

OSC Staff Notice 33-736

→ 2011

Annual Summary Report for Dealers, Advisers and Investment Fund Managers

Contents

Introduction	4
1. New regime for registrants	6
1.1 Implementation of new regime	6
1.2 Ongoing amendments to new regime for registrants	6
1.3 Cost disclosure and performance reporting	8
1.4 Registration of non-resident investment fund managers	10
2. Responding to global financial developments	13
2.1 Over-the-counter derivatives regulation	13
2.2 Systemic risks potentially posed by hedge funds	13
2.3 Fiduciary duty standard for dealers and advisers	14
3. Focusing on registrant misconduct	17
3.1 Registrant conduct and risk analysis team	17
3.2 Publishing decisions on registration matters.....	17
3.3 Strong regulatory response to registrant misconduct	18
4. Information for firms and individuals applying for registration	21
4.1 Risk-based approach to registration for individuals	21
4.2 New trends in registration issues	21
4.3 Common deficiencies from registration applications	24
5. Information for advisers, investment fund managers and dealers	30
5.1 All registrants	30
A. Compliance review process and its outcomes	30
B. Updated risk assessment questionnaire	32
C. Ongoing registrant filings	33
D. New and proposed rules and initiatives impacting all registrants	33
E. Trends in deficiencies from compliance reviews and suggested practices	37
5.2 Portfolio managers	40
A. Trends in deficiencies from compliance reviews and suggested practices	40
B. Marketing practices	44
C. Portfolio manager client account statement practices	45
D. On-line advice	46
E. New and proposed rules impacting portfolio managers	47
5.3 Investment fund managers	48
A. Trends in deficiencies from compliance reviews and suggested practices	48
B. New and proposed rules impacting investment fund managers	50
5.4 Exempt market dealers	52
A. Trends in deficiencies from compliance reviews and suggested practices	52
B. Reviews of higher risk exempt market dealers	56
C. New and proposed rules impacting exempt market dealers	59
6. Additional resources	61
Appendix	62



Introduction

Introduction

This report provides information for dealers, advisers and investment fund managers that are regulated by the OSC, to help them comply with their regulatory obligations under Ontario securities law. It was prepared by the OSC's Compliance and Registrant Regulation (CRR) Branch, which registers and oversees approximately 1,250 firms and 65,000 individuals in Ontario that trade or advise in securities or commodity futures, or act as an investment fund manager (collectively, registrants). The OSC also registers 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 organization (SRO), the Mutual Fund Dealers Association of Canada (MFDA) or the Investment Industry Regulatory Organization of Canada (IIROC), respectively.

This report primarily covers the OSC's 2011 fiscal year (April 1, 2010 to March 31, 2011), with updates to make the information current. It includes trends in deficiencies from compliance reviews of registrants (and suggested practices to address them), new and proposed rules and initiatives impacting registrants, and information to assist firms and individuals applying for registration. We also provide an update on the new regime for registrants, the OSC's response to global financial developments, our focus on registrant misconduct, and how registrants can get more information on their obligations.

For the 2012 fiscal year, the OSC's key strategies for registrants include:

- continuing to implement the new registrant regime
- strengthening our registrant oversight and compliance presence
- continuing to build our approach to registrant misconduct
- creating new policy in high priority areas, and
- modernizing and coordinating our approach to securities regulation.

This report describes what we are doing to fulfill these strategies.

We encourage registrants to use this report to improve their understanding of:

- initial and ongoing registration and compliance requirements
- our expectations of registrants and our interpretation of regulatory requirements, and
- new and proposed rules and other regulatory initiatives.

We also suggest registrants use this report as a self-assessment tool to strengthen their 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. New regime for registrants

- 1.1 Implementation of new regime
- 1.2 Ongoing amendments to new regime for registrants
- 1.3 Cost disclosure and performance reporting
- 1.4 Registration of non-resident investment fund managers

1. New regime for registrants

1.1 Implementation of new regime

In the fall of 2009, National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103) came into force and introduced a new national regime for registrants that is harmonized, streamlined and modernized. We have been focused on assessing compliance by registrants with their capital, proficiency, conduct and practices requirements, and other ongoing registrant obligations that came into force through NI 31-103 and related rules and amendments to the *Securities Act* (Ontario) (the Act). We introduced the new regime for registrants together with other members of the Canadian Securities Administrators (CSA), and we continue to work with them on implementing its requirements in a harmonized manner.

Our implementation work includes assessing whether investment fund managers and exempt market dealers are appropriately registered in their new categories, and that registered individuals meet their new proficiency requirements. We have also been active in reviewing exemptive relief applications, including many involving new issues, such as foreign broker-dealers applying for registration as exempt market dealers (see section 4.2 of this report). Further, we have continued to perform on-site compliance reviews to assess adherence with the new regime for registrants, as well as performing desk reviews to assess capital adequacy. Given the impact of the new regime and the changes to registrants' ongoing obligations, we continue to work with registrants so they understand their requirements and can develop appropriate procedures for compliance.

1.2 Ongoing amendments to new regime for registrants

When we first implemented the new regime for registrants, we indicated that we would propose amendments if investor protection, market efficiency or other regulatory concerns arose. We anticipated that these amendments would be necessary as we gained operational experience with the new regime. Following our monitoring of the implementation of the new regime and based on continued discussions with stakeholders about questions and concerns regarding their practical experience working with the new regime, we published proposed amendments to NI 31-103 and related rules for comment in June 2010.

Working with the CSA, we have now implemented amendments to the new regime and have updated the regulatory framework for firms and individuals who deal in securities, provide investment advice or manage investment funds. On April 15, 2011, the CSA published amendments to NI 31-103, its

companion policy (31-103CP), as well as to National Instrument 33-109 *Registration Information* (NI 33-109) and its companion policy. In addition, we also published amendments to OSC Rule 33-506 (*Commodity Futures Act*) *Registration Information* that mirror the amendments made to NI 33-109.

The amendments came into force in all Canadian jurisdictions on July 11, 2011, and range from technical adjustments to more substantive matters. The revised rules codify current exemption orders and answers to frequently asked questions, provide new filing timelines, refine certain exemptions, and provide extended transition periods in respect of certain requirements. New guidance and clarifications have also been added to improve the framework and to reflect the changeover to International Financial Reporting Standards. We also added *Ongoing Registrant Obligations* to the title of NI 31-103 to better reflect the rule's breadth and scope, which includes initial registration and requirements for ongoing registrant conduct and compliance.

The following highlights some of the key changes for all registrants, and those specific to dealers, advisers, and investment fund managers.

All registrants

- added an explicit restriction on an individual registered with one firm from being registered with another registered firm
- revised the registration requirements for individuals, including time limits on examination requirements and initial and ongoing proficiency
- extended the notice of change filing requirements in NI 33-109 from 7 days to 10 days
- extended the transition period by one year for certain registered firms to make available to their clients independent dispute resolution or mediation services (except in Québec)

Dealers and advisers

- increased from 10% to 25% the beneficial ownership and control thresholds related to the know your client obligation to identify certain shareholders of corporate clients
- clarified the guidance on the incidental activities in respect of merger and acquisition specialists
- clarified the international dealer and international adviser registration exemptions

Investment fund managers

- added a requirement for certain investment fund managers to send trade confirmations to security holders when they execute redemption orders received directly from security holders
- added a limited exception from the restriction on lending to clients for investment fund managers in respect of certain loans to investment funds they manage

- extended the transition period to September 28, 2012 in respect of the temporary exemption from registration in additional local jurisdictions for Canadian investment fund managers registered in their principal jurisdiction, and for foreign investment fund managers (see section 1.4 of this report)
- added guidance for investment fund managers to address situations where the board of directors or the trustee of a fund are directing an investment fund's business, operations or affairs, and guidance in the context of fund complexes and groups with more than one investment fund manager (see section 4.2 of this report)

We think the amendments will enhance investor protection and improve the day-to-day operation of the new regime for both industry participants and regulators. In addition, we believe that the amendments will clarify our legislative intent. For more information, see [Amended NI 31-103, NI 33-109 and OSC Rule 33-506](#).

1.3 Cost disclosure and performance reporting

The CSA, along with IIROC and the MFDA, have been working to develop requirements in a number of areas related to a client's relationship with a registrant. This initiative was previously referred to as the Client Relationship Model (CRM) project, which, as part of the new regime for registrants, developed requirements on relationship disclosure information delivered to clients at account opening, and comprehensive conflicts of interest requirements.

On June 22, 2011, we published proposed amendments on cost disclosure and performance reporting. If adopted, the amendments would introduce performance reporting requirements and enhance existing cost disclosure requirements in NI 31-103.

The purpose of the proposed amendments is to provide clients of all dealers and advisers, whether or not the registrant is a member of an SRO, with clear and complete disclosure of all charges associated with the products and services they receive, and meaningful reporting on how their investments have performed. They are also intended to provide investors with key information about their account and product-related charges and the compensation received by registrants. This information is to be provided at relevant times, such as at account opening, at the time a charge is incurred, and on an annual basis.

We expect that providing investors with clear and meaningful account performance reporting will help them in evaluating their account performance and provide them with the opportunity to make more informed decisions.



If the proposed amendments are adopted, they will result in investors receiving additional reporting from their registrant including:

- a new annual summary of all account-related and product charges, and other compensation received by the registered firm
- the original cost of each security added to account statements, and
- annual account performance reporting.

Furthermore, the proposed amendments are intended to improve investor protection and would:

- enhance the current disclosure of charges related to the operation of an account, and the making, holding and selling of investments
- enhance the current disclosure of the compensation received by a registered firm, particularly relating to charges such as trailing commissions and deferred sales charges, and
- provide guidance on inappropriate switch transactions and the resulting compensation received by registrants.

To help develop the proposals, the CSA requested feedback from investors to evaluate their understanding and expectations on account charges and performance reporting. This was done by surveying about 2,000 investors in July 2010. This investor research provided useful information on the type of information investors want to receive from their dealers and advisers, and also identified areas where investors need more guidance or disclosure. For more information, see [Report: Performance Reporting and Cost Disclosure](#).

The CSA also consulted with dealers and advisers to gain insight into current industry performance reporting practices, and to identify issues and concerns with providing performance information. The consultations found that many registrants already provide some or all of the information required in the proposals to their clients or certain groups of their clients. However, some firms raised concerns about the potential cost, time and resources that would be required to prepare performance information, especially if systems need to be modified. The CSA is planning a phased introduction of the proposals to help address these concerns.

The CSA also developed a sample performance report that reflects the account performance reporting proposals. This document was tested on a one-on-one basis with investors, dealers and advisers to obtain reactions on its usefulness, clarity and overall appeal. For more information, see [Canadian Securities Administrators Performance Report Testing](#).



The CSA continues to consider whether all securities held at issuers in "client name" should be included in account statements. The CSA has determined that more work needs to be done, so further research with investors is being conducted on their understanding and expectations about reporting on their security holdings. As well, further research with industry participants will be conducted to better understand the risks, benefits and constraints of reporting on clients' security holdings and how they should be disclosed.

For more information, see [Notice of and Request for Comment on Proposed Amendments to NI 31-103 and 31-103CP: Cost Disclosure and Performance Reporting](#).

1.4 Registration of non-resident investment fund managers

The new regime for registrants introduced a registration requirement for every firm that directs the business, operations or affairs of an investment fund. All investment fund managers operating in Canada prior to September 28, 2009 were required to apply for registration in the jurisdiction where their head office is located by September 28, 2010.

We continue to work with other CSA members to determine how the investment fund manager registration requirement applies to non-resident investment fund managers, which includes:

- international investment fund managers who carry out investment fund management activities outside of Canada, and
- domestic investment fund managers with a head office in one province or territory who carry out investment fund management activities in other provinces or territories.

On October 15, 2010, the CSA published for comment proposed amendments to NI 31-103 on the registration of non-resident investment fund managers. Under the proposed amendments, a non-resident investment fund manager of an investment fund would need to be registered in a province or territory if:

- the investment fund has security holders resident in that province or territory, and
- the investment fund manager has actively solicited residents in that province or territory to purchase securities of the fund.

We proposed certain exemptions for investment fund managers if the investment funds they manage are only distributed to permitted clients, provided certain other conditions are met. A grandfathering exemption was also proposed for those investment fund managers that have not actively solicited local residents after September 28, 2011.



The CSA continues to review the pending amendments and address issues raised through the public comment process. In the meantime, the temporary exemptions from the investment fund manager registration requirement for non-resident investment fund managers have been extended to September 28, 2012.

For more information, see [Notice of and Request for Comment on Proposed Amendments to NI 31-103: Registration of International and Certain Domestic Investment Fund Managers](#).



2. Responding to global financial developments

- 2.1 Over-the-counter derivatives regulation
- 2.2 Systemic risks potentially posed by hedge funds
- 2.3 Fiduciary duty standard for dealers and advisers

2. Responding to global financial developments

2.1 Over-the-counter derivatives regulation

Over-the-counter (OTC) derivatives are financial contracts such as options, forwards and swaps that do not trade on an exchange. Proposals are being developed by the CSA to significantly enhance the regulation of OTC derivatives in Canada and to manage the risks they pose. This initiative is part of Canada's G20 commitments to develop more robust oversight of the financial markets, including OTC derivatives, as a result of the recent global financial crisis. To start, the CSA published in November 2010 [CSA Consultation Paper 91-401 *Over-the-Counter Derivatives Regulation in Canada*](#) (CP 91-401) for comments. This paper outlined a number of recommendations, including:

- mandatory reporting of all derivatives trades by Canadian counterparties to a trade repository
- provincial regulators obtaining authority to mandate electronic trading of OTC derivatives products where appropriate
- mandatory central clearing of OTC derivatives where appropriate
- using a risk-based approach by imposing capital and collateral requirements to appropriately reflect the risks that an entity assumes, and
- establishing exemptions from the regulatory proposals in CP 91-401 for defined categories of end-users.

The CSA has reviewed the comments it received from CP 91-401 and will be publishing a series of eight additional consultation papers on specific aspects of OTC derivatives regulation that build on the proposals, including one on registration requirements and exemptions for OTC derivatives dealers and advisers. The OSC, led by our Derivatives Branch, is an active participant in these proposals.

2.2 Systemic risks potentially posed by hedge funds

Hedge funds continue to be a topic of interest among regulators around the world following the recent global financial crisis. The financial crisis illustrated that investment risk can spread across global economies, asset classes and capital structures. While hedge funds did not cause the financial crisis, the OSC and other regulators are taking a closer look at the role that they potentially play in spreading systemic risks through the markets.

Systemic risk is commonly viewed as the risk of a breakdown in the entire financial system caused by a chain reaction in which the failure of a firm or group of firms impacts other market

participants in the system. Systemic risk is not unique to hedge funds, but a large fund or group of funds can contribute to systemic risk to the extent they can transmit financial stress to other market participants. Hedge funds have the ability to take on leverage from borrowing and/or derivative transactions and have a wide array of interconnections, including prime broker arrangements and other counterparties.

In April 2009, G20 leaders committed to enhancing the oversight of hedge funds. Given the G20's particular interest in hedge funds, the International Organization of Securities Commissions established a task force (IOSCO Task Force) to focus on assessing systemic risks that hedge funds may pose globally. The OSC and other Canadian regulators are also considering the potential for systemic risks posed by the Canadian hedge fund industry.

The OSC has been engaged in this area of work both globally and in Canada. For example, in 2010, we undertook a data-gathering exercise by sending a survey to known hedge fund managers with a head office in Ontario. This exercise was part of a larger data-gathering initiative led by the IOSCO Task Force. The data collected from the survey provided us with information on the hedge funds in Ontario, and some insight into possible systemic risks in the hedge fund sector. The OSC continues to work with other Canadian regulators and agencies and IOSCO towards establishing principles for hedge fund regulation and on assessing systemic risks that hedge funds may pose both globally and in the Canadian context.

2.3 Fiduciary duty standard for dealers and advisers

We are considering whether an explicit legislative fiduciary duty standard should apply to dealers and advisers in Ontario. A fiduciary duty is essentially a duty to act in a client's best interest. In Ontario, section 116 of the Act applies a fiduciary duty to investment fund managers in their dealings with the investment funds they manage. However, there is no equivalent duty under the Act that explicitly applies a fiduciary duty to dealers and advisers in their dealings with their clients (although there is legislation that requires them to deal fairly, honestly and in good faith with their clients). Although there is no fiduciary legislation in Ontario, Canadian courts can find that a given dealer or adviser owes a fiduciary duty to his or her client. This may be the case, for example, if: (a) the client places significant trust and reliance on the dealer or adviser and the dealer or adviser accepts this responsibility, and (b) where the dealer or adviser has explicit (as in the case of a managed account) or implicit (as in the case of a non-managed account where the client essentially always follows the advice provided) power over the client.

Recently, there have been important international developments on the issue of fiduciary duty. In the United States, the Securities and Exchange Commission is expected to introduce rules in 2012 that would create a common statutory fiduciary duty for investment advisers and broker-dealers when they are providing personalized advice to retail clients. In Australia, the government is expected to introduce legislation in 2012 that will make advisers subject to a fiduciary duty when dealing with retail clients. In the United Kingdom, authorized firms are currently required to act honestly, fairly and professionally in accordance with the best interests of their retail clients. The OSC continues to monitor the fiduciary duty debate in Canada and internationally, as well as rule developments on this topic in the US, Australia and the UK.



3. Focusing on registrant misconduct

- 3.1 Registrant conduct and risk analysis team
- 3.2 Publishing decisions on registration matters
- 3.3 Strong regulatory response to registrant misconduct

3. Focusing on registrant misconduct

3.1 Registrant conduct and risk analysis team

The CRR Branch's Registrant Conduct and Risk Analysis team was formed in early 2010 to develop timely responses to registrant misconduct. This team, which includes staff with prior experience working in the OSC's Enforcement Branch, supports the CRR Branch's other staff when they identify potential registrant misconduct, for example from an on-site compliance review of a registrant or when an individual with a history of misconduct applies for registration. Staff from this team will investigate the misconduct, assist in the formulation of our position when terms and conditions are applied or registration is suspended, and support the CRR Branch in matters resulting in opportunities to be heard (OTBH) before the Director. They also prepare registrant related cases that are referred to the OSC's Enforcement Branch.

This team also adopted negotiated settlements as a way of resolving matters with registrants or applicants for registration. Settlements reduce the number of contested OTBHs, allowing us to balance using our limited resources more efficiently while still meeting our investor protection mandate. Negotiated settlement agreements will be released on our web site and published in the OSC Bulletin (see section 3.2 below). Additionally, their adoption of "term suspensions" (i.e., suspensions for a predetermined period of time) was critical to developing a settlement process. Previously, the only remedies sought by us on an OTBH were indefinite suspensions or terms and conditions. Now, term suspensions provide a new flexibility when developing remedies.

3.2 Publishing decisions on registration matters

Our Registrant Conduct and Risk Analysis team also developed guidelines for increasing the transparency when the CRR Branch makes certain decisions on a firm's or individual's registration. On May 20, 2011, we published OSC Staff Notice 34-701 *Publication of Decisions of the Director on Registration Matters under Part XI of the Securities Act (Ontario) ("Opportunities to be Heard")* (OSC Notice 34-701). This notice introduces a new approach to the publication of OTBH decisions in both the OSC Bulletin and on the OSC's web site. Previously, only Director decisions in contested OTBHs were published. We determined that we could achieve increased transparency and investor protection by publishing decisions in situations where an OTBH is resolved through a negotiated settlement, or where registrant misconduct was identified and a recommendation made to the Director but the registrant elected not to request an OTBH.



Under the new approach, the following types of decisions will now be published:

- decisions approving joint recommendations to settle OTBHs where the result is a suspension of registration or the imposition of terms and conditions requiring strict supervision
- decisions to suspend a registrant where no OTBH has been requested, and
- decisions to impose terms and conditions requiring strict supervision where no OTBH has been requested.

For more information, see [OSC Notice 34-701](#).

3.3 Strong regulatory response to registrant misconduct

We are vigilant when we find evidence of potential registrant misconduct or fraud. This is demonstrated by the fact that about 10% of our on-site compliance reviews of registered firms in each of the last two fiscal years resulted in referrals to the OSC's Enforcement Branch for investigation (see *Compliance review process and its outcomes* in section 5.1A of this report).

The CRR Branch has also pursued a number of cases of registrant misconduct which resulted in the suspension of firms' and individuals' registration or terms and conditions on their registration. Notable cases from the past year include:

- *Re Carter Securities Inc.* (September 22, 2010) and *Re Waterview Capital Corp.* (April 25, 2011): In both of these cases, which involved firms registered as exempt market dealers, staff recommended to the Director that the firm's registration be suspended based on allegations that included, among other things, misleading sales practices in the distribution of securities of related party issuers. The Director accepted staff's recommendations in both cases, following an OTBH. The *Carter* case was the first time a firm's registration was suspended using powers granted to the Director by the 2009 amendments to the Act.²
- *Re Sawh and Trkulja* (January 25, 2011): These individuals had previously run a small firm registered as both a mutual fund dealer and an exempt market dealer. The MFDA brought enforcement proceedings against these individuals and their firm for, among other things, selling certain prospectus-exempt securities to clients without assessing the suitability of those investments. Significant problems with the securities in issue later emerged, as it appeared that the issuers had not used investor funds as intended. The individuals settled the MFDA proceedings, and the terms of settlement included the closing of their firm. The individuals subsequently applied for registration as dealing representatives with another

² Carter Securities Inc. has applied for a review of the Director's decision by the Commission.

mutual fund dealer, and staff recommended to the Director that the applications be refused. Following an OTBH, the Director accepted staff's recommendation.³

- *Re Obasi* (March 4, 2011) and *Re DiPronio* (June 3, 2011): Mr. Obasi was registered as a scholarship plan dealing representative, and Mr. DiPronio was registered as a mutual fund dealing representative. In both cases, staff alleged that the registrants had forged certain client documents. The *DiPronio* case was settled on the basis that the registrant admitted his misconduct and agreed to a nine-month suspension of his registration. The *Obasi* case proceeded to an OTBH, following which the Director also imposed a nine-month suspension.
- *Re Mistry* (April 14, 2011): Staff interviewed Mr. Mistry, who was registered as an exempt market dealing representative, concerning his involvement in the apparent failure of an issuer of which he was a principal. During the interview, Mr. Mistry generally disclaimed any knowledge about the issuer's failure or the reasons for it. Following a subsequent investigation, staff determined that Mr. Mistry's level of knowledge about the events in question was greater than he had represented in the interview. As a result, staff recommended to the Director that Mr. Mistry's registration be suspended, and following an OTBH, the Director accepted this recommendation.
- *Re Royal Securities Corp.* (July 15, 2011): This case involves the first suspension of a portfolio manager by the Director. Staff obtained evidence that Royal Securities Corp., a firm registered as both an exempt market dealer and a portfolio manager, had engaged unregistered individuals to sell units of a high-risk investment fund managed by the firm. These individuals cold-called investors in Ontario and other provinces and made extravagant and misleading claims in order to sell units of the investment fund. Staff recommended to the Director that the firm's registration be suspended, along with the firm's principal, Ningyuan Guo (also known as Mark Guo). Mr. Guo requested an OTBH, but refused to attend on the scheduled date. As a result, staff's recommendation was accepted and both the firm and Mr. Guo were suspended.

For more information, see [Director's Decisions](#).

³ Sawh and Trkulja have applied for a review of the Director's decision by the Commission.



4. Information for firms and individuals applying for registration

- 4.1 Risk-based approach to registration for individuals
- 4.2 New trends in registration issues
- 4.3 Common deficiencies from registration applications

4. Information for firms and individuals applying for registration

4.1 Risk-based approach to registration for individuals

Over the past year, we developed a risk-based approach to assess registration applications for individuals who are to be registered with a currently registered firm. This approach is designed to create operational efficiencies by focusing on those deficiencies in an application that may have an effect on the registration decision. This allows us to allocate resources where they will be of greatest value.

Our risk model takes into account whether an application evidences the three fundamental criteria for determining suitability for registration, which are integrity, proficiency and solvency. It also includes the sponsoring firm's track record of submitting error-free submissions and sponsoring suitable candidates for registration. We plan to refine our approach further to take into account firms with rigorous hiring practices and effective supervisory structures.

4.2 New trends in registration issues

Foreign broker-dealers applying as EMDs

We have recently learned that there may be a number of foreign broker-dealers registered as exempt market dealers (EMD) that are carrying out brokerage services for accredited investors on both foreign markets and Canadian markets. We understand that these are primarily broker-dealer firms registered in the United States that are members of the Financial Industry Regulatory Authority.

Additionally, over the last year, we have received a number of applications by firms seeking registration in the EMD category, and a large number of applications for exemptions from some of the provisions of NI 31-103, such as lending or providing margin, to facilitate a business model which includes brokerage activities, either conducted directly or indirectly.

We believe that the use of the EMD registration category for these activities raises serious policy issues to be considered by regulators and the industry. As a result, we published a CSA Staff Notice to outline our concerns and our interim response to these issues, and to advise that we will be examining these activities in a wider consultation and review process in order to assess whether market participants in Canadian securities markets are operating within a consistent regulatory framework and on a level playing field.



For more information, see [CSA Staff Notice 31-327 Broker-Dealer Registration in the Exempt Market Dealer Category](#).

Trading or advising activities by a foreign bank representative office (FBRO)

An FBRO is the Canadian office of a foreign bank that is registered with and supervised by the Office of the Superintendent of Financial Institutions Canada (OSFI). FBROs are not permitted to carry on any banking activity in Canada other than promoting the services of the foreign bank and acting as a liaison between the foreign bank and its clients in Canada. However, FBROs may be permitted to be engaged in the business of trading or advising in securities in Ontario provided that they obtain OSFI approval and also comply with Ontario securities law, including registering with the OSC under an appropriate registration category or relying on a valid registration exemption.

Investments issued by Antigua-based Stanford International Bank (SIB) were sold to investors from SIB's former FBRO in Québec. This activity was part of an alleged international, multi-billion dollar investment fraud. In response, we completed a review of all 19 of the Ontario-based FBROs that were not registered with us to assess if they were in the business of trading or advising in securities in Ontario. At the same time, the Autorité des marchés financiers (AMF) reviewed the Québec-based FBROs.⁴

Our reviews of the Ontario-based FBROs did not find evidence of fraud. However, we identified concerns with some of the foreign banks' dealings with Ontario residents from their home country and/or their FBROs' activities, which may indicate that some of the foreign banks are in the business of trading or advising in securities in Ontario without registration with us or validly relying on a registration exemption. The AMF had similar findings for the Québec-based FBROs. We are following up with these FBROs in our respective jurisdictions to assess whether they have addressed our concerns.

Mortgage investment entities (MIE)

An MIE is a person or company whose purpose is to directly or indirectly invest substantially all of its assets in debts owing to it that are secured by mortgages, hypothecs or in any other manner on real property. An MIE's other assets are limited to bank deposits, cash, and certain debt securities, real property and hedging instruments.

⁴ Ontario and Québec were the only Canadian jurisdictions where FBROs were located at the time of our review.

To clarify the registration requirements that apply to MIEs in each CSA jurisdiction, on February 25, 2011, the CSA published CSA Staff Notice 31-323 *Guidance Relating to the Registration Obligations of Mortgage Investment Entities* (CSA Notice 31-323).

We intend to monitor the application of registration requirements to MIEs operating in Ontario under different business models and structures, and we may review our position outlined in the notice if investor protection concerns are identified.

For more information, see [CSA Notice 31-323](#).

Proficiency relief granted to registered individuals

We receive numerous exemption requests from proficiency requirements for chief compliance officers, advising representatives and dealing representatives. We have historically only published Director Decisions relating to proficiency which result from a contested “opportunity to be heard” in connection with the denial of an application for registration. As a result, very little guidance exists for registrants on alternative education and experience which the Director has accepted as being equivalent to, or more appropriate in the circumstances than, the applicable proficiency requirements in NI 31-103.

As part of our commitment to dealing transparently with our stakeholders (including investors and securities professionals), we are working with the CSA to develop a strategy for regularly publishing relevant information on the types of education and experience for which proficiency relief has or has not been granted.

Investment fund complexes or groups with more than one investment fund manager

A person or company that directs the business, operations or affairs of an investment fund must obtain registration as an investment fund manager. Some investment fund complexes or groups have more than one entity within the fund complex that trigger the registration requirement because they direct the business, operations or affairs of an investment fund. In these cases, more than one entity is subject to investment fund manager registration unless an exemption is granted. For example, structures where investment funds are organized as limited partnerships may have multiple entities within the fund complex that could require investment fund manager registration.

We amended our guidance to NI 31-103 to address the issue of multiple investment fund manager registration within a fund complex. The registration requirement for investment fund managers is generally not intended to result in multiple investment fund manager registrations



within a fund complex because often many of the fund management functions are centralized and performed by one entity within the group. We will consider granting exemptive relief on a case-by-case basis when we are satisfied that the regulatory risks and concerns are adequately addressed through the registration of at least one investment fund manager in the fund complex. For information about the factors that we typically consider in granting such relief, see [section 7.3 of 31-103CP](#).

4.3 Common deficiencies from registration applications

The processing of applications for registration may be delayed if a registration application form is incomplete or lacks sufficient detail. To address this, we have listed in the tables below the common deficiencies identified from firm and individual registration applications reviewed over the last year. The deficiencies have been separated out by the type of form used. In order to reduce delays in the processing of applications, applicants should avoid these common deficiencies and follow the identified actions to be taken before submitting their applications.

We also provide some guidance on filing notices of changes to registration information and exemption applications that are connected to a registration application.

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

Firm applications

Form 33-109F6 (F6) Firm Registration

Deficiency noted	Action to be taken
Items 2.5 and 2.6 <i>Contact names</i> – the Ultimate Designated Person's (UDP) and Chief Compliance Officer's (CCO) telephone number and e-mail address are not provided.	Include the UDP's and CCO's contact information such as telephone numbers and e-mail addresses.
Item 3.1 <i>Firm's business</i> – insufficient detail is provided regarding the firm's proposed business activities.	Provide detailed description of the firm's intended activities as a registrant, such as its industry focus, target market and the products and services it will provide to clients. Also, describe any unique business activities, such as plans to provide on-line advisory services to clients (see section 5.2D of this report for a discussion of on-line advice).

Deficiency noted	Action to be taken
<i>Item 3.9 Business registration number</i> – the firm’s registration number(s) is not provided where applicable.	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. If registered federally, this does not always preclude a firm from obtaining provincial business registration.
<i>Item 3.12 Ownership chart</i> – the ultimate ownership percentage is not provided.	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. If the ultimate indirect shareholder is an entity, include the shareholder(s) of that entity.
<i>Item 5.5 Bonding or insurance details</i> – incomplete details provided on bonding and insurance.	<p>Include all insurance details including the name of insurer, policy number, specific insuring agreements and clauses, coverage details, amount of deductible and renewal date.</p> <p>The entire policy need not be sent to us; the binder setting out these details is sufficient.</p> <p>For firms providing the Form B Financial Institution Bond, provide information setting out how the Form B is equivalent to the clauses outlined in Appendix A to NI 31-103.</p>
<i>Item 6.1 Client assets</i> – inappropriate responses are provided on whether the firm holds or has access to client assets.	See section 12.4 of 31-103CP for guidance on what constitutes holding or having access to client assets.
<i>Item 6.2 Conflicts of interest</i> – inappropriate responses provided on relationships that could reasonably result in any significant conflicts of interest. For example, firms that have related registrants or issuers do not disclose the details of these conflicts of interest.	Provide details about each significant conflict, and respond if the firm has policies and procedures to identify and respond to its conflicts of interest (and if no, explain why). For guidance on conflicts of interest, see section 13.4 of 31-103CP and CSA Staff Notice 31-326 Outside Business Activities .
<i>Schedule B - Submission to jurisdiction and appointment of agent for service</i> - the information on the form is handwritten and not legible.	Print legible information or have the information in the schedule typed.
<i>Schedule C - Form 31-103F1 Calculation of Excess Working Capital</i> - the current period indicated on the Form does not match the period for the audited financial statements submitted.	Ensure the current period on the Form 31-103F1 matches the period for the audited financial statements submitted.

**Form 33-109F5 Change of Registration Information
(for changes to registered firm information in section 3.1 of NI 33-109)**

Deficiency noted	Action to be taken
<i>Changes to Form 33-109F6</i> - investment dealers (that are members of IIROC) do not file the Form 33-109F5 notifying us of changes.	Investment dealers registered with us must file all changes in their Form 33-109F6 with the OSC by submitting a completed Form 33-109F5.
<i>Item 2 Details of Change</i> - the Form 33-109F5 is filed without sufficient details of the change.	Provide us with details of all changes to information previously submitted on Form 33-109F6, including the item number(s) and details of the change(s).

Individual applications

Form 33-109F4 - Registration of Individuals and Review of Permitted Individuals

Deficiency noted	Action to be taken
<i>Item 1 Name</i> - trade names used by dealing representatives are not disclosed in Question 3 on "Use of other names."	Provide any trade names in both Question 3 of Item 1 and in Schedule A <i>Names</i> .
<i>Item 5 Registration jurisdictions</i> - inappropriate responses are provided to Question 1, which asks: Are you filing this form under the passport system / interface for registration? For example, the question is answered as "yes" when the application cannot be filed under the passport system /interface.	Understand which filings may be submitted under the passport system or the interface system. For more information about registering in more than one jurisdiction, see National Policy 11-204 Process for Registration in Multiple Jurisdictions .
<i>Item 8 Proficiency</i> – the individual has not provided sufficient evidence of their relevant experience to support their application for registration.	Filers should familiarize themselves with the applicable proficiency requirements, and ensure the application reflects how the applicant qualifies for the category of registration they have applied under. See Part 3 of NI 31-103 (for proficiency requirements).
<i>Item 10 and Schedule G Current employment, other business activities, officer positions held and directorships</i> – incomplete responses are provided on Schedule G, Question 3, Description of duties and Question 5, Conflicts of interest. Disclosure of other business activities is often not provided. We are often provided with notices to update this question when the other business activity started before the initial application was submitted.	Item 10, Schedule G, Question 3 on <i>Description of duties</i> : Provide detailed disclosure including the nature of the business, the duties of the applicant and the relationship with the business. When one is seeking registration that requires specific experience, the response to this question should include details for each position at a firm such as level of responsibility, value of accounts under direct supervision, number of years of experience, and percentage of time spent on each

Deficiency noted	Action to be taken
	<p>activity. Often we are not provided with adequate details to establish how their experience is relevant or sufficient to qualify for registration.</p> <p>Item 10, Schedule G, Question 5 on <i>Conflicts of interest</i>: Respond to the question in its entirety by completing parts A to E. For guidance on conflicts of interest, see section 13.4 of 31-103CP and CSA Staff Notice 31-326 Outside Business Activities.</p>
<p><i>Item 11 and Schedule H Previous employment and other activities</i> – incomplete responses are provided. For example, applicants do not provide the reason for leaving their previous employment or the reason provided is not clear.</p>	<p>Include all details required by the questions in Schedule H, including a clear reason for leaving the previous employment. It is not sufficient to only provide a job title to describe your previous firm's business and your duties.</p>
<p><i>Items 12 to 16 inclusive. Resignations and terminations; Regulatory disclosure; Criminal disclosure; Civil disclosure; and Financial disclosure</i> – incomplete information is provided for the applicable questions.</p>	<p>It is the firm's responsibility to conduct its own due diligence on an individual it intends to sponsor. It is critical that information submitted to us is complete and accurate.</p>
<p><i>Item 17 Ownership of securities and derivatives firms</i> – insufficient detail is provided.</p>	<p>Disclose all details on the ownership of any securities or derivatives firms, including the percentage of ownership in the sponsoring firm.</p>

**Form 33-109F5 Change of Registration Information
(for changes to an individual's information in section 4.1 of NI 33-109)**

Deficiency noted	Action to be taken
<p><i>Item 17 Ownership of securities and derivatives firms</i> – we are often not provided notice when an individual becomes a shareholder of their sponsoring firm.</p>	<p>Provide details on any change in ownership in the firm, including the percentage of ownership by submitting Form 33-109F5 within 10 days of the change.</p>

Exemption applications that are connected to a registration application

Deficiency noted	Action to be taken
<p>Insufficient detail is provided on an exemption application from the proficiency requirements for an individual applicant that is connected to his or her registration application. Or, the exemption application is not provided at the same time as the</p>	<p>Provide complete and relevant details on the applicant's education and experience so we are able to determine whether exemptive relief from the proficiency requirements is appropriate. Also, explain how and why the individual's education and</p>



registration application.	experience is equivalent to, or more appropriate in the circumstances than, that required in NI 31-103. An exemption application should accompany the application for registration to avoid having an application for registration returned and therefore delayed.
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We remind sponsoring firms that section 5.1(1) of NI 33-109 requires you to make reasonable efforts to ensure the truth and completeness of the registration information submitted to us for any individual, and that firms themselves are required to provide accurate and truthful disclosure in all applications and notices filed with us to comply with section 122 of the Act.





5. Information for advisers, investment fund managers and dealers

- 5.1 All registrants
 - A. Compliance review process and its outcomes
 - B. Updated risk assessment questionnaire
 - C. Ongoing registrant filings
 - D. New and proposed rules and initiatives impacting all registrants
 - E. Trends in deficiencies from compliance reviews and suggested practices
- 5.2 Portfolio managers
 - A. Trends in deficiencies from compliance reviews and suggested practices
 - B. Marketing practices
 - C. Portfolio manager client account statement practices
 - D. On-line advice
 - E. New and proposed rules impacting portfolio managers
- 5.3 Investment fund managers
 - A. Trends in deficiencies from compliance reviews and suggested practices
 - B. New and proposed rules impacting investment fund managers
- 5.4 Exempt market dealers
 - A. Trends in deficiencies from compliance reviews and suggested practices
 - B. Reviews of higher risk exempt market dealers
 - C. New and proposed rules impacting exempt market dealers

5. Information for advisers, investment fund managers and dealers

The information in this section includes the key findings and outcomes from our ongoing reviews of all the registrants we regulate. Here we highlight deficiencies from our oversight reviews of registrants and provide suggested practices to address those 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 specific to portfolio managers, investment fund managers and exempt market dealers, respectively. This report is organized to allow a registrant to focus on reading the section for all registrants and the sections that apply to their registration categories. However, we recommend that registrants review all sections in this part, as some of the information presented for one type of registrant may be relevant to other registrants.

5.1 All registrants

This section outlines our compliance review process and its outcomes, and details new and proposed rules and initiatives impacting all registrants.

A. Compliance review process and its outcomes

We conduct compliance reviews of selected registered firms on a continuous basis. Generally, we use a risk-based approach to select registrants for review; however, we occasionally select firms for review on a random basis, for example, to help us evaluate the effectiveness of our risk-based approach. Compliance reviews of registered firms generally focus on their conduct, practices, operations and capital adequacy. The risk-based approach is intended to identify those registrants that are most likely to have material issues, including risk of harm to investors. We normally conduct compliance reviews on-site at a registrant's premises, but may also perform reviews from our offices, which are known as desk reviews. The majority of reviews are proactive 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 complaint or a referral from another branch, an SRO or another regulator. We also conduct sweeps, which are compliance reviews of a sample of



registered firms on a specific topic or in an industry sector over a short period of time. Sweeps allow us to respond on a timely basis to industry-wide concerns or issues.

The purpose of compliance reviews is to assess compliance with Ontario securities law. In most cases, the deficiencies noted are raised with the firm reviewed so that appropriate corrective action can be taken. During our 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 to assess overall compliance and to identify areas of focus for future reviews. Compliance reviews often lead to enhanced compliance at registrants, but may result in other regulatory actions such as terms and conditions being imposed on a registrant's registration, suspension of the firm's and its individuals' registrations, or a referral to the OSC's Enforcement Branch. The outcomes of our compliance reviews in fiscal 2011, with comparables for 2010, 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 all registered firms.

Outcomes of compliance reviews (all registration categories)	Fiscal 2011	Fiscal 2010
Enhanced compliance	31%	37%
Significantly enhanced compliance	57%	50%
Terms and conditions on registration	3%	3%
Referral to the Enforcement Branch	9%	10%

Each outcome 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.

- Enhanced compliance:** At the end of a review, we usually issue a report to the firm identifying areas of non-compliance that require corrective action. We work with the firm to facilitate the appropriate resolution of deficiencies. Compliance field reviews generally result in enhanced compliance at these firms following their actions to address the identified matters and to improve their compliance systems, internal controls, or policies and procedures. In 2010-11, 31% of field reviews resulted in enhanced compliance by the registrant.

- **Significantly enhanced compliance:** When the seriousness of the deficiencies identified during a review warrant it, in addition to the steps taken in the enhanced compliance outcome, we 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 actions generally result in significantly enhanced compliance by the firm. In 2010-11, 57% of field reviews resulted in significantly enhanced compliance by registrants.
- **Terms and conditions on registration:** We may impose terms and conditions on a firm's registration to more actively monitor how a registrant is complying with securities law. We may also impose terms and conditions requiring 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 2010-11, 3% of field reviews resulted in the imposition of terms and conditions on the registration of registrants.
- **Referral to the Enforcement Branch:** If we identify a serious breach of securities law, we may also discuss the findings with the Enforcement Branch, and together determine an appropriate course of action. In 2010-11, 9% of field reviews resulted in referrals to the Enforcement Branch.

In fiscal 2011, the CRR Branch also suspended the registration of a registered firm as a result of a compliance review. This was the first time a registered firm's registration was suspended under new powers granted to the Director that came into force at the same time as the new regime for registrants. For more information, see section 3.3 of this report.

B. Updated risk assessment questionnaire

In prior years, a risk assessment questionnaire (RAQ) was developed for separate categories of registered firms. This year, we developed an updated and integrated RAQ which was sent out in June 2011 to all portfolio managers, investment fund managers and exempt market dealers registered in Ontario. The integrated RAQ contains a general section for all registrants, then specific sections on their applicable portfolio manager, investment fund manager and exempt

market dealer registration(s). Therefore, a registered firm was only required to complete one RAQ, even if it was registered in multiple registration categories. The updated RAQ includes questions relating to different areas of a firm's operations such as registration, business activities, financial condition, custody, fee arrangements, and compliance. The completed questionnaires will be risk-ranked, and each registrant will be assigned a risk ranking. We will use the risk ranking as a tool to allocate our resources effectively by focusing our compliance activities on higher risk registrants. Later this fiscal year, we will start conducting on-site compliance reviews of firms that are higher risk based on their responses to the RAQ.

C. Ongoing registrant filings

Registrants have ongoing filing obligations. For example, NI 33-109 requires registrants to update information submitted in applications for firms and individuals, NI 31-103 requires firms to provide us with filings such as annual audited financial statements, and OSC Rule 13-502 *Fees* requires registered firms and unregistered exempt international firms to file Form 13-502F4 and pay capital market participation fees.

All of the above filings have a deadline. We no longer provide reminders with respect to the deadline for filings. It is the responsibility of the firm to have a compliance structure in place that enables it to comply with all regulatory requirements. If the deadline is not met, it may affect a firm's continued suitability for registration and may result in terms and conditions being imposed on the firm's registration or suspension of registration. In addition, firms will incur late filing fees of \$100 for each business day that the filing is late, to a maximum of \$5,000 annually.

Notices of changes to the registration information for individuals are often submitted to us late. Firms should ensure that the individuals they sponsor update them of changes in their registration information on a timely basis so that the firm can submit the notice of change on time and avoid late filing fees. If a firm requires an extension for a filing, it must file a relief application at least 30 days in advance of the deadline.

D. New and proposed rules and initiatives impacting all registrants

In addition to the new regime for registrants, we actively participated in the development and implementation of new and proposed rules and other initiatives. The key rules and initiatives that generally impact all registrants are described below.



International Financial Reporting Standards (IFRS)

For financial years beginning on or after January 1, 2011, Ontario-based registrants are required to deliver to the OSC their annual audited financial statements that are prepared using IFRS. IFRS also applies to certain Ontario-based registrants that are required to prepare and deliver interim financial information to the OSC. For the purposes of this section, Ontario-based registrants include registered firms who are not members of IIROC or the MFDA or registered firms who are registered in any other category of registration (for example, exempt market dealer, investment fund manager) and are also members of IIROC or the MFDA.

Part 12, Division 4 of NI 31-103 sets out the financial reporting obligations for registered firms. It requires Ontario-based registrants to deliver their annual audited financial statements to the OSC within 90 days after their financial year end. It also requires certain Ontario-based registrants, such as investment fund managers and scholarship plan dealers, to deliver to the OSC their unaudited interim financial information within 30 days after the end of each quarter. NI 31-103 and National Instrument 52-107 *Accounting Principles and Auditing Standards* (NI 52-107) require that the financial statements and financial information be prepared in accordance with IFRS, except that the statements must be prepared on a non-consolidated basis. For more details on the requirements, including those for foreign registrants, see [NI 52-107](#).

To assist firms in their conversion to IFRS, the following amendments were made to NI 31-103:

- Registered dealers and investment fund managers were provided a 15-day extension to the deadline to deliver their first interim financial information and completed Form 31-103F1 in the year of adopting IFRS. However, there is no extension for delivering the annual audited financial statements.
- An exemption is available to registrants from the requirement to provide comparative information in financial statements and interim financial information for the financial year beginning in 2011.

For more information, see [Information on IFRS for Dealers, Advisers and Investment Fund Managers](#).

Use of accredited investor exemption

We have concerns that some issuers and dealers are selling exempt securities in reliance on the accredited investor (AI) exemption to individual investors who do not meet the definition of an AI. Securities that are exempt from the prospectus requirement are referred to as exempt securities. In response to our concerns, in May 2011 we published OSC Staff Notice 33-735 *Sale of Exempt Securities to Non-Accredited Investors* (OSC Notice 33-735). The notice provides guidance on the AI definition and the AI exemption contained in National Instrument 45-106 *Prospectus and*



Registration Exemptions (NI 45-106) and our expectations of issuers and dealers who sell exempt securities to AIs.

In Ontario, issuers and dealers are permitted to sell securities without a prospectus if they sell to individual investors who meet minimum asset or income thresholds, referred to as AIs. However, in practice, we have found that many dealers do not collect adequate know your client information to reasonably determine whether an investor is in fact an AI. One frequent misunderstanding of the AI definition relates to the respective meanings of “financial assets” and “net assets”. We remind firms that the two concepts are different and should not be confused. Financial assets include (i) cash, (ii) securities, or (iii) a contract of insurance, deposit or an evidence of a deposit that is not a security for the purposes of securities legislation. The value of an investor’s personal residence or other real estate is not included in the calculation of financial assets. By comparison, net assets includes all of the investor’s assets, minus all of his or her liabilities, and so could include an investor’s personal residence and other real estate.

Issuers and dealers should review their current practices for selling exempt securities to AIs as they are responsible for determining whether an investor meets the definition of an AI and is eligible to purchase exempt securities. Dealers should take any necessary steps to ensure they meet their obligations under securities law when selling exempt securities to an AI. We encourage issuers and registrants to use the notice to assist them in understanding the AI definition and to strengthen their systems of internal controls and supervision to ensure compliance with securities law. For more information, see [OSC Notice 33-735](#).

Electronic delivery of documents

In April 2011, proposed amendments to National Policy 11-201 *Delivery of Documents by Electronic Means* (NP 11-201) were published for comment. The CSA recognizes that the use of electronic communications can enable market participants to provide information in a more cost-efficient, timely and widespread manner than by paper. Proposed NP 11-201 provides the CSA’s views on how obligations under Canadian securities law to deliver documents can be satisfied by electronic means.

Since the initial implementation of NP 11-201, there have been changes to legislation affecting electronic commerce and transactions, including amendments to corporate legislation and the introduction of legislation governing electronic transactions and protection of personal information. Electronic communications have also become much more common. As such, the CSA reviewed and updated NP 11-201 to recognize the changes to other non-securities legislation and the increased familiarity of market participants and investors with the electronic delivery of documents.

The following are the key changes that would result from the proposed amendments:

- alerting stakeholders to other legislation that addresses the electronic delivery of documents
- simplifying guidance on the form and substance of security holder consent to electronic delivery of documents, and
- reducing technology-related language to avoid references to technologies that may become obsolete.

For more information, see [Notice and Request for Comment on Proposed Amendments to NP 11-201](#).

Proposed securitized products rules

The Canadian economy has not been immune to the effects of the global financial crisis. Canada experienced significant turmoil in the market for asset-backed commercial paper (ABCP), as seen in the freezing of \$32 billion of non-bank sponsored ABCP in August 2007. In October 2008, the CSA released a consultation paper⁵ that investigated, among other things, securities regulatory proposals in relation to the sale of ABCP. Since that time, our focus has broadened to cover all securitized products and their distribution both publicly under a prospectus and in the exempt market. Securitization refers to the process by which a special purpose vehicle is used to create securities, which are referred to as securitized products, that entitle holders to payments that are supported by the cash flows from a pool of financial assets held by the vehicle.

In March 2011, the CSA published for comment proposed rules and rule amendments relating to securitized products (the Proposed Securitized Products Rules) that set out a new framework for the regulation of securitized products in Canada. Two main features of the proposed rules are:

- enhanced disclosure requirements for securitized products issued by reporting issuers, and
- new rules that narrow the class of investors who can buy securitized products on a prospectus-exempt basis, and require that issuers of securitized products provide disclosure at the time of distribution and on an ongoing basis.

For more information, see [Notice and Request for Comment on Proposed Securitized Products Rules](#).

⁵ Consultation Paper 11-405 *Securities Regulatory Proposals Stemming from the 2007-08 Credit Market Turmoil and its Effect on the ABCP Market in Canada*

E. Trends in deficiencies from compliance reviews and suggested practices

This section discusses trends in deficiencies identified from our compliance reviews that impact all registered firms (including advisers, investment fund managers and exempt market dealers), and provides suggested practices (where appropriate) to address the deficiencies.

Excess working capital calculation

Some firms are not accurately calculating their excess working capital on Form 31-103F1 *Calculation of Excess Working Capital* (Form 31-103F1). When calculating their excess working capital, registered firms should exclude any current assets that are not readily convertible into cash, such as prepaid expenses and security deposits with service providers. We also have concerns with firms that include accounts receivables, especially from related parties, that are not readily convertible to cash. Any receivables that are not able to be converted to cash in a prompt and timely manner should be excluded from the excess working capital calculation.

Section 12.1 of NI 31-103 requires registered firms to maintain positive excess working capital, as calculated using Form 31-103F1. Registrants should review items that are included in current assets on Line 1 of Form 31-103F1 to identify those that are not readily convertible into cash, and deduct these items on Line 2 of the form.

Inadequate insurance coverage

NI 31-103 requires registered firms to maintain adequate bonding or insurance. Some registered portfolio managers or investment fund managers failed to maintain an adequate amount of insurance as their clients' assets under management increased during the year and the level of insurance was not increased to reflect this change in their business. Furthermore, some registered firms do not maintain bonding or insurance that provides for a "double aggregate limit" or "full reinstatement of coverage".

Registrants must maintain bonding or insurance in the highest of the amounts listed in sections 12.3, 12.4 and 12.5 of NI 31-103, as applicable to their categories of registration. The amount of insurance required is based on calculations which include the firm's total assets as well as clients' assets under management. Registered firms should account for the expected growth in their business in determining the amount of insurance coverage to ensure that their coverage is adequate.

Registered firms should also ensure that their bonding or insurance provides for a "double aggregate limit" or a "full reinstatement of coverage" as explained under Division 2 of Part 12 of 31-103CP.



Suggested practices

To ensure adequate insurance coverage, registered firms should:

- factor in any expected increase in the firm's assets or their clients' assets under management for the next year when determining the amount of their insurance coverage, and
- regularly review the adequacy of their insurance coverage, especially when there is a material change in their business or circumstances.

Use of social media

During our reviews, we found that registered firms are not widely using social media web sites to market their firm's products and services. However, given the steady increase in the general use of social media, such as Facebook and Twitter, we anticipate that firms and their registered individuals will more frequently use social media to market their business activities and communicate with clients. Our expectation is that firms and their registered individuals must comply with applicable securities legislation when using social media.

When using social media as a means of communicating with clients and the general public for business purposes, registered firms need to consider compliance and supervisory challenges, such as the requirement to maintain records of their business activities, financial affairs and client transactions. There is a greater risk that registrants may not be retaining adequate records of their business activities and client communication when using social media since interactive social media includes both real time and static content. Registrants need to design their systems to allow for compliant record retention, as well as retrieval capability.

The use of social media web sites also creates challenges from a supervisory perspective. Firms need to determine the level or extent of supervision necessary to meet their regulatory obligations, including protecting investors from receiving false or misleading statements.

Section 11.5 of NI 31-103 requires registrants to maintain records of their business activities, financial affairs and client transactions. Also, section 2.1 of OSC Rule 31-505 *Conditions of Registration* (OSC Rule 31-505) requires firms and their representatives to deal fairly, honestly and in good faith with their clients, and section 44(2) of the Act prohibits making statements to an investor who is deciding to enter into or maintain a trading or advising relationship, if the statement is untrue or omits information necessary to prevent it from being misleading. These requirements apply to information on social media web sites used by firms and their representatives for business purposes.

Suggested practices

Registered firms should consider the following when determining whether to use social media for business purposes:

- establishing policies and procedures for the review, supervision, retention and retrieval of materials on social media
- designating an appropriate individual to be responsible for the supervision or approval of communications, and
- reviewing the adequacy of systems and programs to ensure compliant record retention and retrieval capability.

Annual compliance report from chief compliance officer

There is often no evidence that a registered firm's Chief Compliance Officer (CCO) has submitted an annual report to the firm's board of directors (or its equivalent) that assesses the firm's, and its registered individuals', compliance with securities law.

Section 5.2 of NI 31-103 outlines the responsibilities of a registered firm's CCO, including:

- establishing and maintaining policies and procedures for assessing compliance by the firm, and individuals acting on its behalf, with securities legislation
- monitoring and assessing compliance by the firm, and individuals acting on its behalf, with securities legislation
- timely reporting to the firm's ultimate designated person of any circumstances indicating that the firm, or any individual acting on its behalf, may be in non-compliance with securities legislation that reasonably creates a risk of harm to a client or the capital markets, or that is part of a pattern of non-compliance, and
- submitting an annual report to the firm's board of directors, or individuals acting in a similar capacity for the firm, for the purposes of assessing compliance by the firm, and individuals acting on its behalf, with securities legislation.

Suggested practices

A CCO should:

- prepare and maintain a written, annual report that they provide and present to the firm's board of directors that outlines the CCO's assessment of the firm's and its registered individuals' compliance with securities law for the period of the report, and

- describe in the written report what steps were taken to perform their assessment, the results of the assessment (including any significant instances of non-compliance such as those that create a risk of harm to a client or the capital markets), and what has been done or will be done to address the non-compliance.

Alternatively, in cases where the CCO has orally presented his or her annual compliance report to the firm's board of directors (and not also prepared a written report as suggested above), it may be appropriate for the minutes to the board meeting to document the discussion, and describe the same information as outlined in the suggested practices for a written report above. This may be appropriate, for example, in the case of a small firm with limited business lines that did not have any significant instances of non-compliance.

We think that these suggested practices apply to a CCO who is the sole member of a registered firm's board of directors.

Acting on the above suggested practices will help us to assess if a CCO has fulfilled his or her responsibilities under section 5.2 of NI 31-103.

5.2 Portfolio managers

This section contains information specific to the approximately 660 portfolio managers registered with us. It includes trends in deficiencies and suggested practices from our compliance reviews of portfolio managers. We also discuss our reviews of the marketing and client account statement practices of portfolio managers, the provision of on-line advice, and new or proposed rules impacting portfolio managers.

A. Trends in deficiencies from compliance reviews and suggested practices

This section discusses trends in the deficiencies identified from our compliance reviews of portfolio managers, along with suggested practices.

Trades between client accounts

We have concerns with portfolio managers who effect trades between client accounts, as some of these trades are prohibited. For these trades, which are commonly referred to as cross trades, the portfolio manager causes (by instructing a dealer) one client account managed by the

portfolio manager to purchase or sell a security from or to the investment portfolio of another client account.

Portfolio managers are reminded that there are restrictions on certain managed account transactions. Section 13.5(2)(b) of NI 31-103 states that an adviser must not knowingly cause an investment portfolio managed by it, including an investment fund for which it acts as an adviser, to purchase or sell a security from or to the investment portfolio of any of the following:

- a responsible person
- an associate of a responsible person, or
- an investment fund for which a responsible person acts as an adviser.

As such, portfolio managers are prohibited from effecting cross trades between one client account and another account of a responsible person, an associate of a responsible person, or an investment fund for which it acts as an adviser. Responsible person is defined in section 13.5(1) of NI 31-103 and includes the portfolio manager, and associate is defined in section 1(1) of the Act.

Portfolio managers should also consider the prohibition that exists for inter-fund trades by public investment funds unless these trades are approved by the funds' independent review committee and they comply with other prescribed conditions under section 6.1 of National Instrument 81-107 *Independent Review Committee for Investment Funds*. Also, see [section 13.5 of 31-103CP](#), under the heading "Restrictions on trades with certain investment portfolios", for further guidance.

For cross trades that are not specifically prohibited by securities law, portfolio managers must ensure that they meet their suitability obligations in section 13.3 of NI 31-103, and their duty to deal fairly, honestly and in good faith in section 2.1(1) of OSC Rule 31-505, to both the purchasing client and the selling client.

Suggested practices

If a portfolio manager crosses trades between client accounts (when not specifically prohibited by securities law and not subject to the requirements that apply to exempt inter-fund trades for public investment funds), they should:

- ensure that the executed price for cross trades is fair to both the purchasing and selling clients (e.g., the mid-point between the bid and ask price)
- ensure that the fees charged on cross trades are reasonable

- ensure that cross trades are executed through a dealer
- establish policies and procedures that contain guidelines on cross trades, including their review and approval, pricing, execution cost, execution through a dealer, and restrictions on certain managed account transactions, and
- ensure that the methodology for allocating cross trade opportunities amongst client accounts is fair and equitable to all clients.

Disclosure regarding use of client brokerage commissions

Some portfolio managers do not provide the required disclosure to their clients when they direct trades involving those clients' brokerage commissions to a dealer in return for goods and services (other than order execution) provided by the dealer or a third party. This practice was formerly referred to as soft dollar arrangements.

National Instrument 23-102 *Use of Client Brokerage Commissions* (NI 23-102) came into force on June 30, 2010. It states that portfolio managers may only direct trades involving clients' brokerage commissions to a dealer in return for order execution and research goods and services provided by the dealer or a third party. Further, portfolio managers must ensure that the goods or services are used to assist with investment or trading decisions, or with effecting securities transactions, on behalf of clients. It also requires portfolio managers to make a good faith determination that clients receive a reasonable benefit considering the use of the goods or services and the amount of commissions paid. Portfolio managers are also obligated to disclose specific information to a client on their practices if any trades involving client brokerage commissions of that client have been or might be directed to a dealer in return for goods or services (other than order execution) provided by the dealer or a third party. For clients that existed on June 30, 2010, the disclosure was required to be sent by December 31, 2010, and then must be provided at least annually. For new clients, the disclosure is required before the portfolio manager open the client's account or enters into a management contract with the client, and then at least annually.

The disclosure obligations are set out in section 4.1(1) of NI 23-102 and include:

- a description of the process for selecting dealers
- a description of the nature of the arrangements
- a list of each type of good or service (other than order execution) that is provided, and
- a description of how the firm has made a good faith determination that its clients receive a reasonable benefit, considering the use of the goods or services and the amount of commissions paid.

Suggested practices

Portfolio managers that are required to provide disclosure to clients on their use of client brokerage commissions should:

- establish policies and procedures that contain guidelines on providing adequate disclosure to clients, including review and approval of written disclosure to clients
- ensure that the period of time chosen for the periodic (i.e., annual) disclosure is consistent from period to period
- determine the form of disclosure based on client needs, and
- provide the required disclosure in conjunction with other initial and periodic disclosure relating to the management and performance of the account.

For additional guidance, see [Part 5 of the Companion Policy to NI 23-102](#).

Delegating know your client and suitability obligations

In last year's report, we highlighted our concern that some portfolio managers delegate their know your client (KYC) and suitability obligations to other parties. Since we continued to identify this practice during this year's reviews, we are re-emphasizing this deficiency again, in addition to taking appropriate regulatory action when identified.

Some portfolio managers enter into arrangements with mutual fund dealing representatives (and their firms) or financial planners, for the referral of clients to the portfolio manager for a managed account. We have concerns when the portfolio manager does not have a meaningful discussion with each referred client to fully understand their investment needs and objectives, financial circumstances and risk tolerance. We have noted that some portfolio managers are relying on the mutual fund dealing representative or financial planner to perform these duties, along with assisting the client in completing the portfolio manager's managed account agreement, and updating KYC information. We have also seen cases where an individual working for the portfolio manager firm is performing these duties but is not registered as an advising or associate advising representative. These practices are contrary to securities law, as registrants may not delegate their KYC and suitability obligations to other parties. Furthermore, portfolio managers cannot adequately perform their suitability obligations if they do not have complete and accurate KYC information for their clients.

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. Furthermore, mutual fund dealing representatives, financial planners, and non-registered individuals at the portfolio manager firm 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 registrable activities unless the individual or firm is appropriately registered.

Suggested practices

An advising representative of the portfolio management firm should:

- have a meaningful discussion with each client to understand their KYC information before managing their portfolio (preferably by meeting the client in-person, but in some cases telephone discussions may be appropriate, for example when the client does not reside near the portfolio manager's offices)
- explain the firm's investment process and strategy and other relationship information to the client
- assist the client in completing 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.

B. Marketing practices

The marketing practices of portfolio managers are an ongoing area of focus for us since the materials used by them to market their firm's services, skills and experience are intended to influence investors. In recent years, we continued to see a number of issues in the marketing practices of portfolio managers. As a result, together with the CSA, we conducted a focused compliance review of the marketing practices of over fifty firms registered as portfolio managers

to better understand their marketing practices and to harmonize our compliance oversight across Canada.

On July 8, 2011, we published CSA Staff Notice 31-325 *Marketing Practices of Portfolio Managers* (CSA Notice 31-325). This notice discusses the findings from our compliance reviews and provides suggested practices to help portfolio managers ensure their marketing practices are in accordance with securities law, including that statements provided to investors are fair and not misleading. The notice updates certain issues and guidance previously provided in November 2007's OSC Staff Notice 33-729 *Marketing Practices of Investment Counsel/Portfolio Managers*, including an update on the use of hypothetical performance data as a result of further information gathered from ongoing compliance reviews and industry consultations.

The suggested practices in CSA Notice 31-325 address the following issues:

- preparation and use of hypothetical performance data
- exaggerated and unsubstantiated claims
- policies, procedures and internal controls
- use of benchmarks
- performance composites
- holding out and use of names
- other performance return issues, and
- disclosure related issues.

We encourage portfolio managers to use the guidance in the notice to assess their own marketing practices, and determine the areas where improvements can be made. We also recommend that registrants in other categories do the same, as some of the issues and guidance may be relevant to their marketing practices as well.

For more information, see [CSA Notice 31-325](#).

C. Portfolio manager client account statement practices

Some portfolio managers do not deliver account statements to their clients, or the statements that they deliver do not include information on each security transaction made for the client. Further, some portfolio managers deliver consolidated account statements, which combine information for more than one account managed for a client on one summary statement, instead of a statement for each account that they manage for the client. Because of these concerns, we performed a desk review of the client account statement practices of portfolio managers to

obtain a better understanding of their practices. In June 2011, we sent a questionnaire to 50 Ontario-based firms registered as portfolio managers requesting information about their practices, including the frequency of delivery and content of statements, if they outsource the delivery of statements to a service provider, and if they provide consolidated statements. We also requested samples of statements and copies of any outsourcing agreements. The information we obtained will be used to assess if further guidance needs to be provided to portfolio managers on their client account statement obligations as described in section 14.14(3) of NI 31-103.

D. On-line advice

Some portfolio managers are providing or propose to provide on-line advisory services, which may include the use of on-line portfolio management tools and the provision of on-line advice or the collection and documentation of KYC information on-line. Portfolio managers may be able to provide on-line advice services where applicable legal requirements can be met since the medium for delivery of advisory services is largely unrestricted under our regulatory regime. However, we remind portfolio managers of certain key areas of obligations under NI 31-103 when providing on-line advice services, including:

- *KYC and suitability obligations* – portfolio managers should ensure that any KYC information collected is verified and accurately reflects the investment needs and objectives, financial circumstances and risk tolerance of clients, and that any investment advice, regardless of how it delivered, is suitable for clients
- *Managing and responding to any conflicts of interest* – portfolio managers should ensure that any conflicts of interest are responded to appropriately
- *Client relationship disclosure requirements* – portfolio managers need to ensure that clients are aware of and understand the nature and level of the advisory services provided, and
- *Books and records* – portfolio managers should establish policies and procedures for the review, retention and retrieval of required books and records, including any client information collected on-line.

We also remind portfolio managers of their obligations to ascertain client identity under NI 31-103 and the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* when opening accounts for clients.

Since we anticipate that there will be an increasing number of firms seeking to provide on-line advice services in the future, this is currently an area of focus for us. As part of our work, we contacted other regulators to gain an understanding of their regulatory approaches on this topic.

We are also in the process of collecting information on the delivery of on-line advice services by registrants through our updated risk assessment questionnaire and plan to conduct compliance reviews of firms in this area.

E. New and proposed rules impacting portfolio managers

Direct electronic access

Some portfolio managers make use of electronic trading, including complex trading strategies that involve high frequency trading. Portfolio managers obtain direct electronic access (DEA) to marketplaces by entering into DEA arrangements with participant dealers.⁶ DEA has enabled clients of participant dealers, such as portfolio managers, to use their own systems or algorithms to directly send orders to the marketplaces of their choice.

As a result of increased risks to the Canadian market brought about by the greater and widespread use of electronic strategies, and DEA to marketplaces, the CSA published for comment Proposed National Instrument 23-103 *Electronic Trading and Direct Electronic Access to Marketplaces* (Proposed NI 23-103) in April 2011. Staff in the OSC's Market Regulation Branch have been actively participating in this proposal. The proposed rule covers electronic trading by marketplace participants and their clients, and introduces specific obligations for DEA. Currently, there are no specific rules that apply to electronic trading, and the only rules in place relating to client trading access are DEA-specific rules or policies at the marketplace level. The proposed rule would provide a regulatory regime for electronic trading and DEA, and includes requirements for marketplace participants, DEA clients, and marketplaces.

Under Proposed NI 23-103, portfolio managers would be permitted to use DEA when it is provided by a participant dealer.⁷ These portfolio managers would be able to trade using DEA for their own account or the accounts of their clients. Some of the proposed requirements for participant dealers when they provide DEA to clients (such as portfolio managers) include:

- setting appropriate standards that DEA clients must meet, such as appropriate financial resources, knowledge and proficiency in the use of the system, knowledge and ability to comply with marketplace and regulatory requirements, and arrangements to monitor entry of orders
- entering into a written agreement with each DEA client that has specific terms, including that the DEA client will comply with marketplace, regulatory and technology security requirements

⁶ A participant dealer is a marketplace participant that is a registered investment dealer and an IIROC member.

⁷ Under proposed NI 23-103, DEA can only be provided to a registrant that is a participant dealer or a portfolio manager. Exempt market dealers are precluded from using DEA. See section 5.4C on DEA in this report.

and trading limits specified by the dealer, that they will cooperate with regulatory authorities, and that the dealer can reject, vary or cancel orders or stop accepting orders

- assessing the knowledge level of the DEA client on marketplace and regulatory requirements and determining any required training, and
- assigning a unique identifier to each DEA client that must be associated with every order and be kept as part of the audit trail.

For more information, see [Proposed NI 23-103](#).

Institutional trade matching and settlement

In May 2011, the CSA published revisions to CSA Staff Notice 24-305 *Frequently Asked Questions About NI 24-101 - Institutional Trade Matching and Settlement and Related Companion Policy* (FAQ Notice). The FAQ Notice was originally published in December, 2007 and sets out questions and answers to assist market participants in complying with NI 24-101. The FAQ Notice was revised as a result of amendments to NI 24-101, which became effective July 1, 2010, and new inquiries received by staff since the original FAQ Notice (including challenges faced by advisers and dealers in calculating their trade-matching statistics).

For questions and answers on NI 24-101, see the [FAQ Notice](#).

5.3 Investment fund managers

This section contains information specific to the over 300 investment fund managers registered with us, including trends in deficiencies and suggested practices from compliance reviews, and new and proposed rules impacting investment fund managers.

A. Trends in deficiencies from compliance reviews and suggested practices

Inappropriate expenses charged to funds

Investment fund managers should only charge expenses to their funds that are related to the operation of the funds. Some investment fund managers are allocating expenses to their investment funds that are related to the operation of the investment fund managers' business and not the investment funds. These expenses include capital market participation fees, expenses relating to social events and holiday parties, premiums on their financial institution bonding or insurance, and expenses relating to the wholesaling activities of the investment fund manager.



Section 116 of the Act imposes a standard of care on investment fund managers for the investment funds they manage. In our view, to meet this standard of care, investment fund managers should ensure that the investment funds they manage are only paying for expenses that are related to the operation of the investment funds. The expenses listed above are related to the operation of the investment fund manager. We consider these expenses to be the cost of running a fund management business and should therefore be borne by the investment fund manager, and not their investment funds.

Suggested practices

An investment fund manager should:

- establish policies and procedures and a system of controls to ensure that their investment funds are only paying for expenses that are related to the operation of the investment funds, and
- review expense allocations on a regular basis to ensure that only appropriate expenses are charged and paid for by their investment funds.

Independent review committee assessments

Investment funds that are reporting issuers must have an independent review committee (IRC). An IRC is a panel of at least three individuals who are independent of the investment funds and their investment fund manager. The role of the IRC is to oversee decisions made by the investment fund manager on issues of perceived or actual conflicts of interest. An IRC is required to review and assess, at least annually, the adequacy and effectiveness of the investment fund manager's written policies and procedures, standing instructions, and the manager's compliance with any conditions imposed by the IRC relating to an IRC recommendation or approval. An IRC is also required to review and assess, at least annually, the compensation and independence of its members.

Some IRCs do not document the results of their assessments and also do not provide their investment fund managers with a written report summarizing the results of the assessments.

Section 4.3 of National Instrument 81-107 *Independent Review Committee for Investment Funds* requires the IRC to provide the investment fund manager with a written report of the results of their assessments that includes any breaches of the manager's policies or procedures or of conditions imposed by the IRC, and recommendations for changes to the manager's policies and procedures.

Suggested practices

An investment fund manager should ensure:

- it receives and maintains records of the regular assessments conducted by the IRC, and
- that any matters raised in written reports from the IRC are addressed in a timely and appropriate manner.

B. New and proposed rules impacting investment fund managers***Investment funds modernization project***

The CSA is undertaking a project to modernize the product regulation of publicly offered investment funds. The OSC, led by staff in its Investment Funds Branch, is actively participating in this project. The first phase focuses primarily on publicly offered “mutual funds”, as defined under Canadian securities legislation, which include open-end mutual funds and exchange-traded mutual funds.

As part of the first phase, proposed amendments to National Instrument 81-102 *Mutual Funds* were published for comment on June 25, 2010 that would codify exemptive relief that has frequently been granted by the CSA to recognize market and product developments, particularly the proliferation of exchange-traded mutual funds. The proposals are also intended to keep pace with developing global standards in mutual fund product regulation. For example, one of the proposed amendments would permit a mutual fund to sell securities short, subject to certain requirements.

The proposals also include new requirements for money market funds. A new liquidity requirement is proposed for a money market fund to have at least 5% of its assets in cash or readily convertible to cash within one day, and 15% of its assets in cash or readily convertible to cash within one week. These requirements would better enable money market funds to meet redemption requests. A new average term-to-maturity limit is also proposed to limit the exposure of money market funds to long-term floating rate debt.

The CSA anticipates publishing the phase one amendments in final form by the end of 2011, with an effective date in early 2012. For more information, see [Notice of Proposed Amendments to NI 81-102 Mutual Funds and NI 81-106 Investment Fund Continuous Disclosure, and Related Consequential Amendments](#).

In the next phase of the project, the CSA is proposing to implement certain key restrictions and operational requirements for non-redeemable investment funds (also referred to as “closed-end funds”), consistent with similar requirements for mutual funds. The CSA anticipates to publish for comment rule proposals on this phase in early 2012. For more information, on phases 1 and 2 of these proposals, see [CSA Staff Notice 81-322](#).

Point of sale disclosure

Our Investment Funds Branch is also working with the CSA on point of sale disclosure for mutual funds. Point of sale disclosure is a multi-stage initiative to address concerns that most investors do not read or understand the information in a mutual fund’s prospectus. In the first stage, effective January 1, 2011, mutual fund companies are required to prepare a Fund Facts document for each class or series of their mutual funds. As of July 8, 2011, a Fund Facts document must be filed with the regulator, made available upon request to investors and posted on the mutual fund’s or its manager’s web site.

The new Fund Facts document is intended to provide investors with more meaningful and effective disclosure. It is in plain language, no more than two pages double-sided and highlights key information about a mutual fund to investors. Investors will generally receive a Fund Facts when they buy a fund for the first time (at or before the “point of sale”). For more information, see [Notice of Amendments to NI 81-101 Mutual Fund Prospectus Disclosure and related amendments](#).

For stage 2, the CSA published for comment on August 12, 2011 a proposal to allow delivery of the Fund Facts document to satisfy the current requirement to deliver a prospectus within two days of buying a mutual fund. For more information, see [Implementation of Stage 2 of Point of Sale Disclosure for Mutual Funds](#).

For stage 3, the CSA plans to publish for further comment any proposed requirements that would implement point of sale delivery for mutual funds. They will also consider point of sale delivery for other types of publicly offered investment funds.

Registration of non-resident investment fund managers

For details on *Registration of non-resident investment fund managers*, see section 1.4 of this report.



5.4 Exempt market dealers

This section contains information specific to the approximately 650 exempt market dealers (EMDs) registered with us, including trends in deficiencies and suggested practices from compliance reviews. We also discuss specific outcomes and deficiencies from our focused reviews of higher risk EMDs, and new and proposed rules impacting them.

A. Trends in deficiencies from compliance reviews and suggested practices

KYC, suitability, and know your product obligations

As part of our ongoing reviews of EMDs, we continue to identify issues in the areas of KYC information, assessment of suitability, and knowledge of products recommended to clients. These include:

- inadequate collection and documentation of KYC information for clients
- inadequate assessment of suitability of investments for clients, and
- insufficient due diligence and knowledge of an investment product prior to recommending it to investors (referred to as “know your product”).

We remind EMDs of their obligations under section 13.2 of NI 31-103 to take reasonable steps to ensure they have sufficient and current KYC information for clients, including their investment needs and objectives, financial circumstances and risk tolerance. Also, EMDs are required under section 13.3 of NI 31-103 to take reasonable steps to ensure that all securities recommended to clients are suitable. To meet this suitability obligation, EMDs should also understand the structure and features of each investment product they recommend, including features such as costs, risks and investor eligibility 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 the investment products they recommend
- have clients sign-off on their completed KYC forms
- 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 a product to clients
- perform an independent analysis of products before recommending them to clients, 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.

Trades with clients that are not accredited investors

Many EMDs are selling prospectus-exempt securities in reliance on the accredited investor exemption to investors who do not meet the definition of an accredited investor as set out in section 1.1 of NI 45-106. Common findings include:

- KYC information that indicates that the client does not qualify as an accredited investor, and
- Insufficient collection of KYC information to determine whether an investor is an accredited investor.

As set out in section 7.1(2)(d) of NI 31-103, an EMD can trade a security only where the trade or distribution is exempt from the prospectus requirement. Section 1.9 of the Companion Policy to NI 45-106 states that it is the responsibility of the person distributing or trading securities to determine whether an exemption is available. EMDs must ensure the information collected from investors supports the selling of prospectus-exempt securities using the accredited investor exemption.

Suggested practices

When selling prospectus-exempt securities to an accredited investor, EMDs should:

- have a process in place to collect and document sufficient KYC information for each client to determine whether the investor meets the definition of an accredited investor
- explain the accredited investor definition to clients before they complete their KYC form, so that their financial assets or net assets information on the KYC form is properly completed, and
- refer to [OSC Notice 33-735](#) regarding the use of the accredited investor exemption, for additional guidance.

Supervision of dealing representatives

Some EMDs are not adequately supervising their dealing representatives, especially when representatives are working in different locations from their supervisor. For example, some dealing representatives did not adequately fulfill their KYC and suitability obligations, and did not have adequate knowledge of investment products recommended to investors. Since dealing representatives are the primary contact for investors, it is important that they are adequately trained in relevant securities law, their sponsoring firm's policies and procedures, and the investment products they recommend. EMDs have an ongoing obligation to monitor and supervise their registered individuals in an effective manner. Supervision of dealing representatives should be performed by an individual who has adequate training, knowledge and authority. EMDs should establish and maintain procedures for supervising their dealing representatives, and maintain evidence of their supervisory reviews.

Section 32(2) of the Act requires registrants to establish and maintain systems of control and supervision for controlling their activities and supervising their representatives. Also, section 11.1 of 31-103CP, under the heading "Day-to-day supervision", states that anyone who supervises registered individuals has a responsibility on behalf of the firm to take all reasonable measures to ensure that each of these individuals:

- deals fairly, honestly and in good faith with their clients
- complies with securities legislation
- complies with the firm's policies and procedures, and
- maintains an appropriate level of proficiency.

Suggested practices

EMDs should provide ongoing training for their dealing representatives so that they:

- are aware of the securities laws impacting their activities
- understand their sponsoring firm's policies and procedures
- have an in-depth understanding of the products they recommend to clients, and
- are informed of any changes to the above on a timely basis.

EMDs should develop written policies and procedures to supervise the activities of their dealing representatives, including:

- the activities to be supervised and by whom
- the frequency of supervision, and
- how the supervision will be evidenced.

Trading in securities without registration

Some individuals, acting on behalf of an EMD, are trading in securities without being registered as a dealing representative with the EMD.

Section 25(1)(b) of the Act requires a person that engages in the business of trading in securities, or holds himself or herself out as doing so, to register as a dealing representative of a registered dealer and to act on behalf of that dealer, unless an exemption applies.

We also remind firms in other categories of registration to assess whether their business activities require EMD registration, especially when there is a change in their activities.

Suggested practices

EMDs should:

- assess whether a change in an individual's role, responsibilities or activities within the firm requires them to be registered
- assess whether changes to the firm's business activity requires registration (for the firm and individuals acting on its behalf) in another category under securities law, and
- obtain qualified legal advice when it is unclear whether activities performed require registration.

Marketing and client disclosure

The marketing practices of EMDs continues to be an area of concern for us. Many EMDs are providing materials to investors with information that is outdated, misleading, or contains unsubstantiated claims. In addition, we identified a continued lack of disclosure to investors on conflicts of interest, particularly with EMDs who trade in securities of related and connected issuers.

Section 44(2) of the Act prohibits any person or company (including EMDs and anyone acting on their behalf) from making untrue or misleading statements about any matter relevant to a reasonable investor who is deciding to enter into or maintain a trading relationship with that person or company. Furthermore, section 2.1 of OSC Rule 31-505 requires registrants to deal fairly, honestly and in good faith with their clients. This provision is a broad principle that applies to registrants generally. We expect registrants to apply it to all areas of their activities, including marketing practices and marketing materials. For additional guidance, please see CSA Notice 31-325 which provides guidance to market participants to help them comply with applicable legislation and best practices in the preparation and use of marketing materials.

Also, section 13.4(3) of NI 31-103 requires EMDs to provide timely disclosure to their 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 31-103CP](#).

Suggested practices

EMDs should:

- provide clear and adequate disclosure in marketing materials to ensure that the information is complete, accurate and meaningful
- substantiate all claims made in marketing materials (information supporting the claim should be referenced to where the claim is made in the marketing material so that investors can easily assess the merits of the claim)
- update marketing materials regularly to ensure all information is complete, accurate and current, and
- provide prominent, specific and clear disclosure to its clients that explains any conflicts of interest and how it could affect the client.

B. Reviews of higher risk exempt market dealers

In October 2009, we sent a risk assessment questionnaire (RAQ) to all EMDs registered in Ontario to help us determine which firms to select for a compliance review and what areas to focus on. Based on the responses, some firms were assessed as higher risk, and included as part of a desk review in May 2010. The objective of the desk review was to obtain additional information on the firm's business structure, products and services, KYC and accredited investor information, and marketing and disclosure practices. Based on the desk review, a number of these EMDs were selected to undergo an on-site compliance review. We also reviewed a random sample of EMDs who ranked in the other risk categories to test the effectiveness of our risk-based approach.

We consider the risk ranking of EMDs to be an effective tool and will continue to use a risk-based approach in selecting them for review. For more information on our updated RAQ and planned reviews of higher risk registrants, see section 5.1B of this report.

In December 2010, we began our on-site compliance reviews. The compliance reviews focused on key risk areas relating to:

- KYC and suitability
- Know your product
- Custody and handling of investor assets
- Disclosure to investors
- Client account reporting
- Marketing to investors
- Referral arrangements
- Compliance structure and supervision

Our reviews resulted in one or more of the following outcomes:

- a deficiency report was sent to senior management of the EMD that outlined non-compliance with Ontario securities law, and required appropriate corrective actions to be taken by the firm
- terms and conditions were imposed on the firm's (and its registered individuals') registration
- referral to the CRR Branch's Registrant Conduct and Risk Analysis Team
- referral to the OSC's Enforcement Branch
- suspension of the firm's (and its registered individuals') registration.

Trends found at higher risk exempt market dealers

We identified a disproportionate rate of compliance deficiencies among EMDs that distribute the securities of related or connected issuers, where the same individuals form the management of both the EMD and the issuer.

In addition to the trends in deficiencies discussed in section 5.4A of this report, the following are specific deficiencies that were identified during the higher risk EMD reviews that we will continue to focus on in future EMD reviews.

Inappropriate use of investor monies

Some EMDs used proceeds raised from investors through their related or connected issuers for purposes that are inconsistent with the investment objectives that are disclosed and marketed to the investors. Specific examples include:

- investor monies being lent to related parties or related issuers on an unsecured basis, bearing no interest and without repayment terms. These related party transactions were not disclosed to investors, and
- investor monies being used to pay for the operational expenses of EMDs, including salaries, rent, legal fees and other administrative expenses.

Section 2.1 of OSC Rule 31-505 requires EMDs to deal fairly, honestly and in good faith with their clients. We expect EMDs to apply this principle to all areas of their activities, including handling of client money in accordance with the use of proceeds disclosed to investors.

Suggested practices

EMDs should:

- provide clear and adequate disclosure to investors regarding the use of investor proceeds
- have policies in place to ensure investor money is used in accordance with the stated investment objectives, and
- disclose related parties and existing or potential conflicts of interest, including fees and payments to related parties.

Outside business activities

Registered individuals are required to disclose to investors and to the OSC potential conflicts of interest. This requirement includes disclosure of outside business activities. Many EMDs failed to disclose outside business activities, including:

- acting as an officer, director or in an equivalent position for a company other than their registered firm, and
- employment with a company other than their registered firm.

Suggested practices

EMDs should:

- provide clients with clear, adequate and timely disclosure of outside business activities
- have policies in place to ensure all registered individuals disclose new outside business activities to the OSC in accordance with NI 33-109, and
- refer to [CSA Notice 31-326 Outside Business Activities](#) for additional guidance on a registrant's obligation to disclose all outside business activities.

Working capital and insurance requirements

We continue to identify EMDs with inadequate working capital and insurance coverage. These deficiencies are discussed in section 5.1E of this report.

C. New and proposed rules impacting exempt market dealers

EMD client account statements

EMDs are required by section 14.14 of NI 31-103 to deliver client account statements at least quarterly. EMDs may also be required to deliver a monthly account statement if a transaction is made for the client during the month. Account statements have two main components:

- transactional information relating to transactions made for the client during the period, and
- account balance information relating to cash and securities “in the account” of a client at the end of the period.

The current regulatory requirements do not specify what securities are considered to be “in the account” of a client for EMDs. So it may be difficult for EMDs to provide clients with account balance information without specific guidance regarding which securities are considered to be “in the account”. To address this, we are working on developing proposals for further requirements or guidance on the content of account statements. Until this is completed, we do not expect EMDs to deliver end of the month account statements or include account balance information in quarterly statements for securities of clients that are not held or controlled by the firm. However, we do expect EMDs to deliver quarterly account statements containing transactional information for any transactions effected for clients, and account balance information for all cash and securities of clients that the firm holds or controls.

For EMDs that are also registered in another dealer category or as an adviser, our expectation is that they will provide all of their clients with account statements that are consistent with their practices under their other category of registration. Similarly, an EMD that is also registered in a category that requires membership in an SRO must comply with the applicable SRO’s rules.

For more information, see [CSA Staff Notice 31-324 *Exempt market dealers and account statement requirements in NI 31-103*](#), which we published in June, 2011.

Accredited investor exemption

Some EMDs that sell prospectus-exempt securities are improperly using the accredited investor exemption. For details, see *Use of accredited investor exemption* in section 5.1D of this report.

Direct electronic access (DEA)

Under Proposed NI 23-103, EMDs are precluded from using DEA. The CSA’s position is that a dealer that wants to use DEA should be an IIROC member and subject to the Universal Market Integrity Rules. For more information, see *Direct electronic access* in section 5.2E of this report.



6. Additional resources

6. Additional resources

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

The CRR Branch works to foster a culture of compliance through outreach and other initiatives. We try to assist registrants in meeting their regulatory requirements in a number of ways.

We encourage registrants to visit the OSC's web site at www.osc.gov.on.ca for more information regarding their obligations. The "Information for Dealers, Advisers and Investment Fund Managers" section provides firms and individuals with detailed information about the registration process and their ongoing obligations under the new regime. It also includes information about compliance reviews and suggested practices, and provides quick links to forms and rules.

Registrants may also contact us. Please see the Appendix to this report for the CRR Branch's contact information. The CRR Branch's portfolio manager, investment fund manager and dealer teams focus on registration, oversight, policy changes, and exemption applications for their respective registration categories. The Registrant Conduct and Risk Analysis team supports the other teams in cases of potential registrant misconduct, and reviews registrant submissions regarding financial reporting, such as audited annual financial statements and calculations of excess working capital. They also lead projects to improve the CRR Branch's operations.

The CRR Branch also plans to host a half-day information session for registrants later this fiscal year. At this session, we intend to provide updates on the new regime for registrants, along with hot topics, compliance guidance and practice tips, and a question and answer period.

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September 23, 2011



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