



Financial and Consumer Services Commission (New Brunswick)
Staff Notice 33-702
Review of Exempt Market Dealer Practices

October 18, 2013

Introduction

The Exempt Market Dealer (EMD) category of registration was introduced with the implementation of National Instrument 31-103 – *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103) on September 28, 2009. Staff of the Financial and Consumer Services Commission (formerly the New Brunswick Securities Commission) completed a series of compliance reviews of a number of EMD firms that have branch offices in New Brunswick. The purpose of this Staff Notice is to:

- provide a summary of the compliance reviews and provide an overview of key issues observed;
- provide information with respect to common issues that were identified during the reviews and provide guidance with respect to suggested practices.

Summary of Initial Compliance Reviews

During 2012 and the beginning of 2013, FCSC staff conducted compliance reviews of a number of EMDs with branch offices located in New Brunswick. The goal of the reviews was to raise general awareness among EMD registrants of their ongoing regulatory obligations, and to better understand the business models and product shelves of EMDs operating in New Brunswick.

During the reviews, staff identified different business models, including:

- distributing prospectus-exempt securities on behalf of related issuers;
- distributing prospectus-exempt securities on behalf of entities that are not related issuers;
- providing underwriting services in relation to prospectus-exempt securities.

Staff reviewed Reports of Exempt Distribution filed in New Brunswick pursuant to National Instrument 45-106 (NI 45-106), interviewed representatives of the EMD firms, and conducted field visits at branches located in the province. In particular, our reviews focused on the operational aspects of each EMD's business in the branches, including compliance and supervision structure, know your client and suitability, know your product, and disclosure. Staff concluded the reviews by communicating to each applicable EMD specific areas of concern and common industry issues. In some cases, we requested that certain EMDs provide additional information for further consideration.

Overall, staff learned that EMDs operating in New Brunswick have a general understanding of their regulatory obligations, but would benefit from further information and guidance to assist them in meeting these obligations. For example, many registrants have not yet fully developed effective compliance systems regarding branch supervision.

Issues Identified During the Reviews

The attached Appendix provides information with respect to common issues identified during the reviews and provides guidance with respect to suggested practices.

1. Compliance System

Registrants are required to maintain and apply policies and procedures that establish a system of controls and supervision to ensure compliance with securities law and to manage day-to-day business risks. Staff identified that, for certain EMDs, their policies and procedures did not reflect the EMD's actual business practices in the branches, and that some EMDs have established only basic monitoring and supervision systems that do not adequately ensure compliance or manage risks.

2. Know Your Client and Suitability

NI 31-103 requires registrants to satisfy certain know your client (KYC) obligations. Among other things, collecting KYC information allows registrants to recommend suitable investments.

During the reviews Staff identified inconsistencies between clients' documented risk tolerance and the types of securities sold to them by EMDs. For example, certain EMDs sold securities that appear to be "speculative" or "risky" to clients identified as having a medium to medium-high risk tolerance.

3. Suitability and Product Due Diligence

NI 31-103 requires registrants to ensure that sales of securities are suitable for their clients. A common issue staff identified during our reviews was that certain EMDs were unable to demonstrate an appropriate level of due diligence on exempt market products offered for sale to clients.

4. Disclosure of Information

NI 31-103 requires registrants to provide certain relationship disclosure information to their clients. A common issue found during the reviews was that EMDs do not always adequately disclose to clients relationships with issuers, and risks related to borrowing money for the purposes of investing. Further, it is not sufficient for EMDs to satisfy disclosure requirements by providing clients with disclosure material they receive from issuers.

Conclusion

The attached Appendix provides information with respect to common issues that were identified during the reviews and provides guidance with respect to suggested practices for registrants.

Please refer questions with respect to this Staff Notice to:

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Review of Exempt Market Dealers Practices
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Explanatory Notes

This Appendix to the Staff Notice is directed at firms trading exempt market products in New Brunswick. Many firms are registered in multiple categories, such as Exempt Market Dealer, Investment Fund Manager and/or Portfolio Manager. Firms registered in multiple categories should ensure they are meeting the regulatory requirements associated with all categories of registration.

This Appendix is intended to provide dealers with general information regarding their regulatory obligations and is not exhaustive. Firms must refer to the applicable legislation for complete information. Firms are expected to develop the necessary elements of an effective compliance system to ensure the fulfillment of regulatory obligations.

Glossary

NI 31-103 refers to National Instrument 31-103 – *Registration Requirements, Exemptions and Ongoing Registrant Obligations*

31-103CP refers to Companion Policy 31-103CP – *Registration Requirements, Exemptions and Ongoing Registrant Obligations*

NI 33-109 refers to National Instrument 33-109 – *Registration Information*

33-109CP refers to Companion Policy 33-109CP – *Registration Information*

NI 45-106 refers to National Instrument 45-106 – *Prospectus and Registration Exemptions*

45-106CP refers to Companion Policy 45-106CP – *Prospectus and Registration Exemptions*

1. Internal Controls and Systems

Compliance System

Requirement	Issues	Suggested Practices	Rule Reference
<p>The firm must establish, maintain and apply policies and procedures that establish a system of controls and supervision to:</p> <p>a) Provide reasonable assurance that the firm and each individual acting on its behalf complies with securities legislation, and</p> <p>b) Manage the risks associated with its business in accordance with prudent business practices.</p>	<p>There were inconsistencies noted between processes set out in the policy and procedures manuals and the actual processes observed in the branch offices.</p> <p>Some firms lack suitable supervision and training programs.</p> <p>The CCO does not appropriately monitor the operations and activities of the firm and its dealing representatives.</p>	<p>Elements of an effective compliance system include the appointment of qualified compliance personnel, relevant policies and procedures, internal controls, day to day and systemic monitoring and supervision systems.</p> <p>Firms should review their compliance manual on an ongoing basis and ensure it is reflective of actual business practices at all levels of business.</p> <p>Firms should develop written policies and procedures to supervise the activities of their dealing representatives on an ongoing basis. Firms should conduct initial and ongoing compliance and product training sessions.</p>	<p>Section 11.1 of NI 31-103 - <i>Compliance System</i></p> <p>Section 11.1 of 31-103CP – <i>Compliance System</i></p>

2. Books and Records			
Requirement	Issues	Suggested Practices	Rule Reference
A firm must maintain books and records that accurately reflect its business activities, financial affairs and client transactions and demonstrate the extent of the firm's compliance with the applicable requirements of securities legislation.	The firm is not able to evidence its compliance with applicable requirements (i.e. trading blotters and client statements did not reflect accurate client holdings or transaction dates).	Firms should be able to evidence compliance with all books and records requirements. Firms may find it useful to develop checklists of their obligations and associated daily, weekly, monthly and ongoing activities in order to guide their oversight and to provide evidence of ongoing review and sign-off of their obligations.	Part 11, Division 2 – <i>Books and Records</i> – of NI 31-103 Sections 11.1 and 11.5 of NI 31-103CP – <i>Compliance System</i>

3. Dealing with Clients			
Know Your Client (KYC)			
Requirement	Issues	Suggested Practices	Rule Reference
A registrant must establish the identity of the client. A registrant must ensure it has sufficient and current information to meet its suitability obligations under Section 13.3 of NI 31-103, such as the client's (1) investment needs and objectives; (2) financial circumstances and (3) risk tolerance. A registrant must take reasonable steps to keep KYC information current.	Registrants are not always obtaining, documenting and verifying sufficient KYC information.	Registrants should ensure that they are collecting and documenting sufficient KYC information so they can properly determine the suitability of recommended products. Firms should implement controls to ensure all KYC information is obtained and is accurate (i.e. controls such as completeness checks and client sign-off on KYC forms). Registrants should ensure that they have a process for updating KYC information as material changes occur, and consider practices such as annual client meetings to review KYC information.	Section 13.2 of NI 31-103 – <i>Know your client</i> Section 13.3 of NI 31-103 – <i>Suitability</i> Section 13.2 and Section 13.3 of 31-103CP
Prospectus-exempt securities may be considered high risk products for a variety of reasons (i.e. there is often limited availability of information regarding the issuer and the security, less recourse for the investor, absent or limited secondary markets, and long or	The risk tolerance documented on a client's KYC form is inconsistent with the risk profile of the product.	Firms must ensure the KYC information collected from the client, such as risk tolerance, net worth and age, is consistent with the risk profile of the security being sold.	Section 13.2 of NI 31-103 – <i>Know your client</i> Section 13.3 of NI 31-103 – <i>Suitability</i> NI 45-106 – <i>Prospectus and Registration</i>

indefinite investment horizons). The firm must ensure that the level of risk associated with an exempt product is consistent with the client's tolerance for that level of risk.			<i>Exemptions</i>
Firms must determine if the client meets the appropriate prospectus exemption requirements being used to purchase the security (i.e. purchases made under the "accredited investor" exemption of NI 45-106).	Some firms do not collect sufficient KYC information to reasonably determine whether an investor qualifies for the exemption being utilized or the KYC information collected is not supported by verification of the client's financial assets or net income.	A firm should ensure that sufficient KYC information is obtained, verified and documented, and that the information is consistent with the exemption being claimed.	NI 45-106 – <i>Prospectus and Registration Exemptions</i>

4. Conflicts of Interest

Requirement	Issues	Suggested Practices	Rule Reference
A firm must take reasonable steps to identify, respond to and disclose existing and potential material conflicts of interest. If a registered individual recommends a security that they own, this may constitute a material conflict that should be disclosed to the client before or at the time of the recommendation.	Some firms have not progressed beyond documenting the principals governing conflicts of interest to implementing effective policies and procedures to identify, avoid, control and disclose potential conflicts of interest.	Firms should implement policies and procedures that ensure they identify, avoid, control and disclose conflicts of interest.	Section 13.4 of NI 31-103 - <i>Identifying and responding to conflicts of interest</i> CSA Staff Notice 31-326 – <i>Outside Business Activities</i> Section 13.4 of 31-103CP

5. Disclosure when Recommending Related or Connected Securities

Requirement	Issues	Suggested Practices	Rule Reference
The firm must not make a recommendation with respect to the securities of	Some firms rely on the issuer's disclosure information to fulfill the	Firms must to be able to demonstrate that these disclosure obligations are being met.	Section 13.6 of NI 31-103 - <i>Disclosure</i>

related or connected issuers without disclosing the extent of the relationship.	<p>firm's dealer obligations (i.e. the disclosure as contained in the issuer's offering memorandum).</p> <p>Some firms provide insufficient disclosure with respect to the extent of the relationship and potential conflicts of interest associated with the relationship.</p>	Firm should include written disclosure explaining the nature and extent of the relationship with the related or connected issuer in all materials distributed or provided to clients. This disclosure should include existing or potential conflicts of interest, including fees and payments to related parties.	<i>when recommending related or connected securities</i>
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6. Referral Arrangements

Requirement	Issues	Suggested Practices	Rule Reference
<p>A registrant must not participate in a referral arrangement unless the terms of the referral arrangement are set out in a written agreement between the registered firm and person or company receiving or giving the referral.</p> <p>The registrant must ensure that the information prescribed by subsection 13.10(1) of NI 31-103 is provided to the client in writing before the party receiving the referral either opens an account for the client or provides services to the client.</p>	Some firms do not have a written agreement in place for their referral arrangements.	<p>Firms should ensure that appropriate written agreements for all referral arrangements that the firm and/or individuals have entered into are in place and that sufficient information is provided to clients at the appropriate time.</p> <p>Firms should implement policies and procedures outlining how the firm will review potential referral arrangements, how existing referral arrangements will be monitored and how any changes to referral arrangements will be communicated to clients.</p>	<p>Part 13, Division 3 - <i>Referral arrangements</i> of NI 31-103</p> <p>Part 13, Division 3 - <i>Referral arrangements</i> of 31-103CP</p>

7. Disclosure when Recommending the Use of Borrowed Money

Requirement	Issues	Suggested Practices	Rule Reference
If a registrant recommends that clients borrow money to finance any part of a purchase of a security, the registrant must, before the purchase, provide the	Some firms recommend consideration of the use of leverage but do not provide clients with a written statement outlining the risks prior to purchase.	A firm must provide to all clients, prior to purchase, a written statement outlining the risks associated with using borrowed money to purchase securities.	Section 13.13 of NI 31-103 - <i>Disclosure when recommending the use of borrowed</i>

client with a written statement outlining the risks associated with investing borrowed money. An example of a written statement can be found under Section 13.13 of NI 31-103.			<i>money</i>
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8. Complaints			
Requirement	Issues	Suggested Practices	Rule Reference
A registered firm must document and, in a manner that a reasonable investor would consider fair and effective, respond to each complaint made to the registered firm about any product or service offered by the firm or a representative of the firm.	<p>Some firms do not have a clearly defined definition of a client complaint.</p> <p>Some firms do not document client complaints.</p>	<p>Firms should use a complaint log and/or a complaint handling form for individuals to document the intake, details and resolution of each complaint.</p> <p>Firms should have clear complaint handling policies and processes for monitoring, reporting to an identified party and responding to both verbal and written complaints.</p> <p>Firms should provide communication to clients that clearly outlines where complaints can be directed.</p>	Part 13, Division 5 of NI 31-103 – <i>Complaints</i>

9. Handling Client Accounts			
Requirement	Issues	Suggested Practices	Rule Reference
<p>A registered firm must deliver to a client all information that a reasonable investor would consider important about the client’s relationship with the registrant.</p> <p>The firm must deliver the information to the client as outlined under Section 14.2 of NI 31-103.</p> <p>The information must be delivered before the firm first purchases or sells a security for a client or advises the client to purchase, sell or hold a security.</p>	<p>Some firms are not providing a disclosure document or are not able to evidence the provision of a disclosure document.</p> <p>Some firms rely on the issuer’s disclosure information to fulfill the firm’s disclosure obligations (i.e. reliance on the disclosure as contained in the issuer’s offering memorandum).</p> <p>There is inadequate disclosure to the client.</p>	<p>Firms should provide, and be able to evidence the provision of, a relationship disclosure document highlighting the information required under Section 14.2 of NI 31-103 and any other information a client would consider important.</p> <p>Firms must disclose information regarding the outside business activities of their dealing representatives which create a potential conflict of interest.</p>	Section 14.2 of NI 31-103 – <i>Relationship Disclosure Information</i>

