

HEDGE FUNDS & STRUCTURED PRODUCTS ADVISORY BULLETIN

July 2006

OSC ISSUES LIST OF "TOP TEN" DEFICIENCIES OF LIMITED MARKET DEALERS

INTRODUCTION

The Ontario Securities Commission (the "OSC" or "Commission") recently published Staff Notice 11-758 – Review of Limited Market Dealers which summarizes the Commission's findings from a compliance review (the "Compliance Review") of a group of limited market dealers ("LMDs") undertaken in 2005. The objectives of the Compliance Review were to: (i) gain insight into the business operations of LMDs; (ii) assess the level of compliance by LMDs with securities laws; and (iii) identify any regulatory gaps.

In June 2005, the OSC held meetings with a voluntary focus group comprised of representatives from a cross-section of LMDs. The Commission also held individual meetings with representatives of other LMDs, the Mutual Fund Dealers Association (the "MFDA"), the Investment Dealers Association of Canada and the Limited Market Dealers Association. A written survey was then circulated by the OSC to all registered LMDs in the Province of Ontario, excluding LMDs that were also members of the MFDA. The survey was designed to obtain 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. The OSC selected 21 LMDs for further review based on the Commission's "risk ranking" of the LMD based on their responses to the survey. The majority of participants in the additional reviews had a risk ranking of "high". The OSC also included other LMDs to ensure representation of the various business models in the study.

As a result of its Compliance Review, the OSC identified a significant number of deficiencies. A majority of the deficiencies were identified in firms registered as "sole LMDs" (LMDs that are not registered in any other category of registration). Fewer deficiencies were identified in LMDs who were registered as Investment Counsel, Portfolio Managers ("ICPMs"). In the Staff Notice, the OSC has identified the following "top ten" most common deficiencies with LMDs and suggested certain practices that are designed to assist LMDs in understanding and addressing these deficiencies in order to strengthen their level of compliance with Ontario securities law.

1. NOT COLLECTING AND DOCUMENTING KNOW-YOUR-CLIENT (KYC) AND SUITABILITY INFORMATION

Explanation and Recommended Practice

Almost 80% of the LMDs reviewed by the Commission were deficient in collecting KYC and suitability information. The Compliance Review showed that KYC forms were not signed by LMD clients and were not reviewed by the LMD prior to a sale. The practice of retaining executed subscription agreements and accredited investor questionnaires is not sufficient to comply with an LMD's KYC and suitability obligations. The OSC suggests in the Staff Notice, the minimum content that the KYC form should contain and recommends that the form be signed by the client and reviewed by the LMD's Compliance Officer prior to any sale of securities.

2. INADEQUATE OR NO FILING OF STATEMENTS OF POLICIES AND REGULATORY FORMS

Explanation and Recommended Practice

Over 60% of LMDs reviewed by the OSC were deficient in this area. Deficiencies included having no Statement of Policies or no current Statement of Policies on file. Many Statements of Policies did not include a list of all related issuers to the LMD. The Compliance Review also found that LMDs were not in compliance with applicable reporting requirements, including the filing of exempt distribution reports and offering memoranda within the prescribed periods. The OSC recommends that LMDs should prepare and file a current Statement of Policies with the Commission and distribute a copy to their 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 also need to be cognizant of their reporting and filing obligations in respect of any trade in securities in which they are involved (either as issuer, seller or agent).

3. MISLEADING MARKETING MATERIALS AND WEBSITES

Explanation and Recommended Practice

The OSC found that more than 40% of LMDs reviewed were deficient in their marketing practices. Noted deficiencies for the marketing materials and websites reviewed included incorrect information, unsubstantiated claims, outdated materials, and misidentification of certain sales persons as officers or directors of the LMD. The Commission recommends that LMDs establish and enforce procedures for the review and approval of marketing materials and websites. LMDs should also conduct regular reviews of the marketing materials and websites to ensure that they are up to date. Furthermore, LMDs should ensure that all claims which are made in marketing materials or on websites can be adequately supported. The OSC cautions LMDs in the use of back-tested performance data in connection with the sale of products because such information can be misleading (as it may be presented or construed as actual results), can be constructed to achieve a desired outcome and is difficult to verify.

4. INEFFECTIVE COMPLIANCE OFFICER

Explanation and Recommended Practice

The Compliance Review showed that over 40% of LMDs reviewed were deficient in this area. Compliance officers appeared to have a lack of understanding of securities legislation and of their roles and responsibilities with respect to the LMD. For example, several compliance officers did not review client trades for suitability or marketing materials for appropriate disclosure. The OSC recommends that LMDs should clearly define the roles and responsibilities of their compliance officers. A detailed job/position description which is provided to, and reviewed with, the compliance officer would be beneficial in this regard. LMDs should also take all necessary steps, including the provision of additional training, to ensure that the compliance officers' responsibilities are met.

5. REGISTRATION ISSUES

Explanation and Recommended Practice

Over 35% of the LMDs reviewed were deficient in the area of registration. Deficiencies included LMDs acting as an ICPM without registration and individuals acting as LMD salespersons without registration. The OSC recommends that LMDs review their current business activities and obtain appropriate registration for all activities that require registration. The Commission also recommends that LMDs review their third party business arrangements to ensure that all such third parties are appropriately registered to carry out their responsibilities.

6. INADEQUATE DISCLOSURE OR MISLEADING STATEMENTS IN OFFERING MEMORANDA

Explanation and Recommended Practice

The Compliance Review revealed that over 35% of the sample LMDs had deficiencies in this area, including the inadequate disclosure of risk factors, conflicts of interest and rights of action for damages or rescission in offering memoranda where the LMD was acting as issuer or seller. The Commission noted that the provision of various types of disclosure documents (such as an investment summary or other offering document) are considered to be “offering memoranda” for the purposes of the *Securities Act* (Ontario) and therefore are subject to the requirement to provide disclosure of the statutory rights of action for damages against the issuer and selling security holder and rescission in the event that the offering memorandum contains a “misrepresentation” (as defined under Ontario securities law).

7. LACK OF WRITTEN POLICIES AND PROCEDURES MANUAL

Explanation and Recommended Practice

The Compliance Review indicated that 35% of LMDs reviewed either had no written policies and procedures, were missing written procedures for some major business areas, or their policies and procedures lacked sufficient detail. The OSC recommends that LMDs develop and enforce written policies and procedures that are tailored to their operations (as opposed to a “cookie cutter” approach). The OSC suggests, at a minimum, that the following areas should be addressed in any policy and procedures manual: role of compliance officer, including the review and supervision of new accounts and supervision of 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; and dealing with conflicts of interest and personal trading.

8. INADEQUATE BOOKS AND RECORDS

Explanation and Recommended Practice

More than 30% of the subject LMDs had inadequate maintenance of books and records. Specific deficiencies included no monthly or annual financial statements, no KYC forms, no trade blotter and trade confirmations, lack of signed subscription agreements and accredited investor forms, inadequate marketing materials and no bank reconciliations for trust and/or operating accounts. The OSC recommends that LMDs determine the appropriate books and records which they need to maintain for their operations. At a minimum, the Commission recommends that LMDs 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

Explanation and Recommended Practice

Over 30% of sample LMDs did not have written agreements with salespersons or promoters (eg. sub-agents) with whom they did business. The OSC recommends that LMDs establish written agreements with salespersons and third parties that clearly define each party’s roles and responsibilities and ensure that each party is appropriately registered to carry out its responsibilities under the agreement.

10. NO WRITTEN REFERRAL AGREEMENTS AND INADEQUATE DISCLOSURE TO CLIENTS

Explanation and Recommended Practice

The OSC's Compliance Review found that over 25% of the subject LMDs were deficient in the area of maintaining written agreements for referral arrangements and in disclosing these arrangements to their clients. The OSC recommends that written agreements be established with all referring parties. These referral agreements should clearly define the roles and responsibilities of each party and the fee to be paid/charged for the referral. LMDs should also provide clients with written disclosure that includes the nature of the referral arrangement, the amount of the fee paid, and a description of any potential conflicts of interest.

WHAT DOES THE FUTURE HOLD FOR LMDs?

The OSC has several options at its disposal when addressing identified compliance deficiencies of LMDs. These options include:

- (a) Issuance of a deficiency report where the LMD has a specified period of time to provide an "action plan" for addressing the identified deficiencies to the Commission's satisfaction;
- (b) Referral of the matter to Enforcement;
- (c) Continued monitoring of the LMD to ensure that steps are being taken and implemented to address the deficiencies; and/or
- (d) The suspension or imposition of terms and conditions on an LMD's registration.

In addition, the OSC has stated in the Staff Notice that due to the nature and quantity of the deficiencies identified in the Compliance Review, the Commission is considering increased regulation of LMDs in the future. This increased regulation could take the form of regulations imposing certain proficiency requirements for the granting of an LMD registration, more detailed books and records requirements, required filing of audited financial statements and/or the maintenance of insurance and minimum capital similar to those applicable to other registered dealers.

The OSC is continuing its regular compliance field reviews of LMD registrants in the current fiscal year. In light of the deficiencies noted by OSC Staff Notice 11-758, we encourage all LMD registrants to review their operations and level of compliance under the Securities Act (Ontario) and to consult with any member of the Structured Products Group at McMillan Binch Mendelsohn in respect of any registration or compliance related issues.

The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

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