

1.1.3 OSC Staff Notice 33-741 – Report on the Results of the Reviews of Capital Markets Participation Fees

OSC STAFF NOTICE 33-741 – REPORT ON THE RESULTS OF THE REVIEWS OF CAPITAL MARKETS PARTICIPATION FEES

July 18, 2013

Purpose of this Notice

Staff of the Compliance and Registrant Regulation Branch (**Staff or we**) of the Ontario Securities Commission (**OSC**) conducted a review of the capital markets participation fees (**participation fees**) that are required to be submitted annually under OSC Rule 13-502 *Fees* (**OSC Rule 13-502**). This Notice summarizes our findings and provides guidance on suggested practices in the calculation of capital markets participation fees. We will also use this Notice and the guidance provided in our ongoing reviews of participation fees.

Background

On an annual basis, registrant firms and unregistered capital markets participants (i.e. unregistered investment fund managers or unregistered exempt international firms) (collectively referred to as **firms**) are required to pay participation fees based on the firms' revenues attributable to their capital markets activities in Ontario. The participation fees are calculated using Form 13-502F4 *Capital Markets Participation Fee Calculation* (**Form 13-502F4**). The participation fees are due on December 31 of each year for registrant firms and unregistered exempt international firms or due no later than 90 days after the end of their fiscal year for unregistered investment fund managers.

In 2012, we identified a number of issues in the calculation of participation fees. As a result, we decided to review a sample of Form 13-502F4s submitted by firms in 2012.

Objectives of the review

The main objectives of the review were to:

- assess the accuracy and completeness of participation fees submitted to the OSC for 2012,
- identify common errors when calculating participation fees,
- broaden our understanding of firms' interpretation of OSC Rule 13-502 and Form 13-502F4, and
- develop guidance for firms to follow when calculating their participation fees.

Scope and methodology

We gathered information on firms' participation fees through a review of the Form 13-502F4s submitted to the OSC for 2012 and then selected samples of firms to review. The types of firms reviewed included:

- Investment Industry Regulatory Organization of Canada (**IIROC**) member firms,
- Mutual Fund Dealers Association of Canada (**MFDA**) member firms,
- unregistered investment fund managers,
- investment fund managers (**IFMs**),
- portfolio managers,
- other dealers (other than IIROC and MFDA members, including exempt market dealers, scholarship plan dealers and mutual fund dealers that are not members of the MFDA),
- firms relying on the international dealer exemption in section 8.18 of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**NI 31-103**) or the international adviser exemption in section 8.26 of NI 31-103, and
- commodity trading managers.

We selected three samples of firms to review between January and April, 2013 as follows:

- 100 firms were selected based on a risk based review of Form 13-502F4s filed by all firms,
- 98 firms were selected for review on a random basis, and
- 291 IFMs with fiscal year ends in September, October, November and December, which had estimated their gross revenues in determining the participation fee for 2012, were selected for review.

For the first two samples, we requested supporting documentation for each line item on Form 13-502F4. For the last sample, we asked firms to confirm that a recalculation of their participation fees was done using the revenues reported on their audited annual financial statements and confirm whether the correct participation fees had been paid.

Summary of issues identified

We identified a number of issues in the calculation of participation fees. The issues fell into the following categories:

- incorrect reporting of revenue,
- incorrect deductions taken,
- incorrect calculation of the Ontario percentage used to determine the specified Ontario revenues subject to participation fees, and
- other.

Specific issues and guidance

The following is a more detailed discussion of the issues we identified along with guidance on how these issues should be addressed.

1. ***Incorrect reporting of revenue***

The issues noted in this category relate to line 1 of Part III of Form 13-502F4 'Gross revenue for relevant fiscal year'.

a) *Gross revenue did not tie into revenue reported on the firm's audited annual financial statements*

A number of firms reported gross revenue attributable to Ontario activities on line 1 of Form 13-502F4, instead of revenue as reported on their annual audited financial statements. As set out in note 1 under this part of the form, the gross revenue on line 1 of Form 13-502F4 is the sum of all revenues reported on the audited annual financial statements, except where unaudited financial statements are permitted in accordance with subsection 3.4(4) or (5) of OSC Rule 13-502. Therefore, the gross revenues on line 1 of Form 13-502F4 should include the gross global revenue reported on a firm's audited annual financial statements, unless as noted above.

b) *No Gross revenue reported based on a "cost recovery model" of operations*

In some instances, firms did not report any gross revenue on the basis that they operated using a "cost recovery model" of operations (i.e. the firm was paid a fee that was equal to the costs or expenses of the firm's operations). In these cases, the firms did not report the fees received to cover their expenses as gross revenue.

Staff's view is that fees received to cover the cost of a firm's operations are gross revenue for the purpose of calculating participation fees. As a result, these fees should be reported on line 1 of Form 13-502F4 as gross revenue.

2. ***Incorrect deductions taken***

Incorrect deductions were identified with respect to two sections of Part III of Form 13-502F4 – line 2 (revenue not attributable to capital markets activities), and lines 3 to 6 (redemption fee revenue, administration fee revenue, advisory or sub-advisory fees paid to registrant firms or exempt international firms, and trailer fees paid to registrant firms).

a) *Deductions for revenue not attributable to capital markets activities*

“Capital markets activities” is defined in section 1.1 of OSC Rule 13-502 to include:

- i. Activities for which registration under the *Securities Act* (Ontario) or an exemption from registration is required,
- ii. Acting as an investment fund manager, or
- iii. Activities for which registration under the *Commodity Futures Act*, or an exemption from registration under the *Commodity Futures Act*, is required.

Firms deducted capital markets revenue earned outside of Ontario on line 2 of Form 13-502F4. The purpose of line 2 is to deduct revenue that is not generated through capital markets activities, such as consulting or interest income. Therefore, on line 2 of Form 13-502F4, firms are required to deduct revenue that is not earned in relation to their global capital markets activities.

b) *Other deductions taken were attributed to Ontario activities only*

The deductions taken should relate to a firm’s global activities for that particular line of Form 13-502F4 and not only to its Ontario activities.

3. *Incorrect calculation of the Ontario percentage used to determine the specified Ontario revenues subject to participation fees*

The issues noted in this category relate to the calculation of the Ontario percentage for the relevant fiscal year.

a) *Firms that recorded only Ontario gross revenues on line 1 of Form 13-502F4 applied 100% as the Ontario percentage*

Many firms applied an Ontario percentage of 100% since they only recorded Ontario gross revenues on the participation fee calculation. As a result, 100% of the revenue recorded was subject to participation fees.

As noted in issue 1 above, gross revenue should include revenue attributable to the firm’s global operations as reported on the firm’s audited annual financial statements. The Ontario percentage should then be determined to reflect the portion of gross revenue attributed to Ontario capital markets activities.

b) *Firms based their Ontario percentage on a factor other than their revenues or taxable income*

Some firms used the number of clients in Ontario relative to the total number of global clients in determining the Ontario percentage for the relevant fiscal year.

The definition of “Ontario percentage” is set out in section 1.1 of OSC Rule 13-502.

For firms with a permanent establishment in Ontario in the fiscal year, the firm’s Ontario allocation factor (**OAF**) expressed as a percentage should be used in determining the Ontario percentage. The OAF, as defined in the *Taxation Act, 2007*, refers to a firm’s Ontario taxable income in comparison to the firm’s total taxable income.

In any other case, firms should use the percentage of the revenues earned from their Ontario clients relative to the revenue earned from all of their global clients in the fiscal year to determine the Ontario percentage.

c) *Incorrect Ontario percentage where firms had the same fiscal year and taxation year*

In some instances where a firm had a permanent establishment in Ontario (required to file an Ontario corporate tax return) and the same fiscal and taxation year, the Ontario percentage derived from a firm’s corporate income tax return varied substantially from the Ontario percentage used to calculate participation fees.

If a firm’s corporate tax year is the same as its fiscal year, we expect that the Ontario percentage used to calculate participation fees would be the same as the Ontario percentage derived from the firm’s corporate tax return.

If a firm’s corporate tax year and its fiscal year are not the same, we expect that a firm would apply the same method used to determine the Ontario percentage on the assumption that the firm had the same corporate tax year as its fiscal year.

4. Other

a) *Management certification*

A number of firms certified the information reported on Form 13-502F4 with one member of senior management in Part IV of Form 13-502F4 when the firms had more than one member of senior management.

General Instruction 11 to Form 13-502F4 requires the information reported on Form 13-502F4 to be certified by two members of senior management to attest its completeness and accuracy. However, it is acceptable to provide certification by only one member of senior management for firms with only one officer and director.

We consider the review and sign off of participation fees by the Ultimate Designated Person (**UDP**) and the Chief Financial Officer (**CFO**) or other similar position, to be an integral aspect of an adequate compliance system. As part of an adequate compliance system, we also expect the Chief Compliance Officer (**CCO**) to understand the process involved in completing the Form 13-502F4 prior to the submission of participation fees to the OSC.

Additional guidance for future filings

We expect firms to take these items into account when completing and submitting the participation fee calculation.

a) *Books and records*

Each firm should maintain a signed copy of the Form 13-502F4 submitted to the OSC. In addition, each firm should maintain adequate books and records to support each figure included on Form 13-502F4, including evidence to support the review and approval by the UDP and the CCO, or senior management in cases where the firm is not registered with the OSC. The books and records should be readily available if requested by Staff.

The requirement to maintain books and records is outlined in section 19(1) of the Securities Act (Ontario) in respect of market participants and section 11.5 of NI 31-103 in respect of registered firms.

b) *Reference fiscal year*

OSC Rule 13-502 was amended effective April 1, 2013. One of the amendments involved the inclusion of a reference fiscal year to calculate participation fees. Please ensure that you are aware of the parameters of when to use a reference fiscal year.

"Reference fiscal year" is defined in section 1.1 of OSC Rule 13-502.

A firm's "reference fiscal year" is its last fiscal year ending before May 1, 2012, assuming it was a registrant firm, unregistered investment fund manager or an unregistered exempt international firm at the end of that fiscal year.

Subparagraph (a)(ii) of this definition only applies where a participant becomes a reporting issuer in that fiscal year as a result of receiving a prospectus receipt.

Next steps

We will continue to review participation fee calculations on an on-going basis. Firms should use this Notice as a self-assessment tool to ensure that participation fees are calculated correctly.

Questions

If you have any questions regarding the contents of this Notice, please refer them to any of the following:

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