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DISTRIBUTING RELATED PARTY EXEMPT PRODUCTS

Can an Exempt Market Dealer sell the securities of a Related Issuer or does the Issuer need to engage a third party Dealer?

EMDs that are established for the sole purpose of selling related party products (“Captive EMDs”) are often treated by the Commissions as having a riskier business model. These firms are good candidates for on-site regulatory visits and may also be subject to greater scrutiny when applying for registration.

However, there remains no prohibition against selling related party exempt products.

This article will explain current regulatory concerns with related party exempt products and will discuss reasonable steps that Captive EMDs can use to address these concerns.

The Related Party Product Scare

In its 2014 annual notice on registrant regulation (OSC Notice 33-745), the Ontario Securities Commission stated the following:

“We continue to have significant concerns with EMDs that trade in, or recommend, the products of related and/or connected issuers (often referred to as “related party products”), particularly those EMDs that trade solely in these products. Material conflicts of interest arise with these relationships, in large part due to the lack of separation between the mind and management of the EMD and the issuer.”

The Ontario Securities Commission appears to have further announced their discomfort with related party products by proposing that the Offering Memorandum exemption (when allowed in Ontario) not be applied to these offerings.

The regulators’ concern about related party products stems from recent high profile cases where captive EMDs sold securities that were either very poorly designed or operated in an unethical manner.

The Commissions’ ongoing interaction with Captive EMDs through on site reviews and registration filings, appear to have further shaken their confidence in these types of registrants.

Why the Industry Needs Captive EMDs

However, Captive EMDs are critical to the Canadian capital markets as they give Issuers the ability to speak directly with investors; without this outlet a few national and regional Dealers will decide what opportunities get financed.

Furthermore, the distribution channels of national and large regional Dealers are becoming more restrictive as they gradually cull their product shelf to better manage risk. If the Dealer is connected to a financial product manufacturer, offerings that compete with those of the manufacturer are unlikely to get on the shelf. Hence captive EMDs are critical for the development of new investment ideas and opportunities.

Why do the Regulators perceive Captive EMDs as “risky”?

Why do the management of captive EMDs often struggle with addressing their regulatory expectations?

The simple answer is that they are experts in their business and not in the operation of a registered Dealer. Furthermore, registrant regulation is fundamentally different from regulation in most other industries.

Most industries operate under prescribed regulation. For example Canadian Agricultural Regulation mandates the ingredients, and minimum and maximum milk fat content (by weight and/or calories) for light cheese.

Registrant regulation; however, is principally based on concepts and ideas, rather than defined rules. The difficult topics such as, “suitability”, “know your product obligation” and “business trigger” are concepts that management must apply within the context of their business, industry standards, and regulatory expectations.

Management of Captive EMDs often struggle with the practical application of regulatory rules and concepts.

Tips for Captive EMDs

Though the needs and circumstances of each Captive EMD are unique, there are general guidelines that management of such firms can follow.

Tip #1: Fall out of in love with your financial offering.

Management of Captive EMDs often treasure their financial products in the same manner that parents treasure their children. They can be blind to or diminish the risks and blemishes of their financial offerings. This lack of unbiased self-examination is a primary reason that many of these firms get into regulatory trouble, and are accused of unsuitable selling.

Management should clearly identify product risks and analyze expected performance under different scenarios. Depending on the product's features, risk should be analyzed based on security of capital as well as the security/timeliness of cash flows.

Management should also carefully review the implicit and explicit liquidity of the offering and how this impacts its suitability for various types of investors. Explicit constraints are provisions such as lock-up periods or restrictions on how frequently investors can redeem their units. Implicit liquidity constraints can arise because of a fund's inability to accommodate significant redemption requests within a short time period.

Tip # 2: Avoid offering guaranteed returns unless backed by a significant amount of money and a lot of experience.

Large financial institutions can make a very good return by offering investors a guaranteed return and investing those monies at a higher rate. However; these institutions are also subject to stringent regulation and have personnel with a strong background in lending.

Exempt market products that offer guaranteed returns are effectively serving as mini lending institutions, but without the regulation and, in many cases, without the experienced personnel.

Guarantees can quickly disappear at the first sight of a major market disruption, or operation and lending mistakes. Unless the product manufacturer has strong lending experience and financial backing to make good on the guarantee (if returns cannot be paid from the fund), they should avoid offering guaranteed returns.

Tip #3: Provide enhanced ongoing disclosures

Exempt market product manufacturers should consider adopting disclosure standards comparable to those of public issuers. Not only does this serve to reduce the perceived risk of the offering but further cements the Issuer's relationship with investors.

Lack of transparency is one of the stated reasons why exempt market products are considered to be high risk.

Tip #4: Access knowledge, experience and judgment on registrant regulation matters

As noted previously, registrant regulation is largely based on concepts rather than prescriptive rules. As a result, Management of Captive EMDs should actively seek knowledge, experience and judgment on regulatory compliance matters.

The registrant outreach program that many Commissions have instituted is an excellent source of insight, along with publications such as annual reports on common registrant deficiencies.

Firms should also consider engaging staff or external consultants who have relevant experience with registrant compliance.

Tip #5 Don't not try to avoid registration by forwarding investors to a third party EMD or having staff registered under an EMD that is not organized.

Recent changes to the exemptions under National Instrument 31-103 have clarified that financial product manufacturers cannot simply avoid registration by passing their investors onto a third party EMD.

Firms should also be careful about accessing distribution by having their staff registered as Dealing Representatives with a third party EMD.

Unless the EMD is in the business of operating a branch network, the manufacturer may be simply exposing itself to the weaknesses of another firm whose motivation may be to defray operating costs.

Captive EMDs currently suffer from a poor image because of recent scandals. However, they are also Canada's only hope against an oligopolistic industry where a few national firms determine what investment ideas will be offered.

To navigate the current environment Captive EMDs need, a better understanding of their role as securities registrants and, a practical application of their regulatory obligations.

Ara Compliance Support

Ara Compliance Support is a boutique firm that provides ongoing compliance support to independent Exempt Market Dealers and Portfolio Managers. Our focus is to help our clients reduce their compliance risk, and apply their time more efficiently. For more information, please contact us at 416-941-1263 or at info@aracompliance.com