ONTARIO'S CAPITAL MARKETS MODERNIZATION TASKFORCE LOOKS TO LEVEL THE PLAYING FIELD

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On January 22, 2021, Ontario's Capital Markets Modernization Taskforce (the "**Taskforce**") released its final report (the "**Final Report**") following consultations and feedback from various stakeholders. The Taskforce was formed in late 2019 to make recommendations to Ontario's Minister of Finance with a view to modernizing the province's regulatory framework and making Ontario's capital markets more attractive globally.

The Final Report sets out 74 recommendations on improving regulatory structure, competition, ensuring a level playing field, the proxy system, corporate governance, mergers and acquisitions, fostering innovation, modernizing enforcement and enhancing investor protection. This bulletin focuses on the Taskforce's recommendations aimed at ensuring a level playing field between small and large market participants.

In making its recommendations, the Taskforce highlights the importance of healthy competition in fostering fair and efficient capital markets and its vision of a regulatory framework that leads to a level playing field between small and large market participants. The Taskforce cites the challenges and frustrations that were voiced by smaller intermediaries during its consultations.

The Final Report sets out the following recommendations that aim to drive competition among intermediaries, increase the variety and quality of independent investment products and provide investors with more choice in their investment decisions:

1. Enhance restrictions on tying commercial lending services and capital markets activities to facilitate growth of independent dealers and ensure issuer choice

The Final Report cites that independent investment dealers and issuers have repeatedly raised the issue of intermediaries engaging in practices that may impede competition such as "tied selling" (e.g., where a commercial lender requires clients to retain the services of an affiliated investment dealer for their capital raising and advisory needs as a condition in commercial lending transactions). Although "tied selling" is restricted under the *Bank Act* (the primary piece of legislation that governs banking in Canada), as well as National Instrument 31-103 - *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103), the Final Report describes repeated concerns from dealers and issuers that

commercial lenders, through their affiliated dealers, continue to engage in these practices. In making its recommendations, the Taskforce weighed competing factors raised by stakeholders and acknowledged the commercial realities of how commercial lenders operate. On the one hand, multiple stakeholders highlighted the negative impacts of these practices on the viability of independent dealers, on the ability of issuers to receive independent advice and on competition. On the other hand, intermediaries noted that bundling capital market services and other services could result in lower financing costs for issuers.

The Taskforce's recommendations, summarized below, aim to address these concerns by giving more "teeth" to the "tied selling" restrictions in NI 31-103 and proposing rules designed to foster competition and provide issuers with greater freedom of choice, without dampening existing economic activities:

- ***Enhance the "tied-selling" restriction in NI 31-103***: The Taskforce recommends prohibiting registrants, as a consequence of an exclusivity arrangement, from providing capital markets services under certain circumstances. An exclusivity arrangement would be defined to exist when: (a) there is an outstanding or proposed loan (or continuation or modification of an existing loan) with an issuer or any affiliate thereof; and (b) in connection with such a loan, a bank practically or legally imposes a requirement that for such a loan to be made or maintained pursuant to an agreement, commitment or other understanding that an affiliate of the bank be retained to provide capital market services for the issuer or an affiliate thereof.
- ***Attestation***: A senior officer of a registrant would be required to attest that no prohibited conduct has occurred each time the registrant provides capital markets services to a reporting issuer with whom the affiliated commercial lender has a banking relationship. The Taskforce further notes that the Ontario Securities Commission (the "**OSC**") should consider imposing terms and conditions on the registration of registrants that fail to comply with these requirements.
- ***Amend National Instrument 33-105 - Underwriting Conflicts (NI 33-105) to require an independent underwriter with a connected issuer***: The Taskforce recommends expanding the definition of "connected issuer" under NI 33-105 such that an issuer would be considered a "connected issuer" to one or more underwriters involved in the offering by virtue of any commercial lending relationship between an affiliate of the underwriter and the issuer. This would have the practical effect of requiring that at least one independent underwriter be included in the syndicate. In addition, the Taskforce recommends that, in a conflict of interest situation where all or part of the proceeds of an offering are intended to be used to repay indebtedness to a commercial lender affiliated with an underwriter to the offering, a new requirement be introduced that an independent underwriter act as the lead or co-lead manager.
- ***Ban on restrictive clauses***: Where a registrant of an affiliated lender provides capital markets services, the Taskforce recommends a ban on certain restrictive clauses in capital markets engagement letters such as "right to act" and "right of first refusal" (ROFR) clauses. This would align with the similar ban

enacted by the U.K. Financial Conduct Authority in 2017.

2. Increase access to the shelf system for independent products

A long-standing concern in the industry relates to the dealer shelf system. In particular, concerns have been raised of dealers incentivizing the sale of proprietary products and restricting independent products on their shelves. One of the much-discussed aspects of the "Client Focused Reforms" (CFRs) under NI 31-103 is the enhanced conflicts of interest requirements coming into effect as of June 30, 2021, which will require dealers that offer independent products in addition to proprietary products to ensure that their shelf development and know-your-product processes, as well as their advisors' product recommendations, are not biased towards proprietary products.

The Taskforce's recommendations aim to support the CFRs and focus on increased oversight and governance relating to product shelf development with a view to ensuring that conflicts of interest are addressed in the best interest of clients, levelling the playing field and encouraging competition of investment products on their merits:

- ***Guidance on New Product Committees***: The Taskforce recommends that the OSC publish guidance to address product shelf issues and outline the makeup of internal committees at dealers responsible for reviewing new products (New Product Committees). This guidance would prohibit input from related and proprietary product divisions in the decision-making of these committees and require that committees include dealing representative representation. Additionally, the Taskforce recommends that dealers with open shelves be required to consider that new securities be made available to clients where those securities are proposed for inclusion on the shelf by their dealing representatives, and that they include them on their shelves unless there is a reasoned basis for exclusion.
- ***Title clarification for proprietary products***: The Taskforce flags as critical that investors are aware that they are not receiving independent advice when purchasing in a proprietary channel. To assist with investor awareness, the Taskforce recommends that the OSC work with self-regulatory organizations (SROs) to develop a regime that will clarify titles for all registrant categories and provide additional clarity to investors with respect to proprietary channels.
- ***Shelf documentation and proprietary product tracking***: The Taskforce recommends that all dealers that sell proprietary products be required to document their rationale when independent products are refused access to their product shelves. The Taskforce also recommends that dealers that sell proprietary products must provide to the OSC detailed quarterly reporting on the makeup of their product shelves, which will be published by the OSC on an annual basis.
- ***Independent manufacturer OSC reporting***: Dovetailing with the above requirement, the Taskforce

further recommends that independent product manufacturers be encouraged to report, on a confidential basis, instances where their products are refused access to a product shelf and that this information be tracked by the OSC.

- ***Limited market check***: The Taskforce also recommends that the regulators (the OSC or applicable SRO) review the findings of limited market check analyses conducted by dealers and the remediation implemented by dealers to ensure that the analyses are robust and remediation is suitable and timely. This limited market check would require all dealers that offer proprietary products to have a process in place to conduct periodic due diligence on comparable unrelated products available in the market, evaluate the competitiveness of their proprietary products and take steps if their proprietary products are determined not to be competitive. The Taskforce notes that dealers would be able to discharge this requirement in a way that is proportionate to the size and scope of their product offerings.

3. Improve corporate board diversity

Pursuant to National Instrument 58-101 - *Disclosure of Corporate Governance Practices*, since 2014, TSX-listed companies have been required to disclose their approach to gender diversity, including data regarding the representation of women on boards of directors and in executive officer positions. The disclosure follows a "comply or explain" model and does not require TSX-listed companies to adopt any gender diversity policies and practices, including targets. The Taskforce highlights that board diversity progress has been painfully slow, citing, among other things, the OSC's review samples that saw a mere 6% increase in board seats occupied by women from 2015 to 2019 and the Canadian Securities Administrators' (the "**CSA**") 2019 review that showed only 22% of the public issuers reviewed had even adopted targets regarding the representation of women on boards.

In making its recommendations, the Taskforce notes that investors are increasingly demanding data on diversity on boards and in executive officer positions to make informed investment and voting decisions and highlights the recent amendments to the *Canada Business Corporations Act* (the "**CBCA**") relating to mandatory board diversity disclosure requirements. As of 2020, all public companies governed by the CBCA are required to report representation of certain designated groups on boards of directors and in senior management. The Taskforce also draws support from its public consultations in this regard, noting that many commenters supported corporate board diversity beyond gender and agreed that board renewal is important to enhancing diversity.

To address this concern, the Taskforce recommends the following:

- ***Board diversity targets and timelines***: The Taskforce recommends amendments to Ontario securities legislation to require publicly listed issuers in Canada to set their own board and executive management

diversity targets (aggregated across both groups) and implementation timelines, and to annually provide data in relation to the representation of those who self-identify as women, BIPOC (black, Indigenous and people of colour), persons with disabilities or LGBTQ+ on boards and executive management. The Taskforce recommends that publicly listed issuers set an aggregated target of 50% for women and 30% for BIPOC, persons with disabilities and LGBTQ+. The Taskforce calls on the implementation of these targets to be completed within five years to meet the target for women and seven years to meet the target for the other diversity groups, placing specific focus and emphasis on representation of Black and Indigenous groups.

- ***Written policy for director nomination process***: The Taskforce recommends additional amendments to Ontario securities legislation to require publicly listed issuers to adopt a written policy respecting the director nomination process that expressly addresses the identification of candidates who self-identify as women, BIPOC, persons with disabilities or LGBTQ+ during the nomination process.
- ***Maximum board tenure limits***: To address board entrenchment, the Taskforce recommends amendments to Ontario securities legislation to set a 12-year maximum tenure limit for directors of publicly listed issuers, with the following exceptions: (a) a 15-year maximum tenure limit for the Chair of the board; (b) non-independent directors of family-owned and controlled businesses, where such nominees represent a minority of the board; and (c) no more than one other director who will be deemed not to be independent, and will still have a 15-year limit.
- ***Diversity at the OSC***: The Taskforce recommends that diversity – including racial diversity – be similarly represented at the board and executive levels of the OSC, which will be responsible for discharging this important mandate.

4. Introduce a retail investment fund structure that pursues investment strategies in less liquid private equity and debt markets, including in early-stage businesses.

During its consultations, the Taskforce heard that there is a funding gap for small issuers that want to raise capital and that it is becoming prohibitively costly for an issuer to become publicly listed. It also heard that many retail investors want to invest in private equity investments but are often prohibited by securities regulation from investing in early-stage, private market opportunities and experience difficulties navigating the complex environment.

To address this concern, the Taskforce recommends that the OSC establish a retail private equity investment fund proposal for public input to incorporate private equity investing best practices and the advantages of the retail investment fund model. The Taskforce suggests looking at other jurisdictions for examples, such as the "interval fund" concept in the United States. The Taskforce notes that such a proposal would have to be balanced and incorporate investor protection safeguards.

If implemented, the Taskforce's recommendations would likely have a significant impact on leveling the playing field for small and independent market participants and may also enhance the quality and diversity of products available to businesses as well as promote board diversity. However, unless these recommendations are implemented across Canada, there may be unintended consequences that could reduce these potential benefits, including the adoption of forum shopping by market participants. The benefits of a retail investment fund structure certainly merit further exploration; however, implementation will have to overcome obstacles posed by the current Canadian securities regulatory framework and tax considerations.

For more insights on Ontario's Capital Markets Modernization Taskforce Final Report, check out our comprehensive series here.

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A Cautionary Note