<p data-bbox="634 449 1425 617">(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 <i>Less current assets not readily convertible into cash (e.g., prepaid expenses)</i>.</p> <p data-bbox="691 663 1442 873">Firms should maintain evidence that if the related party receivable was called upon by the firm, the amount could be promptly received. Evidence may include, among other items, the most recent audited financial statements of the related party or a bank statement supporting the amount of cash available.</p> <p data-bbox="634 940 1438 1108">(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.</p>
<p data-bbox="237 1220 578 1293"><i>Line 5 Add long-term related party debt</i></p> <p data-bbox="237 1346 586 1461">(a) Failure to add back 100% of long-term related party debt.</p> <p data-bbox="237 1591 599 1843">(b) Failure to deliver a copy of the subordination agreement to the regulator when subordination agreements have been executed.</p>	<p data-bbox="634 1331 1435 1541">(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 and content prescribed in Appendix B to NI 31-103 <u>and</u> the firm has delivered a copy of the agreement to its principal regulator.</p> <p data-bbox="634 1591 1338 1665">(b) Firms are required to deliver a copy of all subordination agreements to their principal regulator.</p> <p data-bbox="691 1713 1425 1833">Long-term related party debt is only considered to be subordinated when the executed agreement is delivered to the principal regulator.</p>

Deficiency noted	Action to be taken
(c) Subordinated debt is repaid without prior notice to the regulator.	<p>(c) Firms are required to notify their principal regulator 10 days before the full or partial repayment of a subordinated loan or the termination of the agreement (see section 12.2 of NI 31-103). We may request further supporting documentation, such as updated interim financial information and Form 31-103F1, to assess whether the firm will have sufficient excess working capital following the loan repayment.</p> <p>After a partial repayment of a loan, the firm should provide an updated schedule to its principal regulator indicating the updated outstanding subordinated loan balance.</p>
<p><i>Line 9 Less market risk</i></p> <p>A market risk deduction has not been made when the value of securities are included on Line 1.</p>	<p>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.</p> <p>See Schedule 1 of Form 31-103F1 for instructions on calculating market risk. Firms should provide documentation to support the market risk calculation as part of its annual and/or interim financial statement filing.</p>
Form 31-103F1 is not prepared at least monthly.	<p>Registered firms should know their capital position at all times. This may require a firm to calculate its excess working capital every day. The frequency of capital calculations depends on many factors, including the size of the firm, the nature of its business and the stability of the components of its working capital. However, firms should prepare their excess working capital calculation at least monthly.</p>

### Insufficient working capital and failure to report capital deficiency

Some registered firms do not always maintain sufficient working capital. Section 12.1(2) of NI 31-103 requires that a registered firm's excess working capital using Form 31-103F1 must not be less than zero



for 2 consecutive days. We treat any failures to meet the capital requirements seriously. We expect firms to resolve any capital deficiencies in a timely basis, usually within 48 hours. This may be done in a number of ways, including injection of new capital into the firm or by subordinating any long-term related party debt. If a firm does not resolve a capital deficiency in a reasonable period of time, we may take regulatory action such as recommending terms and conditions be placed on the firm's registration to restrict their business activities (such as no securities dealings until the deficiency is rectified and notification to existing clients of the terms and conditions imposed) or recommending that the firm's registration be suspended.

In addition, some firms do not notify us when their excess working capital is less than zero. These capital deficiencies were later detected during compliance reviews. Firms are required under section 12.1(1) of NI 31-103 to notify their principal regulator as soon as possible of any capital deficiency.

After a firm resolves its capital deficiency, it is our practice to either recommend terms and conditions be placed on the firm's registration requiring it to send to us copies of its Form 31-103F1 and financial statements each month for a period of time, or warn the firm in writing of the seriousness of the deficiency and that if a capital deficiency recurs, we will recommend terms and conditions. When deciding on whether to recommend terms and conditions or issue a warning letter, we consider a number of factors including whether the firm notified us of its capital deficiency on a timely basis.

### ***Suggested practices***

When a firm notifies us of a capital deficiency, they should contact one of the financial analysts in the Compliance, Strategy and Risk team of the CRR Branch (see Appendix A), and:

- Explain the details and nature of the deficiency
- Provide a copy of the firm's Form 31-103F1 and supporting records (such as financial statements and market risk calculation) for the date(s) of the capital deficiency
- Explain what they have done, or will do, to resolve the capital deficiency, and once resolved, what steps were taken to prevent the recurrence of the deficiency
- Once the deficiency is resolved, provide a copy of the firm's Form 31-103F1 and supporting records (as above) that demonstrate that the firm is meeting the capital requirements
- Provide evidence of how the deficiency was resolved (such as a copy of a deposit slip or bank statement to support additional cash injected into the firm or a copy of the executed subordination agreement if long-term related party debt was subordinated).



### **Financial statements not prepared in accordance with NI 52-107**

Some firms prepare their annual financial statements and interim financial information in accordance with International Financial Reporting Standards (IFRS) without accounting for, or disclosing, the adjustments to IFRS as required by NI 52-107 *Acceptable Accounting Principles and Auditing Standards* (NI 52-107).

Section 3.2(3)(a) of NI 52-107 requires a registered firm's financial statements and interim financial information to be prepared in accordance with Canadian Generally Accepted Accounting Principles applicable to publicly accountable enterprises (i.e. IFRS), except that any investments in subsidiaries, jointly controlled entities and associates must be accounted for as specified for separate financial statements in International Accounting Standard 27 *Separate Financial Statements* (IAS 27). Separate financial statements are sometimes referred to as non-consolidated financial statements.

Section 3.2(3)(b) of NI 52-107 also requires a registered firm's annual financial statements to include the following:

- a sentence indicating that the financial statements are prepared in accordance with the financial reporting framework specified in section 3.2(3)(a) or, for foreign firms, section 3.15 of NI 52-107, and
- a description of the financial reporting framework used to prepare the financial statements.

The additional sentence should be outlined in the independent auditor's report. The description of the financial reporting framework used to prepare the financial statements should be disclosed in the notes and refer to the requirement to account for any investments in subsidiaries, jointly controlled entities and associates as specified for separate financial statements in IAS 27, even if the registered firm does not have these types of investments.

Requirements for annual financial statements and interim financial information for foreign registered firms are set out in section 3.15 of NI 52-107.

### **Inadequate relationship disclosure information**

Dealers and advisers regularly do not provide their clients with adequate information on their relationship with clients, as required by section 14.2 of NI 31-103.

In July 2013, we published CSA Staff Notice 31-334 to summarize the findings of the CSA's 2012 sweep of the relationship disclosure information (RDI) practices of over 120 PMs and EMDs. The notice provides guidance on RDI practices, and considers the recent RDI changes made as part of the CRM2 amendments (see section 1.1 of this report).

The notice sets out suggested practices, including on the disclosure of:

- Risks of using borrowed money to finance the purchase of a security,



- The obligation to assess suitability prior to executing a transaction,
- Content and frequency of reporting for each account of a client,
- Types of risks that a client should consider,
- Conflicts of interest,
- All costs to a client for the operation of an account, and
- Compensation paid to the firm.

For more information, see [CSA Staff Notice 31-334](#).

### **Incorrect calculation of capital markets participation fees**

Each year, registered firms and unregistered capital markets participants are required to pay participation fees to the OSC based on the firm's revenues attributable to their capital markets activities in Ontario. Some firms are incorrectly calculating these fees. We recently conducted a review of the 2012 capital markets participation fees that were required to be submitted to the OSC under OSC Rule 13-502, using Form 13-502F4. During the review, we identified a number of errors in some firms' calculations of their capital markets participation fees on Form 13-502F4.

On July 18, 2013 we published OSC Staff Notice 33-741 *Report on the Results of the Reviews of Capital Markets Participation Fees* (OSC Staff Notice 33-741) to summarize the review's findings and provide guidance on the calculation of capital markets participation fees. The review's findings include:

- incorrect reporting of revenue
- incorrect deductions taken from gross revenue
- attributing an incorrect percentage to revenues earned in Ontario, and
- misinterpretation of OSC Rule 13-502.

We will continue to review capital markets participation fees on an ongoing basis.

For more information, see [OSC Staff Notice 33-741](#). Also, see section 3.5 of this report on *Amendments to calculation of capital markets participation fees*.

#### **4.1.3 New and proposed rules and initiatives impacting all registrants**

##### **Review of custody requirements for non-SRO registrants**

Although Ontario securities law does not prohibit registrants from holding client assets, most of the registered firms we directly regulate do not have custody of their clients' assets (securities and cash). Instead, the assets are held at banks, trust companies or dealers that are members of IIROC (Custodian Firms). However, we are aware of a small number of firms that have custody of their clients' assets. By "custody" we mean holding client assets (e.g. by registering securities in nominee name or taking physical



possession) or by having “deemed” custody over client assets (e.g. by acting as trustee for clients or having a power of attorney over some clients’ assets.)

This year, we conducted a desk review of the custody practices of 70 firms in Ontario registered as EMDs, PMs, or IFMs. We identified these firms as potentially having actual custody of clients’ assets from analyzing responses to our most recent risk assessment questionnaires. The purpose of the desk review was to:

- confirm and better understand these firms’ custodial practices including the types of controls that are in place to safeguard client assets, and
- identify risks and investor protection concerns that are not addressed by the existing custody requirements for non-SRO registrants in NI 31-103.

We identified 21 firms in our review that had actual custody of their clients’ assets and were not members of an SRO. The nature of the custody arrangements vary, but include:

- PMs that maintain “omnibus” accounts in their firm’s name at a Custodian Firm to hold their clients’ assets on an aggregate basis, and
- PMs, EMDs and IFMs that hold clients’ share certificates in private companies at their offices.

In addition, we found that a number of registrants have “deemed” custody over clients’ assets, for example, by acting as a trustee for a client or having the authority to withdraw funds from a client’s account at a Custodial Firm through a power of attorney.

We have concerns with these arrangements. It is a risk to investors when registrants have actual or deemed custody of their clients’ assets. The existing custody requirements for EMDs, PMs and IFMs in sections 14.6 to 14.9 of NI 31-103 focus primarily on maintaining clients’ assets separate and apart from the registrants’ assets and do not have specific requirements for who can act as a custodian for client’s securities. Further, when an EMD, PM or IFM has custody of client assets, there is no requirement for them to hold those assets in each client’s name.

Dealers that are members of IIROC and the MFDA commonly hold clients’ assets in nominee name on behalf of their clients. To address the risks related to holding client assets in nominee name, IIROC and the MFDA have prescriptive rules governing capital, insurance, custody and segregation requirements for their members, and they both have investor protection funds for dealer insolvencies. There are also prescriptive requirements for custody of the assets of investment funds sold by prospectus in NI 81-102 *Mutual Funds* (NI 81-102) and NI 41-101 *General Prospectus Requirements* (NI 41-101), including that the fund’s assets must be held at a qualified custodian.

Together with the CSA, we are reviewing the existing custody requirements in NI 31-103 for non-SRO registrants to assess if they adequately protect client assets. When this review is complete, the CSA may



propose enhancements to the custody requirements. We will also continue to review custody practices of registered firms as part of our compliance field reviews.

### **Electronic delivery of documents to the OSC**

On October 31, 2013, we published a rule that will make electronic filing mandatory for a number of documents that are currently filed with the OSC in paper format. The documents generally include the forms, notices and other materials required under Ontario's securities rules that are not covered already by SEDAR, SEDI<sup>7</sup> and NRD, the CSA's national electronic filing systems. The rule is expected to come into force on February 19, 2014.

Electronic filing is a convenience to filers and will allow for the efficient collection and use of information by the OSC. Under the rule, each required document must be transmitted to the OSC electronically in accordance with system instructions on the OSC's website.

The documents that are to be delivered electronically that affect registered firms include:

- Form 31-103F1 together with audited annual financial statements and other financial information,
- Notice of repayment or termination of a subordination agreement,
- Notice of change, claim or cancellation of an insurance policy,
- Capital markets participation fee calculations,
- Notices of proposed ownership changes or asset acquisitions of registrants,
- Reporting obligations related to terrorist financing,
- Firm registrations and changes in registration information,
- Reports of exempt distributions and delivery of an offering memorandum, and
- Registered Firm Exception Report of DAP/RAP Trade Reporting and Matching (Form 24-101F1).

Initially, it is anticipated that many of the required documents will be filed using PDF. However, at the time the rule comes into force, we expect the following forms to be available only as online web-based forms:

- Form 24-101F1,
- Form 31-103F1,
- Forms 45-106F1 and 45-501F1 *Report of Exempt Distribution*, and
- Applications for exemptive relief and pre files.

These forms are currently available on the OSC website either to the general public on a voluntary basis, or to select market participants on a 'pilot' testing basis. We anticipate that the online filing portal will be available on a voluntary basis for all users by January 10, 2014 with electronic filing becoming mandatory on February 19, 2014.

<sup>7</sup> System for Electronic Document Analysis and Retrieval (SEDAR) and System for Electronic Disclosure by Insiders (SEDI).





For more information, see [Notice of Commission Approval of OSC Rule 11-501 \*Electronic Delivery of Documents to the Ontario Securities Commission\*](#).

## Planned research on suitability of advice

In the [OSC's Statement of Priorities for 2013-14](#), we proposed to conduct a "mystery shop" research sweep of dealers and advisers this fiscal year to gauge the suitability of advice currently being provided and identify areas of concern and assist in targeting future OSC suitability sweeps. Mystery shopping is a tool that can be used to measure quality of service or compliance with regulation. The mystery consumer's specific identity and purpose is generally not known by the entity being evaluated. In this case, individuals will pose as investors seeking investment advice and provide detailed reports or feedback about their experiences. Once this research is completed, we expect to publish the findings.

## 4.2 Dealers (exempt market dealers and scholarship plan dealers)

This section contains information that is specific to EMDs and SPDs, including current trends in deficiencies from compliance reviews of EMDs (and suggested practices to address them), an update on the results of our SPD reviews, and our new initiative to address concerns with EMDs that distribute related party products.

### 4.2.1 Current trends in deficiencies of EMDs and suggested practices

This year's compliance reviews of EMDs focused on areas that we found to be problematic in recent years, including:

- inadequate compliance systems and supervision of dealing representatives,
- failure to assess the suitability of trades and the sale of unsuitable investments, especially when there is a high investment concentration in related or connected issuers,
- insufficient product due diligence (KYP),
- failure to identify and respond to conflicts of interest,
- improper reliance on the accredited investor exemption, and
- inadequate collection and documentation of KYC information.

We will continue to focus on these areas of concern in future reviews of EMDs.

In addition to the deficiencies from the Suitability Sweep as outlined in [OSC Staff Notice 33-740](#) and in section 4.1.2 of this report, the following are deficiencies that we identified during this year's compliance reviews of EMDs.



## Conflicts of interest when selling securities of related or connected issuers

We continue to have significant concerns with EMDs that distribute the securities of related or connected issuers, particularly EMDs that solely distribute these types of securities.<sup>8</sup> The significant deficiencies that we identified include:

- misappropriation of investor funds,
- concealment of poor financial condition of the related or connected issuer,
- sale of unsuitable, high-risk investments to investors, and
- high investment concentration in the securities of a related or connected issuer.

These deficiencies are in large part attributable to the lack of separation between the mind and management of the EMDs and their related or connected issuers, which gives rise to significant conflicts of interest. Investor proceeds are not being used in accordance with what has been disclosed to investors and in some instances are used to pay for the personal expenses of officers or directors or to satisfy obligations to existing investors. Also, we identified the sale of unsuitable, high-risk investments, which form a high concentration of investors' portfolios. These deficiencies suggest that the interests of the EMD and its related or connected issuers take precedence over those of investors and, therefore, that the EMD is not dealing fairly, honestly and in good faith with its clients as required by section 2.1 of OSC Rule 31-505.

EMDs are required to take reasonable steps to identify existing material conflicts of interest, and material conflicts that the firm reasonably expects to arise between the EMD and a client (see section 13.4 of NI 31-103). A conflict of interest is any circumstance where the interests of different parties, for instance those of an EMD and its client, are inconsistent or divergent. If the risk of harming a client or the integrity of the markets is too high, then the conflict of interest in question needs to be avoided. If the conflict of interest is not avoided, then the EMD should take steps to control or disclose it, as appropriate. See *Inadequate disclosure of conflicts of interest* directly below for additional information, including suggested practices, on the disclosure of conflicts of interest.

### ***Suggested practices***

EMDs should:

- collect information from the individuals acting on their behalf regarding the conflicts they expect to arise with clients,
- avoid conflicts of interest that are contrary to the interests of clients and where controls or disclosure are not appropriate responses to these conflicts, and

<sup>8</sup> See definitions of "connected issuer" and "related issuer" in section 1.1 of NI 33-105 *Underwriting Conflicts*.

- ensure their organizational structures, lines of reporting and physical locations will enable the firm to control these risks and conflicts of interest effectively.

### **Inadequate disclosure of conflicts of interest**

Some EMDs are not meeting their disclosure obligations in [NI 33-105 \*Underwriting Conflicts\*](#) (NI 33-105). In particular, section 2.1(1) of NI 33-105 imposes a disclosure obligation for distributions where there is a direct or indirect relationship between the issuer or selling securityholder and the underwriter. An offering document must contain the information specified in Appendix C of NI 33-105, which includes a statement on the front page of the offering document that summarizes the basis on which the issuer is a related or connected issuer of the EMD, as well as a cross reference to the applicable section in the body of the offering document where further information concerning this relationship is provided.

An EMD that trades in, or recommends the securities of, a related or connected issuer must provide specific disclosure about the issuer. An EMD may, for instance, maintain and post on its website a list of related or connected issuers for whom it acts as a dealer. This disclosure may not meet the expectations of a reasonable investor when a registered individual recommends a trade in the securities of the related or connected issuer. In these circumstances, the EMD should provide the client with disclosure about the specific conflict of interest with the related or connected issuer, including a description of the nature of the relationship between the two entities, including why the issuer is considered “related” or “connected” (e.g., common ownership) and information on the extent to which the proceeds of a sale of securities will be applied for the benefit of the EMD or a related or connected issuer of the EMD. The EMD must disclose this information in a timely manner, in order to give clients a reasonable amount of time to assess the conflict.

### ***Suggested practices***

EMDs should:

- draft prominent, specific, clear and meaningful disclosure about material conflicts of interest and explain how the conflict of interest could affect the service being offered,
- avoid providing generic disclosure, giving partial disclosure that could mislead clients, or obscuring conflicts of interest in overly detailed or complex disclosure,
- disclose conflicts of interest to clients before or at the time they recommend the transaction in question and keep evidence of this disclosure, and
- refresh disclosure to clients about conflicts of interest, since previous disclosure may no longer be relevant to (or remembered by) the client.

### **Inadequate risk disclosure information**

Some EMDs do not deliver adequate, or any, risk disclosure information to clients before acting for them. Section 14.2 of NI 31-103 requires EMDs to deliver to clients all information that a reasonable investor would consider important about their relationship with the clients. This includes a description of the risks of using borrowed money to finance the purchase of a security and a description of the types of risks that clients should consider when making investment decisions. For more guidance on the risk disclosure requirements in section 14.2 of NI 31-103, see [CSA Staff Notice 31-334](#).

Section 2.1 of OSC Rule 31-505 requires EMDs to deal fairly, honestly and in good faith with their clients. The person purchasing the investment product is the client of the EMD. EMDs' disclosure to clients should accurately reflect the risks of the specific products recommended; and EMDs should ensure that their clients understand the risk features prior to making a purchase in a security. Registered individuals should spend sufficient time with clients to adequately explain the risk disclosure information that is delivered to them.

#### ***Suggested practices***

EMDs should:

- present risk disclosure information in a clear and meaningful manner,
- have policies and procedures in place that require their registered individuals to demonstrate that they have satisfied their obligations to adequately explain the risk disclosure to clients,
- keep evidence of compliance with client disclosure requirements at account opening, prior to trades and at other required times (e.g., through detailed notes and signed client acknowledgements),
- review relevant documents (e.g., KYC forms, term sheets and offering memoranda) regularly to ensure that they contain the required risk disclosure information, and
- promote client participation, for instance by helping clients understand investment risks and encouraging them to review the sales literature and to consult with necessary professionals, including lawyers and accountants, where appropriate.

#### **4.2.2 Update on results of scholarship plan dealer reviews**

In the prior year, we conducted compliance reviews of all five firms registered solely as SPDs in Ontario. An SPD acts as a dealer in securities of scholarship plans, education plans or educational trusts. We referred four SPDs to our Enforcement Branch after identifying serious concerns with the compliance



systems and sales practices of these SPDs. See section 5.3.1 of [OSC Staff Notice 33-738](#) for more information about the key areas of concern from these compliance reviews.

Regulatory proceedings were brought against the four SPDs in response to significant non-compliance by the firms. In order to address our investor protection concerns, interim terms and conditions on their registration were imposed by the Commission on consent of each of Children's Education Funds Inc. (CEFI), Global RESP Corporation (Global RESP), Heritage Education Funds Inc. (HEFI), and Knowledge First Financial Inc. (KFFI). The terms and conditions that were imposed by temporary orders on the four SPDs required them to:

- retain an OSC-approved independent consultant (the Consultant) to develop and implement a plan to strengthen the firm's compliance system (Compliance Plan), and to provide progress reports as to the implementation of the Compliance Plan,
- retain an OSC-approved independent monitor (the Monitor) to review new client applications, call certain clients to confirm accuracy of their KYC information, confirm that the product is suitable and affordable, confirm that the investor understands the applicable fees, and unwind any unsuitable investments, and provide regular reports to us, and
- not open any new branch locations or hire any new dealing representatives (except to replace an existing dealing representative provided that the Consultant is satisfied that the new dealing representative is adequately trained and supervised) until the Compliance Plan has been fully implemented.

Each Compliance Plan was to include recommendations to strengthen the firm's compliance system and to rectify the deficiencies identified in the compliance reviews including:

- documenting and collecting clients' KYC information,
- ensuring that all trades are suitable for its clients,
- training and supervising dealing representatives,
- overseeing branch location, and
- preparing and distributing marketing materials.

For more information, see the temporary orders for [CEFI](#), [Global RESP](#), and [HEFI](#). The temporary orders have been extended and in certain cases have been varied from the original terms and conditions set out above. On October 23, 2013, [KFFI's temporary order was revoked](#) and its remaining terms and conditions were deleted. All public information about the proceedings against the SPDs is available on the OSC's website under [All Commission Proceedings](#).

We are of the view that the imposed terms and conditions were necessary to deal with SPDs that failed to comply with their regulatory obligations. Once the proceedings against the SPDs are concluded, we will



publish a report including a summary of the deficiencies and suggested practices to provide guidance to new firms that plan to register as SPDs on how to meet their regulatory obligations.

### 4.2.3 EMDs that distribute related party products

We have seen a number of cases of commingling of assets and inappropriate use of investor proceeds by the EMD and/or its related party issuer (see section 4.2.1 on *Conflicts of interest when selling securities of related or connected issuers*) when EMDs sell related party investments. We have also found that conflicts of interest matters respecting related parties that were not properly managed. This has resulted in regulatory action being taken on many firms (e.g. suspension of firms, or enforcement proceedings and sanctions).

In light of the significant issues we continue to find, we started an initiative to consider how to address these concerns. Our policy objective is to increase investor protection and deter misuse of investor funds by EMDs and their related parties.

## 4.3 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 sweep of newly registered PMs, PM client account statement practices, and the new framework for direct electronic access.

### 4.3.1 Current trends in deficiencies and suggested practices

#### Inadequate personal trading policies

Some PMs have inadequate policies and procedures for the personal trading of their advising representatives, research analysts, traders and other persons who have access to their clients' trading and investment information (Access Persons).

We found cases where PM firms did not:

- maintain personal trading policies and procedures,
- enforce the firm's established personal trading policies,
- require written pre-approval for personal trades of Access Persons,
- review and maintain the personal trading records of Access Persons to ensure they complied with the firm's personal trading policies, or
- have complete information on the personal trading accounts of all Access Persons.



There is a risk of investor harm when Access Persons trade for their personal accounts since they may put their personal interests ahead of their clients' interests or otherwise abuse their position of trust. Policies and procedures create a framework to monitor and supervise Access Persons' personal trading practices. Without policies and procedures, registered firms are unable to detect inappropriate personal trading practices, which is unacceptable.

Registered firms are required to maintain a control and supervisory system sufficient to ensure compliance with securities law and to manage business risks (see section 32(2) of the Act and section 11.1 of NI 31-103).

Section 119 of the Act prohibits a person with access to information concerning an investment portfolio managed under discretionary authority from making securities transactions for their own account where the client's investment portfolio holds the same security and the person has used the information for their direct benefit.

PMs should establish, maintain and apply written personal trading policies and procedures for their Access Persons. This will help to ensure compliance with section 119 of the Act and prevent and detect self-dealing and other abusive practices.

### ***Suggested practices***

- A PM's personal trading policies should, at a minimum:
  - include an annual acknowledgement in writing from all Access Persons that they understand and will comply with the firm's personal trading policies,
  - appoint a qualified person, such as the CCO, to be responsible for monitoring the firm's personal trading policies,
  - define who is an Access Person,
  - clarify the application of policies to spouses of Access Persons and accounts that Access Persons have control over,
  - maintain a restricted securities list,
  - establish blackout periods,
  - require written pre-approval of Access Persons' personal trades by a qualified person, such as the CCO,
  - require direct receipt of Access Persons' personal trading records (such as account statements),
  - require the review and timely reconciliation of Access Person's pre-approved trades to their personal trading records, and
  - set out details of repercussions for non-compliance with the policies, and reporting of

non-compliance to senior management.

- PMs should maintain records of personal trade pre-approvals and personal trading records of Access Persons.
- PMs should assess compliance with the personal trading policies as part of the CCO's annual compliance report to the board.

### **Inadequate investment management agreements**

Some PMs do not have adequate investment management agreements (IMAs) with their clients. We found cases where:

- The IMA did not state that the PM must manage the client's assets in accordance with their KYC and suitability information or that the PM is responsible for proxy voting.
- The IMA did not clearly state the type of investment authority the PM has over its client's assets. For example, the IMA states that the client grants the PM authorization to make investment decisions in their accounts without stating that the PM has discretionary trading authorization.
- PMs did not sign an IMA with all clients, or could not locate copies of IMAs we requested.
- IMAs were not current. For example, the fee arrangements had changed from what was outlined in the IMA, but the IMA was not updated to reflect the change.
- A PM inappropriately attempted in the IMA to limit the extent of their legal obligation to obtain KYC and suitability information from the client. The IMA stated that the client had sole responsibility for their KYC and suitability information.

There is a risk of harm to investors when they do not have an IMA with their PM, or do not have an adequate IMA. PMs have a significant amount of authority and responsibility over their clients' assets. A well-drafted and up-to-date IMA helps investors to adequately protect their assets and ensure that the PM manages their assets in accordance with their KYC and suitability information and instructions.

Section 11.5(1) of NI 31-103 requires PMs to maintain records to accurately record their business activities, financial affairs and client transactions. Section 11.5(2)(k) of NI 31-103 states that this includes records that document the opening of client accounts, including any agreements with clients.

PMs are responsible for collecting KYC information from clients and keeping the information current to support their suitability determinations; it is not the sole responsibility of the PM's clients. PMs may not use client agreements to limit their KYC or suitability obligations or mislead clients as to their obligation to know their clients and make suitability determinations.





### ***Suggested practices***

- PMs need to have a written IMA with each client that sets out the services to be provided, the roles and responsibilities of each party, and addresses all aspects of the investment advisory process.
- Since the IMA is a legal document, PMs should consult with legal counsel on its terms and keep it current.
- Each completed IMA should be reviewed, approved and signed and dated by senior management of the PM and the client, with a copy provided to the client.
- The terms of an IMA should include, but not be limited to:
  - the type of authority the PM has over the client's assets (such as discretionary or non-discretionary trading authority),
  - how the client's assets managed by the PM will be held (such as in the client's name at a third-party custodian),
  - any client instructions or restrictions,
  - who is responsible for proxy voting and insider reporting obligations,
  - how any conflicts of interests that impact the advisory services to be provided are addressed,
  - fee arrangements with clients, including how and when investment management fees (including performance fees) are calculated and charged, and
  - the notice period for terminating the agreement.
- IMAs should state that the PM is required to manage the client's assets in accordance with the client's investment needs and objectives, risk tolerance, financial circumstances and any client instructions or restrictions.

### **Inadequate supervision of advising representatives and research analysts**

We noted several cases where a PM firm did not adequately supervise its advising representatives (AR), associate advising representatives (AAR), or research analysts.

In one case, a PM firm failed to supervise a number of ARs that the firm sponsored. The ARs operated under the PM firm's name, but effectively carried out their advising activities independent of, and without adequate oversight by, the PM firm. For example:

- the ARs did not follow, and lacked knowledge of, the firm's policies and procedures for meeting with clients and documenting their advising activities,
- clients did not sign a standard IMA with the firm; instead, each AR had a different agreement that their clients signed,

- the firm did not have an established process for collecting, documenting and updating KYC and suitability information from clients; instead each AR had their own process that was often inadequate,
- some of the ARs conducted their advising activities from their home office that was not a registered office of the firm, and that was not subject to adequate oversight by the firm,
- the ARs had their own distinct marketing materials and referral arrangements that often were not reviewed and approved by the firm, and
- some of the AR's books and records were not accessible to the firm.

In another case, an unregistered research analyst employed by a PM firm appeared to be making investment decisions for several managed account clients of the firm as part of a specific investment strategy. The firm's UDP, CCO and sole AR told us that he authorized the analyst's trades before they were placed with a dealer. But we had concerns that this individual did not fully understand the trades made by the analyst, did not adequately document his authorization of the trades, did not adequately monitor the investment strategy in question, and did not adequately supervise the research analyst.

We also noted some cases where a designated AR at a PM firm was not adequately supervising the advice of an AAR that he or she was responsible for (as required by section 25(3) of the Act). Specifically, there was no evidence that the designated AR had pre-approved investment decisions that the AAR had made for clients' managed accounts.

In each of the above cases, we took appropriate steps to ensure the firms took corrective action to adequately supervise their staff and meet other requirements under securities law. In one case, terms and conditions were placed on the firm's registration requiring the retention of a compliance consultant.

PMs are required to maintain a control and supervisory system sufficient to ensure compliance with securities law and to manage business risks (see section 32(2) of the Act and section 11.1 of NI 31-103).

PMs should have written policies and procedures on how they supervise their ARs, AARs, and research analysts, and how designated ARs are to supervise their AARs. A PM's system of control and supervision, and policies and procedures, should apply to all of the firm's ARs, AARs, and research analysts, and should take into account if these individuals work at locations other than the firm's head office. It is unacceptable for PM firms to sponsor individuals as their ARs or AARs when they are permitted to act independently of the firm's system of control and supervision, and policies and procedures.

For PMs to meet their suitability requirements in section 13.3(1) of NI 31-103, an AR (or AAR under the supervision of their designated AR) must fully understand the structure, features and risks of each trade before it is placed with a dealer, and monitor the client's managed account portfolio on an ongoing basis.



Section 4.2 of NI 31-103 requires PMs to designate an AR to approve the advice provided by an AAR. The designated AR must approve the advice before the AAR gives it to a client or makes an investment decision for a client's managed account.

### ***Suggested practices***

- All trades conducted on behalf of a PM's clients should be authorized, in writing, by an AR (or AAR under the supervision of an AR), before the trades are placed with dealers.
- An AR designated to supervise the advice of an AAR should document his or her pre-approval of the advice made by the AAR to clients.
- PMs should train their investment staff on the advising activities they are permitted to perform under their AR or AAR category of registration (if registered) or not permitted to perform (if not registered).
- PMs should refer to [CSA Staff Notice 33-315 Suitability Obligation and Know Your Product](#) for guidance on meeting their suitability and KYP obligations.
- PMs should assess whether a change in an individual's role, responsibilities or activities within the firm requires them to be registered.

### **Delegating KYC and suitability obligations to referral agents**

We continue to be concerned about the practice by some PMs of delegating their KYC and suitability obligations to referral agents such as mutual fund dealing representatives and financial planners. We detailed our concerns in previous annual reports and set out a list of suggested practices for PMs. Despite this, some PMs are still delegating their KYC and suitability obligations to referral agents. In the future, we intend to respond to this type of conduct more aggressively, for example, by recommending a suspension of registration or by referring the matter to our Enforcement Branch.

This year, we reviewed a case where a referral agent, an individual who had formerly been registered with an MFDA member firm, but was no longer registered in any capacity, had referred a large number of clients to a PM, and where no AR of the PM had spoken with those clients before trades were made on their behalf. The referral agent also met with the clients on an ongoing basis to review their investment portfolios, and discussed with the PM the selection of specific securities for inclusion in, or removal from, the clients' portfolios. Many of the activities performed by the referral agent required registration, and should have been carried out by an appropriately registered individual acting on behalf of the PM.

PMs must comply with the referral arrangement requirements in sections 13.8 to 13.10 of NI 31-103 (also, see the guidance in Part 13 of 31-103CP). A client who is referred to a PM becomes the client of that PM for the purposes of the services provided under the referral arrangement. The PM receiving a referral



must meet all of its obligations as a registrant towards its referred clients, including KYC and suitability determinations. PMs may not use a referral arrangement to assign, contract out of or otherwise avoid their regulatory obligations.

PMs that use referral agents should carefully review their practices to ensure that only appropriately registered individuals are performing registrable activities. Registrable activities include meeting with investors to ascertain their investment needs and objectives, risk tolerance and financial circumstances, discussing and recommending investment opportunities, and performing ongoing portfolio reviews. We also encourage PMs to review the guidance in section 5.2A of [OSC Staff Notice 33-736 2011 Annual Summary Report for Dealers, Advisers and Investment Fund Managers](#) under the heading *Delegating know your client and suitability obligations*.

### 4.3.2 Sweep of newly registered PMs

This year we conducted a sweep review of a sample of newly registered PMs in Ontario to gain an understanding of each firm's business, assess their compliance with Ontario securities law, and provide guidance on key regulatory requirements. We selected 23 firms to review using risk-based criteria. Our reviews focused on each firm's compliance system, financial condition and processes for portfolio management, trading, and marketing.

Of the 23 PM firms we reviewed, 18 (78%) were issued a report that required them to take corrective action on deficiencies we identified. A total of 8 firms had experienced an excess working capital deficiency (34%) within the last 12 months that had not been previously reported to the OSC. Each of these 8 firms had already corrected their capital deficiency at the time of our review, or did so after our review on a timely basis. Each of the 8 firms were informed of the seriousness of not meeting their capital requirements (and the requirement to report capital deficiencies to the OSC on a timely basis) either through a warning letter or by placing terms and conditions on the firm's registration requiring them to send to us monthly capital calculations and financial information. We also identified it as a significant deficiency when we reported to the firm on the review's findings.

The common deficiencies we identified from the sweep are listed below, along with where to get more information on the requirements and guidance to address the deficiencies.

1. Excess working capital deficiency. See section 4.1.2 of this report under *Insufficient working capital and failure to report capital deficiency* and *Inaccurate calculations of excess working capital*.
2. Inadequate relationship disclosure information to clients. See section 4.1.2 of this report under *Inadequate relationship disclosure information*.
3. Misleading marketing practices. See [CSA Staff Notice 31-325 Marketing Practices of Portfolio Managers](#).



4. Inadequate trade matching policies. See *Lack of awareness of trade-matching requirements* in section 5.4.1 of [OSC Staff Notice 33-738](#).
5. Inadequate personal trading policies. See section 4.3.1 of this report on *Inadequate personal trading policies*.

We believe that this sweep was effective in helping the reviewed firms to better understand their key regulatory requirements, and in enhancing their compliance through the corrective actions they took to address identified deficiencies. It also developed a relationship for the reviewed firms with staff from the CRR Branch. We will continue to perform sweep reviews of newly registered firms on an ongoing basis and will use the information we obtain to enhance our outreach to registrants.

### 4.3.3 PM client account statement practices

In last year's report, we outlined our concern that some PMs are not meeting their obligations to deliver an account statement to each of their clients as required under section 14.14 of NI 31-103. These PMs are not delivering account statements because their clients' custodians deliver account statements to them for accounts over which the PMs have discretionary trading authority. Some of these PMs told us that they outsourced their account statement delivery to their clients' custodians; however, in many cases these PMs do not appear to be responsible or accountable for the custodians' delivery of the account statements. We also found that some PMs that deliver account statements do not list the transactions that they have made in their clients' accounts, as they only disclose investment holdings.

We expect PMs to deliver an account statement in their firm's name to each of their clients at least quarterly for each account that they manage for the client (unless monthly statements are requested). The statements must contain transaction and holding information, and should not contain disclaimers on the completeness or accuracy of the reported information. A consolidated account statement may be provided when appropriate accounts are grouped and they contain adequate disclosure, and the consolidated statement is delivered in addition to statements for each account managed by the PM (see guidance on *Use of consolidated account statements* in section 5.4.1 of [OSC Staff Notice 33-738](#)).

PMs do not meet their statement delivery obligation by solely relying on the fact that their clients' custodians deliver account statements to them. PMs may outsource statement delivery to a service provider if they meet the guidance in 31-103CP for outsourcing arrangements which includes that they:

- are responsible and accountable for all functions that they outsource to a service provider,
- supervise the service provider, and
- have a written, legally binding contract with the service provider that includes the expectations of the parties to the outsourcing arrangement.



See Parts 11 and 14 of [31-103CP](#) for the CSA's complete expectations when registered firms enter into outsourcing arrangements.

We believe that clients of most PM firms receive account statements from their PM and separate statements from the clients' custodian. The PM statement reports on the trades and investments that the PM has authorized and made for them as being suitable to meet the client's investment objectives and frequently also provides performance and cost reporting. The custodian statement reports the assets that an IIROC dealer member or financial institution holds and protects for a client, and that are obligations of the custodian to the client.

We think that investors are better protected and served when they receive statements from both their PM and custodian. However, given certain firms' practices where only one statement is provided, we are considering whether and in what circumstances investors will be equally protected by this practice. We are working with the CSA to review service arrangements between PMs and their clients' custodians, including for account statement delivery, and to determine if any changes to the custody requirements impact account statement delivery requirements (see section 4.1.3 *Review of custody requirements for non-SRO registrants*). In addition, as part of the CRM2 amendments that begin on July 15, 2015, PMs will be required to provide to their clients "additional statements" about the investments over which they have trading authority. This requirement will be a factor for us to consider as we review the practices of certain firms who provide only one statement.

Until this work is completed, we consider the following when assessing if a PM is meeting its statement delivery obligations to its clients when only the client's custodian delivers a statement to the client:

- if all of the client's assets managed by the PM are held at the custodian (and not the PM or another party);
- if the PM ensures that an account statement is delivered to each of the PM's clients directly by the custodian at the frequency, and with the content, required by NI 31-103 (such as by receiving a copy of the statement or testing the delivery practices of the custodian); and
- if the PM takes reasonable steps to ensure the content of the custodian's statement to its clients is complete and accurate (such as by regularly reconciling its records against the custodian's records).

*[Editor's note: The above interim guidance on PM client account statement practices has been replaced by CSA Staff Notice 31-347 Guidance for Portfolio Managers for Service Arrangements with IIROC Dealer Members, which was published on November 17, 2016]*



#### 4.3.4 New framework for direct electronic access

The CSA and IIROC have established a new regulatory framework for managing the risks associated with direct electronic access (DEA) to marketplaces. On July 4, 2013, the CSA published amendments to NI 23-103 *Electronic Trading* (NI 23-103) and IIROC published related amendments to the Universal Market Integrity Rules and their Dealer Member Rules (see [IIROC Notice 13-0184](#)). The new DEA framework builds on the existing framework to address risks in Canadian markets arising from the speed and automation of electronic trading, and is expected to come into force on March 1, 2014.

The rule changes are relevant for entities that offer or use DEA to send orders to marketplaces. The amendments allow only a participant dealer<sup>9</sup> to offer DEA to others. Participant dealers may not offer DEA to registered dealers including EMDs, as these dealers are not subject to the same standards as investment dealers. We note that the use of DEA by investment dealers is covered under the IIROC amendments rather than under NI 23-103. A PM may use DEA when it is provided by a participant dealer for trading in its own accounts or the accounts of its advisory clients, subject to additional requirements.

For more information, see [Amendments to NI 23-103](#), which is to be retitled as *Electronic Trading and Direct Electronic Access to Marketplaces*.

### 4.4 Investment fund managers

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

#### 4.4.1 Current trends in deficiencies and suggested practices

##### **Inappropriate expenses charged to funds**

We continue to find that some IFMs are charging inappropriate expenses to the investment funds they manage. This negatively impacts the fund's investors, as it inappropriately reduces the fund's net assets and returns. Although we have highlighted this deficiency in previous years, we emphasize it once again given its importance. When we identify this deficiency, we require the IFM to reimburse the applicable fund(s) for the inappropriate expenses, and depending on the facts and circumstances, we may take further regulatory actions, such as imposing terms and conditions or recommending suspension of registration.

IFMs should only charge expenses to their investment funds that are related to the operation of the investment funds. Some IFMs are charging their investment funds expenses that are related to the operation of the IFMs' business and not the investment funds. Some examples of inappropriate expenses

<sup>9</sup> A participant dealer is a marketplace participant that is an investment dealer or in Quebec, a foreign approved participant.



noted in our compliance reviews include fees for the audit of the IFM (as opposed to audit fees for the funds), and insurance premiums, professional dues and recruiting expenses 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 its investment funds.

We also find that a number of IFMs do not properly allocate the appropriate amount of expenses between the operation of the IFM and the operation of the funds. This occurs because often there are expenses common to the operation of the IFM business and the management of the funds. This often results in an over-allocation of expenses to some of the investment funds. For example, some IFMs use a single allocation rate to allocate different types of overhead expenses to their investment funds without considering whether each type of expense relates to the operation of each of the funds, and whether the single allocation rate is the appropriate rate for all types of expenses. Also, some IFMs do not have procedures to review the expense allocation methodology on a regular basis to ensure that it remains fair and reasonable to all 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. They should also ensure that expenses are allocated fairly and appropriately to all funds.

### ***Suggested practices***

IFMs should:

- establish policies and procedures to ensure that their investment funds are only paying for expenses that are related to the operation of those funds. The policies and procedures should, at a minimum:
  - address the types of expenses that are eligible to be paid by the funds,
  - ensure that expense invoices are reviewed and approved by an authorized person before they are processed for payment, and
  - ensure that expenses charged to the funds are only for types of expenses that are disclosed in the funds' offering documents as being permitted expenses.
- review their expense allocation methodology for their funds on a regular basis and maintain evidence of the review. The review should cover, at a minimum:
  - how each type of expense relates to the operations of the funds, and
  - the factors used to determine the allocation rate for each type of expense.
- provide clear and specific disclosure in the funds' offering documents regarding the types of



expenses that will be charged to the funds.

### **Inadequate disclosure in offering memoranda**

We reviewed a number of IFMs that manage investment funds offered through offering memoranda (instead of prospectus or simplified prospectus). We noted some instances where the offering memoranda contained inadequate and/or misleading disclosure, particularly in the following areas:

- conflict of interest matters,

- types of expenses that are paid by the investment funds, and
- the method of calculating performance fees; in particular, how any hurdle rate is to be applied in the event that a fund's performance exceeds any high water mark part-way through the year.

We also noted some cases where the IFMs, who were also the distributors of the investment funds, did not recognize that certain promotional documents (such as term sheets and confidential information memoranda) provided to potential investors met the definition of an "offering memorandum" under section 1(1) of the Act. In these cases, there was no disclosure of the purchaser's right of action for damages and right of rescission under section 130.1 of the Act, and the documents were not delivered to the OSC as required under section 5.4 of [OSC Rule 45-501 Ontario Prospectus and Registration Exemptions](#) (OSC Rule 45-501).

Under the standard of care requirement in section 116 of the Act, IFMs should ensure that all information contained in the offering memorandum of an investment fund managed by them is factual, accurate and not misleading. Section 5.3 of OSC Rule 45-501 requires an offering memorandum to disclose a purchaser's right of action for damages and right of rescission in the event of a misrepresentation (as outlined in section 130.1 of the Act) for many distributions under a prospectus exemption (see section 5.1 of OSC Rule 45-501), including the accredited investor and minimum amount investment exemptions. Furthermore, the offering memorandum needs to be delivered to the OSC within 10 days of the distribution.

### ***Suggested practices***

IFMs should review the offering memoranda of their investment funds to ensure that they adequately and accurately disclose all material facts relating to the investment funds, including:

- the types of expenses that are to be paid by the funds in clear and specific terms,
- conflict of interest matters, such as fees paid to related parties, and
- details on how any performance fees are calculated, including how any hurdle rate is to be applied if the fund's performance exceeds any high water mark part-way through the year.

### **Inadequate oversight of outsourced functions and service providers**

We continue to identify situations where IFMs inadequately oversee their funds' service providers. Many IFMs outsource certain aspects of their IFM operations (such as fund accounting, trust accounting and transfer agency) to third-party service providers. Some IFMs rely solely on third-party service providers 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,
- on an ongoing basis, review the quality of work performed by service providers, including:
  - the calculation of net asset value,
  - reports on income and expenses of the funds,
  - valuation of hard-to-value securities,
  - reconciliation of total number of units outstanding between fund accounting records and transfer agent records,
  - security position reconciliations between fund accounting records and the fund's custodian records, and
  - trust account reconciliations,
- review exception reports and follow-up on variances,
- adequately document their monitoring of service providers,
- ensure that service providers have adequate safeguards for keeping information confidential, and
- develop and test a business continuity plan to minimize disruption to the IFM if the service providers do not deliver their services satisfactorily.

### **Non-delivery of net asset value adjustments**

A number of IFMs did not provide us with a description of net asset value (NAV) adjustments for investment funds that they manage as part of their annual or interim financial reporting.

Section 12.14 of NI 31-103 requires an IFM to deliver to its principal regulator a description of any NAV adjustment made in respect of an investment fund it manages during the year or interim period (as applicable), within 90 days after the end of the IFM's financial year and no later than 30 days after the end of the first, second and third interim period of the IFM's financial year (as applicable). The description of a NAV adjustment must include:

- the name of the fund,
- assets under administration of the fund,
- the cause of the adjustment,
- the dollar amount of the adjustment, and
- the effect of the adjustment on NAV per unit or share and any corrections made to the purchase and sale transactions affecting either the investment fund or security holders of the investment fund.

We expect IFMs to have policies and procedures in place to ensure that descriptions of any NAV adjustments made to their investment funds are delivered to their principal regulator within the required timeframe.

### ***Suggested practices***

We encourage IFMs to also provide the following details as part of the description submitted for a NAV adjustment:

- date(s) of the NAV error
- date of the NAV adjustment
- total dollar amount of the NAV adjustment for each investment fund affected by the NAV adjustment
- percentage change in NAV for each of the investment funds affected due to the NAV adjustment
- if the NAV adjustment was the result of a material error under the IFM's policies and procedures
- date of the reimbursement
- total amount reimbursed to each of the investment funds, if any
- total amount reimbursed to the security holders of each of the investment funds, if any
- description and date of any corrections made to purchase and redemption transactions affecting either the investment funds or security holders of each of the investment funds
- how long before the NAV error was discovered
- how long after the NAV error was discovered that the NAV adjustment was made
- if the NAV error was discovered by the IFM or by another person
- if the policies and procedures of the IFM were changed following the NAV adjustment and if

so, a description of the changes, and

- if the NAV adjustment was communicated to security holders of each of the investment funds affected and if so, a description of the communications

#### 4.4.2 New and proposed rules and initiatives impacting IFMs

Our Investment Funds Branch has worked on a number of new and proposed rules with the CSA on the regulation of investment funds, and other initiatives, which impact IFMs. A summary of some of this work follows.

##### **Investment funds modernization project**

On March 27, 2013, the CSA published for comment (now closed) proposed amendments to NI 81-102 to introduce core operational requirements for publicly offered non-redeemable investment funds. The CSA also sought input on an alternative fund framework, to be effected through amendments to NI 81-104 *Commodity Pools*. This framework would operate in conjunction with the proposed NI 81-102 amendments and would govern investment funds that invest in assets, or use investment strategies, that would not be permitted under the proposed NI 81-102 amendments.

These proposals are the first stage of Phase 2 of the CSA's investment funds modernization project. The objective is to identify and address any market efficiency, investor protection or fairness issues from the differing regulatory regimes that apply to different types of publicly offered investment funds.

The CSA will next review the investment restrictions applicable to mutual funds to assess if any changes should be made in light of market and product developments. For more information, see [Amendments to NI 81-102 and Companion Policy 81-102CP](#).

##### **Point of sale disclosure**

On June 13, 2013, the CSA published the final amendments to NI 81-101 *Mutual Fund Prospectus Disclosure* which (i) include amendments to the Fund Facts form requirements, and (ii) require delivery of the Fund Facts instead of the prospectus to satisfy the requirement to deliver a prospectus within two days of buying a mutual fund. The amendments will take effect June 13, 2014.

The CSA continues to encourage early adoption of the delivery of the Fund Facts instead of the prospectus, in order to assist investors in their decision-making process and in discussions with their financial advisors.

For more information, see [CSA Implementation of Stage 2 of Point of Sale Disclosure for Mutual Funds – Delivery of Fund Facts](#).

### **New prospectus form for scholarship plans**

The CSA amended the prospectus requirements for scholarship plans by introducing a prospectus form tailored to reflect the unique features of scholarship plans. This is an important investor-focused initiative. New Form 41-101F3 *Information Required in a Scholarship Plan Prospectus* will require scholarship plans to provide investors with key information in a simple, accessible and comparable format to assist them in making more informed investment decisions. Central to the new prospectus form is the Plan Summary document. It is written in plain language, will generally be no more than four pages, and highlights the potential benefits, risks and the costs of investing in a scholarship plan. It will form part of the prospectus, but will be bound separately.

The amendments came into force on May 31, 2013. For more information, see the CSA's notice on [Implementation of a New Prospectus Form for Scholarship Plans](#) as part of amendments to NI 41-101.

### **Mutual fund fees**

The CSA is examining the mutual fund fee structure in Canada to see if there are investor protection or fairness issues, and to determine whether any regulatory responses are needed. The CSA published [CSA Discussion Paper and Request for Comment 81-407 Mutual Fund Fees](#) in late 2012, and held a consultation roundtable in June 2013 to engage various stakeholders in the discussion of the issues raised in the paper. At the same time, the CSA continues to monitor and assess the effects of related regulatory reforms in Canada and globally.

### **Continuous disclosure review of sales communications**

Our Investment Funds Branch recently conducted a targeted review of sales communications from a sample of publicly offered investment funds. [OSC Staff Notice 81-720 Report on Staff's Continuous Disclosure Review of Sales Communications by Investment Funds](#) summarizes the findings and provides guidance to address the findings.





## 5. Acting on registrant misconduct

### 5.1 Registrant misconduct cases of interest

## 5. Acting on registrant misconduct

### 5.1 Registrant misconduct cases of interest

We stay alert for signs of potential registrant misconduct or fraud and when we find evidence of either we take appropriate regulatory action. The CRR Branch works together with the Enforcement Branch to maintain an effective compliance-enforcement continuum for registrants, and to take appropriate regulatory action 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 four SPD cases discussed in section 4.2.2 of this report, 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 the OSC's website under [All Commission Proceedings](#). Further, [Director's Decisions](#) from the CRR Branch are also available on our website.

In 2012, we performed a Suitability Sweep of almost 90 PMs and EMDs (see [OSC Staff Notice 33-740](#)). To date, this sweep has resulted in the suspension of one firm and two individuals:

- In [Re Investment Allocation International Inc. and Miller](#) (June 4, 2013), the registrants were a PM and its UDP, CCO, and sole advising representative. During the Suitability Sweep, we found, among other things, that the firm did not have sufficient working capital, and the individual had raised money for his small internet start-up company by selling securities of the company to most of his clients whose portfolios he managed on a discretionary basis. We alleged that the registrants had not properly addressed the conflicts of interest in the sale of these securities, and that certain management fees were not properly disclosed to investors. We recommended to the Director that the registrants be suspended, and the registrants requested an opportunity to be heard (an OTBH) in relation to that recommendation. Ultimately, staff and the registrants settled the matter on terms that included a permanent suspension of the firm and the individual as a UDP and CCO, and a temporary suspension of the individual's registration as an advising representative.
- In [Re Gbalajobi](#) (July 26, 2013), the registrant was the CCO and dealing representative of an EMD. During the Suitability Sweep, we found, among other things, that the registrant had traded in securities while his firm was suspended, that he did not properly record KYC information for a number of clients, and that he could not demonstrate to staff that he had assessed the suitability of an investment for another client. We recommended to the Director that the individual be suspended, and after an OTBH was requested, the matter was settled on the basis that the individual's registration as





a CCO would be suspended for three years, and his registration as a dealing representative would be suspended for nine months.

Although staff has made use of settlement agreements as part of the OTBH process, such arrangements are not appropriate in all cases, and we remain committed to pursuing regulatory action through contested OTBH proceedings when necessary. For example:

- In [\*Re Trinity Wood Securities Ltd. and Browning\*](#) (October 31, 2012), the Director refused a firm's application for registration as an IFM and EMD, and the individual's application to be its UDP, CCO, and dealing representative. The individual applicant, and companies related to him, had incurred outstanding liabilities of approximately \$2.6 million during his previous tenure as the owner of a registered dealer. The Director was not persuaded by the applicant's submissions during the OTBH that his significant financial difficulties were irrelevant to his application because the corporate applicant was not legally responsible for his outstanding liabilities.
- In [\*Re White Capital Corporation and White\*](#) (April 26, 2013), the Director suspended an EMD and its UDP, CCO, and dealing representative. This decision was made following an OTBH in which the Director found, among other things, that the registrants had not properly addressed a conflict of interest arising out of the firm's receipt of funds from a company related to one of the issuers it was selling, and that their books and records were not sufficient to satisfy its KYC and suitability obligations to clients.

Two earlier OTBH decisions of the Director were the subject of review proceedings decided in 2013:

- In [\*Re Pyasetsky\*](#) (March 28, 2013), the Commission reviewed the decision of the Director to refuse the applicant's application for registration as a dealing representative in the category of mutual fund dealer. The applicant had failed to disclose in her application for registration that she had been employed by a "boiler room", and the Director concluded that this, and other statements by her, indicated that she lacked the requisite integrity for registration. Following a hearing and review under section 8 of the Act, a panel of the Commission also concluded that the applicant did not have the integrity required for registration, and refused her application.
- In [\*Sawh v. Ontario Securities Commission\*](#) (June 12, 2013), the Divisional Court dismissed an appeal brought by two applicants in respect of a decision of the Commission to refuse their applications for registration as dealing representatives in the category of mutual fund dealer. In 2011, the Director determined that the applicants lacked the requisite integrity for registration on the basis of, among other things, their conduct in selling prospectus-exempt securities to clients that did not qualify for any prospectus exemptions, and for whom the investments were unsuitable. In 2012, the Commission reviewed the Director's decision pursuant to section 8 of the Act, and reached the same conclusion.



Before the Divisional Court, the applicants argued that the Commission ought to have showed deference to a settlement agreement the applicants entered into with the MFDA regarding the conduct in question. That settlement did not impose a ban on the applicants becoming dealing representatives. The Divisional Court rejected this argument, and confirmed that the Commission, and not the MFDA, has the jurisdiction over the registration of dealing representatives in the category of mutual fund dealer.

This year has also seen a number of registrant-related enforcement matters before the Commission:

- In [\*Re Morgan Dragon Development Corp.\*](#) (April 10, 2013), the Commission imposed monetary penalties and trading and registration bans against a registered firm and its UDP and CCO, who admitted that they had engaged unregistered individuals to act as commissioned securities salespeople, and had traded in prospectus-exempt securities with individuals who did not qualify for prospectus exemptions.
- In [\*Re Juniper Fund Management Corp.\*](#) (April 11, 2013), the Commission found that a fund manager and its president, with respect to its investment funds, (i) failed to maintain proper books and records, (ii) failed to provide full, true and plain disclosure of all material facts, and (iii) breached their statutory duty of care. The Commission also found that one of the Juniper funds provided prohibited loans and held prohibited investments contrary to sections 111 and 112 of the Act. A sanctions and costs hearing started on October 25, 2013 and is ongoing.
- In [\*Re Crown Hill Capital Corp.\*](#) (August 23, 2013), the Commission found that an IFM and its directing mind breached their fiduciary duty in connection with several transactions made for their investment funds. The decision states that an IFM's fiduciary duty under section 116 of the Act requires it to:
  - act with utmost good faith and in the best interests of the investment fund and put the interests of the fund and its unitholders ahead of its own,
  - generally avoid material conflicts of interest and transactions that give rise to material conflicts of interest on the part of the IFM, including self-interested and related party transactions,
  - where a conflict of interest cannot be avoided, or where a material self-interested or related party transaction is proposed, ensure that the conflict of interest or transaction is appropriately addressed as a matter of good governance and in compliance with NI 81-107 *Independent Review Committee for Investment Funds*,
  - make full disclosure to the board of directors, the independent review committee and unitholders, as the circumstances may dictate, in respect of all of the circumstances surrounding a material conflict of interest or self-interested or related party transaction,
  - obtain the informed consent of unitholders where a conflict of interest or self-interested or related party transaction is sufficiently material to warrant obtaining such consent, and



- ensure compliance in all material respects with the terms of the declaration of trust governing the relationship between the IFM and the investment fund.

A sanctions and costs hearing has not yet occurred.

- In [\*Re Quadrex Asset Management Inc.\*](#) (ongoing), the Commission suspended the registration of an IFM, PM, and EMD, and issued a cease trade order in respect of certain investment products managed by the firm, after the firm reported a large capital deficiency that it was unable to rectify. The firm's portfolio management clients have been transferred out, and a receiver has been appointed to manage the wind-up of the firm. This matter remains ongoing.
- In [\*Re Pro-Financial Asset Management Inc.\*](#) (ongoing), the Commission suspended the EMD registration of a firm and placed its PM registration on terms and conditions pending the proposed sale of the firm's portfolio management and investment fund management business. The firm's auditor confirmed a large capital deficiency, and the firm also informed us of a shortfall in the proceeds necessary to honour redemption requests of certain series of principal protected notes. This matter remains ongoing.





## 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 developed a new outreach program to registrants (see section 2.1 of this report) to help them understand and comply with their obligations. We encourage registrants to visit our [Registrant Outreach web page](#) on the OSC's website.

Also, the [Information for: Dealers, Advisers and IFMs](#) section on the OSC website provides detailed information about the registration process and registrants' ongoing obligations. It includes information about compliance reviews and suggested practices, provides quick links to forms, rules and past reports and email blasts to registrants. It also contains links to previous years' versions of our annual summary reports to registrants.

The [Information for: Investment Funds](#) section on our website also contains useful information for IFMs, including past editions of The Investment Funds Practitioner published by our Investment Funds Branch.

Registrants may also contact us. Please see Appendix A to this report for the CRR Branch's contact information. The CRR Branch's PM, IFM and dealer teams focus on registration, oversight, policy changes, and exemption applications for their respective registration categories. The Registrant Conduct team supports the PM, IFM and dealer teams in cases of potential registrant misconduct. The financial analysts on the Compliance, Strategy and Risk team review registrant submissions for financial reporting (such as audited annual financial statements, calculations of excess working capital and subordination agreements).

**Appendix A**  
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November 7, 2013

