



# Registrant Series: Exempt Market Dealers (EMD)

## Presenters:

- Paul Hayward, Senior Legal Counsel, Compliance and Registrant Regulation (CRR)
- Elizabeth Topp, Senior Legal Counsel, CRR
- Stratis Kourous Senior Accountant, CRR

November 21, 2017 (webinar)

November 23, 2017 (in-person)

OSC

ONTARIO  
SECURITIES  
COMMISSION

# Disclaimer

The views expressed in this presentation are the personal views of the presenting staff and do not necessarily represent the views of the Ontario Securities Commission or any of its other staff.

The presentation is provided for general information purposes only and does not constitute legal or accounting advice.

Information has been summarized and paraphrased for presentation purposes and the examples have been provided for illustration purposes only.

Information in this presentation reflects securities legislation and other relevant standards that are in effect as of the date of the presentation.

The contents of this presentation should not be modified without the express written permission of the presenters.

# Agenda

1. Overview of recent EMD-related amendments to NI 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*
2. Targeted compliance review of new prospectus exemptions
3. Summary of Findings - 2017 CRR Annual Report to Dealers, Advisers and IFMs
4. Resources
5. Questions and answers



# **Overview of recent EMD-related amendments to NI 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations***

# Overview of amendments to NI 31-103

- On July 27, 2017, the CSA published final amendments to NI 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103) and NI 33-109 *Registration Information*
- The amendments
  - enhance custody requirements for certain registered firms,
  - clarify activities that may be conducted by exempt market dealers,
  - incorporate previously granted relief from certain Client Relationship Model Phase 2 (CRM2) requirements, and
  - provide for certain changes of a housekeeping nature.
- Subject to receipt of all necessary approvals, the amendments come into force on December 4, 2017
  - Custody amendments come into force on June 4, 2018.

# EMD-related amendments

- Objectives of EMD-related amendments to NI 31-103:
  - Clarify restrictions on EMD participation in prospectus offerings
  - Clarify restrictions on EMDs engaging in brokerage activities involving listed securities
  - Expand dealer registration exemption for investment fund trades by PMs to managed accounts

# Comments on EMD-related amendments

- Amendments published for comment in July 2016
- Comments regarding restrictions on EMD participation in prospectus offerings fairly critical
  - Commenters appeared to be concerned that CSA was proposing to restrict EMDs from participating in any type of distribution by public companies/funds
  - Commenters concerned about potential impact on IFM/PM/EMDs
- Comments were generally supportive of proposed amendment to PM managed account exemption (s. 8.6)

# CSA consultations and response

- CSA carefully considered comments on these proposals (and also comments on similar proposal from December 2013 that was withdrawn)
  - Consulted with various stakeholders including Registrant Advisory Committee (RAC) and Portfolio Management Association of Canada (PMAC) to request additional information regarding industry interpretations & practices
- CSA believe most concerns can be addressed through expanded dealer registration exemption in s. 8.6 and additional guidance
  - See final slide for references



# EMD restrictions on participation in prospectus distributions

- EMDs not permitted to act as a dealer or underwriter in a distribution of securities *being qualified by a prospectus*
- Restriction includes:
  - acting as a “selling group member” (clause (a) of definition of “underwriter” in s. 1(1) of OSA)
  - acting as agent in a special warrant transaction (see commentary in s. 2.8(2) of 41-101CP)
- However, amendments do not have any impact on ability of an EMD to participate in a distribution by an issuer – including a reporting issuer – under a prospectus exemption

# Example

- Facts
  - ABC Co has common shares listed on the TSX Venture Exchange (TSX-V)
  - In January 2018, ABC Co wishes to conduct a prospectus offering of \$10 million common shares to investors
  - ABC Co also wishes to make a contemporaneous private placement of \$5 million common shares to five accredited investors (AIs) in reliance on the AI exemption in s. 73.3(2) of OSA/s. 2.3 of NI 45-106 *Prospectus Exemptions*
- EMD not permitted to participate in prospectus offering (see s. 25(2) and 26(4) of OSA and s. 7.1(2)(d)(i) of NI 31-103)
  - Prospectus offering should be done through investment dealers/IIROC members

# Example (continued)

- EMD can act as a dealer and underwriter in a contemporaneous private placement of common shares to five AIs but note:
  - Investors do not receive statutory prospectus protections
  - Common shares subject to resale restrictions (typically four months)
  - Form 45-106F1 required to be filed
  - If EMD wishes to use prospectus as a marketing document, EMD should explain implications (AIs do not receive statutory prospectus protections, securities are not freely trading, etc.)
    - In Ontario, prospectus would be considered an “offering memorandum” – see s. 130.1 of OSA and Part 5 of OSC Rule 45-501 *Ontario Prospectus and Registration Exemptions* for requirements

# Restrictions on EMDs participating in brokerage activities

- EMDs not permitted to engage in brokerage activities involving listed securities (see s. 7.1(2)(5))
  - CSA policy concerns with EMDs engaging in brokerage activities involving listed securities:
    - CSA Staff Notice 31-327 *Broker-Dealer Registration in the Exempt Market Dealer Category* (September 2011)
    - CSA Staff Notice 31-333 *Follow-up to Broker-Dealer Registration in the Exempt Market Dealer Category* (February 2013)
    - Amendments to NI 31-103 (published for comment December 2013, adopted October 2014, in force July 2015) – introduced current s. 7.1(2)(5)
  - Current restrictions in s. 7.1(2)(5) moved to s. 7.1(2)(d)(ii) to clarify drafting/readability
-

# Example

- In January 2018, EMD acts as agent in private placement of \$5 million of ABC Co common shares to five AIs (AI#1 to AI#5)
  - Common shares subject to four-month resale restrictions
- In February 2018, AI#2 wishes to resell her ABC Co common shares
  - EMD can act as dealer on the resale, since securities subject to resale restrictions and resale is a distribution (see s. 7.1(2)(d)(i))

# Example

- In June 2018, AI#3 wishes to resell his ABC Co common shares
  - Common shares are now freely trading and can be sold through TSX-V
  - EMD not permitted to act as dealer on resale (see s. 7.1(2)(d)(ii)) – this should be done through investment dealers/IIROC members
  - EMD can have a referral arrangement with IIROC firms – see s. 13.8 of 31-103CP

# Expanded exemption for certain trades by PM to managed accounts (s. 8.6)

- Dealer registration exemption in s. 8.6 expanded to cover trade in an investment fund security if
  - the adviser or an affiliate of the adviser acts as fund's adviser,
  - the adviser or an affiliate of the adviser acts as fund's IFM, and
  - the trade is to a managed account
- Intended to remove the need for IFM/PM to obtain/hold EMD registration if dealer activities limited to using proprietary funds as efficient way to allocate shares to managed accounts

# EMD registration does not limit what a PM can do as a PM

- IFM/PM may obtain EMD registration for other reasons (e.g., to sell proprietary funds to AIs)
- Obtaining EMD registration does not limit what a PM may do in the capacity of a PM
- If a PM is simply acting as a purchaser in a prospectus offering (i.e., it is simply purchasing for a fund or managed account advised by the PM), and is not also advising/managing the issuer or being compensated for selling the offering, then PM is not “acting as a dealer”, so no need for dealer registration for this activity



# EMD registration does not limit what a PM can do as a PM

- If the PM is a PM/EMD, analysis does not change – restriction on acting as a dealer or underwriter in a prospectus offering in s. 7.1(2)(d)(i) and s. 7.1(2)(d)(iv) does not apply, since not acting as a dealer or underwriter
  - PM and PM/EMD would generally need to resell the securities through an investment dealer/IIROC member
- PM/EMD not precluded by s. 8.01 from relying on dealer registration exemption in s. 8.6 for activities not authorized to be conducted under EMD registration
  - See (2017), 40 OSCB (Supp-1) at 22-24 (Notice) for relevant commentary



# Targeted compliance review of new prospectus exemptions

# Overview

- New prospectus exemptions introduced in Ontario
  - Offering memorandum (**OM**) prospectus exemption (2016)
  - Family, friends and business associates (**FFBA**) exemption (2015)
- The OM and FFBA prospectus exemptions allow retail investors greater access to securities distributed on an exempt basis
- Targeted expanded exempt market review conducted in 2017
  - Initial review of how exempt market dealers are using and complying with the new prospectus exemptions

# Discussion topics

- New prospectus exemptions
- Expanded exempt market review
- Findings from compliance review

# New prospectus exemptions

## OM prospectus exemption

- Allows both reporting and non-reporting issuers (but not investment funds) to distribute securities to investors without a prospectus – an offering memorandum in the prescribed form must be provided
  - Form 45-106F2 *Offering Memorandum for Non-Qualifying Issuers*
  - Form 45-106F3 *Offering Memorandum for Qualifying Issuers*
- Not available for distributions of specified derivatives and structured finance products
- Risk acknowledgment form (Form 45-106F4 *Risk Acknowledgment* and related schedules)
- Marketing materials incorporated by reference into offering memorandum

# New prospectus exemptions cont'd

## OM prospectus exemption

- Investor qualifications
    - “Eligible investor”
      - Net assets, alone or with a spouse, in the case of an individual, exceed \$400,000
      - Net income before taxes exceeded \$75,000 alone or \$125,000 with a spouse in each of the two most recent calendar years and reasonably expect to exceed that level in current year
  - Investment limits – individuals
    - Accredited investors and investors who qualify under the FFBA exemption – no limits
    - Eligible investors - \$30,000 per year (in all OM investments)
    - Eligible investors who receive advice from an investment dealer, portfolio manager or exempt market dealer that the investment is suitable – up to \$100,000 per year (in all OM investments)
    - Non-eligible investors - \$10,000 per year (in all OM investments)
-

# New prospectus exemptions cont'd

## OM prospectus exemption

- Two day right of withdrawal
  - Offering memorandum and marketing materials must be filed within 10 days
    - Marketing materials must include cover page identifying offering memorandum they relate to
  - Ongoing disclosure requirements
    - Reporting issuers – continuous disclosure obligations under securities law
    - Non-reporting issuers
      - Audited annual financial statements - deliver to regulator and make reasonably available to security holders – within 120 days of year end
      - Annual notice of use of proceeds (Form 45-106F16)
      - In Ontario, New Brunswick and Nova Scotia – notice of specified key events (Form 45-106F17)
-

# New prospectus exemptions (cont'd)

## FFBA prospectus exemption

- Allows reporting and non-reporting issuers (but not investment funds) to raise capital from investors who are principals of the business or within the personal networks of principals of the business
- Specified relationship must exist with one of director, executive officer, control person or founder of the issuer or affiliate of issuer



# New prospectus exemptions (cont'd)

## FFBA prospectus exemption

- Family member of person
  - Spouse, parent, grandparent, brother, sister, child or grandchild
  - Only specified family members
- Family member of the *spouse* of person
  - Parent, grandparent, brother, sister, child or grandchild of the spouse
- “close personal friend” or “close business associate” of the person

# New prospectus exemptions (cont'd)

## FFBA prospectus exemption

- Risk acknowledgment form (Form 45-106F12 *Risk Acknowledgment Form for Family, Friend and Business Associate Investors*)
  - Form must be signed by the purchaser and an executive officer of the issuer other than the purchaser
  - Form must also be signed by both parties to the relationship

# New prospectus exemptions (cont'd)

## FFBA prospectus exemption

- Commission guidance on meaning of “close personal friend” and “close business associate”
    - s. 2.7 and s. 2.8 of National Instrument 45-106 *Prospectus Exemptions* Companion Policy
    - Length of time the individual has known the director, executive officer, founder or control person
    - Nature of the relationship between the individual and the director, executive officer, founder or control person including frequency of contact and level of trust and reliance in other circumstances
    - Number of “close personal friends” to whom securities have been distributed
    - Not a “close personal friend” just because certain relationship exists – i.e. social medial contact or co-worker
-

# Expanded exempt market review

- January 2017 – first targeted review of EMDs to assess compliance with requirements related to OM and FFBA exemptions:
  - OM and FFBA prospectus requirements (s. 2.9, 2.5 and 2.6 of NI 45-106)
  - Know-your-client (**KYC**) and suitability obligations (s. 13.2 and s.13.3 of NI 31-103)
  - Internal controls (part 11 of NI 31-103)
- Looked to Form 45-106F1 *Report of Exempt Distribution* filings:
  - Identified EMDs that distributed securities in Ontario under OM and FFBA prospectus exemptions
- Review period – February 1, 2016 to December 31, 2016

# OM exemption – key deficiencies

- Lack of collection and documentation of information to assess compliance with applicable investment limits
  - Investment limits apply for 12-month period and are cumulative
  - Collect and document inquiries related to other investments the client may have made in the period under the OM exemption
- Failure to comply with applicable investment limits
  - The investment limit for eligible investors can be increased to \$100,000 but only if an EMD provides advice that exceeding the investment limit of \$30,000, and the investment itself, is suitable for the investor
  - Positive suitability assessment in this case precludes the use of a “client directed trade”

# OM exemption – key deficiencies

- Lack of compliance with risk acknowledgment forms:
  - OM exemption (F4) has prescribed form
  - Failure to obtain required form – use of incorrect form
  - Failure to complete schedules to form
  - Modifying prescribed form – changing the language on the form

# FFBA exemption – key deficiencies

- Lack of information or adequate documentation on how a client qualified
    - Steps taken to verify client met criteria for exemption – nature of the relationship
      - Don't rely solely on self-certification
  - Processing trades for clients who don't qualify
    - Only specified family members may rely on this exemption
    - Look to Commission guidance for factors indicating “close personal friend” or “close business associate” relationship exists
  - Relevant factors
    - Length of time the investor has known the key individual
    - Nature of relationship between the investor and the key individual
    - Social media “friends” don't count
  - Use of incomplete or incorrect risk acknowledgment form
-

# Acceptable processes and practices

- Know, understand and provide training on the conditions of the prospectus exemptions being relied on
- Have a process in place to monitor transactions for non-eligible investors and eligible investors to prevent transactions exceeding investment limits in Ontario
- Make inquiries of clients and document information obtained on:
  - Whether the client meets certain definition
  - Other investments made under the OM exemption
  - Relationship between individuals for reliance on the FFBA exemption



# Acceptable processes and practices

- Have a process in place to review information obtained from clients for consistency with terms of exemption relied on
  - KYC information should align with definition of “eligible investor”
- Document determination of whether transaction is suitable or not
- Establish policies and procedures to support compliance with exemptions

# Unacceptable processes and practices

## EMDs must not:

- Process a transaction for a non-eligible investor, or an eligible investor, that would exceed the investment limits under the OM exemption
  - Take instructions from a client who is an eligible investor to exceed the \$30,000 investment limit when the advice provided is that the exceeding the limit would be unsuitable (when relying on OM exemption)
  - Sell an exempt security if they do not have sufficient information to determine whether the client qualifies for the exemption being relied on
    - Document any information obtained from the client
  - Change the language in risk acknowledgment forms
-

# Steps you can take now

- Review the conditions of the OM and FFBA exemptions including the relevant Commission guidance in 45-106CP
  - Provide in-house training sessions for DRs
- Review your policies and procedures manual to confirm it includes sufficient and accurate information about the conditions to use these exemptions and the steps the firm will take
- Review your KYC process and determine if it will demonstrate that your firm is taking reasonable steps to collect and document information about your clients to support that they qualify and the basis for their qualification
- Review the risk acknowledgement forms used and make sure that you are providing the correct forms to your clients



# Summary of Findings - 2017 CRR Annual Report to Dealers, Advisers and IFMs

# Overview

- OSC Staff Notice 33-748 – Annual Summary Report for Dealers, Advisers and Investment Fund Managers
  - Annual summary report prepared by the CRR Branch provides information for registered firms and individuals:
    - Update on our Registrant Outreach program
    - Summary of current trends in registration and in deficiencies identified through compliance reviews of registrants
    - Highlight the types of regulatory action we take when we find serious non-compliance and misconduct
    - Summary of new and proposed rules and policy initiatives impacting registrants

# Discussion topics

- Will discuss the following topics:
  - Findings from compliance reviews
  - Common deficiencies in registration applications
  - Initiatives impacting EMD's

# Findings from compliance reviews

- The following are common findings from our compliance reviews of EMDs:
  - Inadequate collection, documentation and updating of KYC forms and suitability information
    - Most significant deficiency identified
    - Encourage registrants to review their KYC practices
  - Inadequate documentation to support assessment of products
    - Not maintaining evidence they have conducted due diligence
  - Individuals trading without proper registration
    - Firm is responsible for conduct of employees

# Findings from compliance reviews (cont'd)

- The following are common findings from our compliance reviews of EMDs:
  - Inadequate or misleading marketing material
    - Refer to CSA Staff Notice 31-325 *Marketing Practices of Portfolio Managers* for guidance on marketing practices
    - Section 2 of the Marketing Notice addresses exaggerated and unsubstantiated claims
  - Inadequate or no annual compliance report to the board
    - Required to submit an annual report to the firm's board of directors regarding the compliance of the firm



# Findings from compliance reviews (cont'd)

- The following are common findings from our compliance reviews of EMDs:
  - Referral arrangements – inadequate disclosure or lack of agreements
    - Set out the terms of the referral in a written agreement
    - Provide written disclosure to your client

# Common deficiencies in registration applications

- The following are common deficiencies noted in registration applications:
  - Firms failing to know the applicants they sponsor
    - Continue to see issues on individual filings
    - Firms must know the applicants they put forward for registration
  - Use of misleading titles
    - Individuals not registered using titles that imply they are registered in social media
    - Firms should ensure titles do not suggest that individuals are permitted to perform activities they are not registered to perform

# Common deficiencies in registration applications (cont'd)

- The following are common deficiencies noted in registration applications:
  - Late updates for notice of termination filings
    - Continue to see late filing of Form 33-109F1
  - Insurance requirements
    - Conducted desk review of insurance requirements for firms
    - Overall firms had adequate policies, although not all firms understood requirements
    - Recommend all firm review the adequacy of their coverage limits regularly

# Initiatives impacting EMDs

- The following are initiatives impacting EMDs:
  - Senior and vulnerable investors
    - Seniors representing fastest growing demographic in Canada
    - Conducting focused compliance reviews on firms doing business with senior clients
    - We will draft and publish guidance on our work and provide best practices for registrants dealing with senior investors
  - “One person” firms and business continuity/succession planning
    - Along with CSA, conducted reviews of small firms
    - Firms primarily had one registered individual
    - CSA SN 31-250 *Guidance on small firms compliance and regulatory obligations*

# Initiatives impacting EMDs (cont'd)

- The following are initiatives impacting EMDs:
  - Marketing in public places
    - Registrants must provide clear, accurate and non-misleading marketing material to clients in ads in public places
  - Cybersecurity
    - Cybersecurity priority for the CSA
    - OSC participated with other CSA jurisdictions in a survey
    - Published guidance – CSA Staff Notice 33-321
  - Whistleblower review
    - OSC will be working to identify restrictive provisions in employment contracts, severance agreements, confidentiality agreements and other related agreements



# Resources

# Additional CSA Guidance on EMD amendments - References

- Additional CSA guidance included in final version of amendments (published in the July 27, 2017 OSC Bulletin, available at [www.osc.gov.on.ca](http://www.osc.gov.on.ca)):
  - (2017), 40 OSCB (Supp-1) at 22-24 (Notice)
  - (2017), 40 OSCB (Supp-1) at 70-72 (Blackline of NI 31-103)
  - (2017), 40 OSCB (Supp-1) at 172-174, 176 & 202 (Blackline of 31-103CP)
- CSA Staff Notice 31-350 - *Guidance on Small Firms Compliance and Regulatory Obligations*
- CSA Staff Notice 33-321 - *Cyber Security and Social Media*



# Questions

[RegistrantOutreach@osc.gov.on.ca](mailto:RegistrantOutreach@osc.gov.on.ca)

Contact Centre:

[inquiries@osc.gov.on.ca](mailto:inquiries@osc.gov.on.ca)

416-593-8314 or

1-877-785-1555 (toll free)

