Dr. Seuss Edition

We're celebrating Dr. Seuss's March 2 birthday at AUM Law a little early. We've taken to heart his exhortation to "Think left and think right and think low and think high", so that we can help our clients stay on top of regulatory trends and spot compliance issues before they become problems.

In this bulletin:

1. FINTRAC Publishes Guidance on Its Approach to Compliance, Exams and Enforcement
2. Reports of Exempt Distribution Involving Fully Managed Accounts Just Got a Bit More Complicated
3. Reminder: IFRS 16 *Leases* May Affect Your Excess Working Capital Calculations
4. Don't Drop the Ball on Fund Amendments
5. One Bit. Two Bits. Three Bits. Pop! No Prospectus Receipt for a Bitcoin Fund
6. CSA Plans to Harmonize and Refine Start-up Crowdfunding Exemption

In Brief: FINTRAC Staff Comments at OSC Seminar Trigger "Thinking and Wondering" about Registrants' Obligations to Update Client ID Documents ▪ SEC Proposes to Expand "Test-the-Waters" Reform to All Issuers

1. FINTRAC Publishes Guidance on Its Approach to Compliance, Exams and Enforcement

Many people celebrate Dr. Seuss's birthday by reading aloud. At AUM Law, we've been reading FINTRAC's new Assessment Manual (Manual) and its revised Administrative Monetary Penalties (AMPs) Policy, which were published earlier this month along with several other policy documents. FINTRAC intends these documents to provide more transparency and guidance to firms regarding its approach to compliance, examinations, and enforcement.

The Assessment Manual includes practical information on all aspects of the examination process, including how FINTRAC plans and defines the scope of exams, notifies firms of a planned on-site or desktop exam, conducts the exam itself, and develops and communicates its conclusions. Of particular interest, we noted the following:

- **Prepare to be second-guessed on your suspicious transaction report (STR) decisions:** STRs are critical to FINTRAC's financial intelligence function and, therefore, firms can expect FINTRAC staff to review the merits of specific STR filing decisions as well as the effectiveness of a firm's STR processes as a whole. This means that firms should have adequate documentation for specific decisions (including decisions not to file an STR) and be prepared for FINTRAC staff to show little or no deference to the firm's judgment. Keep in mind that FINTRAC staff may know more than you do (*i.e.*, that a custodian filed an STR in a situation where your firm didn't). Find out more about FINTRAC's STR regime in the article we published in last month's bulletin.

In Brief

FINTRAC Staff Comments at OSC Seminar Trigger "Thinking and Wondering" about Registrants' Obligations to Update Client ID Documents

Earlier this month, the Ontario Securities Commission (OSC) hosted a seminar where a FINTRAC staff member discussed registrants' compliance obligations under the Proceeds of Crime (Money Laundering) and Terrorist Financing Act (PCMLTFA). His presentation swerved, however, when he answered a question about what a registrant should do when the document used for identification purposes at the time of account opening expires. He said that if the identification document expired after the identification was made, the firm must gather a current, valid form of identification from the client before completing any further transactions with the client.

This response surprised many members of the audience and led to further questions during the session. After the seminar ended, the OSC and FINTRAC followed up to let seminar participants know that FINTRAC intends to clarify the responses that had been provided to certain questions during the seminar and that it will share these clarifications with all attendees. We are waiting to receive these clarifications and will keep you updated.

- **FINTRAC probably will second-guess your risk assessments, too:** Registrants are required to carry out and document risk assessments of their business-based and relationship-based risks. Expect FINTRAC to verify whether you have adequately assessed the relevant risks, documented your assessment, and implemented controls and a compliance program that are consistent with your risk assessment.
- **Clean up ASAP after voluntary self-disclosures:** FINTRAC has published a notice that encourages firms to voluntarily report non-compliance with the Proceeds of Crime (Money Laundering) and Terrorist Financing Act (PCMLTFA) and describes how and what firms should report. The Manual also indicates that as part of an exam, FINTRAC staff will review a firm's past, voluntary self-disclosures to confirm that the firm has rectified any issues as soon as it is reasonably possible to do so.
- **Use public information from credible sources in your compliance program:** FINTRAC will review how a firm uses publicly available data to inform its compliance program, including as part of its risk assessment, monitoring and STR processes. Expect FINTRAC to examine whether you have taken reasonable steps when you discover something of interest about a client and inquire about your reasons if you do not act on relevant, publicly available information. According to FINTRAC, publicly available information includes news releases from industry regulators, police and other law enforcement agencies, mainstream media and "other credible sources". FINTRAC hasn't defined "other credible sources" and so we will have to wait and see whether this means, for example, that FINTRAC expects firms to use sources such as Facebook or LinkedIn to research their clients. Depending on the types of information that FINTRAC expects firms to collect and retain about their clients, privacy law considerations may arise.
- **Your employees and agents should be prepared for pop quizzes:** FINTRAC will look for documentation about who receives training, which topics are covered, when and how often training takes place, and how training is delivered. Be prepared for FINTRAC staff to interview employees (including your chief compliance officer) and agents to confirm that they understand the law's requirements relative to their responsibilities, follow the policies and procedures, and have received adequate training.

FINTRAC Ready to Issue AMPs Again: FINTRAC revised its AMPs Policy to address findings in several cases a few years ago that its penalty decisions did not adequately explain how it calculated the AMPs it had imposed. For three years (running from the date of those cases until the publication of the revised AMPs Policy), FINTRAC did not issue any AMPs. Now that its approach to determining and imposing AMPs has been published, firms can expect FINTRAC to levy penalties when warranted.

Please contact us if you would like to discuss FINTRAC's new guidance or any other matter relating to your obligations under the PCMLTFA. We can help you review and update your compliance program, advise you on business-based

and relationship-based risk assessments, organize and deliver training for your employees and agents, help you prepare for a FINTRAC compliance exam before it is announced, and/or advise you during an exam. We also can assist you in circumstances where a voluntary self-declaration of non-compliance is being contemplated and/or assist you in developing a rectification plan.

2. Reports of Exempt Distribution Involving Fully Managed Accounts Just Got a Bit More Complicated

Reliance on many of the exemptions in National Instrument 45-106 *Prospectus Exemptions* (NI 45-106) requires issuers (or their underwriters) to file a Report of Exempt Distribution on Form 45-106F1 (Report) and pay fees in each Canadian jurisdiction where a distribution to residents occurred. Information about purchasers must be included in the Report and, for most purposes, "purchaser" means the beneficial owner of the securities.

Since 2016, however, NI 45-106 has deemed that in connection with a distribution made in reliance upon the accredited investor (AI) exemption, a trust corporation, trust company or registered adviser (collectively, the Adviser) purchasing securities on behalf of a fully managed account is considered to be purchasing the securities as principal. As a result, in all jurisdictions the Report only requires issuers (or their underwriters) to provide information about the Adviser, not the beneficial owners of the securities. To our knowledge, market participants have understood these provisions to mean that the Report needs to be filed and fees paid only in the jurisdiction of the Adviser.

Earlier this month, however, the Canadian Securities Administrators (CSA) published Staff Notice 43-325 (Notice) indicating that the regulators are, in effect, taking two (and a half) different approaches to where Reports need to be filed and fees paid:

(1) Group 1 – Manitoba and Québec: If the exempt distribution has a connection to either province (such as beneficial owners of fully managed accounts), issuers and registrants should consider carefully whether a Report must be filed and fees paid in those provinces. The fees payable for filing a Report in Québec may be significant, since they are calculated based on the gross value of the securities distributed in that province.

(2) Group 2 – Almost Everybody Else: The regulators in all the other provinces and territories (except Saskatchewan) have indicated that the Report needs to be filed and fees paid based on the location of the Adviser.

(1/2) Saskatchewan: The regulator in Saskatchewan has granted blanket, exemptive relief so that the outcome (at least for now) is the same as Group 2.

AUM Law can help you navigate the regulatory framework for exempt distributions. Please contact us if you would like to discuss the implications for this Notice for your business. We can advise you about whether and where Reports need to be filed and fees paid, as well as help you with the filings themselves.

In brief cont'd

SEC Proposes to Expand "Test-the-Waters" Reform to All Issuers

In 2012, the U.S. Securities Act of 1933 (Securities Act) was amended to permit emerging growth companies (EGCs) and people acting on their behalf to engage in "test-the-waters" communications with potential investors that are qualified institutional buyers (QIBs) or institutional accredited investors (IAIs) before or after filing a registration statement to gauge such investors' interest in a contemplated securities offering. On February 19, the U.S. Securities and Exchange Commission (SEC) proposed rules that, if adopted, will permit all issuers, including investment companies, to engage in this type of test-the-waters communication. The amendments are intended to give issuers more flexibility regarding their communications with institutional investors about public securities offerings and enable them to evaluate market interest before incurring the costs of such an offering. The comment period closes on April 29.

The Canadian Securities Administrators (CSA) already permit issuers of any size to engage in some test-the-waters communications in connection with initial public offerings (IPOs), but reporting issuers are subject to greater restrictions. We expect that the CSA will monitor this SEC initiative as part of their ongoing project to reduce

In brief cont'd

regulatory burdens for reporting issuers. They noted in their April 2017 Consultation Paper that they are considering whether to further liberalize the pre-marketing and marketing regime for capital-raising. AUM Law will keep an eye on these regulatory developments north and south of the border and keep you updated.

3. Reminder: IFRS 16 *Leases* May Affect Your Excess Working Capital Calculations

Like Dr. Seuss, registered firms that lease property might be wondering how it got "late so soon." IFRS 16 *Leases* (IFRS 16), which was adopted in January 2016, has come into effect for reporting periods beginning on or after January 1, 2019. This standard is intended to increase transparency in accounting practices by moving nearly all leases onto the balance sheet. For registrants, this may have implications for, among other things, how they calculate and report excess working capital to securities regulators.

Don't just lament "how the time has flewn." Contact us and we can work with you to prepare filings such as Form 31-103F1 *Calculation of Excess Working Capital* in accordance with the new standards.

4. Don't Drop the Ball on Fund Amendments

On February 19, the Ontario Securities Commission (OSC) approved a settlement between OSC staff and AlphaNorth Asset Management (AlphaNorth) as well as its ultimate designated person (UDP) Steven Douglas Palmer (Mr. Palmer). In Vice-Chair Moseley's reasons approving the settlement, he stressed that it was important for retail fund managers to follow the rules for conflict mitigation and allocate adequate resources for compliance programs.

Background: AlphaNorth is the investment fund manager and portfolio manager for certain funds (Funds) with retail investors. Collectively, the Funds had approximately $5.6 million in assets under management at the relevant time considered in this case. In 2016, AlphaNorth implemented certain changes to the funds to set lower "high-water marks" for the performance fees to be paid to it by the Funds. AlphaNorth informally notified investors of the changes but didn't seek their approval or update the Funds' prospectuses to reflect the changes.

AlphaNorth's Auditor Spots a Problem: In February 2017, the Growth Fund's external auditor asked for documentation to support the changes described above. AlphaNorth then engaged external counsel to develop a rectification plan, which it carried out after the Funds' Independent Review Committee (IRC) recommended that it proceed and after AlphaNorth notified OSC staff of the issues.

What Went Wrong: The Settlement Agreement and Reasons indicate that AlphaNorth breached securities laws because it failed to:

- Refer the proposed changes to the IRCs for the Funds, as required under National Instrument 81-107 *Independent Review Committees for Investment Funds* (NI 81-107);
- Bring the lower high-water marks to meetings of the relevant classes of shareholders, as required by National Instrument 81-102 *Investment Funds* (NI 81-102); and
- Make appropriate disclosures regarding the changes it had made by, among other things, updating the Funds' prospectus documents, as required by the Securities Act and National Instrument 81-106 *Investment Funs Continuous Disclosure* (NI 81-106).

But Wait, There's More: The Settlement Agreement also addressed deficiencies identified during an OSC compliance review for the period June 2016-May 2017. These deficiencies involved, among other things, inadequate oversight of AlphaNorth's dealing activities for third-party, exempt products and failures to identify, appropriately address and disclose conflict of interests in relation to finder's fees

received from issuers. Mr. Palmer was found to have failed to discharge his responsibilities as UDP to ensure and promote compliance with securities legislation.

The Settlement Agreement describes in detail the steps that AlphaNorth took to rectify the non-compliance, including repayment for the overcharged performance fees, communications with affected shareholders, referring the matter of the applicable finder's fees to its IRC and obtaining their recommendation to proceed, updating filings, and correcting disclosure documents.

Settlement Terms: The OSC approved a settlement in which:

- AlphaNorth agreed to pay an administrative penalty of $147,000 as well as $10,000 costs and undertook not to increase its fees or take any other steps that would result in its clients sharing the burden of the settlement; and
- Mr. Palmer agreed to pay an administrative penalty of $100,000 and complete an educational program in regulatory compliance and risk management within a year.

Our Takeaways: Even though AlphaNorth acted to rectify the non-compliance, repay investors and self-report to the OSC once it became aware of the problems, the firm and its UDP incurred significant monetary penalties, relative to the Funds' assets under management. Of course, if AlphaNorth had not acted swiftly and cooperated with the OSC, the penalties and costs might well have been significantly higher.

These outcomes underscore for firms and their senior management the importance of having an effective compliance regime that enables them to, among other things, identify and mitigate conflicts of interest. And when fund managers consider making changes to elements like fund fees, it's essential to step back and determine whether any special procedures (like IRC review, investor approval and/or updates to offering documents) are required. AUM Law can help you by, for example, conducting a compliance risk assessment, advising on specific conflict of interest matters, and/or working with you to develop and implement plans to change features of your funds in compliance with applicable regulatory requirements.

5. One Bit. Two Bits. Three Bits. Pop! No Prospectus Receipt for a Bitcoin Fund

Responding to retail investors' pent-up desire to keep their money in something other than a sock, 3iQ Corp. (3iQ) designed a non-redeemable investment fund (Fund) to let them store it on the block. But in a decision released earlier this month, the Acting Director (Director) of the Investment Funds and Structured Products at the Ontario Securities Commission (OSC) declined to issue a receipt for 3iQ's prospectus. This appears to be the first time that Canadian securities regulators have considered whether or not to permit a public offering of a fund that would invest substantially all of its assets in a cryptocurrency.

The Director declined to issue a receipt for the fund, mainly because in his view the operational risks associated with a fund investing in bitcoin weren't sufficiently mitigated. He noted:

> "Bitcoin and other cryptoassets create novel challenges in striking a balance between product innovation that may promote fair and efficient capital markets and the protection of investors. In my view, because of the lack of established regulation for the bitcoin market at this time, an investment in the Fund raises a number of investor protection issues, notably, issues concerning the valuation, safeguarding and liquidity of bitcoin."

He also accepted OSC staff's position that bitcoin is an illiquid asset and, therefore, he had to refuse a receipt for the Fund's prospectus because it did comply in a substantial respect with the restriction in National Instrument 81-102 *Investment Funds* (NI 81-102) against the holding of illiquid assets. Under NI 81-102, an "illiquid asset" means a portfolio asset that cannot be readily disposed of through market facilities that meet certain criteria. The Director accepted that the term "market facilities" does not require that an asset can be readily disposed of through a regulated exchange or marketplace. But he agreed with staff that "market facilities" implies some form of established and mature trading facility or network to promote a robust valuation of a fund's assets, and that such a facility does not exist yet for bitcoin.

It will be interesting to see if other securities regulators in North America take a similar approach and also whether fund managers are able to take the lessons learned from this decision and effectively address the investor protection concerns that lie at the heart of the decision. Please contact us if you'd like to discuss further the implications of this decision for your business.

6. CSA Plans to Harmonize and Refine Start-up Crowdfunding Exemption

On February 21, the Canadian Securities Administrators (CSA) issued Staff Notice 45-324, indicating that they are developing a national instrument with the same key features as the start-up, crowdfunding prospectus and registration exemption orders (Local Orders) that have been operating in British Columbia, Saskatchewan, Manitoba, Québec, New Brunswick and Nova Scotia (Participating Jurisdictions) since May 2015. CSA staff have indicated that the planned national instrument will incorporate the key features of the Local Orders that it will replace, along with some targeted amendments to improve harmonization and the effectiveness of crowdfunding as a capital-raising tool for start-ups and early stage businesses.

CSA staff anticipate that the planned national instrument will not be implemented by the time the existing Local Orders are set to expire on May 13, 2020. Accordingly, staff expect that the existing Local Orders will be extended to remain available for issuers and portals until the national instrument comes into effect. AUM Law will monitor developments in this area and update you when the planned national instrument is published for comment.