BACK TO SCHOOL HOMEWORK – KEY HIGHLIGHTS AND TAKEAWAYS FROM THE 2024 OSC REGISTRATION, INSPECTIONS AND EXAMINATIONS DIVISION SUMMARY REPORT

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Categories: Insights, Publications

The Ontario Securities Commission (the "**OSC**") recently published Staff Notice 33-756 – *Summary Report for Dealers, Advisers and Investment Fund Managers* (the "**Report**") for the 2023-2024 fiscal year. The Report is authored by the rebranded Registration, Inspections and Examinations Division of the OSC (the "**RIE**"), previously known as the Compliance and Registrant Registration Branch.

The Report is extremely useful for investment fund managers ("**IFM**s"), portfolio managers ("**PM**s") and exempt market dealers ("**EMD**s") and provides helpful compliance "homework" for registrants regarding common deficiencies and registration requirements. The Report also provides insights into some proposed rules and regulatory initiatives that may impact a registrant's operations in the coming months and years.

Key Report Highlights

Review of High-Risk Firms

The RIE categorizes certain firms as high-risk based on their proposed business operations, compliance systems and/or proficiency of the firm's individuals. As a result, it will typically conduct targeted reviews of these firms early (and often) to assess their compliance with Ontario securities law.

The reviews conducted during the 2023-2024 period on firms classified as high-risk found the following significant deficiencies:

- inadequate compliance system and the Ultimate Designated Person ("**UDP**") or Chief Compliance Officer ("**CCO**") not performing their responsibilities;
- inadequate disclosure to clients regarding conflicts of interest; and
- firms not being always aware of their financial condition/incorrect calculations of excess working capital.

In addition, applicants for registration as an IFM, PM or EMD who are classified as "high-risk" as result of their business plan or structure may have their registration application treated as a first compliance review. This means that the applicant will generally be expected to have well-advanced business plans/arrangements as well as comprehensive policies and procedures in place at the time of registration.

Business Arrangements Sweep and Registrable Activities Conducted by Unregistered Firms

The RIE conducted a focused compliance review in 2023 of several Ontario-based firms that had entered a business arrangement to provide either IFM or PM services to or on behalf of an unregistered firm. The aim of the review was to determine: (i) whether each firm that was a party to the business arrangement was conducting activities that were appropriate for its respective category of registration (or in the case of an unregistered firm, that such firm was not conducting registerable activities), and (ii) that any marketing materials used in connection with the business arrangement correctly described each party's roles and responsibilities.

Unregistered Firms conducting IFM Activities

As a result of the focused review, significant regulatory concerns were identified for business arrangements where a PM without an IFM registration retained IFM services from an unrelated third-party for certain proprietary investment funds managed by the PM. The review found that the third party IFM was not actually performing its IFM duties either because it was restricted by the written business agreement, or it had inappropriately delegated its IFM responsibilities to the PM.

Some examples of problematic clauses identified in these types of business agreements included:

- the PM being permitted to terminate or change the IFM of the investment fund;
- the PM being responsible for certain key operational decisions of the investment fund; and
- the PM being compensated for acting as an IFM.

Agreement terms that restrict the IFM from exercising its statutory standard of care required under section 116 of the *Securities Act* (Ontario) are contrary to Ontario securities law. *Only a registered IFM is permitted to direct the business, operations or affairs of an investment fund and it is not permitted to delegate its duties to an unregistered party*.

Unregistered Firms conducting Investment Advisory Activities

Another common issue encountered during the focused review was unregistered firms making investment decisions on behalf of an investment fund instead of the PM of the fund. In these instances, the written business agreement between the unregistered firm and the PM specified that the unregistered firm would

participate and assist the PM in the making of investment decisions on behalf of the investment fund, but that the PM would make the final investment decision. However, in several instances, evidence to the contrary was found suggesting that the unregistered firm was, in fact, making the investment decisions for the investment fund.

It is recommended that PMs and IFMs carefully review the terms and implementation of all business arrangements to determine that all parties are performing responsibilities which are appropriate for their respective category or categories of registration (if any). Marketing materials should also be scrutinized to ensure that they properly reflect the role of each party to the business arrangement.

Referral Arrangements Between PMs and Unregistered Firms

The Report identifies certain instances during the review period where registered firms improperly delegated portfolio management activities to referral agents who are not registered as PMs. Activities that require PM registration include collecting and updating "know your customer" ("**KYC**") information, providing advice to clients on investment strategies, selecting investment mandates, and maintaining direct contact with clients to discuss account details.

All clients referred to a PM should be communicating with a registered advising representative of the PM.

If a PM has a referral arrangement with an unregistered party, the PM must:

- *implement adequate monitoring procedures designed to ensure that the unregistered party is not conducting any activities that would require registration;*
- *proactively develop a relationship with the referred client so that they can understand the PM's role; and*
- *ensure that all fees relation to portfolio management services are paid directly to the PM.*

PM Required for the Top Fund in a Fund of Fund ("FOF") structure

For investment funds utilizing a FOF structure, IFMs should analyze whether it is necessary to appoint a PM to advise the top fund, even if the top fund holds only securities of the underlying fund. The Report indicates that the position of the OSC staff is that where "advising" or "investment decisions" are necessary at the top fund level, a PM should be appointed. Examples of activities at the top fund level which would likely constitute investment advice include:

i. decisions on the timing for the making of new/additional investments in the bottom fund;
ii. the management of redemption requests;
iii. determining when distributions are to be made by the top fund to investors; and

iv. determining how much cash the top fund should hold.

An IFM registration alone does not permit the registrant to advise in securities, therefore a PM (appointed by the IFM) is required to provide investment management and advisory services to the top fund.

Awards and Ranking Contests for Advisers

Registered firms and/or their registered individuals must not use potentially misleading internal or external awards and/or contest-ranking results in client-facing interactions and communications. Examples of the types of contests or awards/lists that can be problematic include those where the firm or individual is identified as the "top" or "best" (overall or in a specific category). In some cases, a fee is required to be paid by the registrant just to be considered or to participate. Furthermore, a registered individual's level of sales activity, revenue generation or assets under management is not a representative proxy for their experience or qualifications.

Registered firms and individuals are reminded of the requirements relating to misleading communications applicable to them under section 13.18 of National Instrument 31-103 – *Registration Requirements, Exemptions and Ongoing Registrant Obligations* ("**NI 31-103**"). Staff of the RIE will continue to monitor and evaluate compliance with the requirements of this section.

Registered firms should adopt and encourage best practices by utilizing clear written policies and procedures on when participation in a contest or award program is permitted, removing references to previously granted awards and implementing a process to monitor the participation of registered individuals in any contest. Postings concerning awards and recognitions on social media platforms should be reviewed and updated regularly to ensure that they are consistent with the requirements of section 13.18 of NI 31-103.

Foreign Firms that Do Not Rely on the International Adviser Exemption

Certain foreign-domiciled firms rely on the international adviser exemption which permits them to provide investment advice to certain "permitted clients" in Canada in relation to "foreign securities".

The Report notes that any foreign-domiciled advisers who do not meet the necessary conditions to rely on the international adviser exemption but wish to provide investment advice to Ontario clients must register as a PM with the appropriate securities regulatory authorities in Ontario. In addition, individual representatives of these firms who are conducting registerable activities in Ontario must be registered as either an advising representative or an associate advising representative. This applies to both individuals who conduct relationship management activities (e.g., collecting and/or updating KYC information) and individuals who select securities for client portfolios.

Business Continuity Planning

The Report highlights that section 11.1 of NI 31-103 and its Companion Policy requires small firms and firms with only a few registered individuals to have a written business continuity plan ("**BCP**"), which is intended to manage the impact of potential major disruptions to the business operations of the firm. Events which could trigger the implementation of a BCP include the death or an injury/illness resulting in the prolonged absence of key personnel.

When developing the BCP, firms should, as appropriate for their size and business model, consider a number of factors including the following:

- *procedures to mitigate, respond and recover from business interruptions;*
- *how the firm will communicate any business interruptions to key stakeholders;*
- *the firm's business succession or wind-down procedures;*
- *who will be responsible for notifying the regulators in the event of death or prolonged absence of the sole registered individual; and*
- *how often the BCP needs to be updated and its effectiveness assessed.*

Furthermore, small firms should designate an adequately trained BCP executor. The BCP executor must know how to execute the BCP effectively and be authorized to provide instructions on behalf of the firm to third parties. Firms with only one registered individual and no other support may have to designate a BCP executor external to the firm.

Investment Fund Manager Proficiency

The Report stresses that the regulatory obligations and functions of an IFM are very different from those of a PM or EMD given the activities that an IFM needs to carry out regarding the day-to-day operations of an investment fund.

Applicants for registration as an IFM should expect specific questions and detailed follow-up requests for information in relation to individuals who are applying to be registered as the UDP or CCO of an IFM. These questions aim to assess whether these individuals have the relevant and sufficient experience to meet proficiency requirements outlined in part 3.4 of NI 31-103.

Applicants should provide detailed and complete submissions in their registration applications regarding the relevant experience of the UDP and CCO with IFM operations and how the CCO meets the proficiency requirements for this position in NI 31-103.

Exemption to Allow EMD Participation in Selling Groups in Offerings of Securities Under a Prospectus

The vital role that EMDs play in helping to raise capital for early-stage and small and medium-sized businesses

is acknowledged in the Report. However, as issuers grow, they may seek financing through the distribution of their securities under a prospectus, which means that the EMD becomes limited in their capacity to support such businesses. As a result, EMDs have historically been prevented from participating as a selling group member in prospectus offerings.

On June 20, 2024, the OSC published Coordinated Blanket Order 31-930 - *Exemption to allow Exempt Market Dealer Participation in Selling Groups in Offerings of Securities under a Prospectus* (the "**Blanket Order**"). The Blanket Order provides an exemption to permit EMDs to act as a member of a selling group in the distribution of securities under a prospectus. The benefits of EMD participation include allowing EMDs to build and maintain their relationships with businesses they have helped to nurture and grow, as well as providing additional sources of investment for issuers.

In order to rely on the exemption provided by the Blanket Order, the following terms and conditions must be met:

- the EMD must agree to and follow the terms of the selling group agreement;
- the EMD is only permitted to act as a dealer to an investor in respect of whom an exemption from the prospectus requirement would otherwise be available (e.g., the accredited investor exemption) if the distribution of securities had been made on a private placement basis;
- the EMD cannot act as an underwriter in connection with the distribution of the issuer's securities under a prospectus and its interest in the transaction must be limited; and
- the EMD's compensation must not exceed 50% of the lowest total compensation paid or payable to any investment dealer member of the selling group.

Fee Rule Amendments

Amendments to OSC Rule 13-502 – *Fees* ("**Rule 13-502**"), which came into effect on July 2, 2024, introduced two classes of additional fees for firms registered as restricted dealers in Ontario:

- an additional fee of $24,000 during OSC registration; and
- if applicable, an additional exemptive relief application fee of $24,500 for restricted dealers operating as a marketplace.

In recent years, the "restricted dealer" class of registration has been used by crypto trading platforms ("**CTP**s") seeking registration in Ontario and other Canadian jurisdictions.

The additional fees introduced in Rule 13-502 are intended to be reflective of the extra work required to assess the appropriate regulatory framework considering the complex business models of most firms (CTPs) seeking

registration as a restricted dealer.

Additionally, the amendments to Rule 13-502 include a change to the definition of "registrant firm" to include "a person or company registered or required to be registered". Therefore, any unregistered firm that conducts capital markets activities in Ontario will also be required to calculate and pay annual participation fees.

Emerging Issues

During the review period covered by the Report, there was an uptick in the suspension of redemptions by certain real estate/mortgage issuers primarily as a result of higher interest rates. In response to these developments, the RIE contacted the applicable market participants to better understand:

- the terms of any suspension of redemptions and whether the suspension was permitted under the terms of the offering and/or constating documents of the issuer;
- whether investors and dealers were provided full disclosure of the suspension, how long the suspension was expected to last and any factors or conditions that may either shorten or lengthen the term of the suspension;
- the expected impact of the suspension on any regularly scheduled distributions to investors;
- whether any marketing materials being used during a period of suspension indicated that redemptions were halted at that time; and
- the manager's plan to resolve liquidity issue within the real estate/mortgage portfolio and to resume redemptions.

The RIE intends to follow-up with firms in the real estate/mortgage product sector who have or are experiencing liquidity issues, along with any other market participants on emerging matters as needed.

Other Deficiencies and Guidance

Other noteworthy inclusions from the Report were:

- Issuer-sponsored dealing representatives – a noted increase in the number of registered firms using an "issuer-sponsored" dealing representative business model and the inherent conflicts of interest created by such a model; given these and other concerns, terms and conditions have been imposed on the registration of certain firms using this business model;
- Enhanced disclosure requirements under the OM Exemption - amendments to National Instrument 45-106 which set out new disclosure requirements in the offering memorandum utilized under the offering memorandum exemption by issuers engaged in "real estate activities" and those that are "collective investment vehicles";
- Excess Working Capital Calculation Errors - instances where several firms included related party

receivables as “current assets” in line 1 of Form 31-103F1- *Calculation of Excess Working Capital* (“**Form**”) where such assets did not meet the definition of “current asset” in the Form or maintaining adequate evidence of the conditions needed to be met for the asset to be classified as a current asset;

- Capital Markets Participation Fee Calculation Errors - errors in the calculation of capital markets participation fees under Rule 13-502. Specifically, some participants made deductions for revenue by incorrectly excluding them as “capital market activities” while others were found to have significantly understated their participation fees; and
- Submission of Incomplete Registration Applications - a trend of incomplete registration applications or registration applications with incomplete information being filed with the OSC, resulting in delays in processing the application or impairing the ability of the OSC to assess the suitability of individual applicants. Applicants are encouraged to submit complete applications in order to become registered as quickly as possible.

Conclusion

The Report highlights for registrants some key compliance deficiencies and provides recommendations on how registrants may enhance their compliance with Ontario securities law. If you would like to discuss the Report in more detail or explore ways to enhance your firm’s compliance policies and procedures, please contact any member of McMillan’s Investment Funds & Asset Management Group who would be pleased to speak with you at your convenience.

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A Cautionary Note