



ONTARIO
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Compliance and Registrant Regulation Branch Annual Report

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Introduction

Introduction

This report is a summary of the Compliance and Registrant Regulation (CRR) Branch's key activities and initiatives for the 2010 fiscal year (April 1, 2009 to March 31, 2010). The CRR Branch's mission is to protect investors by registering and overseeing approximately 1,400 firms and 65,000 individuals in Ontario that trade or advise in securities or commodity futures, or act as an investment fund manager. This includes direct oversight of firms and individuals registered in the categories of portfolio manager, investment fund manager, commodity trading manager, exempt market dealer and scholarship plan dealer. We also register firms and individuals in the category of mutual fund dealer and firms in the category of investment dealer that are directly overseen by their self-regulatory organizations, the Mutual Fund Dealers Association of Canada (MFDA) and the Investment Industry Regulatory Organization of Canada (IIROC), respectively.

In previous years, the Compliance team of the CRR Branch published annual reports that summarized the findings from compliance oversight reviews of registrants, together with our suggested practices. This year's report continues this, but also covers our branch's other activities such as:

- the introduction of the new registration regime
- the reorganization of our branch in March 2010, and
- the common deficiencies found in our reviews of registration applications and actions to address them.

This report is primarily targeted to registered firms and individuals, and people that support them such as their legal counsel and compliance consultants. We encourage existing and potential registrants to use this report to improve their understanding of:

- their initial and on-going registration and compliance requirements
- our expectations of registrants and our interpretations of regulatory requirements, and
- new and proposed rules and other regulatory initiatives.

This report can also serve as a self-assessment tool to strengthen registrants' compliance with Ontario securities law, and to improve their systems of internal controls and supervision.¹

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



1. Registration reform

- 1.1 New registration regime
- 1.2 Reorganization of CRR Branch
- 1.3 New CRR Branch organization chart

1. Registration reform

1.1 New registration regime

After years of work, we developed and implemented a new registration regime that came into force on September 28, 2009. We developed the new regime with other members of the Canadian Securities Administrators (CSA), with an objective to harmonize, streamline and modernize the registration requirements across Canada. In Ontario, these reforms were introduced through National Instrument 31-103 Registration Requirements and Exemptions (NI 31-103) and amendments to the Securities Act (Ontario) and to related rules. These reforms replaced a patchwork of rules across Canada that imposed different requirements in each jurisdiction, and are intended to strike an appropriate balance between providing an efficient system for registrants and protecting investors.

The reforms introduce new requirements for the registration of individuals and firms, along with new on-going requirements for their business operations and client relationships.

Key changes to the requirements for individual and firm registration include:

- requiring firms and individuals to register as a dealer when they are in the business of trading in securities (which is a business trigger) instead of when they trade in a security (which is a trade trigger)
- the introduction of the investment fund manager category of registration for firms that direct the business, operations and affairs of investment funds
- the introduction of the exempt market dealer category of registration, which replaces the former limited market dealer category and adds more robust requirements (including new proficiency, working capital and insurance requirements), and
- the introduction of registration requirements for chief compliance officers and ultimate designated persons for all registered firms.

Key changes to the on-going requirements for the business operations and client relationships of registered firms include:

- more robust and risk-based working capital and insurance requirements
- a requirement to identify and respond to conflicts of interest
- a requirement to fairly and effectively deal with client complaints, and
- new requirements for referral arrangements, including written disclosure to clients.

Changes were also made to the National Registration Database to convert firms and individuals that were already registered to their new categories of registration. We also updated our compliance oversight programs to reflect the new requirements.

Since we've harmonized on-going requirements for registrants, it is important to continue to harmonize our registrant oversight. We are working with other members of the CSA to harmonize the compliance oversight programs for registrants across Canada.

To help make market participants aware of the new requirements, we have

- responded to questions from stakeholders (together with the OSC's Inquiries and Contact Centre)
- published responses to frequently asked questions (FAQs) on NI 31-103 (see [CSA Staff Notices 31-313](#) and [31-314](#))
- issued relief orders to deal with some transitional issues (see [CSA Staff Notice 31-315](#)), and
- communicated changes to the industry through speaking engagements and e-mail blasts to registrants.

We will continue to keep our stakeholders informed of key developments.

On June 25, 2010, the CSA published for comment a package of proposed amendments to NI 31-103. If the amendments are implemented in their current form, they would primarily address practical issues identified during the implementation stage. They would also:

- expand the circumstances in which registered firms are required to ensure that independent dispute resolution or mediation services are made available to their clients to resolve complaints to include, for example, cases of misrepresentation, theft, fraud, misappropriation or forgery
- codify, as part of the proficiency requirements, an obligation for registered individuals to understand the structure, features and risks of each security they recommend (referred to as "know your product")
- address the impact of the coming introduction of International Financial Reporting Standards on the valuation of securities, such as for account reporting to clients, and
- obligate investment fund managers to deliver trade confirmations and account statements to investors who deal with them directly, rather than through a dealer.

The CSA also requested feedback to questions on potentially amending NI 31-103 to require periodic account statements to include reporting of client name securities. For more information, see [Notice of and Request for Comment on Proposed Amendments to NI 31-103](#).



1.2 Reorganization of CRR Branch

This section describes the changes we made to our branch to better serve our stakeholders under the new registration regime.

The new registration regime introduced a significant number of new on-going requirements, many of which are principles-based. To deal with these changes, and to improve the effectiveness and efficiency of our branch and ultimately improve investor protection, we reorganized the branch effective March 2010.

Former branch structure

Previously, our branch was organized into three groups:

- the registration group, which consisted of registration officers who reviewed and processed firm and individual registration applications
- the compliance group, which primarily consisted of accountants who performed oversight reviews of registrants to assess compliance with regulatory requirements, and
- the registrant legal services group, which consisted of lawyers who developed policy affecting registrants and handled exemptions from registration requirements.

New branch structure

As part of the reorganization, the previous groups were replaced with three integrated teams of lawyers, registration officers, and accountants. Each team focuses on registration, oversight, policy changes, and exemption applications for a particular category of registrant. One team focuses on portfolio managers, the second on investment fund managers, and the third on dealers (including exempt market dealers and scholarship plan dealers). Each team has developed depth of knowledge of their particular registration category and can draw on the experience of team members trained in different disciplines.

A fourth team was created to focus on registrant conduct and risk analysis. This team supports the other three teams in cases of potential registrant misconduct and on risk assessment matters. For example, it handles opportunity to be heard hearings before the Director, and is involved in suspensions of registration, applying terms and conditions on registration and referrals of certain suspected registrant misconduct to the Enforcement Branch. This team will also lead in the development of a risk-based approach for assessing applications for initial registration.

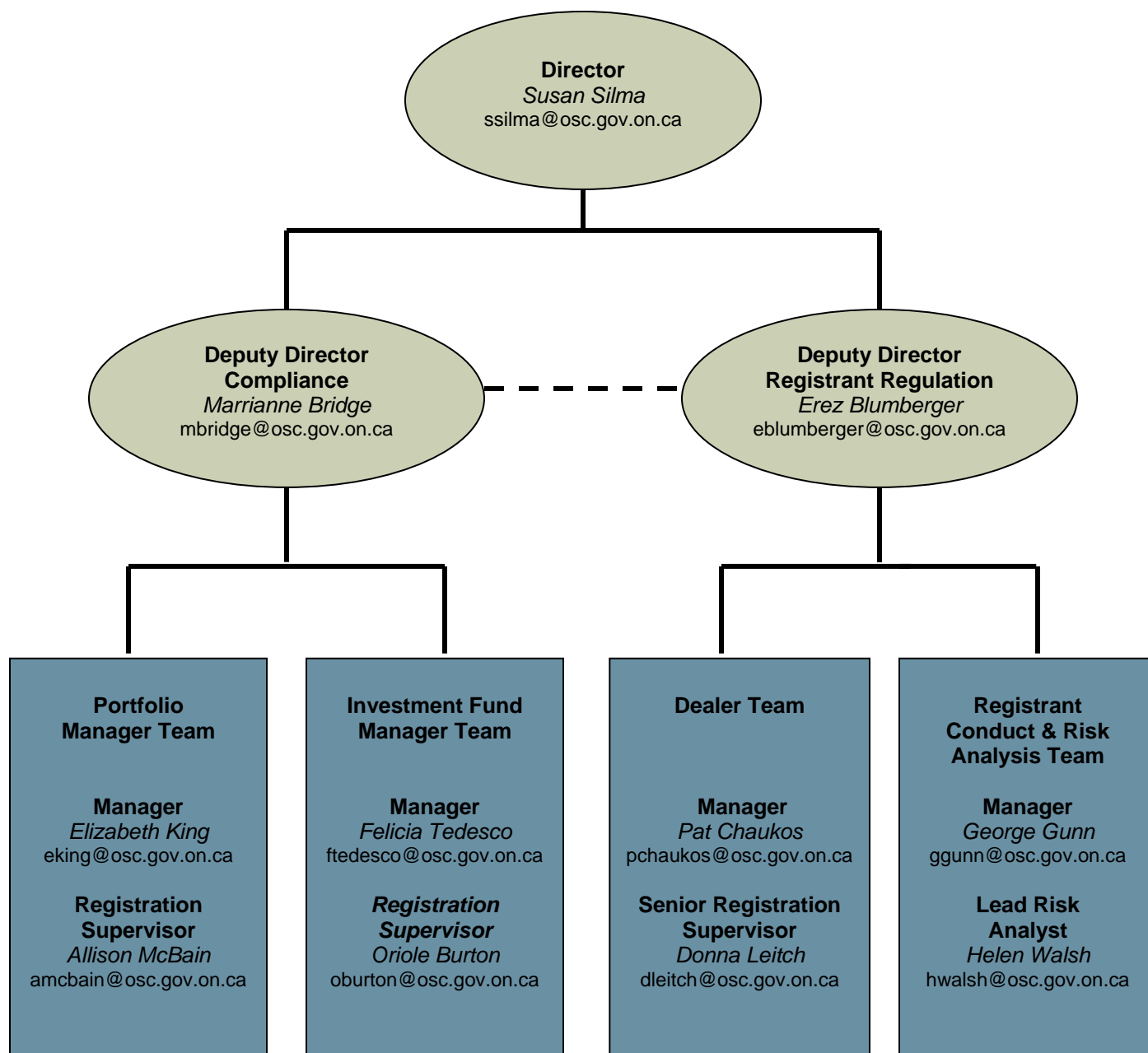
It is anticipated that the reorganization will further enhance our ability to:

- protect investors



- promote high standards of registrant conduct
- treat registrants fairly and consistently
- understand the products and business of registrants and the issues they face
- use risk-based approaches to pursue the higher-risk issues, and
- be proactive and strive for practical, timely and valued added outcomes.

1.3 New CRR Branch organization chart



See Appendix for the organization charts for each of the CRR Branch's teams.



2. Information for new applicants for registration

- 2.1 Applying for registration
- 2.2 Risk-based approach to registration reviews
- 2.3 Common deficiencies from registration applications

2. Information for new applicants for registration

2.1 Applying for registration

This section provides information for firms and individuals applying for registration for the first time.

The CRR Branch reviews firm and individual applications for registration as an adviser, dealer or investment fund manager under securities law and commodity futures law in Ontario. Firms and individuals must complete prescribed forms to register. For example, Form 33-109F6 *Firm Registration* and Form 33-109F4 *Registration of Individuals and Review of Permitted Individuals* must be completed by firms and individuals applying for registration under the *Securities Act*. For more information about the registration process, see the [Information for Dealers, Advisers and Investment Fund Managers](#) section of the OSC's website.

An applicant may apply for registration in more than one province or territory as part of its application. If the OSC is the principal regulator, the application is processed under the passport system. We conduct a review of the application and our decision will be effective in the other jurisdictions. If the OSC is not the principal regulator, the application is processed under the interface system. Generally, this means that the applicant only deals with the principal regulator who reviews the application. We decide whether to opt in (with or without local terms and conditions) or opt out of the principal regulator's decision. If we are unable to resolve opt out issues, the applicant will need to deal with us directly to resolve them. For more information about registering in more than one jurisdiction, see [National Policy 11-204 Process for Registration in Multiple Jurisdictions](#).

2.2 Risk-based approach to registration reviews

We intend to rate an applicant's risk of not meeting registration requirements by establishing a risk model that will allow us to focus more attention on higher risk applicants. We plan to develop a risk assessment process for reviewing both firm and individual registration applications. In the short term, we will be focusing our attention on investment fund manager registration applications (which were due by September 28, 2010). A risk assessment process for other registration categories will be developed in the longer term. Our risk model may include the following criteria:

- previous sanctions or warning letters issued to an applicant
- if the applicant is the subject of an investigation
- criminal record
- solvency, and
- firm record.

Other factors may also impact our risk assessment.

2.3 Common deficiencies from registration applications

Sometimes, the registration review process is longer because the information provided to us in a registration application form is incomplete or lacks sufficient detail for us to adequately assess the information. To address this, we created a list of the most common deficiencies from our reviews of individual and firm registration applications. To address each deficiency, we provide actions to be taken by applicants when completing their registration applications. To expedite the application and review process, we encourage applicants for registration to review these common deficiencies and to follow the provided actions before submitting their registration applications to us.

The deficiencies and actions to be taken are listed in the same order as the information is requested on the applicable registration application forms. References to item numbers and schedules are to specific sections of the firm or individual registration application forms.



Firm applications - Form 33-109F6

Deficiency noted	Action to be taken
The firm's National Registration Database (NRD) number is not provided. (Item 1.2)	Include the firm's NRD number. To obtain an NRD number, firms must enroll on NRD. For more information, visit www.nrd-info.ca
Agent and address for service information is not completed, when applicable. (Item 2.4/Schedule B)	Include the agent's name, full address and contact details (telephone, fax number and e-mail address) when the firm does not have an office in a jurisdiction of Canada where it is seeking registration.
Insufficient information is provided regarding the firm's proposed business activities. (Item 3.1)	Provide detailed information about the firm's proposed activities, target market, and products and services to be offered. Section 26 of the <i>Securities Act</i> should be kept in mind when completing this item.
The firm's business registration number(s) is not provided, when applicable. (Item 3.9)	Provide the firm's business registration number(s) for each jurisdiction of Canada where the firm is seeking registration, when a business registration number is required under the local laws of the jurisdiction.
The firm's ownership chart is incomplete or does not provide the requested information. (Item 3.12)	Include a complete ownership chart that includes the owner's name(s), and the class, type, amount and voting percentage of ownership of the firm's securities.
The firm's subordination agreement(s) is not provided, when applicable. (Item 5.1/Line 5 of Schedule C)	Provide a copy of all subordination agreements (in the form set out in Appendix B to NI 31-103) that the firm has executed with its lenders to exclude an amount from its long-term related party debt as calculated on Form 31-103F1 <i>Calculation of Excess Working Capital</i> .
Bonding or insurance details are incomplete. (Item 5.5)	Include all requested bonding or insurance details, including name of insurer, policy number, coverage details, amount of deductible, and renewal date. We will accept a binder of insurance with the initial application. Confirmation that the insurance is in effect must be provided prior to registration being granted.

Individual applications – Form 33-109F4

Deficiency noted	Action to be taken
<p>Proficiency information is not provided or updated.</p> <p>(Item 8)</p>	<p>Include information on all required and otherwise relevant courses and examinations, along with student numbers where requested.</p>
<p>Incomplete information is provided on current employment, other business activities, and officer and director positions held. For example, some activities are missing or the description of the activities is missing or inadequate.</p> <p>(Item 10, Schedule G)</p> <p>Also, activities outside of the sponsoring firm are not approved by the sponsoring firm, and the potential conflicts of interest from these outside activities is not addressed by the sponsoring firm.</p>	<p>Individuals must provide information on all current employment and other business activities for which they receive compensation, as well as any officer or director positions held (whether or not compensation is received). This includes, for example, positions as directors of charitable organizations.</p> <p>Individuals should provide a detailed description of their duties for each activity. This helps us to assess if any of these activities (especially those that are securities related) are a conflict of interest with the individual's activities as a registrant.</p> <p>The sponsoring firm must approve activities outside of the sponsoring firm, and potential conflicts of interest must be addressed. See section 13.4 of the Companion Policy to NI 31-103 for guidance on conflicts of interest.</p>
<p>Incomplete information is provided for:</p> <ul style="list-style-type: none"> • resignations and terminations • regulatory disclosure • criminal disclosure • civil disclosure, and • financial disclosure. <p>(Items 12 to 16 inclusive)</p>	<p>It is the responsibility of the firm to conduct its own due diligence on an individual it intends to sponsor. Firms should ensure that resignations and terminations, and regulatory, criminal, civil and financial disclosure are complete and accurate. Incomplete or misleading information may lead to the individual's registration being delayed or refused or to other regulatory action.</p>
<p>Information on the ownership of securities and derivatives firms is missing or incomplete.</p> <p>(Item 17)</p>	<p>Information on the ownership of any securities or derivatives firms should be provided and be complete and accurate.</p>

Other common deficiencies applicable to both firm and individual applications

Deficiency noted	Action to be taken
<p>Updating the Form 33-109F6 (F6) and Form 33-109F4 (F4): Changes to the information previously filed on these forms are often not made within deadlines prescribed under securities law.</p>	<p>Use Form 33-109F5 (F5) to update changes in information on the F6 and F4. The F5 must generally be filed within seven days of most changes to the information provided in the forms. <u>National Instrument 33-109 Registration Information</u> outlines the changes that require notification to the regulator and the filing deadlines.</p> <p>Making these filings on time will prevent the firm being assessed a late fee of \$100 per business day, as well as, in some cases, the imposition of terms and conditions.</p>
<p>Exemption applications: Applications for exemption from the proficiency requirements are received without sufficient detail to determine if exemptive relief is appropriate.</p>	<p>Provide complete and relevant details on the nature of the relief sought, and the reasons why the relief should be granted. For example, explain how the applicant's education or experience is equivalent to the education or experience requirements under securities law.</p> <p>Exemption applications should be provided with, or shortly following, the submission of an application for registration. If this is not done, the application for registration may be delayed.</p>
<p>Trade names: We are often not properly notified of the use of trade names. Trade names are registered to, and used by, (a) one or more representatives, or (b) a firm. We often incorrectly receive an F5 from a firm requesting that an individual's trade name be added as the firm's trade name.</p>	<p>If one or more representatives are using a trade name, this information must be added under Item 1(3) of each individual's F4.</p> <p>If a firm is using a firm-wide trade name, this information must be added by filing an F5.</p> <p>All trade names must be registered, where required, under the business names legislation that applies to the firm (for example, the <i>Business Names Act</i> (Ontario)).</p>
<p>Certification: Required forms are often certified as true and complete, when some applicable questions are not completed, or supporting documents are not included.</p>	<p>Ensure that all required documents and attachments are submitted and questions are answered with an appropriate level of detail before certifying the information in the form.</p> <p>Incomplete applications will not be treated as filed and will not be added to the queue for review.</p>





3. Information for advisers, investment fund managers and dealers

- 3.1 All registrants
 - A. Compliance review process and its outcomes
 - B. New and proposed rules and initiatives impacting all registrants
- 3.2 Portfolio managers
 - A. Trends in deficiencies from compliance reviews and suggested practices
 - B. Deficiencies from focused reviews of large portfolio managers and suggested practices
 - C. Deficiencies from compliance reviews of newly registered portfolio managers and suggested practices
 - D. Sweep of marketing practices in 2010
 - E. New and proposed rules impacting portfolio managers
- 3.3 Investment fund managers
 - A. Deficiencies from compliance reviews of investment fund managers and suggested practices
 - B. Focused reviews of investment funds in response to market turmoil
 - C. Registration of non-resident investment fund managers
- 3.4 Exempt market dealers
 - A. Risk assessment questionnaire for exempt market dealers
 - B. Deficiencies from compliance reviews of exempt market dealers and suggested practices



3. Information for advisers, investment fund managers and dealers

The information in this section includes the key findings from our normal course reviews of all registrants² we regulate, and also our focused reviews (sweep) of investment fund managers conducted as a result of the market turmoil, our sweep of large portfolio managers, and our sweep of newly registered portfolio managers. We highlight deficiencies from our oversight reviews of registrants and provide suggested practices to address the deficiencies. The suggested practices are intended to give guidance to registrants to help them comply with their regulatory obligations, as they provide our interpretations of the legal requirements and our expectations of registrants. We also discuss new or proposed rules and initiatives impacting registrants.

This part of the report is divided into four main sections. The first section contains general information that is relevant for all registrants. The other three sections contain information and trends specific to portfolio managers, investment fund managers and exempt market dealers, respectively. We recommend that registrants review all sections in this part, as some of the deficiencies noted in the past year for one type of registrant could be relevant in future years to other registrants.

3.1 All registrants

This section includes a general discussion of our compliance review process and its outcomes. It also includes new or proposed rules and initiatives impacting registrants.

A. Compliance review process and its outcomes

On an on-going basis, the CRR Branch conducts compliance reviews of selected registered firms using a risk-based approach. However, we occasionally select firms for review on a random basis, for example, to help us evaluate the effectiveness of our risk-based approach. We usually conduct compliance reviews on-site at a registrant's premises, but may also perform reviews from our offices (known as desk reviews). Most reviews are routine in nature, but we also perform reviews on a for-cause basis where we are aware of a potential compliance issue, for example, from a referral or complaint. We also conduct sweeps, which are reviews of a sample of registered firms on a specific topic or industry sector over a short period of time. Sweeps allow us to respond quickly to industry-wide concerns or issues, such as the recent market turmoil.

² In this report, registrants includes investment fund managers as the new registration regime requires these firms to register, subject to transition provisions.

The purpose of compliance reviews is to assess compliance with securities laws. Any deficiencies noted are raised with the registered firm we reviewed so that appropriate corrective action is taken. During our compliance reviews, we also stay alert to any signs of potential fraud, and will take appropriate steps if we identify these signs.

We monitor the outcomes from our reviews of registrants to assess overall compliance and to identify areas of focus for future reviews. Compliance reviews often lead to enhanced compliance at registrants, but may also result in regulatory actions such as terms and conditions being imposed on a registrant's registration, or referrals to our Enforcement Branch. Also, as part of the new registration regime, amendments were made to the *Securities Act* that provide the Director with the power to revoke or suspend a registrant's registration.³ The four outcomes of our compliance reviews in fiscal 2010, with comparables for 2009, 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 registered firms.

Outcomes of compliance reviews (all registration categories) ⁴	Fiscal 2010	Fiscal 2009
Enhanced compliance	37%	60%
Significantly enhanced compliance ⁵	50%	32%
Terms and conditions on registration	3%	4%
Referral to the Enforcement Branch	10%	4%

Each of the outcomes is explained below. 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. We also provide an explanation for the changes in outcomes from last year.

³ See section 28 of the *Securities Act* (Ontario)

⁴ Includes portfolio managers, exempt market dealers (formerly limited market dealers) and investment fund managers (before the new registration regime an investment fund manager was a market participant but not a registrant).

⁵ In previous years, we referred to this outcome as >30% significant deficiencies.



- **Enhanced compliance:** At the end of a review, in almost all cases, we issue a report to the registered firm identifying areas of non-compliance that require corrective action. We work with these firms to facilitate the appropriate resolution of these deficiencies. Compliance reviews result in enhanced compliance, as registrants' actions to address the identified deficiencies improve their compliance systems. In fiscal 2010, 37% of reviews resulted in enhanced compliance by the registrant. The decrease from 60% in fiscal 2009 is offset by the increase in the significantly enhanced compliance outcome, as explained below.
- **Significantly enhanced compliance:** Where warranted by the seriousness of the deficiencies identified during a review, in addition to the steps taken in the enhanced compliance outcome, we also increase our monitoring of the registrant. For example, we may conduct a follow-up review of a registrant or require the registrant to provide additional evidence, to assess if they have appropriately addressed the identified deficiencies. The increased monitoring and the registrant's response generally results in significantly enhanced compliance. In fiscal 2010, 50% of field reviews resulted in significantly enhanced compliance. This outcome increased from last year's 32% primarily as a result of us focusing our attention on areas that we considered to be problematic during the recent market turmoil.
- **Terms and conditions on registration:** We may impose terms and conditions on a firm's registration to more closely monitor a registrant's compliance with securities law. We may also impose terms and conditions to require a registered firm to take a specific action or to restrict their business activities. For example, terms and conditions may require the firm to submit information (such as financial statements and capital calculations) to the OSC more frequently, retain a consultant to improve its compliance systems, or prohibit the registrant from opening new client accounts. In fiscal 2010, 3% of field reviews resulted in the imposition of terms and conditions on registration, which is consistent with last year's result of 4%.
- **Referral to the Enforcement Branch:** If we identify a serious breach of securities law, we will discuss our findings with the Enforcement Branch, and together determine an appropriate course of action. In fiscal 2010, 10% of field reviews resulted in referrals to the Enforcement Branch, compared to 4% in fiscal 2009. The increase from the prior year is a result of performing more for-cause reviews, and continued enhancements to our risk-based approach to selecting registered firms for review.

B. New and proposed rules and initiatives impacting all registrants

In addition to the new registration regime, we actively participated with other members of the CSA in the development and implementation of new and proposed rules and other initiatives. We also worked with other OSC branches on policy initiatives that impact registrants. The key rules and initiatives that generally impact all registrants are described below.

“Know your Product” (KYP) obligation

CSA Staff Notice 33-315 *Suitability Obligation and Know Your Product* (CSA Staff Notice 33-315) was published on September 4, 2009. This notice reminds registrants of their requirement to satisfy their suitability obligations to clients, including the duty to fully understand the structure, features and risks of products they recommend to clients. It also provides guidance to registrants on how to meet these obligations. For more information, see [CSA Staff Notice 33-315](#). Proposed amendments to NI 31-103 would codify the KYP obligation as part of the proficiency requirements for registered individuals.

Client Relationship Model (CRM)

Together with the CSA, IIROC and the MFDA, we are continuing to work on improving and harmonizing requirements in a number of areas related to a client’s relationship with a registrant. We addressed some elements of the CRM in NI 31-103 by requiring disclosure of relationship information to clients (including disclosure of costs for the operation of their account) and requiring registrants to identify and respond to conflicts of interest.

We have now started phase 2 of CRM, in which we anticipate proposing the introduction of the following additional CRM principles and requirements for registered firms in NI 31-103:

- additional disclosure to clients of all costs associated with the products and services they receive, and
- meaningful reporting to clients on how their investments perform.

Improvements to reporting process on terrorist financing

Working with the CSA, we have improved the process for reporting terrorist financing information by introducing a consolidated reporting form. The reporting requirements apply to registered dealers and advisers, and exempt dealers and advisers who are in the business of dealing in securities or providing portfolio management or investment counselling services in any CSA jurisdiction. The reporting requirements do not apply to investment fund managers unless they are also in the business of trading or advising in securities.

To facilitate reporting and explain the changes, we have published guidance for firms on their monthly reporting and other requirements relating to terrorist financing and *United Nations Act* sanctions on



certain countries. The guidance provides information on the new consolidated reporting form that will be used by each principal regulator, describes the new process for sending the monthly reports by e-mail to the principal regulator, and provides summary information on the relevant laws. For more information, see [CSA Staff Notice 31-317 \(Revised\) Reporting Obligations Related to Terrorist Financing](#).

International Financial Reporting Standards (IFRS)

Canada's public companies and registrants are moving to adopt IFRS for financial reporting. This move reflects an increasing international acceptance of a single, harmonized set of accounting standards. For financial years beginning on or after January 1, 2011, Canadian registered firms will be required to present their financial statements using IFRS. The OSC and the CSA have released regulatory proposals and guidance to assist registrants as they prepare for the changeover. For more information, see [Notice of IFRS-Related Amendments to Registration Materials](#).

Contracts for difference

In October 2009, OSC staff issued OSC Staff Notice 91-702 *Offerings of Contracts for Difference and Foreign Exchange Contracts to Investors in Ontario* (OSC Staff Notice 91-702) to provide general guidance to market participants about offerings of Contracts for Difference (CFDs), foreign exchange (forex) contracts and similar over-the-counter (OTC) derivatives to investors in Ontario. The notice also highlights our investor protection concerns, particularly when these products are offered to retail investors by unregistered, offshore entities through the internet.

OSC staff concluded that CFDs are "securities" when they are offered to Ontario investors. As such, in staff's view, engaging in or holding oneself out as engaging in the business of trading or advising in CFDs triggers the dealer and adviser registration requirements under the *Securities Act*. The notice states that since CFDs use margin, the appropriate registration category for a dealer who trades in CFDs is investment dealer (which requires IIROC membership), regardless of whether the trades are made to retail investors or accredited investors. For more information, see [OSC Staff Notice 91-702](#).

Alternative exam providers

Proficiency requirements for registered individuals are prescribed by NI 31-103 and generally include industry experience and completion of specific examinations. As the investment industry changes and new investment products emerge, it is important for us to be flexible in deciding which exams are required for proficiency in the future. As such, we are participants in a CSA committee which will review proposals from exam providers to consider alternatives to the proficiency exams prescribed in NI 31-103. This may allow for the development of specialized courses and exams, instead of generalist ones, and for a wider variety of exam providers.



3.2 Portfolio managers

This section contains information specific to portfolio managers. It includes trends in deficiencies and suggested practices from our normal course compliance reviews of portfolio managers, along with deficiencies and suggested practices from our focused reviews of large portfolio managers and our sweep of newly registered portfolio managers. We also discuss our in-progress sweep on marketing practices and new or proposed rules that will impact portfolio managers.

A. Trends in deficiencies from compliance reviews and suggested practices

This section discusses some new trends in the deficiencies identified from our normal course compliance reviews of portfolio managers, along with suggested practices to prevent their recurrence.

Delegating know your client (KYC) and suitability obligations to other parties

Some portfolio managers enter into referral arrangements with mutual fund dealers and their salespersons, or with financial planners, for the referral of clients to the portfolio manager for a managed account, in return for an on-going referral fee. In some of these cases, the portfolio managers do not meet with their clients to understand their investment needs and objectives, financial circumstances and risk tolerance. Instead, they rely on the mutual fund salesperson or financial planner to perform these duties, assist the client in completing the portfolio manager's managed account agreement, and updating KYC information. This practice is contrary to securities law, as registrants may not delegate their KYC and suitability obligations to other parties. If portfolio managers do not have complete and accurate KYC information for their clients, they cannot adequately perform their suitability obligations.

Portfolio managers are required by sections 13.2 and 13.3 of NI 31-103 to establish the identity of each of their clients and to ensure they have sufficient and current KYC information for each client (including the client's investment needs and objectives, financial circumstances, and risk tolerance) so that they can assess the suitability of each trade made for their clients. Further, mutual fund salespersons and financial planners do not have the proficiency or registration required to perform these activities for a managed account. Referral arrangements must not allow an individual or firm to perform registerable activities unless the individual or firm is appropriately registered.



Suggested practices

A registered portfolio manager should:

- meet with each client to understand their KYC information before managing their portfolio
- explain the firm's investment process and strategy and other relationship information to the client
- assist the client in completing and signing necessary forms and agreements, such as an investment policy statement and managed account agreement
- regularly communicate the investment holdings and performance of the managed account to the client, and
- keep each client's KYC information up-to-date by:
 - immediately contacting the client when they know that their circumstances have changed, and
 - periodically contacting the client (at least annually) to assess if their circumstances have changed.

Also, registered firms should review referral arrangements to ensure that all activity requiring registration is performed by appropriately registered firms and individuals.

Marketing performance returns from a previous firm

We have concerns with portfolio managers who market the performance returns achieved by their advising representatives when they were employed at another firm. This is often done by newly registered portfolio managers with no (or a limited) performance track record of their own.

We have seen cases where portfolio managers were marketing the performance returns from another firm when:

- the advising representative was not responsible for generating the presented returns, or
- the investment strategy at the previous firm was different from that of the new firm.

In our view, it is misleading and not relevant to market the returns from a previous firm in these cases.

Misleading statements are prohibited by section 2.1 of OSC Rule 31-505 *Conditions of Registration* (OSC Rule 31-505) which requires registrants to deal fairly, honestly and in good faith with clients. Also, section 44(2) of the *Securities Act* prohibits making statements to an investor who is deciding to enter into or maintain an advising relationship, if the statement is untrue or omits information necessary to prevent it from being misleading.

However, there are limited cases where, in our view, it may not be misleading to market the performance returns from a previous firm, as explained below.

Suggested practices

Portfolio managers should present the returns of the firm's actual performance composite(s) or investment fund(s) since the firm has been registered.

There are some limited circumstances where it may be relevant and not misleading to market the performance of a previous firm, such as when:

- the key investment decision maker(s) at the previous firm are now employed at the new firm
- the investment strategy at the previous firm is substantially similar to that of the new firm
- the new firm has books and records that adequately support the historical data presented from the previous firm, and
- there is adequate disclosure that the performance presented is from a previous firm, and of any other relevant facts.

Best execution obligations

Some portfolio managers use only one dealer (which is generally the clients' custodian) to execute all of their clients' trades. We are concerned that this practice may result in the portfolio manager not meeting its best execution obligations to its clients. If portfolio managers use one dealer to execute all clients' trades, they need to have adequate support to demonstrate that they are meeting their best execution obligations.

Section 4.2 of National Instrument 23-101 *Trading Rules* (NI 23-101) requires portfolio managers to make reasonable efforts to achieve best execution when acting for a client. Section 4.3 of NI 23-101 states that, to satisfy the above requirement, portfolio managers should make reasonable efforts to use facilities providing information regarding orders and trades.

Best execution is defined in section 1.1 of NI 23-101 as the most advantageous execution terms reasonably available under the circumstances. See [Part 4 of the Companion Policy to NI 23-101](#) for additional guidance on best execution.



Suggested practices

- Maintain and apply written policies and procedures which outline a process designed to achieve best execution
- The policies should describe how the portfolio manager evaluates whether best execution was obtained and should be regularly reviewed
- Consider a number of factors to achieve best execution, including assessing a particular client's requirements or portfolio objectives, selecting appropriate dealers and marketplaces and monitoring the results on a regular basis, and
- Disclose the portfolio manager's trading practices to clients in writing, including selection and use of dealers, especially if only one dealer is used to execute clients' trades.

Risk management

All registered firms, regardless of size, should have adequate risk management processes to mitigate risk and protect firm and client assets. Some portfolio managers do not have an adequate system of controls to identify and manage their firm's key business risks. These include for example, the firm's operational, financial, regulatory and legal risks, and also investment risks in client portfolios. The risk management processes should reflect the firm's size, business activities, and clients' investments.

An example of a business risk is failing to resume services to clients on a timely basis after a business interruption or disaster. This risk can be managed through developing and testing a business continuity plan. An example of an investment risk in client portfolios is foreign currency risk. This risk can be managed through currency hedging.

Internal controls are an important element of a registrant's compliance system. Section 32(2) of the *Securities Act* requires registrants to establish and maintain systems of control and supervision in accordance with the regulations for controlling their activities and supervising their representatives. Section 11.1 of NI 31-103 requires registered firms to establish a system of controls and supervision by establishing, maintaining and applying policies and procedures which are sufficient to provide reasonable assurance of compliance with securities legislation and that manage the firm's business risks in accordance with prudent business practices.

For further guidance on internal controls and risk management, see [Part 11 of the Companion Policy to NI 31-103](#), under the heading "Internal controls."

Suggested practices

All registered firms should:

- appoint a senior individual or committee to be responsible for risk management that reports to senior management or the board of directors
- establish and apply written policies and procedures which demonstrate how the firm identifies and manages or controls the firm's business risks
- on a regular basis, identify, understand, evaluate and monitor the firm's key business risks and how each risk is managed or controlled, and
- document, and periodically review and update, the identified key risks and how each risk is managed or controlled.

B. Deficiencies from focused reviews of large portfolio managers and suggested practices

We conducted reviews of a sample of large portfolio managers (based on client assets under management). We focused on the firms' portfolio management and risk management processes, and on their marketing practices. These reviews were performed to allocate some of our compliance oversight resources on larger firms since a breakdown in their compliance systems may have a significant impact on investors and the capital markets.

The key deficiencies we identified from these focused reviews are discussed in the following table, along with suggested practices (or where to get more information).



Deficiency noted	Suggested practices
<p>Marketing practices. Some firms had marketing materials that included:</p> <ul style="list-style-type: none"> (a) exaggerated or unsubstantiated claims regarding the firm's products, services or skills (b) improper claims of compliance with the CFA Institute's Global Investment Performance Standards (GIPS) (c) inadequate disclosure when comparing the firm's performance against a benchmark, and (d) improper statements indicating that the OSC had approved the financial standing, fitness or conduct of a registrant. 	<ul style="list-style-type: none"> (a) See OSC Staff Notice 33-729 Marketing Practices of Investment Counsel/Portfolio Managers for a discussion and suggested practices on exaggerated and unsubstantiated claims (b) It is misleading to claim compliance with the GIPS standards, such as compliance with the composite calculation methodology, unless all requirements of the GIPS standards are met. Firms should refer to the GIPS standards when making any reference to these standards in marketing materials (c) See OSC Staff Notice 33-729 for a discussion and suggested practices on the use of benchmarks, and (d) Section 46 of the <i>Securities Act</i> prohibits representing that the OSC has approved the financial standing, fitness or conduct of a registrant. As a result, registrants should not state, for example, that an OSC compliance review resulted in no material findings.
<p>Risk management. Some firms had inadequate written policies and procedures to demonstrate how they identify and prudently manage their business risks (including investment risks in client portfolios). Although the firms generally had an adequate risk management process, the overall processes followed by the firms were not documented in writing.</p>	<p>Each firm should have written policies and procedures to demonstrate how it identifies and manages its business risks. See section 3.2 of this report for a discussion on risk management and suggested practices.</p>
<p>Know your product. Some firms had inadequate written policies and procedures to demonstrate how they review the structure, features and risks of investment products they purchase for clients (referred to as "know your product"). Although the firms generally had an adequate know your product process, the processes followed were not documented in writing.</p>	<p>Each firm should have written policies and procedures to:</p> <ul style="list-style-type: none"> • identify investment products which require review • review these products' structure, features and risks, and • assess the suitability of these products for each client. <p>See CSA Staff Notice 33-315 for further guidance on suitability obligations and know your product.</p>

C. Deficiencies from compliance reviews of newly registered portfolio managers and suggested practices

We continued our practice of conducting sweeps of newly registered firms to assess their compliance with Ontario securities law and to provide guidance and information to them on their key regulatory requirements (including NI 31-103). In the fall of 2009, we used a risk-based approach to select a sample of newly registered portfolio managers. We then conducted an on-site review of each selected firm to gain an understanding of its business, products and services, and clients. As part of these reviews, we assessed each firm's portfolio management process, trading practices, compliance systems, marketing practices and financial condition.

The common deficiencies we identified from these reviews are discussed in the following table, along with suggested practices (or where to get more information).



Deficiency noted	Suggested practices
<p>Inadequate marketing practices, including:</p> <ul style="list-style-type: none"> (a) marketing materials that disclosed exaggerated or unsubstantiated information regarding the firm's products, services or skills (b) inappropriate use of benchmarks (c) improper use of back-tested performance data, and (d) improper marketing of performance returns from a previous firm. 	<p>See OSC Staff Notice 33-729 for a discussion and suggested practices on marketing practices, including exaggerated and unsubstantiated claims, benchmarks, and hypothetical performance data (including back-tested performance data). See section 3.2 of this report for a discussion and suggested practices on marketing performance returns from a previous firm.</p>
<p>Inadequate written policies and procedures relating to key business areas such as portfolio management, trading and brokerage, and marketing, or non-compliance with existing written policies and procedures.</p>	<p>See our report titled 10 Most Common Deficiencies Among Portfolio Managers for topics and guidelines that should be included in a standard policies and procedures manual for a portfolio manager. Firms should provide a copy of, and training on, their written policies and procedures to their staff, and monitor for compliance on an on-going basis.</p>
<p>Lack of or inadequate business continuity plan (BCP) to allow the firm to mitigate, respond to, and recover from a disaster or disruption that may impact its ability to provide services to clients.</p>	<p>See our report titled 10 Most Common Deficiencies Among Portfolio Managers for suggested practices on what a firm's BCP should cover.</p>
<p>Inadequate disclosure to clients regarding fairness in allocation of investment opportunities amongst clients (fairness policy), or on conflicts of interest such as advising in securities of related or connected issuers.</p>	<p>For guidance on the content of a fairness policy and disclosing conflicts of interest to clients, see sections 14.10 and 13.4 respectively, of the Companion Policy (CP) to NI 31-103.</p>

We also noted capital calculation deficiencies, including using an insufficient amount of minimum capital, failing to deduct the deductible under the firm's bonding or insurance policy, and not preparing capital calculations on at least a monthly basis. For capital calculation requirements under NI 31-103 (which apply to all registrants as of September 28, 2010), please see [section 12.1 of NI 31-103 and its CP, and Form 31-103F1 Calculation of Excess Working Capital](#).

D. Sweep of marketing practices in 2010

Since we continue to find deficiencies in the marketing practices of portfolio managers during compliance reviews, we decided to conduct a second sweep of their marketing practices as part of a CSA initiative.



This sweep will help us to assess if investors are being provided with fair and accurate information when they decide to enter into, or maintain, an advising relationship with a portfolio manager. We started the marketing sweep in the summer of 2010 by sending a sample of portfolio managers a survey that requested information about their marketing practices and copies of their marketing materials. A sub-set of the portfolio managers who received the survey have been selected for on-site reviews, which are in-progress. At the end of the sweep, we plan on publishing our findings in a CSA Staff Notice.

E. New and proposed rules impacting portfolio managers

This section discusses new and proposed rules that impact portfolio managers.

Use of client brokerage commissions

National Instrument 23-102 *Use of Client Brokerage Commissions* (NI 23-102) was published on October 9, 2009 and became effective on June 30, 2010, at which time OSC Policy 1.9 was rescinded. NI 23-102 sets out new requirements for trades in securities involving brokerage commissions charged to clients that are directed by a portfolio manager to a dealer in return for the provision of order execution goods and services or research goods and services. It also requires portfolio managers to disclose certain information to their clients on their use of client brokerage commissions by the end of 2010. For more information see [NI 23-102](#).

Institutional trade matching

Final amendments to National Instrument 24-101 *Institutional Trade Matching and Settlement* (NI 24-101) came into force on July 1, 2010, at which time the transitional requirements in OSC Rule 24-502 were revoked. The revised NI 24-101 requires registered advisers and dealers to match delivery against payment/receipt against payment (DAP/RAP) trades by no later than noon on the business day following the trade date, and no longer has an ultimate requirement to match DAP/RAP trades by the end of the trade date. For more information see [revised NI 24-101](#).

Sub-adviser registration exemption

Together with the CSA, we are considering adding a sub-adviser registration exemption in NI 31-103 that would apply across Canada that is similar to the existing Ontario exemption in section 7.3 of OSC Rule 35-502 *Non Resident Advisers*. Most other Canadian jurisdictions currently grant discretionary relief with similar terms in exemption orders, but there are different CSA views on how to interpret the terms. As part of this work, we will review how the industry uses the existing exemptions.



3.3 Investment fund managers

This section contains information specific to investment fund managers, including the findings and suggested practices from compliance reviews, an update on our focused reviews of investment funds as a result of the market turmoil, and proposals for the registration of non-resident investment fund managers.

A. Deficiencies from compliance reviews of investment fund managers and suggested practices

Use of side letters

We have concerns with investment fund managers that give preferential treatment to one or more investors in the same class of units of an investment fund, as they disadvantage the other investors. Some investment fund managers of non-prospectus investment funds have entered into agreements (or “side letters”) with one or more investors in their funds that give those investors preferential rights and terms compared to those given to other investors in the same class of units of the fund. Examples include preferential portfolio transparency, redemption rights, fund reporting, and management and performance fees.

Side letters that give preferential rights to one or more investors can harm the fund and its other investors. For example, if some investors have portfolio transparency and more frequent redemption rights, they can use their knowledge of the portfolio and their right to redeem their units before others, to their benefit and to the disadvantage of the fund and its other investors.

Section 116 of the *Securities Act* imposes a standard of care on investment fund managers for the investment funds they manage. In our view, investment fund managers do not meet their standard of care by giving preferential rights and terms to one or more investors, but not all investors, in the same class of units of an investment fund.

Also, sections 13.4(1) and (2) of NI 31-103 require registered firms to identify and respond to all existing or potential material conflicts of interest between their firm, including the individuals acting on its behalf, and its clients. In our view, it is a material conflict of interest to provide preferential rights and terms to an investor in the same class of units as other investors in an investment fund.



Suggested practices

- Avoid entering into arrangements (including “side letters”) that give preferential rights and terms to one or more investors in the same class of units of an investment fund
- If investors in the same investment fund are provided with different rights and terms:
 - create separate classes of units for the fund, and
 - disclose the rights and terms of each class of units in the fund’s offering documents.

Responsibility for valuation and error correction

Some investment fund managers appear to be contracting out of their duties and obligations under securities law to properly value their funds’ investments and correct any net asset value (NAV) calculation errors. We noted a small number of cases where non-prospectus funds’ offering documents state or imply that when there is a valuation error, the investment fund manager will not adjust the NAV of the fund retroactively.

In our view, for investment fund managers to meet their standard of care under section 116 of the *Securities Act*, they should ensure that the NAV of each fund under their management is accurately calculated, and that they correct any of their fund’s material NAV errors (including making retroactive adjustments). Investment fund managers may not avoid their legal duties or obligations through disclosure in an investment fund’s offering documents.

Suggested practices

- Maintain and apply written policies and procedures to ensure that the fund’s investments are properly valued and that the NAV is accurately calculated
- Maintain and apply written policies and procedures to identify and correct any NAV calculation errors, including policies and procedures that:
 - establish a reasonable materiality threshold for NAV error corrections
 - rectify NAV calculation errors, and
 - make the fund and its unitholders whole as appropriate where the NAV has been materially overstated or understated
- Make adjustments to the fund’s NAV (including retroactive adjustments) to make the fund and its unitholders whole as appropriate when there is a material NAV calculation error, and
- Ensure that disclosure in the fund’s offering documents and the fund manager’s policies are consistent with the fund manager’s standard of care to make the fund and its investors whole when there has been a material NAV calculation error.

Prohibited investments for investment funds

Some investment funds make investments that are prohibited under securities law. We found cases where investment funds' portfolios held securities:

- of companies that were related to the fund or its investment fund manager, portfolio manager, or principal distributor, or to any of their shareholders, directors or officers
- in the form of loans from the investment fund to its related parties (including the fund's portfolio manager and investment fund manager), and
- in companies and other investment funds, which represented an ownership of more than 20% of the outstanding voting securities of those companies or other investment funds.

In most cases, these investments were held in portfolios of non-prospectus qualified investment funds.

Investment funds that meet the definition of a mutual fund in Ontario⁶ have specific prohibitions against investments (including loans) in securities of their related parties, unless an exemption applies. Section 111 of the *Securities Act* outlines the investments that are prohibited for mutual funds in Ontario. One of the prohibitions disallows making or holding an investment in any person or company (including another investment fund) in which the mutual fund, alone or together with its related mutual funds, owns more than 20% of the outstanding voting securities.

In addition, section 13.5 of NI 31-103 prohibits a portfolio manager from causing an investment portfolio managed by it, including an investment fund, from providing a guarantee or loan to a responsible person or associate of a responsible person (which includes the portfolio manager).

For investment funds sold by simplified prospectus, further investment restrictions may apply. For example, see Parts 2 and 4 on Investments and Conflicts of Interest respectively, in National Instrument 81-102 *Mutual Funds*. In some cases, investment funds that are reporting issuers with an independent review committee (IRC) may be permitted to make investments in securities of related parties if they are in the best interests of the fund and are approved by the IRC, and if the other conditions in National Instrument 81-107 *Independent Review Committee for Investment Funds* are met.

There are also general requirements that apply to all investment funds. For example, section 116 of the *Securities Act* imposes a standard of care on investment fund managers, requiring them, among other things, to act in the best interests of their investment funds. In our view, this obliges them to ensure that any investments (including loans) in securities of related parties held by their investment funds are in the best interests of the fund. Compliance with this obligation may prevent investment funds from making certain investments, even if they are not specifically prohibited by securities law.

⁶ See definition for mutual fund in Ontario in section 1(1) of the *Securities Act*.

Suggested practices

- Prior to making an investment (including a loan) for an investment fund in securities of its related parties, assess if it complies with all relevant investment restrictions under applicable securities legislation and is in the best interests of the fund, and document the results of the assessment
- Maintain records of the investments held by all mutual funds under common management to monitor if any mutual fund (alone or together with its related mutual funds) approaches or exceeds ownership of more than 20% of the outstanding voting securities of those investments (including investments in other investment funds)
- Review any existing investments (including loans) by an investment fund in securities of its related parties, and any concentrated positions in securities, to determine if the investment complies with all relevant securities legislation, and is in the best interests of the fund, and
- Take appropriate action to address any instances of non-compliance.

B. Focused reviews of investment funds in response to market turmoil

We responded to the turmoil in the financial markets in 2008 and 2009 by using a risk-based approach to conduct focused reviews of investment funds. We performed on-site compliance reviews of samples of Ontario-based money market funds, non-conventional investment funds and hedge funds. We have now completed our focused reviews, and despite the market downturn, we did not identify any industry-wide compliance issues during the period reviewed. Instances of non-compliance identified during our on-site reviews were addressed separately with each individual fund manager.

A summary of our initiative was published on January 19, 2010 as [OSC Staff Notice 33-733 Report on Focused Reviews of Investment Funds](#). This report summarizes our findings based on the industry's responses to our questionnaires, as well as our observations and suggested practices from all three phases of our on-site reviews.

Going forward, we will continue to monitor market conditions and will conduct focused reviews or sweeps to address any significant market issues which may arise.

C. Registration of non-resident investment fund managers

The new registration regime introduces the investment fund manager category of registration for firms that direct the business, operations and affairs of investment funds. We are working with the other

members of the CSA to determine how this registration requirement applies to non-resident investment fund managers. Specifically, we are examining the following:

- the circumstances under which investment fund managers resident outside of Canada would need to register, and
- in what provinces and territories an investment fund manager with a head office in Canada would need to register in addition to the province or territory where its head office is located.

In the fall of 2010, we expect to publish for comment proposed changes to NI 31-103 with respect to the registration of non-resident investment fund managers.

3.4 Exempt market dealers

A. Risk assessment questionnaire for exempt market dealers

We developed and sent out a risk assessment questionnaire (RAQ) to all exempt market dealers (formerly limited market dealers) registered in Ontario to help us determine which firms would be selected for a compliance review and what areas of their business to focus on. We reviewed the responses to the RAQs to get a general understanding of each firm and its business activities. Based on the information provided to us, we selected a smaller group of firms from which to obtain additional information on the firm's business activities, KYC and accredited investor information, products and services, and marketing and disclosure practices. We are reviewing this additional information, and may ask further questions or conduct on-site reviews of these firms.

B. Deficiencies from compliance reviews of exempt market dealers and suggested practices

During the course of our compliance reviews, we reviewed a number of exempt market dealers (EMDs) that were distributing high-yield investment products. Our reviews identified significant deficiencies, including the failure to adequately meet know your client (KYC) and suitability obligations (including know your product), inadequate disclosure to clients, and inadequate compliance systems. We generally raised these and other deficiencies with each EMD reviewed so that they could take appropriate corrective action to address the concerns. However, where appropriate, we referred the case to our Enforcement Branch or took action to suspend the firm's registration.

As part of our on-going reviews of EMDs, we will continue to focus our attention on the areas that we found deficiencies from prior reviews, and will take appropriate regulatory action if we identify significant deficiencies.



The key deficiencies from our reviews are discussed below, accompanied by suggested practices.

KYC and suitability obligations (including know your product (KYP))

Significant KYC and suitability deficiencies noted during field reviews conducted in fiscal 2008 and 2009 continue to exist. For example, we noted that:

- the majority of EMDs reviewed did not adequately collect and document KYC information for clients
- some EMDs that collected KYC information were not using it appropriately in their suitability assessment
- when assessing suitability, many EMDs did not have adequate knowledge of the investment product being recommended (referred to as KYP), and
- many EMDs did not perform sufficient product due diligence prior to recommending a product to investors.

Many EMDs did not collect and document their clients' investment needs and objectives, risk tolerance, and financial circumstances. In some cases, EMDs that collected this KYC information recommended a security to the client that was not suitable.

Many EMDs (both the firm and its registered individuals) did not adequately understand the structure, features and risks of the investment products that they recommended. In addition, there was a lack of ongoing due diligence, as they were unaware of changes to the investment product's key features and risks, and to the issuer's financial condition – all of which could impact investors' decisions and future returns.

Many of the EMDs that distributed products of a third-party issuer had only a basic understanding of the investment product. EMDs generally relied on the information provided by the issuer and did not perform sufficient due diligence before accepting the product for distribution and had limited or no information regarding the issuer's financial condition.

EMDs distributing products of a related issuer did not disclose the issuer's financial condition to their clients, even though they had knowledge of this information. As a result, some EMDs were misrepresenting the product to their investors, and investors may have been misled regarding the financial viability and risks of the product.

Section 13.2 of NI 31-103 requires registrants to take reasonable steps to ensure they have sufficient and current KYC information for clients including the clients' investment needs and objectives, financial circumstances and risk tolerance. Section 13.3 of NI 31-103 requires registrants to take reasonable steps to ensure that all securities recommended to clients are suitable. See [sections 13.2 and 13.3 of the](#)



Companion Policy to NI 31-103 and CSA Staff Notice 33-315 for guidance on KYC, suitability and KYP requirements.

Suggested practices

EMDs and their registered individuals should ensure that they:

- have a process in place to collect and document sufficient KYC information for each client (for example by using a standard KYC form) so they can properly assess the suitability of investment products they recommend
- have an in-depth understanding of:
 - the general features and structure of the product
 - the product risks including the risk/return profile and liquidity risks
 - the management and financial strength of the issuer
 - costs, and
 - any eligibility requirements for each product
 before recommending it to clients
- perform an independent analysis of the product rather than recommending a product solely based on information from issuers, similarities with other products, or suggestions from other parties, and
- perform ongoing due diligence of the issuer and products to assess changes to their structure or features and determine the impact on their clients' investments.

Inadequate disclosure to clients

We identified a number of areas where clients did not receive sufficient disclosure to properly assess the relevant attributes and associated risks of the investment products recommended by EMDs. For example, we noted:

- inadequate disclosure of investor rights, costs, risks, and eligibility requirements of recommended products
- inadequate disclosure of the use of investor money
- inadequate disclosure of conflicts of interest, and
- misleading disclosure in marketing materials.

Section 2.1 of OSC Rule 31-505 requires EMDs to deal fairly, honestly and in good faith with their clients. In our view, this includes ensuring that information contained in offering documents and marketing materials is complete, accurate, and not misleading.

Also, section 13.4(3) of NI 31-103 requires EMDs to provide timely disclosure to its clients on the nature and extent of existing or potential material conflicts of interest between the EMD (including each individual acting on its behalf), and the client. In our view, this includes disclosing to clients any conflicts of interest that could impact a client's decision to purchase an investment product. The disclosure should be provided when a reasonable investor would expect to be informed of the conflict. In our view, this is before or at the time an EMD recommends a security transaction that gives rise to the conflict. For additional guidance on conflicts of interest, see [section 13.4 of the Companion Policy to NI 31-103](#).

Suggested practices

Disclosure in offering documents

- Guidelines should be set by the firm to ensure appropriate disclosure on the general features and structure of the product, risks, fees, management and financial strength of the issuer, and any eligibility requirements of each product, and
- All offering documents should be reviewed and approved by the EMD prior to distribution to investors.

Disclosure of the use of investor money

- There should be complete and accurate disclosure to clients on the issuer's use of investor proceeds, and
- Funds lent to related parties should be disclosed, including the nature of the loan and relevant terms such as the risks associated with the loan, whether investor funds are secured against assets, repayment terms, and interest rates.

Disclosure of conflicts of interest

- Guidelines should be set by the firm to ensure conflicts of interests that are relevant to a client's investment decision are disclosed in a timely manner. Specifically, relationships with affiliates and other related parties should be disclosed. The disclosure should be prominent, specific, clear and meaningful to the client, and explain the conflict of interest and how it could impact the client.

Disclosure in marketing materials

- Marketing materials must be free of misleading or inaccurate information. As such, comparisons to alternative investments should be restricted to products with similar features and risks, and relevant differences should also be disclosed to enable the investor to adequately assess the risks and rewards of each investment product.

Inadequate compliance system

A number of EMDs reviewed did not have an adequate compliance system to ensure that the firm and its individuals complied with securities legislation, as evidenced by the following findings:

- inadequate collection, review and approval of KYC and suitability information for clients prior to an investment being made
- inadequate review of accredited investor information to assess whether the accredited investor exemption relied on was consistent with the information obtained in the KYC process
- inadequate review and approval of offering documents and marketing materials, resulting in misleading or inaccurate information being provided to clients and inadequate disclosure of product risks
- written policies and procedures were inadequate and did not cover all business areas, and
- existing policies and procedures were not enforced.

Section 11.1 of NI 31-103 requires EMDs to establish a system of controls and supervision by establishing, maintaining and applying policies and procedures that ensure compliance with securities legislation and manage their business risks. See [section 11.1 of the Companion Policy to NI 31-103](#) for guidance on compliance systems.

Suggested practices

- Clients' KYC information documented by the EMD's dealing representatives should be reviewed for completeness and be approved by the EMD's compliance officer
- Investments recommended to clients by the EMD's dealing representatives should also be assessed for suitability by the EMD's compliance officer using each client's KYC information
- Accredited investor information should be compared to completed KYC forms to assess whether the use of the accredited investor exemption is reasonable. Where KYC information is not sufficient to make this assessment, evidence of follow-up supporting the appropriateness of the firm's reliance on the exemption should be included in the client's file
- EMDs should review offering documents and marketing materials to ensure they present information to clients in a clear, accurate and complete manner, and
- Written policies and procedures should be tailored to a firm's business operations, be up-to-date with Ontario securities law, and be enforced.



4. Additional resources

4. Additional resources

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

A part of our branch's mandate is to foster a culture of compliance through outreach and other initiatives. Although as a regulatory body we cannot provide legal or financial advice, we try to assist registrants in meeting their regulatory requirements in a number of ways. Some special stakeholder initiatives this past year are discussed below.

We updated the CRR Branch's section of the OSC's website (www.osc.gov.on.ca) in May 2010. The "Information for Dealers, Advisers and Investment Fund Managers" section of the website provides firms and individuals with comprehensive information about the registration process and their ongoing obligations under the new registration regime. The new section features an expanded navigation and layout which makes it easier to understand the initial registration process and the ongoing obligations of a registrant. It also includes information about compliance reviews and suggested practices. The section also provides quick links to forms, FAQs relating to the new registration rules and various guides.

Also, we hosted a forum for chief compliance officers (CCOs) of portfolio managers in February 2010. The objective of the forum was to heighten CCOs' awareness of their responsibility for compliance and the importance of a strong and effective compliance regime. Topics discussed included:

- Importance of a compliance regime
- OSC's compliance oversight approach
- Portfolio manager common deficiencies
- NI 31-103
- *Proceeds of Crime (Money Laundering) and Terrorist Financing Act*
- Soft dollars
- IFRS

Until February 1, 2011, you may access an audio recording of this forum by going to the following web page and following the on-screen instructions:

<http://events.startcast.com/events6/413/C0001/Default.aspx>



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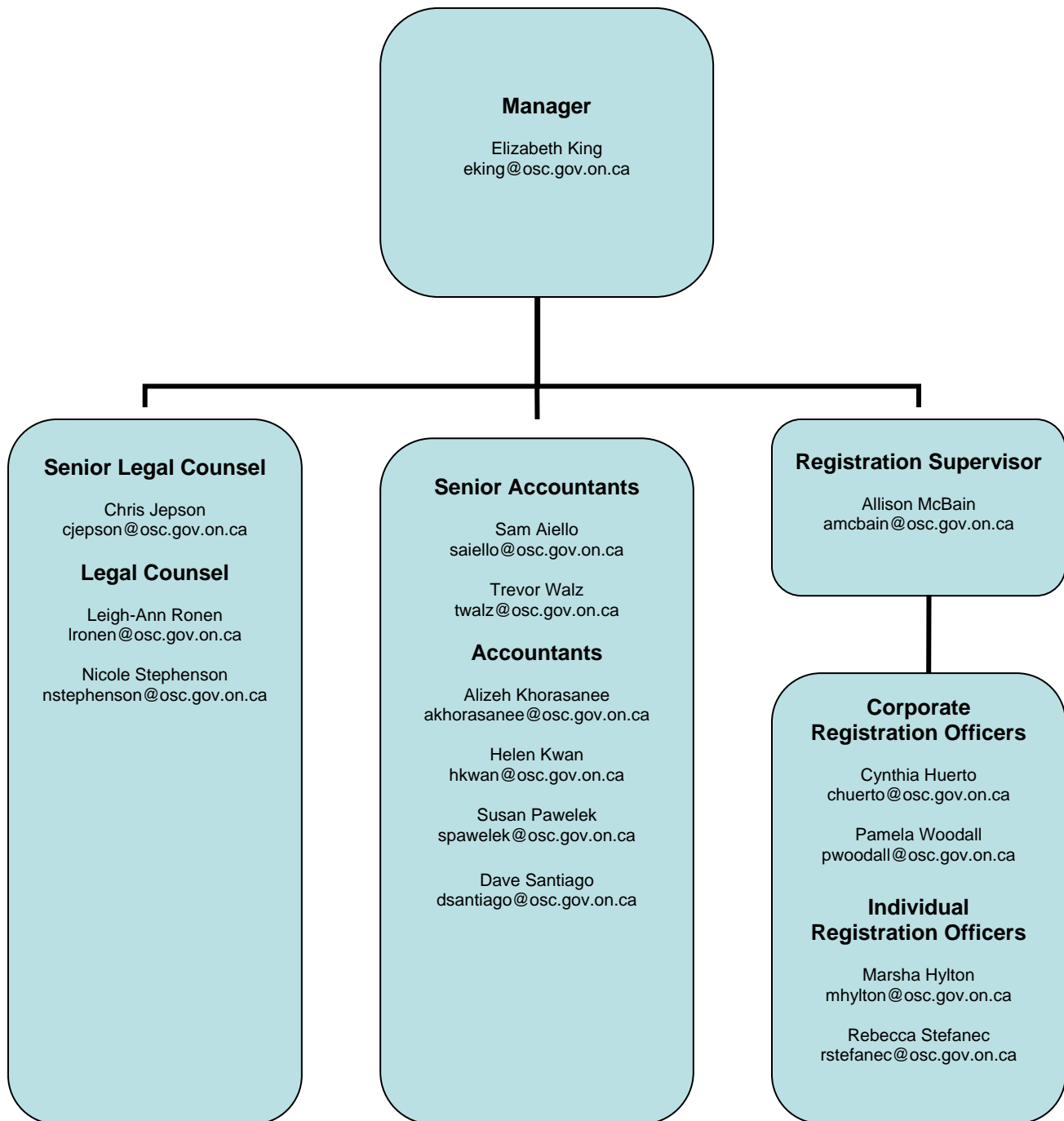
E-mail: inquiries@osc.gov.on.ca Fax: (416) 593-8122

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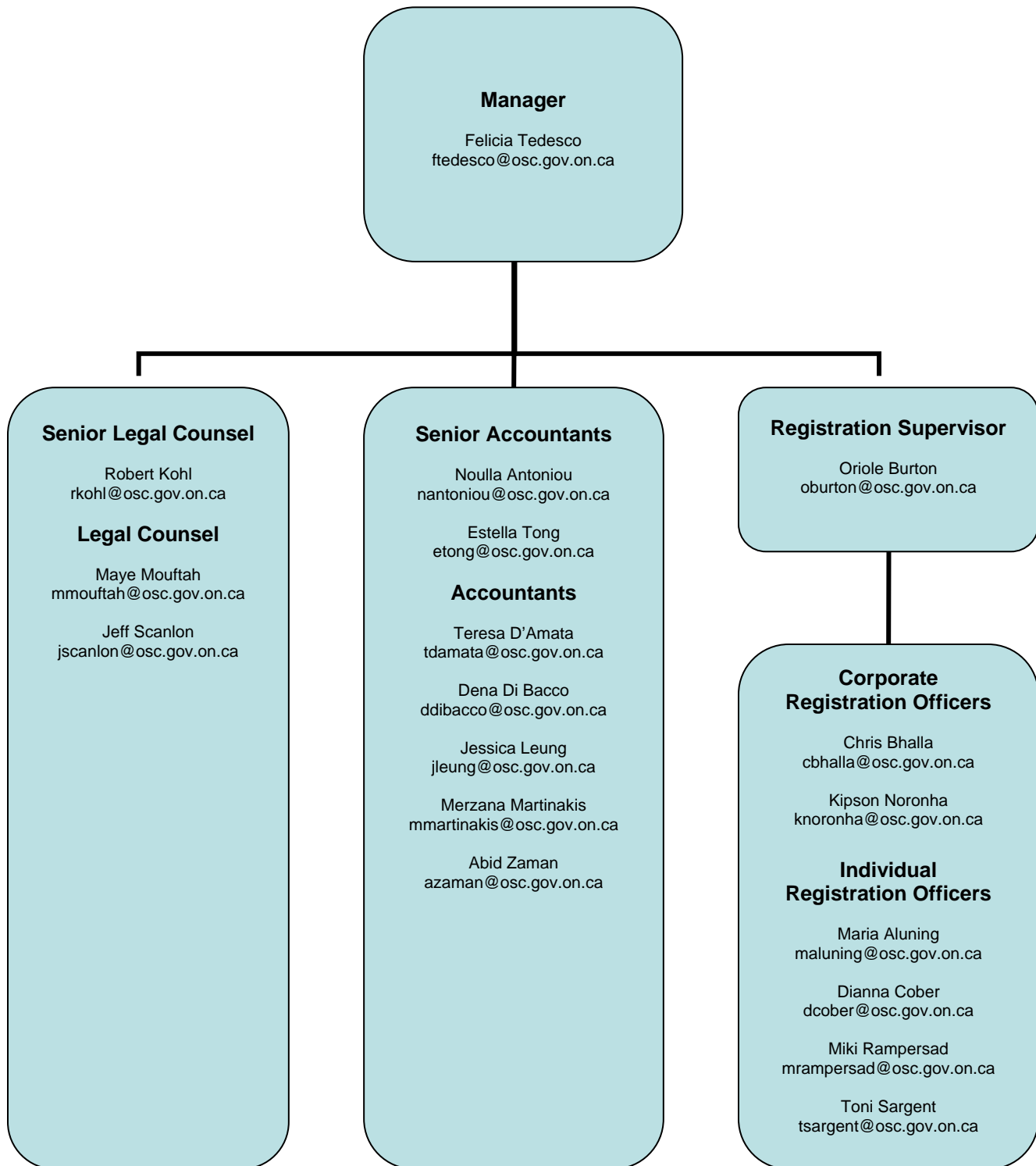
As the regulatory body responsible for overseeing the capital markets in Ontario, the Ontario Securities Commission administers and enforces the provincial Securities Act, the provincial Commodity Futures Act and administers certain provisions of the provincial Business Corporations Act. The OSC is a self-funded Crown corporation accountable to the Ontario Legislature through the Minister of Finance.

Portfolio Manager Team



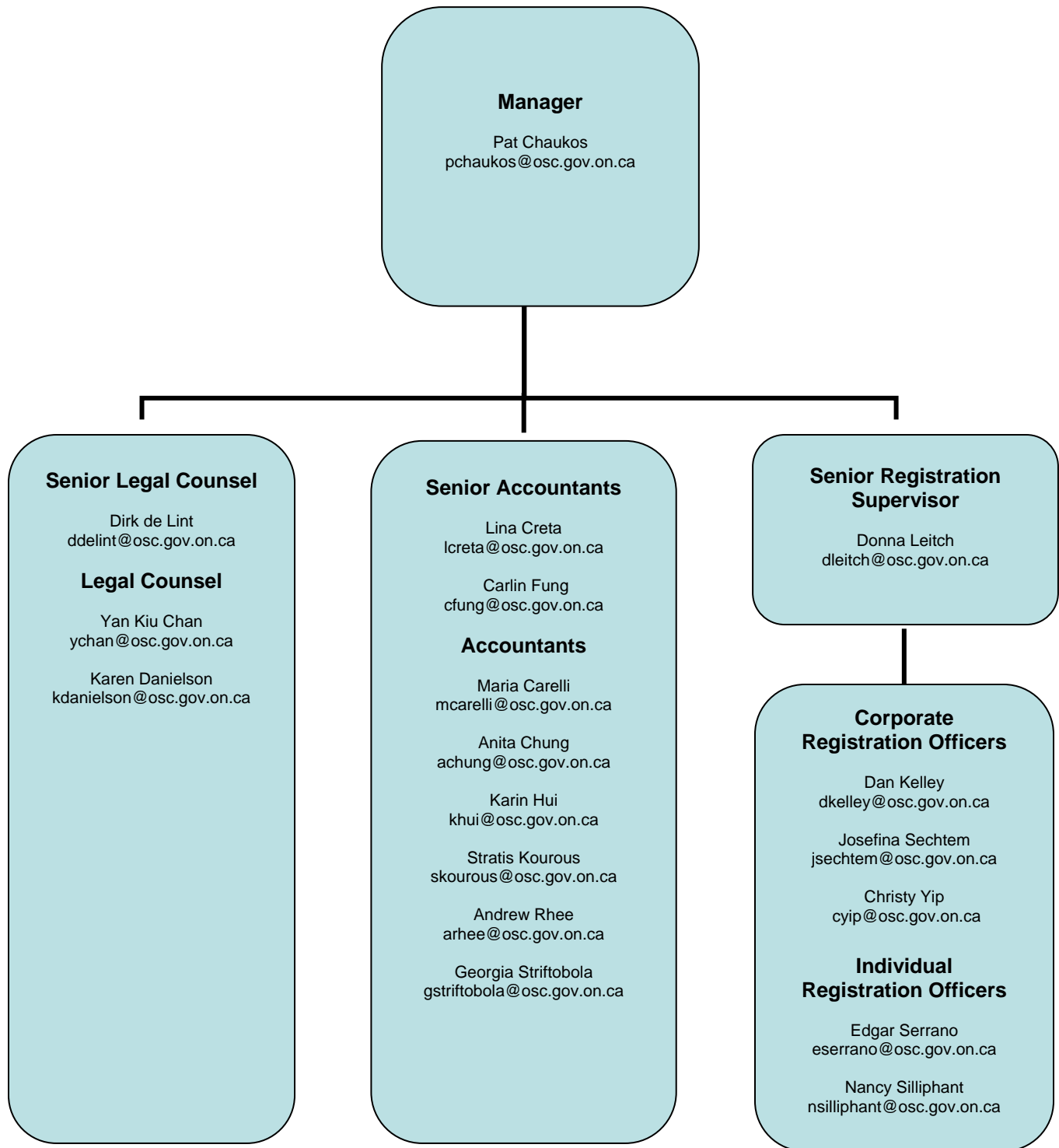
For general questions and complaints, please contact the OSC Inquiries and Contact Centre at inquiries@osc.gov.on.ca

Investment Fund Manager Team



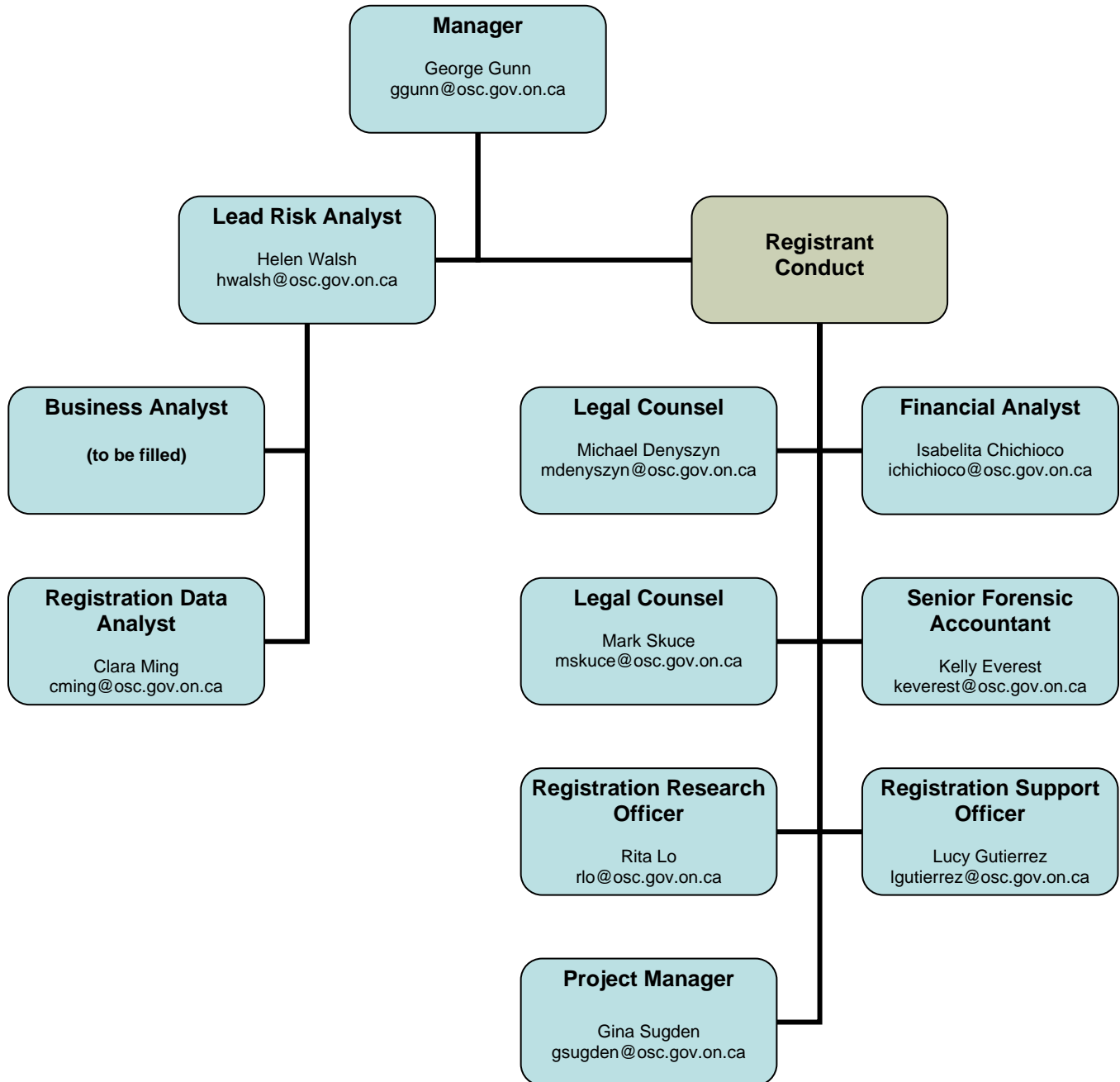
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Dealer Team



For general questions and complaints, please contact the OSC Inquiries and Contact Centre at inquiries@osc.gov.on.ca

Registrant Conduct and Risk Analysis Team



For general questions and complaints, please contact the OSC Inquiries and Contact Centre at inquiries@osc.gov.on.ca