OSC Staff Notice 33-753

OSC Consultation on Tied Selling and other Anti-Competitive Practices in the Capital Markets

November 30, 2021

Introduction

On November 19, 2021, the Honourable Peter Bethlenfalvy, Minister of Finance, requested that the Ontario Securities Commission (the **Commission** or **we**) undertake an analysis of questions regarding the practice of tied selling raised by the Capital Markets Modernization Taskforce (the **Taskforce**) in their consultations last year. As part of this analysis, we will engage with all relevant stakeholders including members of the Taskforce, as well as those who participated in the Taskforce's consultations.

The request by the Minister has been made in the wake of recent amendments to the mandate[1] of the Commission to include, among other objectives, fostering capital formation and competitive markets.

As discussed below, the Taskforce identified concerns that certain commercial lenders may be engaging in improper practices that may impede competition, such as arrangements where a lender requires issuer clients to retain the services of a dealer or adviser affiliate of the lender for their capital raising and/or advisory needs, as a condition of entering into a commercial lending transaction, or vice versa.

We are publishing this notice (the **Notice**) to request submissions together with supporting evidence and analysis from issuers, dealers and other market participants as well as from investors and other stakeholders with a view to establishing the extent to which such conduct that may impede competition is occurring.

The Commission believes that such conduct by commercial lenders and their affiliated firms, if it is occurring, is likely to impede effective capital formation, distort pricing for capital markets services and undermine both the efficiency of, and confidence in, our capital markets. Taking

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[1] The purposes of the *Securities Act* (Ontario) (the **Act**) as set out in section 1.1 of the Act are

(a) to provide protection to investors from unfair, improper or fraudulent practices;

(b) to foster fair, efficient and competitive capital markets and confidence in capital markets;

(b.1) to foster capital formation; and

(c) to contribute to the stability of the financial system and the reduction of systemic risk.

steps to effectively respond to such practices is within the Commission's mandate to foster fair, efficient and competitive capital markets and capital formation.

Pursuant to Section 143.7 of the *Securities Act*, we will be reporting our findings, as well as potential recommendations, to the Minister by February 28, 2022.

Background

The Capital Markets Modernization Taskforce

In February 2020, the Ontario government created the Taskforce to review and modernize Ontario's capital markets regulatory framework.

In July 2020, the Taskforce published a Consultation Paper[2] that included a request for comment on several recommendations, including a recommendation aimed at prohibiting registered dealers affiliated with commercial lenders from benefiting from tying or bundling of capital market and commercial lending services.

In January 2021 the Taskforce released its final report.[3] In the final report, the Taskforce reiterated the concern that financial institutions and other commercial lenders may be engaging in practices that impede competition, such as arrangements where a commercial lender requires clients to retain the services of an affiliated investment dealer for their capital raising and advisory needs, as a condition in commercial lending transactions:[4]

> Independent investment dealers and issuers have repeatedly raised the issue of intermediaries engaging in practices that may impede competition, such as arrangements where a commercial lender requires clients to retain the services of an affiliated investment dealer for their capital raising and advisory needs, as a condition in commercial lending transactions. As a consequence, issuers do not maintain existing relationships with the independent investment dealer or exempt market dealer who intermediated their early capital raising activities.

The Taskforce noted that, although the practice of "tied selling" is restricted under the *Bank Act*[5] and for registered firms under National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**NI 31-103**),[6] the Taskforce had heard repeatedly from dealers and issuers that commercial lenders, through their affiliated dealers, continue to engage in these practices. The Taskforce concluded that these practices are having a significant negative

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2 Capital Markets Modernization Taskforce: Consultation Paper July 2020, available at https://files.ontario.ca/books/mof-capital-markets-modernization-taskforce-report-en-2020-07-09.pdf

3 Capital Markets Modernization Taskforce: Final Report January 2021, available at: https://www.ontario.ca/document/capital-markets-modernization-taskforce-final-report-january-2021.

4 Ibid at p. 58.

5 See Section 459.1 [*Restriction on tied selling*] of the *Bank Act* https://laws-lois.justice.gc.ca/eng/acts/B-1.01/section-459.1.html

6 See Section 11.8 [*Tied selling*] of NI 31-103 and related Companion Policy guidance in section 11.8 of CP 31-103.

impact on competition but also noted that these practices may result in lower financing costs for issuers:

> We heard from multiple stakeholders that these practices are having significant negative impacts on the viability of independent dealers and on the ability of issuers to receive independent advice and on competition. However, we also learned that some intermediaries indicate that their bundling of capital markets services and other services may result in lower financing costs for issuers.

In light of these concerns, the Taskforce recommended action to enhance restrictions on tying commercial lending services and capital markets activities to facilitate growth of independent dealers and ensure issuer choice. The text of these findings and recommendations is reproduced as Appendix A to this Notice.

Concerns expressed by the UK Financial Conduct Authority

We also note that similar concerns have been identified in other jurisdictions. For example, in May 2020, the UK Financial Conduct Authority (the **FCA**) expressed similar concerns that banks may have used their lending relationships to exert pressure on corporate clients to secure roles on equity mandates that the issuer would not otherwise appoint them to.[7]

> We have heard credible reports of a small number of banks failing to treat their corporate clients fairly when negotiating new or existing debt facilities, as clients navigate the current exceptional circumstances. In particular, we have heard reports that banks may have used their lending relationship to exert pressure on corporate clients to secure roles on equity mandates that the issuer would not otherwise appoint them to. In some cases, these roles may be 'in name only', with few or no additional services being provided in exchange for a share of the fee pool. We will be looking into this further, but want any practice of this nature to cease immediately.
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> We are concerned that tying clients to take additional services, or demanding fees for services not provided is not in the best interests of those clients, distorts competition, undermines market confidence and calls into question firms' and individuals' integrity. This conduct is also likely to increase overall transaction costs for corporates trying to raise money.

This communication followed on steps taken by the FCA to prohibit the use of restrictive clauses in capital markets engagements that could limit issuers in the future choices regarding market services.[8]

Request for submissions

We welcome submissions on the issues discussed in this Notice and the need for regulatory or other action related to relationships involving dealers and commercial lenders. While we expect

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[7] https://www.fca.org.uk/publication/correspondence/dear-ceo-ensuring-fair-treatment-corporate-customers-preparing-raise-equity-finance.pdf ; See also the IOSCO Report, Conflicts of interest and associated conduct risks during the debt capital raising process - Final Report (September 2020) which references the FCA findings: https://www.iosco.org/news/pdf/IOSCONEWS576.pdf

[8] https://www.fca.org.uk/publication/policy/ps17-13.pdf

that this will be a subject of ongoing concern for the Commission, we would appreciate receiving submissions to the address below by January 10, 2022 to allow us to incorporate these comments into our report and recommendations to the Minister.

The Secretary
Ontario Securities Commission
20 Queen Street West
22nd Floor
comments@osc.gov.on.ca

All comments received will be posted on the Commission's website at www.osc.ca. Therefore, you should not include personal information directly in comments to be published. It is important that you state on whose behalf you are making the submission.

We have set out a series of specific questions below but also invite comment generally on any matter that is relevant to the contents of this Notice.

We are also interested in hearing from academic and regulatory experts and professional advisors in related fields, including Banking and Competition law and on the economic impact of tied selling and other anti-competitive practices.

1. Is there evidence of commercial lenders requesting issuer clients to retain the services of a dealer or adviser affiliated with the commercial lender to assist with the issuer's capital raising and/or advisory needs, or vice versa? If yes, please provide particulars.

2. To the extent there is evidence of commercial lenders requesting issuer clients to retain the services of an affiliated dealer or adviser, please explain the nature of the request. Specifically,

   (a) Can the request reasonably be characterized as "bundling" of services or "relationship pricing", which is specifically contemplated and permitted by the *Bank Act* and NI 31-103?

   (b) Can the request reasonably be characterized as a requirement or condition of financing; namely that the commercial lender would only make available a credit facility, or a credit facility at a more favourable cost, if the issuer client retained the services of an affiliated dealer or adviser?

   (c) Did the request require a minimum amount of business be allocated to the affiliated dealer or adviser?

   (d) Did the request include a condition that the issuer not retain or discontinue the use of services provided by any other dealer or adviser, such as a dealer or adviser affiliated with a competitor of the commercial lender?

3. Some commenters have suggested that, if improper tied selling is occurring, this should be addressed through existing enforcement mechanisms such as the *Competition Act*, the *Bank Act* and/or NI 31-103. Do you feel this is an effective way to deal with the potential concerns outlined in this Notice? If not, why not?

4. Some commenters have suggested that the recommendations of the Taskforce contained in the Final Report (reproduced in Appendix A) will, if adopted, restrict issuer choice and negatively impact capital raising and/or simply benefit foreign dealers at the expense of Canadian dealers. Do you agree or disagree with these comments? Please explain.

5. The Taskforce recommended that the Commission work with the Canadian Securities Administrators (the **CSA**) to amend National Instrument 33-105 *Underwriting Conflicts* and/or through the adoption of a local rule to require an independent underwriter in prospectus offerings in circumstances where the issuer would be considered a "connected issuer" to one or more of the underwriters involved in the offering by virtue of any commercial lending relationship between an affiliate of the underwriter and the issuer. Do you agree or disagree with this recommendation? Please explain.

6. The Taskforce also recommended that, where a registered firm provides capital markets services to an issuer and also has an affiliated commercial lender, there should be a ban on certain restrictive clauses in capital markets engagement letters. This includes agreements that restrict a client's choice of future providers of capital market services (as defined above), such as "right to act" and "right of first refusal" clauses, where a commercial lending and capital markets relationship exists. Do you agree or disagree with this recommendation? Please explain.

7. Are there any other practices that commercial lenders and their affiliated firms are engaging in that are negatively affecting competition in the Ontario capital markets?

8. Are there regulatory changes that the Commission should consider to increase competition for capital markets services in Ontario?

Questions

Please refer your questions to any of the following:

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Appendix A
Excerpt from the Capital Markets Modernization Taskforce: Final Report January 2021[9]

2.3 Ensuring a Level Playing Field

Healthy competition fosters fair and efficient capital markets by creating an ecosystem that can provide more choice for investors and opportunities for entrepreneurs. The Taskforce envisions a regulatory framework that leads to a level playing field between small and large market participants, where an appropriate level of competition helps grow Ontario's economy.

In our consultations, smaller intermediaries have noted the challenges and frustrations they face when they are unable to continue to assist their growing clients' needs in accessing capital. To ensure an appropriate level of competition, the Taskforce includes recommendations that aim to increase capital raising opportunities for small intermediaries and increase the variety and quality of independent investment products available to retail investors.

Globally, the relationships between investors and issuers continues to evolve. Companies and their shareholders are realizing that diverse boards and executives provide more effective and capable oversight and strategic direction.

These recommendations are aimed to drive competition among intermediaries and products and provide investors with more choice in their investment decisions.

Enhance restrictions on tying commercial lending services and capital markets activities to facilitate growth of independent dealers and ensure issuer choice

Facilitating the incubation of entrepreneurial and venture issuers is critical for the growth of our primary market in Ontario. Independent investment dealers and issuers have repeatedly raised the issue of intermediaries engaging in practices that may impede competition, such as arrangements where a commercial lender requires clients to retain the services of an affiliated investment dealer for their capital raising and advisory needs, as a condition in commercial lending transactions. As a consequence, issuers do not maintain existing relationships with the independent investment dealer or exempt market dealer who intermediated their early capital raising activities.

Although tied selling is restricted under the *Bank Act*, as well as National Instrument 31-103, the Taskforce has heard repeatedly from dealers and issuers that commercial lenders, through their affiliated dealers, continue to engage in these practices. We heard from multiple stakeholders that these practices are having significant negative impacts on the viability of independent dealers and on the ability of issuers to receive independent advice and on competition. However, we also learned that some intermediaries indicate that their bundling of capital markets services and other services may result in lower financing costs for issuers.

[9] Capital Markets Modernization Taskforce: Final Report January 2021, available at: https://www.ontario.ca/document/capital-markets-modernization-taskforce-final-report-january-2021.

Furthermore, the Taskforce heard that some commercial lenders and their affiliated investment dealers calculate their return on capital across product lines. Then, in order to meet an internally specified client threshold return, they are requiring issuers and clients to which they have extended credit to transfer capital markets business to their affiliated investment dealer.

In addition, it may not always be in the best interest of issuers to procure their underwriting and advisory services from their lender — they may benefit from independent advice.

Recommendation:

To address this concern, the Taskforce recommends the following:

1. Enhance the Tied-Selling Restriction in National Instrument 31-103

The Taskforce recommends making legislative amendments to Ontario securities legislation, including amendments to National Instrument 31-103 and/or through the adoption of a local rule, to prohibit registrants, as a consequence of an exclusivity arrangement, from providing capital markets services under certain circumstances.

An exclusivity arrangement would be defined to exist when:

- There is an outstanding loan, a loan proposed to be made or the continuation of an outstanding loan including any modification thereof, with an issuer or any affiliate; and

- In connection with such loan, a bank practically or legally imposes a requirement for such a loan to be made or maintained pursuant to an agreement, commitment, or understanding that an affiliate of the bank (typically a bank-owned dealer) be retained to provide capital markets services, as defined, for the issuer or an affiliate thereof, or be required to be retained for future capital markets services.

Capital markets services would be defined to include debt and equity financing activities such as acting as a dealer or underwriter in an equity or debt offering or negotiating a new or existing credit facility, as well as M&A advisory activities such as providing a fairness opinion on a transaction.

The Taskforce believes that providers of capital markets services should compete on their merits and that an issuer should be free to choose the registrant that best suits its needs without a concern that its choice of registrant may negatively impact the availability of credit to the issuer. Accordingly, it would be prohibited for a registrant affiliated with a commercial lender to provide capital markets services to an issuer in circumstances such as the exclusivity arrangement defined above, where the affiliated commercial lender has previously tied a decision to extend, renew or limit credit to the issuer on whether the issuer provides capital markets business to the affiliated registrant.

2. Attestation

A senior officer of a registrant such as the Ultimate Designated Person, would be required to attest that no such prohibited conduct has occurred each time the registrant provides such capital markets services to a reporting issuer with whom the affiliated commercial lender has a banking relationship.

As part of the attestation, the registrant should engage with the affiliated commercial lender to ensure that such conduct did not occur. The Taskforce would expect that commercial lenders provide meaningful support and cooperation to their affiliated registrant firms in complying with this attestation requirement. If it becomes apparent that this is not occurring, the OSC should consider imposing terms and conditions on the registration of the affiliated registrant that would restrict its ability to act as a dealer or underwriter in offerings involving an issuer that has a relationship with a commercial lender affiliated with the registrant.

3. Amend NI 33-105 to require an Independent Underwriter with a Connected Issuer

The Taskforce recommends that the OSC work with the CSA to amend National Instrument 33-105 and/or through the adoption of a local rule to require an Independent Underwriter in prospectus offerings:

- The issuer would be considered a "connected issuer" to one or more of the underwriters involved in the offering by virtue of any commercial lending relationship between an affiliate of the underwriter and the issuer.

The Taskforce recommends adding a definition that considers an issuer that has a commercial lending relationship with an affiliate of the registered firm as a "connected issuer" and thus, under the new amendment to NI 33-105, at least one Independent Underwriter would be required in a syndicate.

The Independent Underwriter would be required to underwrite at least 20 per cent of the offering or receive at least 20 per cent of the total fees. These steps are carefully tailored to ensure that this requirement would be in line with provincial jurisdiction over registrants.

The Taskforce recommends that the OSC work with the CSA to update the Companion Policy to NI 33-105 to clarify that commercial lending relationships that would rely on the underlying credit of the issuer would be presumed to give rise to a connected issuer relationship.

Where part or all of the proceeds of the offering are intended to be used to repay indebtedness to a commercial lender affiliated with an underwriter involved in the offering, there exists an acute potential conflict of interest between the underwriter and the issuer. In these cases, the role of an independent underwriter in structuring and pricing the transaction is particularly important. Accordingly, the OSC should consider introducing a new requirement that an independent underwriter act as the lead

manager or co-lead manager (or “bookrunner” or “co-bookrunner”) for offerings in these circumstances.

For greater clarity, if the proceeds of the underwriting are used to pay down a commercial loan (of a syndicate member), the Independent Underwriter would then be required to be a book runner.

4. Ban on Restrictive Clauses

Finally, where a registrant of an affiliated lender provides capital markets services, the Taskforce recommends a ban on certain restrictive clauses in capital markets engagement letters. This includes agreements that restrict a client’s choice of future providers of capital market services (as defined above), such as “right to act” and “right of first refusal” clauses, where a commercial lending and capital markets relationship exists. This would align with the U.K. Financial Conduct Authority’s similar enacted ban in 2017.

The above recommendations in relation to the provision by registrants of capital market services to issuers are focused on non-investment fund issuers and exemptions for investment funds should be provided where similar competitive concerns do not arise.

These recommendations would create competition in Ontario’s capital markets, incubate a diverse and healthy intermediary market and increase choices for issuers, without dampening existing economic activities. The objective of these recommendations is to significantly increase the amount of competition in Ontario’s capital markets. In this regard, the Taskforce recommends that the OSC be mandated to review the effectiveness of these recommendations in achieving this objective after implementation. If it is determined that the recommendations are not having the intended outcome, then the OSC would proceed with further reforms.