

1.1.2 OSC Staff Notice 11-758 - Review of Limited Market Dealers

OSC STAFF NOTICE 11-758 REVIEW OF LIMITED MARKET DEALERS

Overview

The limited market dealer (LMD) category of registration was created in Ontario in 1987 when the Ontario Securities Commission (OSC) implemented the “universal registration” system. At that time, the OSC extended registration requirements to all market intermediaries, including LMDs that operate in the exempt market under prospectus and registration exemptions.

LMDs are subject to some of the conditions of registration that apply to investment dealers under Ontario securities law, such as know your client, and suitability and supervisory functions. However, they are not subject to other conditions, such as proficiency, minimum capital requirements and filing of financial statements.

The LMD category is diverse and includes three main groups:

- LMDs that are not registered in any other registration category (sole LMDs)
- LMDs that are also registered as Investment Counsel Portfolio Managers (ICPMs)
- LMDs that are also members of the Mutual Fund Dealers Association (MFDA)

As of January 31, 2006, approximately 550 LMDs were registered with the OSC. Approximately 46% of these were sole LMDs, 40% were also registered as ICPMs, 13% were also mutual fund dealers and 1% were also registered in other categories.

Historically, the OSC’s Compliance team monitored LMDs to a limited extent as part of its reviews of ICPMs that are also registered as LMDs. We initiated this review as a result of an increase in the number of firms registered as LMDs, and also to address specific areas of concern, including suitability, trade supervision and sales practices.

In 2005, the OSC conducted its first compliance review of LMDs. Our goals were to better understand their business operations, review their compliance with securities law and identify any regulatory gaps. This was a first step in enhancing compliance oversight and helping LMDs develop stronger compliance and internal controls. The results of this review will also assist the CSA Registration Reform Steering Committee in harmonizing registration requirements by identifying any specific risks this category poses to investor protection.

We identified a significant number of deficiencies as a result of our review. The 10 most frequent deficiencies were identified in at least 25% of our sample. The most significant deficiency—not collecting and documenting know your client (KYC) and suitability information—was identified in almost 80% of the LMDs reviewed. Without the necessary documentation, determining the suitability of a particular investment becomes more difficult.

For LMDs with significant deficiencies, we have taken further action including referring the matter to Enforcement, and closely monitoring the LMD. Approximately two thirds of the LMDs with deficiencies have resolved their issues to our satisfaction. We will continue to follow up with the remaining LMDs to ensure that all deficiencies are dealt with appropriately and within a reasonable time frame. If deficiencies cannot be resolved within a reasonable time frame, further action may be taken such as imposing terms and conditions on registration, or referring the matter to Enforcement. Commencing in the current fiscal year, we also intend to conduct regular compliance field reviews of LMDs to review their compliance with securities law.

This notice describes how we conducted the review and provides a summary of the results.

Information gathering

The Compliance team gathered information about the business operations of LMDs through a focus group, individual meetings and a written survey.

Focus group and individual meetings

The Compliance team held a focus group with representatives from LMDs in June 2005. All LMDs were invited and participation was voluntary. The firms that attended included a cross-section of the LMD population.

We also held individual meetings with other representatives from LMDs, on a voluntary basis. As well, we met with the MFDA, the Investment Dealers Association of Canada (IDA), and the Limited Market Dealers Association to hear their views on the LMD registration category.

LMD survey

We developed a written survey as our primary tool for gathering information. The survey consisted of structured questions and focused on key information about LMDs and their business operations, including corporate/management structure, products distributed, size of business, client base, policies and procedures, books and records, compliance with legislation, referral arrangements, outsourced functions, and custody and lending activities.

Specific criteria were developed for each question to ensure that the surveys were evaluated consistently. The survey was risk weighted and resulted in a risk score that translated into a risk ranking of high, medium high, medium low or low.

The survey excluded LMDs that were also members of the MFDA. The MFDA conducted a separate survey of all of its members, including approximately 75 LMDs in June 2005. The MFDA is addressing any issues identified from its survey through its oversight process.

In July 2005, we sent the survey to the remaining 475 LMDs who were not members of the MFDA. Almost all of the firms completed and returned the survey. We determined that 106 of these firms were inactive and excluded them from our overall results. The majority of the inactive firms were not using their LMD registration or were in the start-up phase of their business cycle.

We identified eight different business models from the survey (see Appendix 1):

- Firms registered as sole LMDs were distributed across five business models.
- Firms dually registered as LMDs and ICPMs were primarily distributed across two business models.
- A small number of LMDs were operating as Inter-Dealer Bond Brokers (IDBs).

Although the majority of LMDs operated under one business model, some operated under two or more business models.

Compliance reviews

We analysed the information we gathered in the first phase to conduct a focused compliance review of a sample of LMDs.

Objective

We had three objectives for the reviews:

1. To gain insight into the business operations of LMDs, including the type of exempt products they distribute and the nature of their clients
2. To assess LMDs' compliance with securities law
3. To identify any regulatory gaps

Scope

The reviews focused on areas with the greatest overall regulatory risk to investors:

- KYC and suitability
- Know your product
- Disclosure to investors
- Referral arrangements
- Custody
- Compliance and supervision structure

Sample selection

We selected 21 LMDs for review, representing 6% of registered LMDs (excluding inactive firms, members of the MFDA and IDBs). Risk ranking was a key factor in determining the sample. The majority of the sample consisted of LMDs with a risk ranking of "high". We also made specific selections to ensure that the various business models were adequately represented. A proportionately higher weighting of sole LMDs was selected as a result of our preliminary analysis of the surveys.

How the reviews were conducted

Our review teams were primarily made up of Compliance staff, but we also drew on resources and expertise from other branches in the OSC, including Corporate Finance, Investment Funds and Enforcement. The reviews began in mid-October 2005 and were largely completed by December 2005. We performed on-site visits of all 21 LMDs in the sample. We later determined that two of these firms were inactive. Our results are based on 19 reviews.

Results

We identified a significant number of compliance deficiencies during our reviews (see Appendix 2). The majority were identified in firms registered as sole LMDs. Very few deficiencies were identified in LMDs that are registered as ICPMs, or provide mergers and acquisitions services.

We found that LMDs may have roles outside the scope of their LMD registration. For example, an LMD may also be the issuer, ICPM or fund manager of non-prospectus qualified investment funds. We identified a number of deficiencies stemming from these other roles.

Common deficiencies

The following is a discussion of the 10 most frequent deficiencies we identified. To assist LMDs in understanding the deficiencies, we have included the applicable legislation and suggested practices to address each deficiency. We encourage all LMDs to use this as a self-assessment tool to strengthen their compliance with Ontario securities law.

1. Not collecting and documenting KYC and suitability information

Almost 80% of the LMDs reviewed were deficient in this area. Examples included:

- No KYC and suitability information was collected or documented
- KYC forms were not signed by the clients
- No evidence that KYC forms were reviewed

In most cases, LMDs had documents from clients confirming that they were accredited investors. However, they did not collect and document KYC and suitability information (e.g. investment objectives and risk tolerance). The fact that a client is an accredited investor does not mean that any investment product is suitable for him or her. Without the necessary documentation, determining the suitability of a particular investment becomes more difficult.

Applicable legislation

It is the dealer's obligation to collect and document KYC information and assess the suitability of client trades as required by section 1.5 of OSC Rule 31-505 - *Conditions of Registration* (OSC Rule 31-505).

Suggested practices

At a minimum, the KYC form should contain the investor's name, address, investment objectives, risk tolerance, investment restrictions, investment time frame, annual income and net worth. The KYC form should be signed and dated by the client and reviewed by the compliance officer.

2. No or inadequate filing of regulatory forms and/or statement of policies

Over 60% of the LMDs reviewed were deficient in this area. Examples included:

- No statement of policies
- The most current statement of policies was not filed with the OSC

- Statements of policies did not include all related issuers
- Exempt distribution reports were not filed with the OSC
- Offering memoranda, where distributed, were not filed with the OSC

Applicable legislation

Section 223 of R.R.O. 1990, Regulation 1015 made under the Act (the Regulation) requires a dealer to prepare and file a statement of policies with the OSC, as well as provide a copy to its clients. The statement should outline the activities of the dealer in respect of related or connected issuers.

Section 6.1 of National Instrument 45-106 - *Prospectus and Registration Exemptions* (NI 45-106) requires the issuer of the security to file Form 45-106F1 with the OSC for a trade made in reliance on certain exemptions from the prospectus requirement within 10 days of the distribution. If a trade is made in a security of a mutual fund or non-redeemable investment fund (investment funds), the filing requirement is within 30 days after the financial year end of the investment funds.

Section 6.4 of revised OSC Rule 45-501 - *Ontario Prospectus and Registration Exemptions* (OSC Rule 45-501) requires the seller to deliver a copy of the offering memorandum to the OSC within 10 days of the distribution if the trade is made in reliance on certain exemptions from the prospectus requirement.

Suggested practices

LMDs should prepare and file a current statement of policies with the OSC and distribute a copy to clients. The statement of policies should include a complete listing of related issuers and a concise description of the nature of the relationship with each related issuer. LMDs that are issuers should refer to section 6 of NI 45-106 for reporting requirements. LMDs acting as sellers should refer to section 6.4 of revised OSC Rule 45-501 as noted previously.

3. Misleading marketing materials/websites

Over 40% of the LMDs reviewed were deficient in this area. Examples included:

- Websites and marketing materials with incorrect information (e.g. brochures with an incorrect description of LMD activities and the products or services provided)
- Marketing materials that claimed "superior methodology" and "high returns" without any support to substantiate these claims
- Websites with outdated materials
- Certain salespersons who were incorrectly held out as officers and directors of the LMD in marketing materials
- Back-tested and pro-forma performance data (i.e. simulated historical and future trading performance that does not represent actual results) that was presented to clients.

Applicable legislation

Section 2.1 of OSC Rule 31-505 requires dealers to deal fairly, honestly, and in good faith with their clients. Section 45 of the *Securities Act (Ontario)* (Act) states that no person or company who is not registered shall hold himself, herself or itself out as being registered.

Suggested practices

LMDs should establish and enforce procedures for reviewing and approving marketing materials and websites. This is to ensure that all marketing materials and websites contain accurate and up-to-date information. All claims made in marketing materials and websites should be adequately supported. Back-tested performance data can be quite misleading to investors because it is typically presented as actual results of the funds or the investment strategy. Back-tested data can be constructed to achieve a desired outcome and is difficult to verify.

4. Ineffective compliance officer

Over 35% of the LMDs reviewed were deficient in this area. Examples included:

- Compliance officers who did not understand their roles and responsibilities (e.g. no review of clients' trades for suitability or marketing materials for appropriate disclosure)
- A lack of understanding of securities legislation

Applicable legislation

Paragraph 1.3 of OSC Rule 31-505 requires dealers to designate a registered partner or officer as the compliance officer who is responsible for discharging the obligations of the dealer under Ontario securities law. It also requires the designated compliance officer to be responsible for opening new accounts and supervising trades for each client.

Suggested practices

LMDs should clearly define the roles and responsibilities of their compliance officers. A compliance officer should fully understand his or her roles and responsibilities and LMDs should take the necessary steps, including providing additional training, to ensure that these responsibilities are met.

5. *Registration issues*

Over 35% of the LMDs reviewed were deficient in this area. Examples included:

- LMDs acting as an ICPM without registration
- Individuals acting as salespersons without registration

Most of the LMDs were only involved in the distribution of investment fund units. However, some LMDs performed multiple roles and were affiliated with the issuer. For example, some LMDs were acting as general partners or portfolio managers for their funds. These LMDs were actively involved in providing investment advice and managing the funds' portfolios, but were not registered as ICPMs. In all cases, the individual who managed the funds' portfolios did not meet the proficiency requirements of an ICPM under Part 3 of OSC Rule 31-502 - Proficiency Requirements for Registrants.

We also identified a number of cases where an individual employee or a third-party financial planner was selling investment products for LMDs without registration.

Applicable legislation

Section 25 of the Act prohibits trading in securities or acting as an adviser unless you are appropriately registered with the OSC.

Suggested practices

LMDs should review their current business activities and obtain the appropriate registration for all registerable activities. They should also review their business arrangements with third parties to ensure that each party to the agreement is appropriately registered to carry out its responsibilities.

6. *Inadequate disclosure and/or misleading statements in offering memoranda*

Over 35% of the LMDs reviewed were deficient in this area. Examples included:

- Risk factors that were inadequately disclosed or not disclosed
- Inadequate disclosure of conflicts of interest
- Back-tested and pro-forma performance data (i.e. simulated historical or future trading performance that does not represent actual results) was presented to clients (see common deficiency no.3)
- Statutory right of action for damages against the issuer and selling security holder, and right of rescission was not disclosed

Some of the LMDs or their affiliates were acting as fund managers, general partners or issuers. Clients were given various types of disclosure documents, such as an offering memorandum, an investment summary or other offering document. We consider these documents to be offering memoranda as defined in subsection 1(1) of the Act.

Applicable legislation

Subsection 2.1(1) of OSC Rule 31-505 requires a dealer to deal fairly, honestly and in good faith with its clients.

For certain exemptions from the prospectus requirement, section 6.3 of revised OSC Rule 45-501 requires the right of action (set out in section 130.1 of the Act) for damages against the issuer and a selling security holder, and the right of rescission to be described in the offering memorandum.

Suggested practices

LMDs or their affiliates should disclose all relevant information to their clients, including, but not limited to, risk factors, conflicts of interest and rights of action for damages or rescission in offering memoranda. This information is critical to clients when making investment decisions.

7. *Lack of written policies and procedures manual*

Over 35% of the LMDs reviewed were deficient in this area. Examples included:

- No written policies and procedures manual
- Missing procedures for some major areas of the business
- Insufficient detail about policies and procedures

Applicable legislation

Section 1.2 of OSC Rule 31-505 requires dealers to develop and enforce written procedures for dealing with clients that conform to prudent business practice and enable them to serve clients adequately. The policies and procedures should be in sufficient detail, updated periodically and made available to all staff. In addition, the relevant regulatory requirements should be outlined in the policies and procedures.

Suggested practices

LMDs should develop and enforce written policies and procedures manuals that are tailored to their operations. At a minimum, the following areas should be covered:

- Role of the compliance officer, including reviewing and approving new accounts and supervising trades
- Supervision and training of registered salespersons
- Collection and documentation of KYC and suitability information
- Prospectus exemptions available to investors and their application
- Maintenance of books and records
- Handling of client money in trust accounts
- Review and approval of marketing materials and websites
- Dealing with conflicts of interest
- Personal trading

8. *Inadequate books and records*

Over 30% of the LMDs reviewed were deficient in this area. The following are examples of books and records that were not maintained:

- Monthly and annual financial statements
- KYC forms

- Trade blotter and trade confirmations
- Signed subscription and accredited investor forms
- Bank reconciliations for both trust and operating bank accounts
- Marketing materials

Applicable legislation

Subsection 19(1) of the Act requires a market participant to keep books, records and other documents for the proper recording of its business transactions and financial affairs, and the transactions that it executes on behalf of others.

Suggested practices

LMDs should determine the appropriate books and records to be maintained in their operations. At a minimum, they should maintain records of client information, KYC forms, agreements with third parties, a trade blotter and financial statements.

9. *No written agreements with salespersons or third parties*

Over 30% of LMDs did not have written agreements with salespersons or promoters.

Applicable legislation

Subsection 19(1) of the Act requires a market participant to keep books, records and other documents for the proper recording of its business transactions and financial affairs, and the transactions that it executes on behalf of others.

Suggested practices

LMDs should establish written agreements with salespersons or third parties. The agreements should clearly define the roles and responsibilities of each party and ensure that each party to the agreement is appropriately registered to carry out its responsibilities.

10. *No written referral agreement and inadequate disclosure to clients*

Over 25% of the LMDs reviewed were deficient in this area. Examples included:

- No written agreement for third-party referral arrangements
- Inadequate disclosure to clients about the arrangement and the amount of fees paid to third parties

Applicable legislation

Subsection 19(1) of the Act requires a market participant to keep books, records and other documents for the proper recording of its business transactions and financial affairs, and the transactions that it executes on behalf of others.

Subsection 2.1(1) of OSC Rule 31-505 requires a dealer to deal fairly, honestly and in good faith with its clients. LMDs should provide adequate disclosure to clients regarding any conflicts of interest.

Suggested practices

LMDs should establish written agreements with referring parties. The agreements should clearly define the roles and responsibilities of each party and the amount of the fee. LMDs should also provide written disclosure to clients that includes the nature of the referral arrangement, the amount of the fee paid and any potential conflicts of interest.

Our response

As a result of these reviews, the OSC has taken steps to help address the deficiencies and improve compliance oversight.

When further action beyond a deficiency report is necessary, the Compliance team may, among other things:

- Refer the matter to Enforcement

- Closely monitor the LMD
- Impose terms and conditions on registration

Where appropriate, we referred matters resulting from the reviews to Enforcement. We continue to monitor some LMDs. We have suspended a few of the LMDs we reviewed because of registration renewal issues. These suspensions were made independently of our initiative.

Compliance deficiency reports were sent to the LMDs reviewed, where applicable. Each LMD was required to provide a written response, effectively an action plan, to all deficiencies identified in our report within 30 days. Approximately two thirds of the LMDs with deficiencies have resolved their deficiencies to our satisfaction. We will continue to follow up with the remaining LMDs to ensure that all deficiencies are dealt with appropriately and within a reasonable time frame. If deficiencies cannot be resolved within a reasonable time frame, further action, as noted above, may be taken such as imposing terms and conditions on registration, or referring the matter to Enforcement.

Commencing in the current fiscal year, the Compliance team will be conducting regular compliance field reviews of LMDs to review their compliance with securities law.

As noted previously, the results of this initiative will assist the CSA Registration Reform Steering Committee in harmonizing registration requirements. As a result, registration requirements may not be extended to some of the currently registered LMDs, for example, those providing mergers and acquisitions services. Also, due to the nature and frequency of the deficiencies identified, increased regulation of LMDs is being considered, including requirements for proficiency, books and records, filing of audited financial statements, and maintaining insurance and minimum capital, similar to those applicable to other registrants.

We expect that this initiative will assist LMDs in enhancing their compliance structure and will result in a more effective regulatory regime.

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Appendix 1

Summary of LMD business models

Model	% of LMDs surveyed*	Business objectives	Type of investors	Products
1. Sole LMD (mergers and acquisitions)	13.1%	Provides assistance in mergers and acquisitions and disposition of corporations	Institutional	No products distributed Only services provided as previously discussed
2. Sole LMD (private placement)	24.7%	Provides advice on capital structuring to raise financing Distributes new issues to accredited investors	Institutional and high net worth (accredited investors)	Shares, corporate debt, units of trusts, etc. (depends on the investment vehicle used to structure the private placement)
3. Sole LMD (relationship facilitator)	9.7%	Facilitates relationships between investors and registrants Does not distribute securities Provides advice on the suitability of the investment opportunity; this is done when the initial matching of the two parties occurs	Institutional and high net worth (accredited investors)	No products distributed Only services provided as previously discussed
4. Sole LMD (distributes exempt products)	21.3%	Distributes non-prospectus qualified products	Institutional and high net worth (accredited investors)	Pooled funds, hedge funds, etc.
5. Sole LMD (full-service)	3.1%	Distributes non-prospectus qualified and other types of investment products	Institutional and high net worth (accredited investors)	Pooled funds, hedge funds, etc. and other investment products (e.g. equities, fixed income, etc.)
6. ICPM (integrated)	28.4%	LMD is used to: facilitate the investment management of discretionary client accounts distribute products that are developed and managed (on a discretionary basis) in-house	Institutional and high net worth (accredited investors)	Pooled funds, hedge funds, etc.
7. ICPM (non-integrated)	24.4%	LMD is used to distribute products that are developed and managed (on a discretionary basis) in-house The products are distributed to investors who do not have a managed account with the registrant	Institutional and high net worth (accredited investors)	Pooled funds, hedge funds, etc.
8. Inter-dealer bond broker (IDB)	0.6%	Acts as an intermediary and matches buyers and sellers of government and Canadian bonds anonymously Recognized by the IDA as an IDB	Institutional (e.g. major banks, IDA member firms and international dealers)	Canadian federal bonds, provincial bonds, corporate bonds, T-Bills, repurchase agreements, federal and provincial government derivatives, forward currency swaps, overnight interest rate swaps, etc.

*Based on active LMD population identified from surveys submitted. The total of the percentages is greater than 100% because some LMDs operate under multiple business models.

Appendix 2
Top 10 most frequent deficiencies

Deficiency type	Number of deficiencies identified in LMD sample	% of total active LMD sample
Not collecting and documenting KYC and suitability information	15	79%
No or inadequate filing of regulatory forms and/or statement of policies	12	63%
Misleading marketing materials/website	8	42%
Ineffective compliance officer	7	37%
Registration issues	7	37%
Inadequate disclosure and/or misleading statements in offering memoranda	7	37%
Lack of written policies and procedures manual	7	37%
Inadequate books and records	6	32%
No written agreements with salespersons or third parties	6	32%
No written referral agreement and inadequate disclosure to clients	5	26%