Let's inspect the OSC's 2024 Registration, Inspections and Examinations Division Summary Report

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OSC Staff Notice 33-756 *Registration, Inspections and Examinations Division Summary Report for Dealers, Advisers and Investment Fund Managers* (Annual Report) marks the first from the newly renamed Registration, Inspections and Examinations (RIE) division at the Ontario Securities Commission (OSC) (previously the Compliance and Examinations Branch).

2024-2025 Compliance priorities

RIE's compliance priorities for the year ahead include a continued focus on "Registration as the First Compliance Review" program, as well as reviews of high-risk firms, as determined by an analysis of the data RIE collected through the Risk Assessment Questionnaire (RAQ), the largest firms by AUM ("high-impact firms") and firms that are specialized dealers and derivatives dealers. This last point is of particular interest, given the Sept. 28, 2024, effective date of Multilateral Instrument 93-101 *Derivatives: Business Conduct*, signaling a need for derivatives firms to be ready to hit the ground running.

Findings from RIE reviews

KYC, KYP & Suitability review

The industry will need to wait a while longer for the findings from the Know-Your-Client, Know-Your-Product and Suitability sweep undertaken as a result of the implementation of the Client Focused Reforms. Stay tuned for the release of a joint CSA/CIRO staff notice.

Review of high-risk firms

RIE reviewed firms classified as high-risk as a result of the data collected in the RAQ and found the following common deficiencies:

- inadequate compliance systems, and CCOs and UDPs not performing their responsibilities;
- inadequate disclosure to clients regarding conflicts of interest; and
- firms not being aware of their financial condition at all times and incorrect calculation of excess working capital.

Business arrangement sweep

RIE conducted a focused review of both registered and unregistered Ontario-based firms that had a business arrangement with an unrelated registered firm for its IFM and/or PM services.

Building on the reminder issued in the OSC's 2023 Summary Report, RIE stressed that only IFMs can direct the business operations or affairs of an investment fund. In exercising its duty of care owed under Ontario securities law, the IFM cannot delegate its duties to the fund. We encourage clients to review their business arrangements in light of this guidance and the problematic clauses highlighted by RIE.

RIE most frequently identified deficiencies involving arrangements with firms that had proprietary investment funds for which the firm acted as the PM, but for whom an unrelated third-party firm was appointed as the IFM. RIE examined the activities conducted by each party and noted cases where the PM - not the appointed third-party IFM - directed the affairs of the investment funds.

In its review of written agreements between the PM and the IFM, RIE identified clauses suggesting the PM had certain rights and obligations that are central to the role of an IFM in directing or managing the business, operations or affairs of an investment fund, including the PM being permitted to terminate or change the IFM for the fund and the IFM requiring the prior consent of the PM to change certain of the fund's service providers.

Similarly, RIE found instances where unregistered firms were making investment decisions for an investment fund, inappropriately relying on the PM registration of another firm.

Models where compliance functions were provided by a third-party entity were also reviewed, resulting in RIE reiterating that registrants cannot outsource their compliance functions.

Referral arrangements between PMs and unregistered firms

RIE reminded registered firms not to delegate portfolio management activities to unregistered referral agents. RIE considers referral arrangements to be prima facie material conflicts of interest. We suggest that firms with referral arrangements review the related guidance to ensure that their referrals withstand regulatory scrutiny.

This year, RIE advises that unregistered parties should not maintain direct contact with clients to discuss account details (such as investment performance or to address client concerns with their accounts). Referred clients should be speaking with a registered Advising Representative (AR) about questions on their portfolio holdings and changes to

KYC information and should not be in continued communication with the referral agent on such matters. RIE indicates that, when a referral agent has a continuing relationship with referred clients (for example, providing financial planning services), the registrant must ensure that all fees relating to portfolio management services are paid directly to the registered firm.

RIE takes their guidance further than what has been expressed to date by imposing a gatekeeping function on the registrant, stating that the registrant's policies and procedures regarding referral arrangements with unregistered parties should establish processes to:

- evaluate the referral agent's marketing to verify that any claims or statements they make about the registered firm's products and services are accurate, substantiated and not misleading;
- monitor the referral agent's relationship with referred clients to determine whether the referral agent is performing an activity that requires registration; and
- monitor and resolve instances where clients are confused about the role of the registrant and/or referral agent.

Emerging issues sweep

This year, due to the current environment of higher interest rates, some real estate/mortgage issuers halted or suspended redemptions. RIE reached out to them for additional information. Next year, RIE will further scrutinize the roles and responsibilities of exempt market dealers (EMDs) in the distribution of real estate and mortgage products. The CSA continues to monitor issues of liquidity risk management in the wider market and RIE has said it will engage directly with firms in the real estate sector experiencing liquidity issues that cause the suspension of redemptions to understand their portfolio liquidity management plans and how they plan to resume redemptions.

PM considerations in Fund of Fund (FOF) structures

Where an investment fund holds only one portfolio security (including a FOF structure where a top fund has been created as a separate issuer and invests only in the securities of the bottom fund), an analysis is required to determine whether 'advising' is taking place at the top fund level. If so, there should be a PM - appointed by the IFM - to advise the top fund. While the top fund's investment objective may be to invest only in securities of the underlying fund, RIE takes the view that a PM is required to make investment decisions at the top fund level, which decisions include the timing of new investments into the bottom fund, managing redemption requests and determining how much cash the top fund should hold.

Appointment of IFM

RIE noted instances of IFMs being named in fund offering documents without having been appointed in constating documents. Funds must have documentation evidencing delegation of the IFM function to a registered IFM firm by an entity, such as the general partner (GP) through a GP agreement (for example, a limited partnership agreement) or by the trustee in the declaration of trust.

Foreign firms that do not rely on the international adviser exemption

RIE reminds foreign advisers who do not meet the conditions to rely on the foreign international adviser exemption, but who are providing advice to Ontario clients, that they are required to be registered with the appropriate CSA member(s). RIE noted representatives of these foreign advisers performing registerable activity without being registered as ARs or associate advising representatives (this includes both individuals conducting relationship management activities as well as those selecting securities), as well as instances where the foreign adviser's policies and procedures were not tailored to Ontario-specific rules and guidance. RIE also reminds foreign advisers that they are required to provide adequate training to their employees on the registration requirements in Ontario.

Issuer-sponsored dealing reps (EMDs)

RIE noted an increase in the number of registered firms using the issuer-sponsored Dealing Representative (DR) business model – a model in which a DR that works for an issuer or its affiliate is registered with an independent EMD firm to market the issuer's securities to investors. RIE has various concerns with this business model, including conflicts of interest, suitability concerns and client confusion and, as a result of these concerns, has imposed terms and conditions on the registration of firms using this model, including those relating to compensation and product shelf availability. Firms are reminded of the requirement to submit a Form 33-109F5 before commencing use of this type of business model.

Dealer obligations when relying on the offering memorandum exemption (EMD/DR)

While these obligations are those of the issuer, RIE reminds registrants of their role in the sale of products to investors in reliance on the offering memorandum exemption in section 2.9 of National Instrument 45-106 *Prospectus Exemptions* (NI 45-106), which includes performing reasonable procedures to ensure that the offering memorandum (OM) provided to clients contains the required NI 45-106 disclosure, including the disclosure required by the March 2023 changes to this prospectus exemption for issuers engaged in real estate activities and those that are "collective investment vehicles".

Related party receivables in excess working capital (Form 31-103F1)

Related party receivables are considered high risk, especially when the amount is material and a registrant is dependent on the receivable to meet its excess working capital requirements. RIE's review of Form 31-103F1 – *Calculation of Excess Working Capital* identified a number of firms that inappropriately included related party receivables as "current assets" in line 1 of Form 31-103F1. The Annual Report contains important details about evidencing certain conditions in respect of a receivable that firms may wish to review and confirm.

Capital markets participation fees

RIE's reviews of Form 13-502F4 indicate an incorrect application by some firms of OSC Rule 13-502 *Fees*. Specifically, some firms appear to incorrectly deduct revenue. Some

firms were also found to have significantly understated their participation fees for several years, necessitating the payment of outstanding participation fees, plus late fees, as well as the refiling of Form 13-502F4. Other firms incorrectly calculated their Ontario percentage – resulting in firms understating specified Ontario revenues and participation fees payable.

Registration applications

RIE has provided additional guidance and expectations around registration applications, reviews and approvals – a topic that has been the cause of much consternation for industry as of late.

Application deficiencies flagged by RIE that result in delayed registration approvals include applications filed with incomplete or insufficient information; not concurrently filing individual applications for "mind and management" of the firm (without which firm registrations cannot be approved); and putting forward individuals unsuitable for registration due to lack of proficiency and or experience. RIE notes that staff may request that filers withdraw incomplete applications and that such applications are not subject to the OSC's Service Commitment.

RIE notes a "trend" of insufficient information provided to support the requisite relevant investment management experience (RIME) required for AR registration applications which necessitates follow-ups for clarification purposes and results in longer processing times.

AR registrants must demonstrate what RIE considers a high degree of proficiency and quality of RIME as a result of having discretionary authority over investments and RIE takes issue with firms submitting "vague supporting information". The Annual Report contains a discussion of what constitutes sufficient detail in support of an AR registration application that is worth reviewing.

IFM proficiency

RIE continues to highlight the difference between the regulatory obligations and functions of an IFM as opposed to those of a PM or EMD. As a result, the Annual Report alerts firms that staff may have clarifying questions for individuals registering to act as UDP or CCO of an IFM firm, in order to evaluate the sufficiency of their experience for the role. Applicants should submit detailed applications that discuss their experience with IFM operations, for instance, net asset value calculations, fund and trust accounting, recordkeeping, oversight of service providers and regulatory requirements.

Crypto-asset trading platform registration matters and compliance deficiencies

In keeping with the wider CSA focus on crypto-asset regulation and compliance, there is a fulsome chapter on crypto-asset trading platforms. This section includes a discussion of issues ranging from mandatory arbitration clauses of regulatory concern, to crypto-asset-trading-platform-specific conflicts of interest, marketing concerns and registration application matters.

Voluntary surrender of registration

RIE highlights that firms must submit their voluntary surrender of registration before the cutoff date annually set by the OSC. Surrenders submitted late may result in capital markets participation fees being charged. In practice, BLG recommends submitting any such application for surrender no later than October 1, as we have noticed issues with timing for ones submitted later.

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