A|S|C
Alberta Securities Commission

ASC NOTICE 33-705

EXEMPT MARKET DEALER SWEEP

May 10, 2017

Introduction and Purpose of this Notice

Registrant Oversight staff (**staff** or **we**) of the Alberta Securities Commission (**ASC**) recently completed focused compliance reviews of exempt market dealers (**EMDs**) in Alberta whose principal regulator is the ASC (the **Sweep**). The purpose of the Sweep was to determine if registrants were compliant with Alberta securities laws. The Sweep focused on compliance obligations concerning aspects of the client relationship under National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**NI 31-103**), and considered the guidance provided under the Companion Policy to NI 31-103 (**31-103CP**). We also assessed compliance against other National Instruments and Companion Policies, as well as various staff notices from the ASC and the Canadian Securities Administrators (**CSA**).

The purpose of this Notice is to summarize the results of the Sweep and provide guidance to assist firms in complying with their regulatory obligations. We recommend that firms use this Notice to strengthen their compliance with Alberta securities laws.

Overview and Key Points

- Staff completed 66 reviews of Alberta-based EMDs (including one affiliated registrant) in the Sweep to determine if registrants were compliant with Alberta securities laws. Staff examined material aspects of the client relationship for compliance with regulatory requirements at both the firm and individual registrant levels. The Sweep population included firms with various business models, some being registered solely as EMDs with others registered as EMDs and in other categories.

- We identified deficiencies in compliance with regulatory obligations in all areas tested. Major findings identified during the Sweep include:
    - Inaccurate, incomplete or inadequate policies and procedures manual (**P&PM**)
    - Failure of the chief compliance officer (**CCO**) to adequately perform responsibilities
    - Inadequate collection and documentation of know-your-client (**KYC**) information
    - Inadequate know-your-product (**KYP**) analysis of exempt market products
    - Risk tolerances of clients that were not consistent with the risk of the product
    - Inadequate consideration of client investment concentration levels in the suitability analysis
    - Marketing materials that contained unsubstantiated or exaggerated claims
    - Inadequate identification and response to conflicts of interest

- Overall, staff found a spectrum of compliance levels among the firms reviewed. A number of firms achieved a high level of compliance or were at least generally compliant – these firms prioritized compliance and implemented effective compliance systems. On the other end of the spectrum, compliance levels of certain firms necessitated staff taking regulatory action and other steps to address identified concerns. The firms in between on the spectrum demonstrated varying levels of compliance, and additional compliance-focused work is required by these firms. Staff's principal objective in the Sweep, including in reviews of these firms, has been to improve compliance by firms so that regulatory obligations are met. In most cases, this involved requiring firms to rectify identified deficiencies, including requiring written responses from firms detailing how significant deficiencies would be addressed.

- Staff are committed to education initiatives designed to assist registrants and, in addition to summarizing the results of the Sweep, the purpose of this Notice is educational: that is, to provide guidance to assist firms in complying with their regulatory obligations. To this end, the Notice includes detailed suggested practices and unacceptable practices. Many of the mentioned suggested practices are based on best practices we observed being employed by a number of firms we reviewed. We would like to thank these firms for their contributions to this Notice.

- We strongly encourage registrants to use this Notice to improve their understanding of, and compliance with, their regulatory obligations.

Scope of the Sweep

The Sweep examined material aspects of the client relationship for compliance with regulatory requirements at both the firm and individual registrant levels. Areas reviewed included the following:

- compliance system;
- KYC;
- KYP;
- suitability;
- sales practices and marketing;
- conflicts of interest;
- relationship disclosure information (**RDI**); and
- reporting to clients.

Staff completed 66 reviews of Alberta-based EMDs (including one related registrant) in the Sweep. The initially higher project population was reduced due to a number of firms surrendering their registration or otherwise ceasing to carry on business; in some cases, as noted below under *Summary of Results and Outcomes*, this occurred after we had commenced our review of the firm.

The 66 completed reviews were comprised of the following types of firms:

- 12 firms (18 per cent) registered as EMDs[1], offering primarily third party exempt market products;
- 5 firms (8 per cent) registered as EMDs, offering only related party exempt market products;
- 23 firms (35 per cent) registered as EMDs, investment fund managers (**IFM**) and portfolio managers (**PM**) or restricted PMs (**RPM**), with their primary business being related to venture capital and private equity in the oil and gas industry, or hedge funds and non-reporting issuer investment funds invested in publicly traded securities;
- 25 firms (38 per cent) registered in various categories with their primary business being related to mortgage syndication and mortgage investment funds; and
- 1 firm (2 per cent) registered as an RPM and IFM; this firm was reviewed in connection with the review of a related EMD firm.

Summary of Results and Outcomes

We identified deficiencies in compliance with regulatory obligations in all areas tested. Overall, staff found a spectrum of compliance levels among the firms reviewed. A number of firms achieved a high level of compliance or were at least generally compliant**.** Staff's assessment of these firms was that they placed a priority on regulatory compliance requirements and implemented effective compliance systems accordingly. On the other end of the spectrum, due to the seriousness of the deficiencies identified by staff, regulatory action and other steps were taken (as discussed below). The firms in between on the spectrum demonstrated varying levels of compliance. Additional compliance-focused work is required by these firms.

A compliance report was issued by staff for each review, with each review subject to a range of possible regulatory outcomes. The most common outcome was the requirement that the firm rectify the deficiencies identified in the compliance report. In the case of significant deficiencies, the firm was also required to provide staff with a written response detailing how the deficiencies would be rectified.

To the extent that we were not satisfied with the firm's response, staff followed up with the firm until we were satisfied with the manner in which the firm intended to address the deficiencies.

In some cases, due to the seriousness of the deficiencies, regulatory action or other steps were taken by staff. The following summarizes regulatory action and other steps taken and pending as a result of the Sweep:

- Termination/Suspension: One firm's registration was terminated as a result of significant deficiencies and related investor protection concerns, and another firm was suspended due to not meeting conditions specified in terms and conditions imposed on the firm based on staff's deficiency findings (see *Terms and Conditions* below).

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[1] Eleven firms are sole EMDs, while one is an EMD/RPM/IFM which only raises capital for third party issuers.

- Terms and Conditions: In three cases, terms and conditions were imposed on the firm's registration as a result of our reviews. For two of these firms, the terms and conditions included the requirement that the firm retain a compliance monitor. In the case of the other firm, the firm was required to find a replacement manager for the investment fund it managed and was thereafter restricted from conducting registerable activities unless certain conditions were met; the conditions were ultimately not met and the firm has been suspended.

  Staff are also considering recommending that terms and conditions be imposed on two additional firms as a result of our review.

- Undertakings: Undertakings were provided by two firms as a result of our review. In one case, the firm agreed to retain a compliance monitor to assist it in rectifying the deficiencies identified by staff. In the other case, the firm agreed to not perform any registerable activities except as required to wind-up the fund it manages. In addition, interim undertakings were provided by two firms pending surrender (see *Voluntary Cessation of Operations* below).

- Voluntary Cessation of Operations: In two cases, after being advised that we were prepared to recommend regulatory action in the form of terms and conditions (including the requirement to retain a compliance monitor), the firms voluntarily ceased carrying on registerable activities and subsequently surrendered their registrations. These firms provided interim undertakings that limited their activities pending surrender.

- Warning Letters: In four cases, we issued a warning letter to the firm based on our deficiency findings.

- Enhanced Informal Compliance: In one case, the firm retained the services of a compliance consultant upon the recommendation of staff.

- Referrals to Enforcement and Corporate Finance: Based on concerns relating to information uncovered in certain findings, staff referred two matters to the ASC's Enforcement Division and five matters to the ASC's Corporate Finance Division for consideration and possible further investigation.

In the case of three reviews, staff terminated the review prior to completion. Staff recommended suspension of one firm's registration for reasons unrelated to the review; this firm was subsequently suspended. Another firm advised staff mid-review that it was ceasing operations. The registration of this firm was ultimately terminated for failure to comply with regulatory obligations. In the case of the third firm, the firm represented to staff that it would cease operations and subsequently surrendered its registration.

Major Findings

The following discussion outlines the major findings from the Sweep, based on significant deficiency findings. Deficiencies were considered on a case-by-case basis with regard to the

firm's operations and the severity of the deficiency. In determining the significance of a deficiency, we considered a number of factors, including the prevalence and consequences of the deficiency, such as the existence of, or potential for, client harm.

Best Practices: The discussion below also provides guidance to assist firms in meeting their compliance obligations, including suggested practices. Many of the suggested practices are based on observed practices employed by certain firms we reviewed in the Sweep. Staff would like to acknowledge the contributions of these firms to the guidance in this Notice.

1. Compliance System

Pursuant to section 11.1 of NI 31-103, a firm is required to establish, maintain and apply policies and procedures that establish a system of controls and supervision sufficient to provide reasonable assurance that the firm and individuals acting on its behalf comply with securities laws, and to manage risk. As outlined in 31-103CP, elements of an effective compliance system include:

- internal controls designed to assist firms in monitoring compliance with securities laws and in managing business risks;
- monitoring and supervising operations, including taking actions to correct non-compliance or internal control weaknesses; and
- other specific elements, such as: a visible commitment to compliance; sufficient resources and training; detailed policies and procedures; and detailed records of activities conducted to identify compliance deficiencies and the actions taken to correct them.

Issues identified relating to the compliance system in place at the firm include:

- **Inadequate policies and procedures manual**
  In the reviews, many firms had significant deficiencies relating to inadequate P&PMs. Generally, staff found that the P&PM did not accurately reflect the current operations and compliance environment of the firm and had not been updated on a regular basis to reflect regulatory changes. Additionally, staff noted P&PMs that neither clearly articulated to whom responsibilities were assigned, nor how or when tasks were to be performed. As discussed in 31-103CP, a firm should have detailed written policies and procedures that, among other things, identify the controls to be in place to ensure compliance with legislation, manage risk and set standards for compliance conduct. Policies and procedures should also provide systems for monitoring and enforcing compliance and be updated when regulatory requirements and the firm's business practices change.

- **Inadequate performance of chief compliance officer**
  We also identified significant deficiencies where firms and their chief compliance personnel did not comply with securities legislation, demonstrating that many firms do not have an adequate compliance system and resources in place to ensure that they meet all regulatory requirements.

Section 5.2 of NI 31-103 sets out core responsibilities of the CCO, which include establishing and following policies and procedures for assessing compliance by the firm, and individuals acting on its behalf, with securities laws, and preparing and submitting an annual compliance report to the firm's board of directors.

In many reviews, staff identified a substantial number of significant deficiencies that demonstrated that the CCO did not adequately perform his or her responsibilities. In addition, we found that many CCOs did not comply with the annual report requirement.

Of particular concern were instances where the firm failed to implement changes or improvements to its compliance system to rectify findings from previous compliance examinations, after stating to the ASC that certain actions would be taken.

- **Inadequate training or oversight of dealing representatives and business locations**
  In some reviews, we found significant deficiencies where firms had not adequately supervised dealing representatives' (**DRs**) sales activities, conducted adequate business location reviews or ensured that DRs stored confidential client information securely. We also found that a number of firms had provided inadequate training to DRs on product features and risks, conflicts of interest, complaint handling processes and marketing practices. Also, many firms relied on issuer representatives to provide product training directly to the firm's DRs with little or no oversight from the firm.

  A firm is responsible for overseeing the compliance of registered individuals acting on its behalf. Section 1.3 of 31-103CP provides that a firm "*has an ongoing obligation to monitor and supervise its registered individuals in an effective manner,*" and section 11.1 of 31-103CP provides that "*[t]he firm should provide training to ensure that everyone at the firm understands the standards of conduct and their role in the compliance system, including ongoing communication and training on changes in regulatory requirements or the firm's policies and procedures.*"

- **Inadequate books and records**
  In some reviews, significant deficiencies relating to inadequate books and records were identified. We found firms with weaknesses in documenting compliance with internal controls, policies and procedures, KYC and suitability requirements, complaint handling procedures, and compliance and supervision actions taken by the firm.[2]

  Section 11.5 of NI 31-103 requires that firms maintain documentation to accurately record business activities, financial affairs and client transactions, and to demonstrate the extent of the firm's compliance with applicable requirements of securities laws. The importance of documenting compliance actions is paramount; a firm is unable to demonstrate its internal controls and is not compliant with Alberta securities laws without adequate evidence to support actions taken.

[2] Requirements of section 11.5(2)(d)(e)(l)(m) and (o) of NI 31-103.

- **Inadequate complaint handling**
  We also identified significant deficiencies relating to inadequate complaint handling. Generally, staff found that written correspondence to clients did not include the following information required by section 13.16(2) of NI 31-103, which must be provided by the firm to a client following receipt of a client complaint:

  - a description of the firm's obligations under section 13.16 of NI 31-103;
  - the steps that the client must take in order for an independent dispute resolution or mediation service to be made available to the client; and
  - the name of the independent dispute resolution or mediation service that will be made available to the client and contact information for the service.

  Staff recommend that firms take a proactive approach to complaint handling. Firms should consider practices such as reviewing policies and procedures to identify and address weaknesses, reviewing client files to ensure adequate notes are being taken to document client-DR interactions (including potential complaints), diarizing complaint actions to ensure deadlines are not missed and extending the scope of complaint reviews to determine if complaints received are indicative of more pervasive problems. Firms should also ensure that all complaints are documented and addressed, not just complaints relating to possible securities laws violations. A "complaint" is defined as any complaint that "*relates to a trading or advising activity of a registered firm or a representative of the firm.*"[3] Properly documenting complaints will assist firms in managing business risks and identifying potential trends or patterns that, once identified, should be thoroughly investigated.

***Suggested Compliance System Practices** – Firms should consider:*

P&PM:

- Update P&PM -- updating individual sections of their P&PM as changes in securities laws or in the firm's business arise, and dating each section as updates are made.
- Update personnel -- communicating updates to firm personnel in a timely fashion and providing an appropriate level of training to ensure that such individuals understand the firm's policies and procedures, including changes made. Firms should provide regular training sessions (e.g., annually) to ensure that individuals responsible for compliance matters are kept up to date on regulatory developments and understand the firm's policies and procedures.
- P&PM training -- implementing a comprehensive DR onboarding program that includes training in each policy area and proficiency testing prior to new DRs being permitted to conduct registerable activities. Also, firms should provide regular training (e.g., annually) to their personnel.
- Compliance confirmation -- requiring that DRs and other registered individuals periodically (e.g., annually) read the P&PM and confirm in writing that they have read, understood and abided by, and will continue to abide by, the firm's policies and

[3] Section 13.16(1) of NI 31-103.

procedures.

CCO Performance:

- Outside advice -- retaining the services of qualified advisers, such as legal counsel or compliance consultants, to review the P&PM and other documentation and provide compliance guidance to the CCO.
- Newsletters and other communication tools -- circulating electronic newsletters to personnel on a periodic basis (e.g., monthly) discussing topics such as changes to regulations, new policies and procedures, and advice on best practices.

DR and Business Location Oversight:

- Compliance check-ups -- providing questionnaires and interviewing DRs on a periodic basis to ensure DRs understand relevant topics such as compliance, regulations and products. This practice will assist in keeping DRs current with the firm's business and promoting a culture of compliance.
- Keep training records -- maintaining records of training materials, including videos and transcripts of presentations and webinars. In addition to evidencing compliance by the firm with its oversight obligations, this will provide DRs access to these materials after the training session is completed. Firms should also maintain records of their review of all training materials.
- Quizzes -- administering quizzes on product features, risks, conflicts of interest, etc. prior to allowing DRs to market or sell products. Firms should consider requiring a minimum quiz score that demonstrates proficiency prior to a DR being authorized to sell the product.
- Risk-based reviews -- establishing a risk-based schedule for reviewing DRs and their business locations. In preparing the schedule, firms should consider factors indicative of compliance levels and business risks, such as complaints received, completeness and accuracy of client files, volume of sales, marketing activities and use of referral agents.
- Third party resources -- using third party educational resources for DR training. For example, firms should encourage and financially assist DRs to take relevant investment-related courses. Firms are reminded that their compliance obligations include having oversight over information provided to DRs for training purposes by third parties.

Books and Records:

- Secure records -- ensuring that electronic files are encrypted and backed-up on a server in a secure off-site location.
- Centralize -- establishing a centralized books and records system (e.g., requiring DRs and employees to use a server managed by the firm) to avoid books and records being maintained independently from the firm.
- Periodic reviews -- establishing a systematic process to periodically review opportunities to improve the way in which the firm maintains its books and records.
- Internal audits -- conducting regular internal audits to ensure that items such as client files, marketing approvals and anti-money laundering files contain sufficient information to support the firm's and its representatives' compliance activities.

Complaint Handling:

- Review operations -- reviewing the firm's operations and policies and procedures as part of complaint handling (e.g., following receipt of a complaint) to identify and address areas of weakness.
- Review files -- reviewing DR and client files to ensure that accurate and thorough notes of interactions and communications with clients are maintained. Detailed notes will assist the firm in conducting a fair investigation of a client complaint, and will assist the DR in providing his or her version of events in a timely and reliable manner.
- Diarize complaint handling activities -- diarizing actions relating to client complaint handling to ensure that the firm responds in a timely fashion and in compliance with section 13.16 of NI 31-103.
- Extend scope of review -- reviewing the activities of individuals who are subject to complaints beyond the specific complaint matters to determine if the nature of the complaint is pervasive. For example, firms should consider establishing a system to review additional client files and conduct quality assurance calls to clients of DRs subject to a significant number of complaints.

Unacceptable Compliance System Practices *– Firms should not:*

P&PM:

- Inappropriate use of templates -- use template P&PMs that do not reflect the operations and compliance environment of the firm.
- Fail to update -- fail to maintain an up-to-date P&PM that is reflective of regulatory requirements and the firm's operations.

CCO Performance:

- Inadequate resources -- fail to employ adequate compliance resources to enable the CCO to perform required oversight activities. Developments such as increasing the number of DRs, products and business locations are examples of changes that stretch resources and should cause a firm to consider whether its resources are sufficient to ensure compliance with securities laws.
- No annual compliance report -- fail to submit an annual compliance report to the firm's board of directors or equivalent body for the purpose of assessing the firm's compliance with securities laws.

DR and Business Location Oversight:

- Rely on issuer training -- rely on issuer representatives to provide initial and ongoing product training to DRs without oversight by the firm of the materials and other information presented.
- Delegate responsibility -- delegate responsibility for training to DRs. For example, having a policy that makes DRs solely responsible for staying abreast of product features and regulations is not adequate.

Books and Records:

- Lack of oversight -- have little or no oversight over books and records maintained by DRs at business locations outside of the firm's head office. Of particular concern is the

security of confidential materials maintained by DRs such as KYC forms and other client records.

- Lack of records supporting compliance -- have client files that do not contain sufficient KYC and suitability assessment information, or evidence of trade review.
- Delegate responsibility -- delegate to DRs responsibility for processing and submitting final trade documentation to issuers without any, or only minimal, supervision by the firm.

Complaint Handling:

- Fail to document -- fail to document all client complaints, meaning all complaints relating to trading or advising activity of the firm or a representative of the firm. This is not limited to possible violations of securities laws. Recording all client complaints, as defined, will not only assist in meeting the specific complaint handling requirements, but will also assist firms in identifying potential trends or patterns; any trends or patterns identified should be thoroughly investigated.
- Inadequate disclosure -- fail to provide adequate disclosure to clients of dispute resolution services available to them, including not disclosing time limitations and steps that must be taken by the client to use the services.

2. Know Your Client

Firms are gatekeepers of the capital markets and, as set out in section 13.2 of NI 31-103, are required to take reasonable steps to establish the identity of a client and ensure they have sufficient information to meet their suitability obligation, including collecting information on the client's investment needs and objectives, financial circumstances and risk tolerance. The KYC obligation is, like the KYP obligation discussed below, an essential element of a registrant's obligation under section 13.3 of NI 31-103 to ensure that its investment recommendations to clients are suitable (see *Suitability* below).

Inadequate collection of KYC information may result in the firm being unable to demonstrate that it obtained information sufficient to make an appropriate suitability assessment, as required by section 13.3 of NI 31-103.[4] CSA Staff Notice 31-336 *Guidance for Portfolio Managers, Exempt Market Dealers and Other Registrants on the Know-Your-Client, Know-Your-Product and Suitability Obligations* (**CSA Staff Notice 31-336**) and CSA Staff Notice 33-315 *Suitability Obligation and Know Your Product* (**CSA Staff Notice 33-315**) provide further guidance on how a firm can meet its KYC, KYP and suitability obligations under securities laws.

Firms must also ensure adequate information is documented to support a client's reliance on a prospectus exemption to comply with the requirements of National Instrument 45-106 *Prospectus Exemptions* (**NI 45-106**).

KYC-related deficiencies identified include:

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[4] Section 13.3(1) of NI 31-103 requires a registrant to ensure that, before it makes a recommendation to or accepts an instruction from a client to buy or sell a security, the purchase or sale is suitable for the client.

- **Inadequate collection and documentation of KYC information**
  We identified significant deficiencies in the collection and documentation of KYC information in many reviews. In particular, we observed that many firms had not collected adequate KYC information, for example by:

  - using inadequate KYC forms or not collecting all required information (e.g., having incomplete KYC forms where key information was left "blank," see discussion below); and
  - collecting incorrect information within the KYC forms (e.g., joint account information based on only one of the account holders' KYC information).

  Section 13.2(4) of NI 31-103 requires firms to make reasonable efforts to update their clients' KYC information, and section 13.2 of 31-103CP provides that *"[a] dealer that only occasionally recommends trades to a client should ensure that the client's KYC information is up-to-date at the time a proposed trade or recommendation is made*." Also, CSA Staff Notice 31-336 provides that it is expected that EMDs that have an ongoing relationship with their clients will update KYC information at least annually, and more often if there is a material change in the client's circumstances. Without adequate and current KYC information, firms cannot meet their suitability obligation. Where an EMD acts for a client only occasionally, updating KYC at the time of each trade will satisfy the requirement to maintain current KYC for such client.

- **Inadequate KYC forms**
  We also observed significant deficiencies relating to firms that used inadequate KYC forms.

  We identified KYC forms that failed to capture all information required to be collected in order to achieve compliance with section 13.2 of NI 31-103, including the client's investment needs and objectives, financial circumstances (including the use of leverage), risk tolerance, time horizon for the account and investment knowledge (including the joint account holder's investment knowledge in the case of a joint account). We consider the collection of this information to be a reasonable step toward achieving compliance with section 11.5(2)(1) of NI 31-103, meeting the firm's obligation to know its client as required by section 13.2 of NI 31-103 and meeting the firm's suitability obligation under section 13.3 of NI 31-103.

- **Prospectus exemption qualification**
  Significant deficiencies in which a prospectus exemption was improperly relied upon or could not be substantiated were identified in some reviews.

  The most frequently observed deficiency in this area was the inadequate or improper recording or characterization of financial information, including using inflated income or asset amounts or failing to include debt in the calculation of net financial assets, which resulted in clients being improperly considered to "qualify" for the prospectus exemptions relied upon.

Prospectus exemption requirements are set out in NI 45-106; as noted in CSA Staff Notice 31-336, failure to comply with these requirements could constitute an illegal distribution of securities, which is a serious breach of securities laws, and may provide "*an investor with a continuing right of action for rescission or damages against the issuer or dealer for non-delivery of a prospectus.*"

We also observed instances where multiple purchases of related issuer securities were transacted in the amount of $10,000 on the same day, in circumvention of the $10,000 cap applicable to non-eligible investors under section 2.9 of NI 45-106 (in effect prior to April 30, 2016). Cap circumvention is an unacceptable practice and contrary to securities laws. We also remind EMDs that new caps for non-eligible and eligible investors, as set out in section 2.9(2.1)(b) of NI 45-106, have been in effect in Alberta since April 30, 2016.

***Suggested KYC Practices** – Firms should consider:*

KYC Collection:

- Review information with client -- reviewing KYC information with the client after collection to ensure accuracy. We observed firms that performed a preliminary collection of KYC information that was subsequently reviewed with the client prior to completing the trade.
- Date and sign -- ensuring that KYC forms and updates to KYC information are initialled/signed and dated by the client and the firm. By doing this firms can demonstrate when the KYC data was collected as well as the timeliness of review and approval.
- Online searches -- performing an online search of the investor to verify the investor's profession and position, and, in turn, determine (at least at a high level) whether that profession and position corresponds with the income and net financial assets reported in the investor's KYC form and to help identify potential concerns as to whether the investor meets the prospectus exemption requirements.
- Quality assurance calls -- conducting quality assurance calls with a sample of clients prior to processing trades to ensure that: all KYC information is correct; the client qualifies for the prospectus exemption relied upon; the investment is suitable; the client has received RDI and the offering documents; and the client understands the features and risks of the investment.
- Update -- providing clients with a periodic reminder (e.g., in connection with account statements) to update the firm on material changes to personal and financial circumstances.
- Questionnaires -- utilizing questionnaires to assist in the KYC collection process. This may facilitate a meaningful discussion with the client about the client's investment needs and objectives, as well as the client's personal and financial circumstances.

Prospectus Exemption Practices:

- Refer to information collected -- checking the KYC form, or supplemental information form, that collects necessary personal and financial information to substantiate the exemption relied upon.

- Policies and procedures -- having policies and procedures to ensure the prospectus exemption criteria relied upon in the subscription agreement is consistent with the KYC information collected.
- Exempt market holdings -- maintaining a database of client exempt market purchases (including information about purchases made through other dealers) to allow compliance staff to (i) verify that investors have not exceeded the offering memorandum caps, and (ii) assess suitability (see *Suitability* below).
- Meaningful ranges -- collecting financial information in ranges that are not only relevant for suitability assessment purposes, but also assist in determining qualification for prospectus exemptions.

***Unacceptable KYC Practices** – Firms should not:*

KYC Collection:

- Permitted client status -- fail to collect KYC information when the firm has determined that the investor is a permitted client. Firms must collect full KYC information unless the client is a permitted client and has waived in writing the KYC requirements permitted to be waived under section 13.2(6) of NI 31-103. Furthermore, even in cases where a permitted client waiver is appropriately obtained:
    - the firm must have reasonably determined that the client meets the permitted client requirements, and
    - the firm is still required to collect information establishing the client's identity; in staff's view this includes:
        - for individual clients: reviewing valid government-issued photo identification and retaining a copy of the document or recording its details (e.g., number and expiry date);
        - for non-individual clients: conducting public registry searches to establish the legal existence and full legal name of the client and other relevant information, such as the current board of directors for corporate entities; the firm should also obtain documentation evidencing the individual(s) authorized to act on behalf of the client. In addition, the firm must establish the nature of the client's business and the identity of any individual who is the beneficial owner of, or exercises control or direction over, more than 25 per cent of a corporate client's voting securities, or, in the case of a partnership or trust, the identity of any individual who exercises control over the affairs of the client;

      furthermore, if the firm has cause for concern, the firm is required to make reasonable inquiries as to the reputation of the client; and
    - the firm must also establish whether the client is an insider of a reporting issuer or any other issuer whose securities are publicly traded.
- Outdated information -- use outdated KYC information; reasonable steps must be taken to keep KYC information current.
- Financial information ranges -- collect financial information in ranges that are not meaningful. Some firms collected financial information in ranges that did not correspond with prospectus exemptions relied upon in circumstances where information was not otherwise collected to substantiate the availability of a prospectus

exemption. In addition, some firms collected net financial assets information in ranges that were not helpful in assessing client concentration levels in exempt market products (see *Suitability* below).

- Incorrectly categorize assets/liabilities -- categorize client assets or liabilities incorrectly. For example, the potential payout amount of an insurance policy is not an asset for the purposes of determining a client's net financial assets.

Misleading Terminology in KYC Forms:

- Predetermining responses -- include wording in KYC forms that pre-determines or shoehorns risk tolerance for clients. For example, collecting risk tolerance information solely within a range limited to risk levels within the exempt market (e.g., low, medium or high risk tolerances within the exempt market) may pre-empt clients from stating what their actual risk tolerance is. Similarly, having only one category for risk tolerance (e.g., high risk) is not acceptable.
- Inappropriate disclaimers -- include disclaimers in KYC forms that attempt to shift or limit the firm's regulatory obligations; for example, by stating that the client (and not the firm) is responsible for ensuring the client's purchase is suitable.

Prospectus Exemption Practices:

- Rely solely on client representations -- rely solely on a client's representation that they meet the prospectus exemption criteria when there are reasonable grounds to believe the representations may be incorrect. For example, it may be necessary to question a client's future income if the client is approaching retirement and relying on income eligibility criteria under an exemption.
- Non-individual clients -- fail to ensure and document that a client entity meets the prospectus exemption criteria. For example, some firms only collected information for the entity owner(s) where the exemption relied upon was based on the financial status of the entity.

3. Know Your Product

As part of the initial and ongoing proficiency obligations under section 3.4 of NI 31-103, registered individuals, and by extension firms, must understand the structure, features and risks of each security they recommend. The KYP obligation, like the KYC obligation, is an essential element of a registrant's obligation under section 13.3 of NI 31-103 to take reasonable steps to ensure that its investment recommendations are suitable (see *Suitability* below). Section 13.3 of 31-103CP states that "*registrants should have in-depth knowledge of all securities that they buy and sell for, or recommend to, their clients*" and that "*[r]egistrants should know each security well enough to understand and explain to their clients the security's risks, key features, and initial and ongoing costs and fees*."

Failure by firms and DRs to understand the key features of their products may result in incorrect or misleading information being provided to clients in breach of a registrant's obligation under section 75.2 of the *Securities Act* (Alberta) (the **Act)** to deal fairly, honestly and in good faith with its clients. This may also result in a registrant recommending unsuitable trades in breach of the registrant's suitability obligation.

Firms are required to identify and respond to existing and potential material conflicts of interest relating to products they sell, and the KYP process should include a conflict of interest assessment for all products. This process will assist firms in identifying and responding to conflicts of interest as required by section 13.4 of NI 31-103.

A firm must also conduct KYP on an ongoing basis to maintain an understanding of the products on its shelf and keep up with material changes to product features and issuer circumstances. The guidance in CSA Staff Notice 33-315 states that "*[w]e expect firms to have a process for reviewing and approving ... existing products whose structure or features have significantly changed.*" It further states that "*[r]egistrants will also need to re-evaluate an existing product if a change to a key feature causes significant changes to the risk and return profile of the product*."

Moreover, registrants should understand that products on the firm's "approved list" are not automatically suitable for all clients. Firms are required to determine the suitability of each proposed transaction for each client.

In many reviews, we found significant deficiencies where firms had not performed an adequate assessment of the products that were recommended to clients.

For example, staff identified firms that relied on a related or connected issuer's KYP information, but did not engage in, or at least document, sufficient analysis and consideration of the risks of the product. In circumstances where there is common mind and management between the firm and its related issuer, we do not expect firms selling related issuer products to duplicate KYP work done at the issuer level. However, we do expect the firm's KYP to include security or product-level KYP to demonstrate, among other things, an understanding of the security's risks associated with the exempt market. We have observed in a number of reviews that KYP knowledge gathered at the issuer level did not extend to this level of analysis. Furthermore, if DRs involved in the sale of related party products have no direct involvement in the issuer operations or management activities, the firm must be able to demonstrate how KYP information gained at the issuer level has been passed on to its DRs. In addition, some firms relied on third party reports for their product assessment but had no evidence that such reports were adequately and independently reviewed and assessed, such as evidence to support that the assumptions and projections in reports were reasonable. We noted that in many cases the third party reports were produced for the product issuer, which causes additional concerns about the lack of independent review by firms.

Given the high number of firms that failed to conduct an appropriate level of analysis of the products on their shelves, including an adequate review of product risk, we recommend that firms consider the matters listed below when conducting KYP due diligence. Staff acknowledge that the nature and extent of a firm's KYP due diligence obligation, including the relevance and significance of some of KYP matters listed below, will depend on the circumstances, including the nature and complexity of the product, the firm's knowledge of and experience with the product type and the issuer, whether the issuer is new or has an established track record, and other relevant matters. Where there is any uncertainty as to whether a particular avenue of investigation (including any the matters identified below, which is not intended to be an

exhaustive list) may assist in the KYP process, we recommend that firms err in favor of conducting the investigation.

***Matters to Consider When Conducting KYP Due Diligence*:**

- Track Record of the Issuer and People:
  - Review the issuer's performance and history to assess the issuer's track record.
  - Investigate and assess whether the issuer, its principals and promoters have a track record in the business or in related ventures and a good reputation, including through conducting online searches.
  - Conduct background and regulatory checks for key issuer-related individuals, including management.

- Independent Verification:
  - Independently assess offering documents and issuer marketing materials and test for veracity and accuracy. For example, if, as a selling point, an issuer states that its assets are insured, verify the terms of the insurance policy, including scope and deductibles. Also, if an issuer states that its business is focused in a certain industry or industry segment, verify this.
  - Review financial statements and determine if the track record and projections represented by the issuer are reasonable.

- Stress Testing:
  - Consider economic and financial variables that may have an impact on the issuer's performance (e.g., interest rate levels, unemployment rate, commodity prices and exchange rates).
  - Independently assess all key assumptions and projections in offering documents and, if and as applicable, stress test them for a variety of economic and financial scenarios to determine a range of potential returns and losses. In particular, firms should determine the risk of the investment resulting in significant losses to investors.

- Pricing Analysis:
  - Review financial statements, business plans and available forecasts, along with the product's structure, to determine if the security is fairly priced.
  - As part of this review, consider:
    - whether the issuer, or any underlying investment structure, has experienced any losses which are not accurately reflected in pricing; and
    - if the security should be subject to a discount due to lack of voting rights and insiders having control over all decisions relating to the issuer.

- Costs to Investors:
  - Identify fees and commissions applicable to the investment. Firms should identify all embedded costs that may be indirectly borne by investors and determine how such costs affect the overall return of the investment. In particular, firms should identify and assess the effect of payments by the issuer to related parties or any

other non-arm's length transactions that may affect an investor's investment, including whether such payments reflect fair market value for services/products received in return.
- Identify future costs that may be borne by investors; for example, redemption fees and performance fees. Firms should also identify and assess all material features of these fees (e.g., high water marks).

- Conflicts of Interest:
  - Identify existing and potential material conflicts of interest related to the product.
  - Once identified, ensure that all conflicts of interest are appropriately disclosed or otherwise responded to. Conflicts of interest can exist between the issuer and the client (e.g., when management of the issuer has control of all voting shares and the issuer's management also benefits monetarily from the product).
  - Assess the issuer's track record in managing conflicts.
  - Conflicts of interest between the firm and the client (e.g., when the firm receives a trailing commission, has a material ownership position in the issuer, or when the issuer has an ownership position in the firm) should also be identified.
  - See also *Level of Independent Oversight* below.

- Risk Factors:
  - Review offering documents to assess disclosed risk factors.
  - Independently consider the risks of the product, and ensure all additional material risks are identified and taken into account in the KYP process.
  - In particular, identify and consider factors that increase risk, such as:
    - use of blind pools;
    - use of leverage by the issuer;
    - portfolio concentration in a few borrowers (for mortgage and other credit-providing issuers) or investments;
    - high credit risk transactions engaged in by issuers (e.g., unsecured lending and lending that involves high interest rate spreads over risk free bond rates);
    - limited lending underwriting processes (e.g., no review of credit score);
    - unlimited management discretion over use of proceeds or insufficient definition of investment criteria that management must adhere to;
    - lack of (or poor) income/cash flow history;
    - investing in related party securities;
    - underlying investments located in less developed countries; and
    - key person risk (i.e., issuer operations are dependent on one person or a few people).

    Where the issuer has made loans to related parties or otherwise entered into material transactions with related parties, this should be scrutinized to determine if the issuer is making sound decisions within disclosed/expected risk parameters or is acting in the interest of the related party and increasing risk to investors. Also, related party transactions should be assessed to determine if they are being undertaken at reasonable values or at values that are detrimental to investors.

  - Identify if the issuer uses a complex legal structure that reduces the transparency of the product, including flows of funds between related parties. Firms should also review whether the issuer has structured different product tranches with different risk profiles.
  - Consider risk factors relating to the nature of exempt market products, including illiquidity, valuation issues, lack of continuous disclosure and reduced regulatory oversight.
  - Review and assess risk factors relating to the industry and legal and regulatory framework that the issuer operates in, including related economic conditions, as well as pending and other probable future changes.

- Level of Independent Oversight:
  - Identify if the issuer has established independent oversight of its activities or if investors have input (e.g., veto rights) into decision-making, to mitigate conflicts of interest that may exist between management and investors.
  - Look for the use of auditors, independent trustees, independent board members, independent valuation services (e.g., appraisers), independent portfolio and fund managers, and independent review committees.

- Offering Documents:
  - Review the disclosure provided in offering documents to ensure it is accurate, complete and balanced, having regard to other KYP information gathered.
  - Identify material information relating to the issuer and the product that should be disclosed to investors such as costs, performance fees and redemption features and restrictions.

We expect firms to have adequate policies and procedures to ensure an appropriate level of due diligence is conducted to satisfy the KYP requirement, including policies and procedures that require that KYP analysis be documented and that address DR training. DR training is an important element of an adequate KYP process and firms should ensure that product training sessions are robust enough to provide DRs with adequate KYP knowledge of the products they sell; it is paramount that DRs fully understand and are able to clearly explain a product's features and risks to clients. As stated above (see *Compliance System above*) it is not adequate to solely rely on issuer representatives to conduct KYP training.

The reviews identified many firms that did not have adequate policies and procedures for conducting KYP on their products. We observed firms that conducted ad-hoc product reviews, often only using materials provided by issuers, resulting in KYP analysis of varying quality depending on what was provided by the issuer.

CSA Staff Notice 31-336 and CSA Staff Notice 33-315 provide additional guidance relating to the KYP obligation.

***Suggested KYP Practices** – Firms should consider:*

- Policies and procedures -- having policies and procedures that guide the KYP process,

including key criteria used in assessing the investment.

- Documentation -- documenting their analyses and bases for KYP decisions.
- Independent review -- establishing an independent board or a committee to review due diligence materials and approve products or provide recommendations to those ultimately responsible for product approval.
- Background checks -- conducting background checks on issuer principals and key individuals.
- Offering summaries -- creating an offering sheet summarizing the due diligence performed and the merits of the investments as well as key product information, such as investment objective, risk factors and time horizon. This can be used by DRs in the suitability assessment.
- Independent sources -- using independent expert and unbiased third party services as part of the due diligence process. Firms are reminded, however, that they should not blindly rely on third party reports, including independent reports. Firms are required to conduct their own product due diligence and this includes assessing the reasonableness and the strength of information provided in third party reports.
- Monitor changes -- monitoring changes to the issuer's financial and operational status, including amendments to offering documents. This would include monitoring changes in the industry that the issuer operates in that may result in material adverse changes to the issuer.

***Unacceptable KYP Practices** – Firm should not:*

- Risk comparison -- solely assess the risk of products on the firm's shelf against the risk of other exempt market products, or other products on the firm's shelf, and not with the general universe of investment options. The former practice creates a significant risk that investment risk will be miscommunicated to or misunderstood by investors.
- Exempt market product risks -- fail to consider the risks of exempt securities when conducting KYP, such as illiquidity, valuation issues, lack of continuous disclosure and reduced regulatory oversight.
- Not providing an overall risk assessment -- assign risk scores to particular aspects of a product (e.g., liquidity, operating history, credit risk) without providing clear commentary on overall product risk.
- Lack of ongoing KYP -- fail to conduct ongoing KYP due diligence for products on the firm's shelf for a significant timeframe (e.g., through a period of material change at the issuer). Similarly, relying on KYP performed on stale offering documents is not acceptable.
- Over-reliance on third party information -- rely on information provided by an issuer or other third parties without independently analyzing the assumptions and projections provided by the issuer or other third party.
- Selling prior to KYP review -- put a product on the firm's shelf and distribute it prior to the KYP review being completed.

4. Suitability

As required by section 13.3 of NI 31-103, a registrant must take reasonable steps to ensure that, before it makes a recommendation to or accepts an instruction from a client to buy or sell a security, the purchase or sale is suitable for the client.

As provided in section 13.3 of 31-103CP, firms should know their products in order to understand and be able to explain to clients each product's risks, key features, and initial and ongoing costs and fees. Also, firms must be able to determine the suitability of each product for each client on a case-by-case basis. We expect firms to be able to demonstrate suitability for each trade made (except where a suitability exemption exists for the trade; for example, for permitted clients who waive the requirement). To meet this requirement and to comply with compliance system requirements in part 11 of 31-103, firms must have in place an adequate process for determining and evidencing suitability. Also, we expect firms to confirm the eligibility of investors to utilize the prospectus exemption relied upon. CSA Staff Notice 31-336 provides further guidance on how a firm can meet its KYC, KYP and suitability obligations.

Issues identified relating to the suitability of investment recommendations include:

- **Risk tolerances of clients not consistent with the risk of the product**
  The reviews frequently identified investors with low or medium risk tolerances invested in high risk exempt market securities without an adequate explanation of investment suitability.

- **Investment objectives of clients not consistent with the nature of the product**
  We found that many clients invested in exempt market securities having a growth investment objective, notwithstanding that the stated investment objective in the client's KYC form was for "preservation of capital" or "income."

- **Time horizons of clients not consistent with the time horizon of the product**
  The reviews identified clients with short time horizons being invested in long term, illiquid securities.

- **Elderly clients**
  We noted that some firms had not conducted adequate suitability assessments for elderly investors based on the client's financial circumstances, risk tolerance and time horizon. Where applicable based on a firm's client base, staff expect to see policies and procedures that identify issues specific to seniors such as cognitive impairments, and related measures to prevent the registrant from engaging in unfair practices that are in contravention of sections 92(3)(d) and 92(5)(b) of the Act.[5]

[5] Section 92 of the Act – *Prohibited transaction*

- **Other vulnerable clients**
  We also found instances where firms did not adequately consider the suitability of trades for other vulnerable clients, such as individuals with limited investment knowledge, limited income, limited assets or unstable income sources.

- **Failure to identify use of leverage**
  In some reviews, staff identified firms that failed to monitor and assess clients' use of leverage when purchasing exempt market securities. Some firms did not require their clients to disclose whether they were borrowing funds when investing with the firm and the KYC forms did not collect information about use of leverage. This is concerning because EMDs distribute exempt market products that are typically illiquid and generally high risk. The use of leverage in such circumstances may significantly affect the suitability of the investments. Leveraging strategies should be assessed having regard to nature of the product (including liquidity, product objective, e.g., income or growth, and time horizon) and the client's investment knowledge, financial circumstances, risk tolerance and investment objectives. Any negative returns, delays in interest payments or changes in a client's financial circumstances may have serious consequences on an investor's ability to repay a loan.

- **Inadequate assessment of client account concentration levels**
  We found many instances of clients who had invested in various products through the firm; however, over-concentration in exempt market illiquid securities raises concerns even when a client's portfolio is diversified within the exempt market. Diversification is an important factor in assessing suitability, and a lack of diversification, including over-concentration in the exempt market, may expose clients to significant investment risks.

  We found that firms did not always collect or consider information about other high risk or exempt securities that a client may hold outside of products purchased through the firm when assessing the client's concentration levels. We also found instances where financial information was recorded in ranges which did not permit a sufficient assessment of investment concentration risks.

  Additionally, in some instances, concentration levels calculated by the firm did not include investments made through the client's personal holding companies or other related entities. Such additional holdings may increase concentration risk.

  As noted in CSA Staff Notice 31-336, staff have concerns about potential overconcentration in securities of a single issuer or a group of related issuers, and securities that provide exposure to a single industry or asset class. CSA Staff Notice 31-336 further states that "*[m]ost CSA staff will consider investments (either individually or taken together with prior investments) in securities of a single issuer or group of related issuers that represent more than 10% of the investor's net financial assets as potentially raising suitability concerns due to concentration*."

***Suggested Suitability Practices** – Firms should consider:*

- Document suitability -- including a written suitability assessment for each client trade demonstrating how the trade is suitable.
- Second level review -- escalating transactions with "red flags" to the CCO for a second level review. Examples are:
  - transactions with concentration near or over 10 per cent of net financial assets;
  - transactions for clients over 60 years of age or with limited investment knowledge;
  - leveraged transactions; and
  - transactions where the client is close to not qualifying for the prospectus exemption relied upon.
- Elderly clients -- adopting policies and procedures regarding seniors. Firms should consider the following guidance:
  - IIROC – Investment Industry Regulatory Organization of Canada Notice 16-0114 (dated May 31, 2016): *Guidance on compliance and supervisory issues when dealing with senior clients*; and
  - SEC – *Protecting Senior Investors: Compliance, Supervisory and Other Practices Used by Financial Service Firms in Serving Senior Investors – 2010 Addendum* – U.S. Securities and Exchanges Commission's Office of Compliance Inspectors and Examinations, North American Securities Administrators Association, and Financial Industry Regulatory Authority (dated August 12, 2010).
- Other vulnerable clients -- adopting policies and procedures regarding other vulnerable clients (in addition to seniors).
- Investment concentration considerations -- taking into account a client's concentration levels, including concentration in exempt market securities (such as investments in real estate-backed exempt market securities). Acceptable practices include:
  - *Holdings purchased through firm* -- considering client holdings of other exempt securities offered by the firm, and documenting this in the client file, as part of the suitability assessment.
  - *Holdings outside firm* -- collecting and considering information about client holdings of exempt market securities purchased outside the firm.
  - *Other diversification considerations* -- taking into account other diversification considerations. The issue of concentration in exempt market products flows from the importance of investment diversification and how diversification (or lack thereof) affects investment risk and ultimately the suitability of an investment. Therefore, EMDs should also consider, as part of the suitability analysis, other elements of investment concentration, such as the concentration of investments in a particular industry or sector of the economy (e.g., real estate), geographic area or type of product (e.g., income versus growth), and assess this in relation to the client's risk tolerance. Also, as one aspect of exempt market products that gives rise to concentration issues is that they are generally illiquid, it is recommended that if a client has other material financial assets that are also illiquid (e.g., other illiquid securities), this should be taken into account in the suitability analysis.
  - *Discuss concentration risks* -- discussing with clients concentration issues identified and what these mean in terms of risk.

- *Document concentration analysis* -- including and documenting in the suitability assessment evidence that the firm has considered concentration risks.
- *Concentration policies* -- implementing policies and procedures on concentration risk that explain how concentration is to be assessed (e.g., based on net financial assets) and why such method is the most appropriate based on the firm's business model and investor base. While each trade must be assessed for suitability, to streamline the process, firms may consider implementing thresholds whereby any concentration in excess of the thresholds requires further assessment or review by compliance staff.
- *Establish thresholds for certain clients* -- establishing stricter/lower concentration thresholds for clients who require liquidity or have limited ability to withstand losses. For example, seniors, individuals with limited assets or income, and individuals with limited investment knowledge.

***Unacceptable Suitability Practices** – Firms should not:*

- Inadequate review -- approve and process trades for investors who have financial circumstances or objectives that differ from the product being sold (e.g., firms facilitating trades of high risk exempt market securities to clients who have a lower risk tolerance) unless the firm documents a suitability analysis, including all relevant circumstances, that clearly demonstrates the suitability of the trade notwithstanding this discrepancy.
- Sophisticated clients -- rely on a client's sophistication or opinion to determine suitability (except where a suitability exemption is available, such as a permitted client that has waived the suitability requirement).
- Disclosure only -- except where a permitted client waiver has been obtained, rely on disclosure to clients of risk and material information relating to the investment to satisfy the suitability obligation. Staff noted a number of P&PMs that indicated that if the firm determined the client was capable of making an independent investment decision, disclosure of product information to clients satisfied the suitability obligation.
- Timing of suitability assessment -- determine suitability after the trade has been settled and cannot be reversed.
- Investor profile -- fail to adequately consider a client's age (e.g., seniors), financial circumstances (e.g., limited income) and investment knowledge when selling high risk exempt market securities.
- Concentration policies -- fail to incorporate the concentration impact of dividend reinvestment or subsequent transactions.
- Insufficient information for permitted clients' status -- fail to collect adequate information to evidence that the client is a permitted client (e.g., failing to determine that an individual has net financial assets that exceed $5 million).

5. Sales and Marketing Practices

Section 75.2 of the Act requires firms to deal fairly, honestly and in good faith with their clients. In addition, firms are prohibited from making statements (including in marketing materials) about matters that a reasonable investor would consider important in deciding to enter into or

maintain a trading or advising relationship with the firm, if such statements are untrue or omit information that is necessary to prevent the statements from being false or misleading.[6] We have concerns that investors may rely on incorrect or misleading information when deciding whether to do business with firms. Additional guidance related to marketing can be found in CSA Staff Notice 31-325 *Marketing Practices of Portfolio Managers* (**CSA Staff Notice 31-325**).

Issues identified relating to sales and marketing practices include:

- **Unsubstantiated claims, unbalanced or misleading information and inadequate disclosure in marketing materials**
  In many reviews, we found significant deficiencies relating to unsubstantiated claims, unbalanced or misleading information and inadequate disclosure in marketing materials.

  Unsubstantiated or exaggerated claims are statements made by firms in marketing materials without sufficient evidence to verify these claims or adequate support to substantiate these general statements. Staff also identified many firms using marketing materials that did not include an adequate discussion of the risks of investing in the product being marketed. We also noted that firms used marketing materials provided by the issuer that had not been adequately vetted by the firm; these materials often omitted important risk disclosure and were overly promotional.

  Staff also noted unsubstantiated and misleading comparisons between exempt market securities and publicly traded products. For example, we noted misleading claims of exempt products having lower volatility than publicly traded securities; volatility of illiquid securities cannot be meaningfully measured and compared to volatility of publicly traded securities. We also found statements promoting private capital allocation models used by institutional investors (e.g., pension funds), without providing fair and balanced disclosure of the significant differences between retail investors and institutional investors in relation to financial circumstances, knowledge, risk tolerance, time horizon and investment objectives.

  With respect to hypothetical performance information, the reviews frequently identified a lack of supporting documentation and sourcing for third party performance information (e.g., issuer prepared) presented in marketing materials. Firms must maintain source data and information necessary to support the claims made in marketing materials disseminated to clients. Firms should also disclose sufficient information to make these claims understandable to clients.

- **Inadequate marketing policies and procedures**
  Significant deficiencies relating to inadequate marketing policies and procedures were identified in some of the reviews.

  We identified instances where the firm's marketing policies and procedures did not include adequate processes regarding the preparation, review and use of marketing

[6] Section 100(2) of the Act.

materials. These guidelines are necessary to provide adequate control over marketing activities of the firm and its representatives. As provided in section 11.1 of 31-103CP, firms must have detailed policies and procedures in place, and these policies must ensure marketing materials do not misrepresent the firm's services or provide misleading product information.

- **Inadequate oversight of marketing materials**
  We also identified significant deficiencies relating to inadequate oversight of marketing materials.

  Staff frequently identified a lack of evidence of review and approval by compliance staff, such as initialling and dating final marketing materials and changes to content. A firm must maintain records of the preparation, review and approval of marketing materials in order to demonstrate compliance with its policies and procedures and applicable securities laws as required by section 11.5 of NI 31-103.

  Regarding social media, we found that many firms did not have any controls over online marketing activities of DRs. CSA Staff Notice 31-325 provides that supervision of marketing materials "*may include the use of a risk-based approach to determine the extent to which a firm's review of electronic communications is appropriate to meet its supervisory obligations*." A social media policy should address the appropriate use, review, supervision, retention and frequency of retrieval of materials on social media and websites.

- **Inadequate supervision of referral arrangements**
  Significant deficiencies relating to referral arrangements were identified in some reviews.

  Sections 13.7 to 13.11 of NI 31-103 address referral arrangements, including the requirement for a firm to take reasonable steps to satisfy itself that referral agents have the appropriate qualifications to provide the services and, if applicable, are registered to provide those services. We note there may be strong financial incentives for referral agents to promote the firm's products and to act in ways contrary to regulatory requirements. As set out in section 13.6 of 31-103CP, "*firms have a responsibility to monitor and supervise all of their referral arrangements to ensure that they comply with the requirements of NI 31-103 and other applicable securities laws and continue to comply for so long as the arrangement remains in place*." Accordingly, a firm's oversight of referral agents should ensure that the firm's guidelines and securities laws are followed.

Suggested Sales and Marketing Practices *– Firms should consider:*

Oversight of Marketing Materials:

- <u>Monitoring social media</u> -- using service providers to search, capture and archive activities in social media accounts of DRs. Service providers allow firms to select words and phrases that are screened for real-time and flagged for further review, if identified.

- Electronic records -- storing marketing electronically in a firm-operated database; this will assist in monitoring marketing activities.
- Centralized website -- establishing a centralized website that hosts all DR web pages to ensure the firm has control over materials and updates posted.
- Review issuer materials -- independently reviewing all marketing materials prepared by issuers to ensure the firm can substantiate all information contained in the marketing materials, including having back-up information for performance data.

Marketing Policies and Procedures:

- CSA Staff Notice 31-325 -- establishing marketing policies and procedures that adopt the guidance in CSA Staff Notice 31-325.
- Foreign language materials -- creating policies and procedures that ensure that marketing materials in foreign languages are translated independently (e.g., by a non-conflicted third party), and reviewed and approved by compliance staff prior to publication.
- Trade name use -- establishing policies and procedures requiring approval of all trade names prior to use. Such policies and procedures should extend to requiring timely disclosure of trade names to the applicable regulator, and should apply also to outside business activities of DRs.
- Third party service providers -- engaging independent third party service providers to perform performance calculations. As an alternative, some firms obtain independent audits of performance calculations.

Reviewing Marketing Materials:

- Evidence review and approval -- evidencing review and approval of marketing materials by maintaining records of the source material reviewed and changes/comments made as a result of the review. Firms should also initial and date materials reviewed.
- Website review and approval -- evidencing review and approval of websites and social media with screenshots of content and changes made as a result of the review.
- DR access -- controlling access to marketing materials. Some firms control DR access to marketing materials, for example, by requiring the DRs to only use marketing materials retrieved from a central database where the firm maintains all approved marketing materials.

Referral Agents:

- Standardization -- standardizing marketing materials and templates for use by referral agents. Marketing materials used by referral agents should not include any information recommending products, unless the referral agent is registered to provide investment advice or recommend securities.
- Background checks -- conducting background checks on referral agents prior to commencing referral activities.
- Review referrals -- establishing an in-depth review process for referred trades, including performing quality assurance calls to a sample of referred investors to assess the investors' understanding of the investment and of the relationship between the registrant and the referral agent, as well as to ensure that unregistered referral agents

are not performing registerable activities.
- Educate agents -- requiring referral agents to take a course to ensure they understand compliance basics before they are permitted to make referrals.

Unacceptable Sales and Marketing Practices – *Firms should not:*

Claims Made in Marketing Materials:
- Misleading statements -- include misleading or overly promotional claims in marketing materials. For example, blanket claims that exempt market products provide higher returns or lower volatility than publicly traded securities are unacceptable. Similarly, it is unacceptable to compare returns of exempt market securities to returns of publicly traded securities (e.g., mutual funds) without disclosing the costs, commissions and fees applicable to exempt market securities and including them in the return calculations.
- Opinions -- present information based on the opinion of the firm, as a fact.
- Unclear claims -- make claims that are vague, unclear or otherwise not capable of being clearly substantiated. Firms should include sufficient information so that investors can understand and assess claims made.
- Supporting documentation for claims -- make claims without maintaining supporting evidence to substantiate the claims.
- Third party sources -- include information from third parties, such as research or written and oral statements, without adequate disclosure of the source and adequately maintaining source material on file.
- Performance information -- fail to include adequate disclosure of whether performance information is gross or net of fees, or whether performance information is hypothetical or pro forma; as discussed above, firms should disclose sufficient information to make this information understandable to clients, and should retain source data and information necessary to support performance information included in marketing materials. Staff consider it inappropriate to compare hypothetical performance of exempt market securities with actual returns of other securities or benchmarks, except in limited circumstances, as set out in CSA Staff Notice 31-325.
- Name of other registrants -- include the name of other registrants in marketing materials, unless the firm has written authorization to use the name.
- Holding out -- hold out or imply that any securities regulator has endorsed or validated the compliance or activities of the dealer or issuer.

Marketing Policies and Procedures:
- Issuer marketing materials -- permit DRs to provide clients with issuer marketing materials prior to review and approval by the CCO or other compliance staff.
- Performance data -- fail to have adequate policies and procedures for calculating and presenting performance data, including the requirement to maintain documentation to evidence performance calculations.

Reviewing Marketing Materials:
- DRs -- rely on DRs to self-report their marketing activities for review and approval, without any pro-active oversight by the firm.
- Third parties -- fail to have their compliance department review marketing materials

created by third parties such as issuers, including materials such as presentation decks that are presented directly to firm clients.

Referral Agents:

- Delegating -- delegate authority to unregistered referral agents to promote or discuss details about exempt market securities with clients. Similarly, delegating other registerable activities to unregistered referral agents such as collecting KYC information is unacceptable.
- Incentives -- place referral agents under the supervision of DRs or other individuals whose compensation is based on sales volumes.

6. Conflicts of Interest

Section 13.4 of NI 31-103 requires a registered firm to take reasonable steps to identify and respond to existing material conflicts, and material conflicts of interest that the firm, in its reasonable opinion, would expect to arise, between the firm, including each individual acting on the firm's behalf, and a client. As outlined in 31-103CP, a conflict of interest is considered to be any circumstance where the interests of different parties, such as the interests of a client and those of a registrant, are inconsistent or divergent. Registrants are expected to avoid conflicts of interest that pose a high risk of harming a client or the integrity of the markets, while they must mitigate and disclose other conflicts of interest.

The guidance in 31-103CP also describes specific situations where a registrant could be in a conflict of interest position and how to manage the conflict. This guidance discusses the following examples of conflicts of interest that may be present in a registrant's business model:

- relationships with related or connected issuers;
- relationships with other issuers;
- competing interests of clients;
- individuals who serve on a board of directors;
- individuals who have outside business activities; and
- compensation practices.

While we acknowledge that most firms have some mitigating internal controls and policies relating to some existing or potential conflicts of interest, many firms we reviewed were unable to articulate what material conflicts of interest exist within their business model, how those conflicts may affect clients and the services offered to them, and how the conflicts are managed by the firm. Identification, assessment and appropriate response to conflicts of interest are essential elements of a compliance system, and firms are expected to maintain appropriate records of this process, as required by section 11.5 of NI 31-103. Firms must also disclose all material conflicts of interest that a reasonable investor would expect to be informed of, as required by section 13.4(3) of NI 31-103.

In addition, firms registered solely as EMDs that distribute securities of related or connected issuers with common mind and management (captive dealers) should follow the guidance in CSA Staff Notice 31-343 *Conflicts of Interest in Distributing Securities of Related or Connected*

Issuers in regard to acceptable and unacceptable practices for addressing conflicts of interest which arise from their business model.

Issues identified relating to conflicts of interest include:

- **Inadequate identification and response to conflicts of interest**
  In many reviews, we observed significant deficiencies relating to inadequate identification and response to conflicts of interest.

  Staff found that some firms had responded to certain conflicts of interest by disclosing or mitigating them, but had not identified, assessed and responded to all material conflicts within their business model. Often, unidentified conflicts included conflicts of interest associated with compensation arrangements. The guidance in section 13.4 of 31-103CP states that "*[r]egistered firms should consider whether any particular benefits, compensation or remuneration practices are inconsistent with their obligations to clients, especially if the firm relies heavily on commission-based remuneration.*"

  Further, some firms did not identify, assess and respond to material conflicts arising out of their relationship with related or connected issuers, including circumstances where firms were financially dependent upon the success of the related or connected issuer's financings. In some cases, firms gave inappropriate assurances to clients that no conflicts of interest existed. Staff also identified circumstances where conflicts of interest relating to employees' personal ownership in products sold by the firm were not identified and addressed by the firm.

- **Inadequate conflicts of interest policies and procedures**
  In some reviews, we found significant deficiencies relating to inadequate conflicts of interest policies and procedures.

  Policies and procedures related to conflicts of interest provide assurance that the firm has a framework to identify and respond appropriately to its conflicts of interest. Guidance in 31-103CP provides that a firm's policies and procedures should identify conflicts of interest that should be avoided, determine the level of risk that a conflict of interest raises and respond appropriately to conflicts of interest. Also, when responding to a conflict of interest, firms should consider their obligation to deal fairly, honestly and in good faith with their clients and apply consistent criteria to similar types of conflicts of interest.

***Suggested Conflicts of Interest Practices** – Firms should consider:*

Conflicts Identification and Response:

- Product-specific disclosure -- for firms that sell their own products or sell related party products, creating a product-specific disclosure form that discusses conflicts of interest that apply to a particular product (e.g., having product-specific RDI).
- Ongoing review of conflicts -- requiring an individual such as the CCO, or a committee that includes compliance staff, to review conflicts of interest on an ongoing basis (e.g., annually), and requiring that such review be documented and include the

firm's assessment and response to the conflicts identified.

- Disclosure acknowledgement -- disclosing conflicts of interest in an acknowledgement form that clients are required to review and sign prior to purchasing any product.

Conflicts Policies and Procedures*:*

- Log conflicts -- implementing an organized method, such as the use of a log, to record and track all existing and potential material conflicts of interest along with the firm's response to these conflicts. Similarly, firms should establish a practice that requires the CCO or another qualified individual to update this document on an ongoing basis. This process should include a review of conflicts of interest arising from the firm's activities and products sold, and from the activities of registered individuals.
- Update disclosure of conflicts -- establishing a requirement for individuals acting on behalf of the firm to update and report their conflicts of interest to the firm on a periodic basis (e.g., annually), including a requirement to report new outside business activities and personal investments.
- Independent review -- establishing a system to independently review DR activities to identify existing and potential conflicts of interest between DRs and clients. Potential areas of review include social media, marketing activities, outside business activities and personal investing.
- Training -- conducting regular DR training on conflict of interest identification and disclosure.
- Compliance personnel contact with clients -- having the CCO or other compliance personnel discuss directly with each client, whether in person or over the phone, all material conflicts of interest to ensure the client understands the firm's conflicts prior to commencing trading activity. Such contact with clients can be also used to ensure other compliance requirements are being met.

***Unacceptable Conflicts of Interest Practices** – Firms should not:*

Conflicts Identification and Response:

- High level only disclosure -- provide high level disclosure of conflicts of interest without an adequate explanation of the extent of the conflict and how it affects the client.
- Lack of documentation -- fail to maintain documentation of the firm's review and response to all conflicts of interest identified.
- Reliance on issuer -- rely on the conflict of interest disclosure provided by the issuer in offering documents. This is inadequate because conflicts of interest applicable to registrants will differ from conflicts of interest applicable to issuers.
- Disclose only on demand -- only provide disclosure when requested. Certain firms reviewed stated that they only disclosed conflicts of interest when asked by the client. This is an unacceptable practice. Firms must proactively disclose conflicts of interest to clients.

Conflicts Policies and Procedures:

- Lack of policies -- have P&PMs that lack policies and procedures for identifying, assessing and responding to conflicts of interest.

- Over-rely on documentation -- rely solely on disclosing conflicts of interest in RDI or other documentation. DRs should discuss conflicts with clients in addition to providing written disclosure; there should be documented policies and procedures regarding this practice.

7. Relationship Disclosure Information

Section 14.2(1) of NI 31-103 requires a registered firm to deliver to a client all information that a reasonable investor would consider important about the client's relationship with the registrant. In addition, section 14.2(2) of NI 31-103 requires specific information to be delivered to a client.

Significant deficiencies relating to relationship disclosure information were identified in many of the reviews. The deficiencies noted included firms that failed to deliver an RDI document, firms that delivered inadequate RDI and firms that had inadequate RDI policies and procedures.

Section 14.2(3) of NI 31-103 requires a firm to deliver relationship disclosure information in writing before the firm first purchases or sells a security for the client, or first advises the client to purchase, sell or hold a security.

In the reviews, staff found firms using RDI that had not been updated to comply with regulatory amendments or reflect other significant changes, as required by section 14.2(4) of NI 31-103. In addition, given the deficiencies noted above relating to the identification and response to conflicts of interest, many firms had RDI that did not adequately disclose conflicts of interest. As provided in section 13.4 of 31-103CP, disclosure of conflicts of interest should "*be prominent, specific, clear and meaningful to the client*" and "*explain the conflict of interest and how it could affect the service the client is being offered … .*"

As also stated in 31-103CP, firms should not provide generic disclosure, give partial disclosure that may be misleading or obscure conflicts of interest in other disclosure.

In many reviews it was noted that the firm's RDI document either did not disclose all of the elements required to be disclosed under section 14.2(2) of NI 31-103 or failed to adequately disclose certain of these elements, including: a description of the products and services offered; investment risks (including leveraging risk); disclosure of conflicts of interest (as noted above); the operating and transaction charges a client might be required to pay; a general description of compensation paid to the firm; a description of the content and frequency of reporting, including that a client may request monthly statement delivery; disclosure of the firm's obligations relating to client complaints, including the requirement to provide information about the dispute resolution service; and the suitability and KYC obligations of the firm.

Our reviews also identified instances when investors were not given clear and meaningful disclosure of the compensation paid to the EMD by the issuer. In particular, we noted that exempt market product sales commissions are frequently paid to the firm as a direct result of the client's investment, and this fact was not adequately disclosed to investors. Section 14.2(2)(h) of NI 31-103 requires firms to provide "*a general description of any compensation paid to the registered firm by any other party in relation to the different types of products that a client may*

purchase through the registered firm." Further, CSA Staff Notice 31-334 *CSA Review of Relationship Disclosure Practices* (**CSA Staff Notice 31-334**) states that: "*it is important for both EMDs and PMs to provide clear and meaningful disclosure about the compensation that they receive from any other parties*."

Also, certain firms' P&PMs did not provide procedures and controls relating to the firm's RDI obligations. We found that the RDI policies were limited to repeating information prescribed by section 14.2 of NI 31-103 and were not tailored to the firm's operations to ensure adequate disclosure of relationship information content to clients, including conflicts of interest and compensation as discussed above.

We also found many firms that did not have an adequate process for documenting and evidencing their delivery of RDI to clients.

Suggested RDI Practices *– Firms should consider:*

Providing RDI:

- Acknowledge receipt -- including a field in the KYC form for the client to acknowledge that they have received the RDI document.
- Read and understood -- including fields in the RDI document for the client to acknowledge that each section has been discussed with the DR and is understood.
- Disclosure of fees -- disclosing all fees payable by the client relating to custody (e.g., custodian fees for RRSP and TFSA accounts).
- Providing RDI in a single document -- combining RDI in one document. Although required disclosures may be made through various documents, combining this information in one document makes review, update and dissemination of the RDI information easier for the firm. Where a firm has elected to provide product-specific RDI (see *Conflicts of Interest* above), this would mean combining all RDI relating to a product in a single document for such product.
- Quality assurance calls -- using quality assurance calls to ensure clients have received and understood RDI.
- Plain language -- drafting RDI using simple language and clear and comprehensive disclosure tailored to the firm's operations. Firms should avoid RDI that is too high level, boilerplate, overly complicated or unclear.

RDI Policies and Procedures:

- Ongoing review of RDI -- establishing policies and procedures that require that RDI be reviewed on an ongoing basis and kept up to date to reflect current regulatory requirements and the firm's operations.
- Timely delivery -- implementing policies and procedures for timely delivery of RDI.

Unacceptable RDI Practices – *Firms should not:*

Failing to Provide Adequate RDI:

- Permitted client exception -- fail to provide RDI to permitted clients who are individuals. Only non-individual permitted clients are exempt from RDI requirements.

- RDI updates -- fail to provide updated RDI to clients when there has been a significant change in regulatory requirements or other information that must be disclosed.
- Misleading comments -- for firms compensated through sales commissions paid by the issuer, state in the RDI document that clients do not pay any fees; this may be misleading unless it is also clearly disclosed that the firm is compensated directly by the issuer as a result of the sale. Also, if the firm acts as PM or IFM for the issuer and receives management fees, this should be clearly disclosed as well.
- Non-standard RDI -- provide clients with non-standard RDI created by DRs but not reviewed and approved by the firm.
- Unclear RDI -- provide unclear disclosure, or disclosure such that clients cannot easily access or discover the information (e.g., confusing references to various offering documents for explanation).
- Risks and conflicts -- fail to include all relevant risks and conflicts of interest in RDI.
- Inappropriate disclaimers -- include disclaimers in RDI that attempt to shift or limit the firm's regulatory requirements, or that attempt to limit the firm's liability to the client.

RDI Policies and Procedures:

- No policies or procedures -- fail to have policies and procedures regarding how the RDI document must be prepared and updated by the firm, including who is responsible for this.

8. Reporting to Clients

Section 14.12 of NI 31-103 requires delivery of trade confirmations where a registered dealer has acted on behalf of a client in connection with a purchase or sale of a security; sections 14.14 and 14.14.1 of NI 31-103 set out requirements relating to delivery of client account statements.

Issues identified relating to trade confirmations and client account statements include:

- **Failure to deliver trade confirmations/Inadequate trade confirmations**
  The Sweep found instances where firms failed to provide trade confirmations to clients. We also identified instances where the trade confirmations provided did not include all information required by section 14.12 of NI 31-103. ASC Staff Notice 33-704 *Review of Exempt Market Dealers* recommends that firms "*provide clients with a single page trade confirmation summary which includes all required information.*"

  We also found that some firms did not provide separate trade confirmations to clients, but instead relied on a completed subscription agreement, a copy of which was delivered at the time of signing, to meet the trade confirmation requirements. Confirmation of a trade cannot be provided prior to it taking place and subscription agreements usually do not contain all information required by section 14.12 of NI 31-103, such as the settlement date or whether the registered dealer acted as principal or agent.

  We also observed instances of firms relying on client account statements to satisfy the trade confirmation requirement. This resulted in trade confirmations being provided on a

quarterly basis, which does not meet the requirement to promptly deliver this information to clients.

- **Failure to deliver client statements/Inadequate client statements**

Sections 14.14 and 14.14.1 of NI 31-103 address delivery, timing and content of client statements. The applicable requirements of these provisions will depend on certain factors, such as the firm's relationship with its clients, the manner in which the firm receives compensation in relation to the product sold and whether the firm holds client securities. We encourage registrants to review the guidance regarding this matter in CSA Staff Notice 31-345 *Cost Disclosure, Performance Reporting and Client Statements – Frequently Asked Questions and Additional Guidance.*

During the Sweep, we found many instances of firms that did not include all required information in their client statements or that did not provide quarterly or monthly statements, only annual statements. Some firms also included erroneous or misleading information in client statements, in particular regarding the valuation and performance of securities. It is not acceptable to include an inaccurate valuation of securities (e.g., which does not consider impairments or losses) or projected performance information (e.g., projections of quarterly returns shown as annual returns) in client statements without adequate disclosures.

We also saw instances of firms that relied on issuer or custodian issued statements without any oversight by the firm, which is not an acceptable practice.

Suggested Client Reporting Practices *– Firms should consider:*

- Outsourcing arrangements -- using a third party to produce trade confirmations or client statements (under the terms of an outsourcing agreement that clearly sets out the responsibilities of both parties) and conducting adequate oversight over the third party's activities.
- Policies and procedures -- implementing policies and procedures to ensure timely delivery of trade confirmations and client statements.
- Acknowledging receipt -- establishing a requirement for the client to acknowledge receipt of trade confirmations and client statements (e.g., by obtaining an electronic notice of delivery).
- Back office system -- using a back office system that automatically generates trade confirmation slips following transaction activity.
- Committed capital/cash call disclosure -- for investments subject to cash calls (e.g., private equity or progress draw mortgages), providing clients with clear disclosure of committed capital and the remaining amount of capital to be called.

Unacceptable Client Reporting Practices *– Firms should not:*

- Subscription agreement in lieu of trade confirmation -- provide a copy of the subscription agreement in lieu of a trade confirmation without accompanying additional information that meets the trade confirmation requirements, including the

timing requirement.

- Rely on issuer -- rely on trade confirmations and client statements provided by an issuer or custodian with no oversight by the firm.
- Timing -- fail to provide trade confirmations and client statements on a timely basis; for example, providing account statements only on an annual basis is unacceptable.
- Monthly account statements -- fail to provide clients with the option of receiving monthly statements.
- Inaccurate/misleading information -- include inaccurate or misleading information about a security's value and investment performance in trade confirmations or client statements.

9. Other Compliance Issues

While conducting the Sweep, staff also found deficiencies in other areas, including the following.

- **Inadequate supervision of outside business activities (OBAs)**
  The reviews identified that a number of firms did not adequately supervise the OBAs of their registered individuals. Instead, some firms relied on the individuals to self-report their activities without performing independent verification of this information. Common OBAs include: financial planning; mortgage brokerage; insurance sales; and holding director, officer, or equivalent positions in other companies, as well as positions of influence (including paid and unpaid influential roles with charitable, social, political or religious organizations). Firms are required to notify the ASC of all OBAs, irrespective of whether individuals are compensated for the OBA.

  OBAs can create conflicts of interest between the firm, including its registered individuals, and its clients because of the compensation individuals receive for these activities or because of the nature of the relationship between the individual and the outside entity. OBAs can also create client confusion as to what capacity an individual registrant is acting in when providing advice or services to a client, and correspondingly give rise to misled client expectations. Therefore, staff expect firms to act in accordance with section 13.4 of NI 31-103 and consider the guidance in section 13.4 of 31-103CP when evaluating and approving these activities. Section 13.4 of 31-103CP provides that firms are responsible for monitoring and supervising individuals whose registration they sponsor. We suggest that firms perform periodic (e.g., monthly) internet searches for known and undisclosed OBAs and retain evidence (e.g., screenshots) of searches and results.

  Firms should have appropriate policies and procedures to deal with OBAs, including ensuring that OBAs do not involve activities inconsistent with securities laws or interfere with the registered individual's ability to remain current on securities laws and product information. The firm's policies should require each registered individual to disclose to the firm, and the firm to review, any OBA prior to the individual engaging in the OBA. Requiring DRs to periodically provide the firm with a list of their current OBAs is a suggested practice that would assist firms in monitoring and supervising individuals.

Additionally, we remind firms that they must follow applicable securities laws when using or permitting the use of trade names. As set out in CSA Staff Notice 31-325, where a firm uses a business or trade name, the firm is required to notify the ASC of its use and must register the name under applicable law. Firms and registered individuals should also not use trade names that are misleading (see *Sales and Marketing Practices* above). In addition, section 100 of the Act prohibits firms and individuals from making false representations about their registration; for example, a DR stating or implying that their trade name or OBA is a registrant.

- **Inadequate reporting and updating of registration information on National Registration Database (NRD)**
  As noted above, we found a significant number of deficiencies related to inadequate or non-disclosure of the OBAs of registered individuals.

  We also encountered firms that made significant changes to their business model after registration without informing the ASC of these changes. We expect all firms to file business model change information by filing a Form 33-109F5 – *Change of Registration Information*. Registrants should assess their business models on an ongoing basis to ensure compliance with their filing obligations.

  In addition, we found that certain firms had not maintained up-to-date information on NRD for their business locations, such as the business location active/inactive status or address. We suggest that firms implement procedures to ensure registered individuals provide periodic business location updates. Firms should also frequently conduct searches for business location information to assist in ensuring that firm records are current.

  Firms are also reminded of the requirement under section 11.9 of NI 31-103 to notify securities regulators prior to acquiring direct or indirect ownership of 10 per cent or more of the voting securities (or securities convertible into voting securities) of another firm or a parent company of another firm, and the requirement under section 11.10 of NI 31-103 to notify securities regulators as soon as possible if the firm knows, or has reason to believe, that any person or company (including in combination with others) is about to acquire or has acquired, directly or indirectly, ownership of 10 per cent or more of the voting securities (or securities convertible into voting securities) of the firm or a parent company of the firm. All such ownership changes are subject to approval by applicable securities regulators.

- **Non-registrants performing registerable activities**
  Section 75 of the Act provides that no person or company shall act as a dealer (which includes an EMD), adviser (PM or RPM), or an IFM unless registered to do so in accordance with securities laws. Section 75 of the Act also provides that no individual shall, directly or indirectly, perform registerable activities on behalf of a person or company required to be registered unless such individual is registered in accordance with securities laws. Staff have noted situations where registerable activities were being performed by non-registered individuals, such as KYC collection and suitability assessments. Also, delegating certain aspects of product discussions with clients to unregistered individuals is an unacceptable practice even if a registered individual has performed a preliminary suitability assessment.

In addition, we found instances where investment decisions for investment funds were not being made by the registered advising representative of the PM/RPM, but by non-registrants. Any person in the business of making securities investment decisions on behalf of another is subject to the adviser registration requirement under securities laws.

Similarly, certain firms permitted unregistered individuals to participate in investment committees responsible for making investment decisions on behalf of a managed portfolio or investment fund. When using the advisory services of experts as part of the portfolio management due diligence process, firms must ensure that only registered individuals have the final decision-making authority for investment decisions.

- **Issues related to the allocation of investment opportunities among clients**
  Staff found that some PM (and RPM) registrants did not have policies to ensure fairness in allocating investment opportunities among clients as required by section 14.10 of NI 31-103. PMs must also ensure that they provide clear disclosure to clients in respect to the firm's investment allocation policies. Additionally, PMs that allow related parties to invest in their funds alongside investors must document how arm's length clients were provided with fair allocation of the opportunities.

  We also reviewed EMDs that did not have policies to manage competing interests of clients as provided in section 13.4 of 31-103CP. For example, we reviewed certain firms that provided priority investment opportunity access to related parties and other non-arm's length investors without disclosing this conflict of interest to their clients.

  Additionally, staff found allocation policies that appeared to allow an inequitable allocation of opportunities in circumstances where multiple investment funds managed by a PM (or RPM)/IFM were not managed independently of one another, with allocations being made based on relative yields, prior fund returns, cash flow requirements and other circumstances of the investment funds, or without considering all accounts under management when allocating investments.

- **Inadequate performance of portfolio management activities**
  A number of the EMDs we reviewed also conducted PM activities. We identified instances where firms either failed to document, or inadequately documented, the performance of their PM duties. For example, some of the firms reviewed did not maintain adequate documentation to support their investment recommendations and ongoing monitoring of investments in fund portfolios as required by section 11.5(1)(b) of NI 31-103.

  CSA Staff Notice 31-336 provides that "*failure to document the KYC, KYP, and suitability process also significantly raises the risk of adverse legal and regulatory consequences to the registrant in the event a client's investment ultimately proves to be unsuitable*."

  In addition, certain firms did not fully disclose their related funds' investment management criteria to clients, only disclosing limited facts or aspirational goals and leaving the actual investment guidelines buried in an internal management agreement between the firm and the fund. For example, if the PM has unconstrained and full discretionary authority, this should

be clearly disclosed to the client. Similar requirements apply to firms that sell third party products; firms should ensure that the issuer's investment criteria are clearly and accurately disclosed and in conformance with the issuer's investment practices.

We also identified P&PMs that did not adequately govern how firms performed their portfolio management activities. On the other hand, we did observe some best practices employed by firms, such as: creating scorecards to evaluate the performance of investment decisions or strategies adopted by the firm in quantitative and qualitative terms; maintaining files containing detailed due diligence supporting each investment recommendation or decision made; and establishing compliance trading controls that alert compliance staff when certain trades take place (e.g., trade in an illiquid security) or when a concentration threshold is exceeded (e.g, when a trade results in a security representing over 5 per cent of a portfolio).

- **Inadequate internal controls concerning the calculation and disclosure of net asset value (NAV) and management/performance fees**
  Staff found in some reviews that IFMs did not have adequate policies and procedures related to the NAV calculation for investment funds they managed. For example, policies did not include adequate processes for calculating and verifying the realizable value of assets, such as exempt market securities and impaired assets. Some firms also had inadequate controls with respect to disclosure of NAV to investors. If NAV is not adequately calculated, it may result in new investors unknowingly acquiring shares at inflated prices, or non-redeeming investors subsidizing redeeming investors who receive redemption proceeds exceeding the value of their securities.

  We also noted instances where the firm's P&PM did not include guidelines for the calculation, review and approval of performance fees that may be charged to investors on a periodic basis if their account outperforms its benchmark. Firms should establish controls relating to the calculation of performance fees such as an error correction policy, segregation of duties procedures and independent audit procedures. In addition, we note that the calculation of performance figures presents a potential conflict of interest between the firm and its clients that must be considered by the firm when creating its policies and procedures, given that the firm has financial incentives to collect higher performance fees.

  Further, CSA Staff Notice 31-334 outlines that "*PMs should provide clients with a clear description, and calculation method where applicable, of any fees that the PM charges*."

  Finally, we note that we observed some best practices in this area, such as firms that:

  - used a third party independent service provider to calculate NAV and, by extension, performance fees;
  - adopted International Financial Reporting Standards 13 for the fair value measurement of illiquid securities; and
  - established a requirement for an auditor to independently review performance fees if they exceed a certain threshold (e.g., $500,000).

- **Restricted transactions in investment funds**
  During the Sweep, we found instances of PM/RPM firms that had executed trades between funds or accounts they managed. Such trades involve conflicts of interest between the funds or accounts and are particularly concerning where securities may be impaired or are illiquid and cannot be accurately valued by referencing an independent source of pricing data.

  Section 13.5(2) of NI 31-103 prohibits a PM/RPM from causing an investment fund or any other managed account, for which it acts as an adviser, to trade securities from or to another investment fund managed by it. Section 13.5 of 31-103CP states that "*[s]ection 13.5 [of NI 31-103] prohibits a registered adviser from engaging in certain transactions in investment portfolios it manages for clients on a discretionary basis where the relationship may give rise to a conflict of interest or a perceived conflict of interest.*"

Questions

Please contact the ASC Registrant Oversight team if you have any questions.

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