



Exempt Market Dealers – 101

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Agenda

- Who we are
 - Exempt Market Dealer (EMD) Business Models
 - Compliance Deficiencies of EMDs
 - Referral Arrangements and Finders
 - NI 31-103 – Proposed EMD-Related Amendments
 - CSA and OSC Exempt Market Reviews - Impact on EMDs
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Who we are

- We are part of the Compliance and Registrant Regulation Branch at the OSC
- Our branch is responsible for registration of firms and individuals
- Our team is dedicated to exempt market dealers and scholarship plan dealers
- We consider exemptive relief applications
- We conduct compliance reviews
- From these reviews we see trends with respect to compliance deficiencies

Business Models



Compliance Deficiencies of EMDs

- Insufficient know your product (KYP) due diligence
- Inadequate suitability assessment
 - Assessing concentration in exempt market products
 - Dealing with senior investors
- Conflicts of interest when selling securities of related or connected issuer

Insufficient KYP due diligence

Why important?

Suggested practices

1. Have a list of criteria to accept or reject a product for your clients
 2. Have professional staff with adequate skills and experience to analyze the product
 3. Analyze the issuer's past and expected use of investor proceeds
 4. Check the background of the issuer and its principals
 5. Assess the issuer's underlying business operation and related risks
 6. Analyze the financial statements and other financial information of the issuer and its underlying business
 7. Assess the existence of any conflicts of interest
- Etc.

Insufficient KYP due diligence

Reliance on due diligence conducted by related issuers or other third parties

- Registrant is ultimately responsible and accountable for approving the product for distribution
- Perform your own product assessment
 - Review and assess the quality of work performed by third parties
 - Consider whether the report is fair, balanced and not misleading
 - Consider existing or potential conflicts of interest that may influence the opinion rendered
- Independently determine if the product would be suitable to some investors

Suitability – Assessing concentration in exempt market products

Why is over-concentration an issue?

- Illiquid
- Risky

Is there over-concentration in the following securities?

- Securities of a single issuer or group of related issuers
- Securities of illiquid exempt market securities
- Securities in a single industry or asset class

Suitability – Assessing concentration in exempt market products

What to consider?

1. Composition of a client's net financial assets
2. Liquidity needs and time horizon
3. The client's entire portfolio holdings, including but not limited to:
 - Other high risk or exempt market securities
 - Previous investments in the same product of an issuer or group of related issuers
4. Whether client has borrowed to invest
5. Must consider client's ability to accept risk, not just the client's stated willingness

Suitability – Dealing with senior investors

Seniors as a vulnerable group

- Becoming a larger part of the population
- Rely on investments for financial security in retirement
- Reduced investment time horizon to recover from financial loss
- Possible diminished mental capacity and physical illness
- Susceptible to financial abuse

Suitability – Dealing with senior investors

Some key areas to consider:

1. Communicate effectively with senior investors
2. Identify senior-specific issues (e.g. signs of diminished capacity and financial abuse, etc.)
 - Train dealing representatives to identify the issues
 - Establish policies and procedures for dealing with these issues

Suitability – Dealing with senior investors

3. Ensure suitability of investments

- Time horizon
- Investment objectives
- Risk tolerance
- Liquidity
- Less time to recover from losses and inability to make up losses through employment income

4. Incorporate additional supervisory procedures to review trades for senior investors

Conflicts of interest when selling securities of related or connected issuers

What is a related or connected issuer?

- A related/connected issuer relationship arises where there is common ownership or an influential relationship between the issuer of securities and the registrant firm that distributes the securities (see definition in National Instrument 33-105 – *Underwriting conflicts*)
- Sometimes called 'related party products'

EXAMPLES:

- There is the same mind and management between the issuer and the EMD
- The issuer owns the EMD or vice versa
- The CEO of the issuer is the owner of the EMD

Conflicts of interest when selling securities of related or connected issuers

- We have identified concerns with EMDs that trade in, or recommend, related/connected issuer products
- The concern especially arises with EMDs that solely trade in these products
- Significant investor protection concerns have included:
 - Misappropriation of investor funds
 - Concealment of poor financial condition of the related/connected issuer
 - Sale of unsuitable investments(beyond investor's risk tolerance or capacity to absorb loss)
 - Concentration in the securities of the related/connected issuer
- There are significant conflicts of interest that arise

Conflicts of interest when selling securities of related or connected issuers

What is a conflict of interest?

- A conflict of interest arises when the interests of different parties (e.g., the EMD and its client) are inconsistent or divergent
- Where the EMD is also the owner of the issuer, the EMD will financially benefit from the sale of the issuer's securities. Therefore, the dealing representative of the EMD may have an incentive to trade in, or recommend, these securities even though they may be unsuitable for the client
- This conflict of interest becomes more significant when the EMD trades solely in the issuer's securities (e.g., because there may be an incentive to have a client highly concentrated in that issuer's securities)

Conflicts of interest when selling securities of related or connected issuers

How can an EMD deal with a conflict of interest?

- Avoid
- Control
- Disclose

Conflicts of interest when selling securities of related or connected issuers

- If the risk of harming a client or the integrity of the markets is too high, the conflict of interest should be avoided
 - Controlling the conflict may include:
 - Independent review committee
 - Audited financial statements
 - With related party products, the EMD must also disclose the relationship to clients (NI 33-105 *Underwriting Conflicts*)
 - Disclosure should be specific, clear and meaningful and should explain how the conflict of interest could affect the service being offered
 - Disclosure should be available to the investor before or at the time of the trade or recommendation
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Referral Arrangements and Finders

- Section 13.8 of NI 31-103 describes the circumstances in which referral arrangements are permitted
 - The referral arrangement must be a written agreement
 - All referral fees must be recorded
 - Disclosure must be provided to clients

Referral Arrangements and Finders

- There are two key things to remember about referral arrangements:
 - The arrangement must be disclosed to clients
 - A registrant firm cannot contract out of its regulatory obligations
- Further information on what must be included in the disclosure to clients is provided in section 13.10 of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103) and in the Companion Policy to NI 31-103
- The party receiving the referral must be appropriately qualified to perform the services
- In some cases, this may require that the party be registered

Referral Arrangements and Finders

- A person or company shall not engage in or hold himself, herself or itself out as engaging in the business of trading in securities unless the person or company is registered as a dealer
- Engaging in the business of trading in securities may include:
 - Soliciting investors to enter into securities transactions
 - Assisting issuers in structuring prospective securities transactions or helping issuer to identify potential purchasers of securities
 - Participating in the negotiating process or otherwise bringing buyers and sellers of securities together
 - Receiving compensation contingent on the success of a securities transaction or based on the amount or value of a securities transaction

Referral Arrangements and Finders

- Section 8.5 of NI 31-103 provides an exemption from registration as a dealer if the trade is made solely through a registered dealer
- If the finder is “in the business of trading”, s. 8.5 does not provide an exemption from registration
- The CSA proposed an amendment to s. 8.5 to clarify this
- The person or company seeking the exemption cannot solicit or contact directly any purchaser or prospective purchaser in relation to the trade
- Finders cannot rely on s. 8.5 and need to consider whether they should be registered

NI 31-103 – proposed EMD-related amendments

- NI 31-103 provides in section 7.1(2)(d) a list of activities in which exempt market dealers are permitted to engage
- The CSA proposed amendments to the section
- The intention is to prohibit an EMD from conducting brokerage activities and to clarify that EMDs should not be trading on or off exchange

NI 31-103 – proposed EMD-related amendments

- The CSA proposed amendments after observing a trend where firms that are broker-dealers in non-Canadian jurisdictions register as exempt market dealers in order to conduct brokerage activities with accredited investors
- We were not convinced that this category was appropriate for such activity since, in Canada, we register firms that conduct brokerage activities as investment dealers
- In earlier staff notices we defined brokerage activities to mean trading securities listed on an exchange in foreign or Canadian markets
- Due to marketplace concerns, the proposed rule amendment also restricts trading listed securities off exchange

NI 31-103 – proposed EMD-related amendments

EXAMPLES:

- A private company proposes to issue shares through a private placement. An EMD is permitted to participate in the distribution of the private placement. In this example, the EMD distributes the securities to accredited investor A.
- During the 4 month hold period, accredited investor A decides to sell his securities. He contacts the EMD. The EMD can facilitate the sale of the securities from accredited investor A to accredited investor B.
- After the hold period expires, investor B decides to sell the securities and contacts the EMD. The EMD can also participate in the resale of the securities to accredited investor C.

NI 31-103 – proposed EMD-related amendments

EXAMPLES Cont'd:

- A reporting issuer company decides to distribute securities through a private placement. The EMD can participate in the distribution to accredited investor A.
- During the 4 month hold period the EMD can facilitate a trade between accredited investor A and accredited investor B.
- After the expiry of the hold period, the securities are listed and freely tradeable. The EMD may not participate in further trades of the security.

NI 31-103 – proposed EMD-related amendments

- The CSA does not intend to make any further changes to the permitted activities of exempt market dealers
- Comments received to the proposed amendments expressed concern that EMDs would be prohibited from selling mutual funds
- Exempt market dealers are still permitted to distribute, to accredited investors, securities of mutual funds. We will clarify this point.

CSA - Proposed amendments to Minimum Amount and Accredited Investor Exemptions

Minimum amount exemption:

- Proposed amendments will restrict the use of this exemption to non-individuals

Accredited investor exemption:

- No change to income and/or asset thresholds in definition of accredited investor
- Require a risk acknowledgement form from individual accredited investors (other than permitted clients)
- Provide companion policy guidance in National Instrument 45-106 *Prospectus and Registration Exemptions* regarding verification of accredited investor status

CSA – Other proposed amendments

Other changes:

- Amend the accredited investor exemption in Ontario to permit fully managed accounts, where the adviser has a fiduciary relationship with the investor, to purchase any securities on an exempt basis, including investment fund securities
- Currently, in Ontario only, investment funds are carved out of the managed account category of the accredited investor exemption
- Removing the carve-out will harmonize the managed account category of the accredited investor exemption in Canada
- Introduce family trusts as a new category of accredited investor

OSC - Proposed capital raising prospectus exemptions

Objective

- Facilitate capital raising for businesses, particularly start-ups and small and medium enterprises (SMEs), while protecting the interests of investors

Four exemptions

- OM exemption
- Family, friends and business associates exemption
- Crowdfunding exemption, including registration framework for online funding portals
- Existing security holder exemption

Other

- 2 new forms of report of exempt distribution

OM exemption

Key components of proposal

Element of exemption	Proposal
Issuer qualifications	<ul style="list-style-type: none">- Available to both reporting and non-reporting issuers- Not available to investment funds- No industry or other restrictions
Types of securities	<ul style="list-style-type: none">- Not available for distributions of specified derivatives and structured finance products
Offering parameters	<ul style="list-style-type: none">- No limit on size of offering or number of offerings- No restriction on length of time an offering can remain open
Registrant involvement	<ul style="list-style-type: none">- Prohibition on using registrants that are related to an issuer
Marketing and advertising	<ul style="list-style-type: none">- No new restrictions on advertising- Marketing materials incorporated into an OM and therefore subject to liability if misrepresentation

OM exemption (cont'd)

Key components of proposal

Element of exemption	Proposal
Investor qualifications	<ul style="list-style-type: none">- Substantially the same definition of eligible investor <p><u>Individuals:</u></p> <ul style="list-style-type: none">- Net asset test – \$250,000 excluding primary residence- Net income test – retaining current levels of income at \$75,000 alone and \$125,000 with a spouse <p><u>Non-individuals:</u></p> <ul style="list-style-type: none">- Net asset test – \$400,000- Removal of net income test of \$75,000
Investment limits	<p><u>Individuals:</u></p> <ul style="list-style-type: none">- Accredited investors - no limits- Eligible investors - \$30,000 per year- Not an accredited or eligible investor - \$10,000 per year <p><u>Non-individuals:</u></p> <ul style="list-style-type: none">- No investment limits

OM exemption (cont'd)

Key components of proposal

Element of exemption	Proposal
Risk acknowledgement form	- Must be signed by individual investors
Point of sale disclosure	- OM must be provided to investors - Subject to liability if misrepresentation
Cooling off period	- Investors have two business day right of withdrawal
Resale restrictions	- Subject to resale restrictions
Ongoing disclosure	<u>Reporting issuers:</u> - Subject to ongoing CD obligations <u>Non-reporting issuers:</u> - Audited annual financial statements - Annual notice of use of proceeds - Notice of certain specified events

Family, friends and business associates (FFBA) exemption

Key components of proposal

Element of exemption	Proposal
Issuer qualifications	<ul style="list-style-type: none">- Available to both reporting and non-reporting issuers- Not available to investment funds- No other restrictions
Types of securities	<ul style="list-style-type: none">- Only available for distributions of specified securities<ul style="list-style-type: none">- Common shares- Non-convertible preferred shares- Securities convertible into common shares and non-convertible preferred shares- Non-convertible debt securities linked to an interest rate- Flow-through shares
Offering parameters	<ul style="list-style-type: none">- No limit on size of offering or number of offerings
Solicitation and advertising	<ul style="list-style-type: none">- Advertising to solicit investors is prohibited- Payment of fees and commissions to any person prohibited

FFBA exemption (cont'd)

Key components of proposal

Element of exemption	Proposal
Investor qualifications	<ul style="list-style-type: none">- Same as currently permitted under CSA exemption- Specified insiders- Specified family members- Specified close personal friends- Specified close business associates
Investment limits	<ul style="list-style-type: none">- None
Risk acknowledgement form	<ul style="list-style-type: none">- Must be signed by individual investors

Crowdfunding exemption

Key components of proposal

Element of exemption	Proposal
Issuer qualifications	<u>General</u> <ul style="list-style-type: none">- Available to both reporting and non-reporting issuers- Not available to investment funds- Not available to non-reporting real estate issuers or blind pools <u>Nexus to Canada</u> <ul style="list-style-type: none">- Incorporated or organized in Canada- Head office in Canada- Majority of directors resident in Canada
Types of securities	<ul style="list-style-type: none">- Only available for distributions of specified securities<ul style="list-style-type: none">- Common shares- Non-convertible preferred shares- Securities convertible into common shares and non-convertible preferred shares- Non-convertible debt securities linked to an interest rate- Flow-through shares

Crowdfunding exemption (cont'd)

Key components of proposal

Element of exemption	Proposal
Offering parameters	<ul style="list-style-type: none">- Cannot raise more than \$1.5 million under exemption during 12 months preceding current offering- Distribution cannot remain open longer than 90 days
Solicitation and advertising	<ul style="list-style-type: none">- Offering materials can only be made available to potential investors through portal- Potential investors can be directed to portal through print and social media
Investment limits	<ul style="list-style-type: none">- Investors cannot invest:<ul style="list-style-type: none">- More than \$2,500 in single investment- More than \$10,000 in total under exemption in calendar year

Crowdfunding exemption (cont'd)

Key components of proposal

Element of exemption	Proposal
Risk acknowledgement form	<ul style="list-style-type: none">- Must be signed by investors
Point of sale disclosure	<ul style="list-style-type: none">- Crowdfunding offering document in Form 45-●●●F1 must be provided to investors- Videos and term sheets can also be made available- Subject to liability if misrepresentation
Cooling off period	<ul style="list-style-type: none">- Investors have two business day right of withdrawal
Ongoing disclosure	<p><u>Reporting issuers:</u></p> <ul style="list-style-type: none">- Subject to ongoing CD obligations <p><u>Non-reporting issuers:</u></p> <ul style="list-style-type: none">- Audited or reviewed annual financial statements- Annual notice of use of proceeds- Notice of certain specified events- Books and records

Crowdfunding portal regime

Key components of proposal

Element of exemption	Proposal
Registration	<ul style="list-style-type: none">- Registered as a restricted dealer- Dual registrations not permitted
Obligations	<p><u>General obligations</u></p> <ul style="list-style-type: none">- General registrant obligations applicable to EMDs (some exceptions)- Exempt from KYC, suitability and certain other requirements <p><u>Additional obligations</u></p> <ul style="list-style-type: none">- Conduct background checks on issuers and principals- Understand general structure, features and risks of offering- Review issuer information posted on portal- Deny access if reason to believe offering is fraudulent- Provide investor education materials
Permitted activities	<ul style="list-style-type: none">- May apply criteria to limit offerings on platform, subject to conditions

Crowdfunding portal regime (cont'd)

Key components of proposal

Element of exemption	Proposal
Prohibited activities	<u>Advice</u> <ul style="list-style-type: none">- Cannot provide specific recommendations or advice to investors- Cannot endorse or comment on merits or expected returns of investment <u>Solicitation</u> <ul style="list-style-type: none">- Cannot engage in solicitation (or compensate employees or agents for solicitation) <u>Investor funds or securities</u> <ul style="list-style-type: none">- Cannot hold or handle investor funds or securities

Crowdfunding portal regime (cont'd)

Key components of proposal

Element of exemption	Proposal
Prohibited activities (cont'd)	<u>Interest in issuer</u> <ul style="list-style-type: none">- Cannot invest in issuer on platform (subject to receiving fees in form of securities that do not exceed 10% ownership interest) <u>Secondary trading</u> <ul style="list-style-type: none">- Cannot facilitate secondary trading

Reports of exempt distribution

Objective

- Two new forms of report tailored to type of issuer
 - Investment funds
 - Non-investment fund issuers
- Obtain better data on exempt market activity to:
 - Facilitate effective oversight of exempt market
 - Inform future exempt market related policy initiatives

Reports of exempt distribution (cont'd)

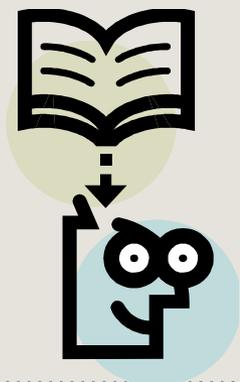
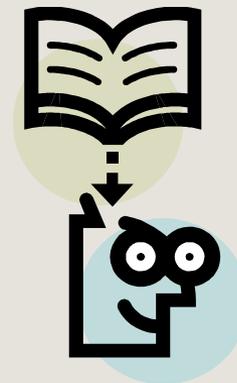
Additional information for investment funds

- Type of investor (individual vs institutional)
- Reporting of redemptions
- Size of fund
- Category of fund
- Additional profile information about fund and its key service providers

Additional information for non-investment funds

- Details about issuer, including its stage of development and industry
 - Exchange on which issuer's securities listed (if applicable)
 - Identification of issuer's directors, executive officers, control persons and promoters
 - Details regarding involvement of registrants, finders and insiders (including compensation)
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Questions? Comments?



References & Web Links:

Exempt Market Dealers 101 (slide deck):

http://www.osc.gov.on.ca/en/Dealers_registrant-outreach_index.htm#rr101

OSC Staff Notice 33-742 2013 – OSC Annual Summary Report for Dealers, Advisers and Investment Fund Managers:

http://www.osc.gov.on.ca/en/SecuritiesLaw_sn_20131107_33-742_annual-rpt-dealers.htm

CSA Staff Notice 31-336 – Guidance for Portfolio Managers, Exempt Market Dealers and Other Registrants on the Know-Your-Client, Know-Your-Product and Suitability Obligations:

http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20140109_31-336_kyc-kyp-suitability-obligations.htm

CSA Staff Notice 33-315 – Suitability Obligation and Know Your Product:

http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20090902_33-315_know-your-product.htm

References & Web Links:

Introduction of proposed prospectus exemptions and proposed reports of exempt distribution in Ontario:

http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20140320_45-106_rfc-prospectus-exemptions.htm

Proposed amendments to accredited investor and minimum amount investment prospectus exemptions:

http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20140227_45-106_rfc-pro-amendments.htm