OSC's Investment Management Division Report focused on AI, crypto and ESG

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Investment Management Division Report

On Nov. 5, 2024, the Ontario Securities Commission (OSC) published OSC Staff Notice 81-736 (the Staff Notice), summarizing the activities and regulatory focus of the OSC's Investment Management Division (IM Division), formerly known as the Investment Funds and Structured Products Branch, for the fiscal year ended March 31, 2024.

This bulletin highlights certain key insights from the Staff Notice, including:

- New artificial intelligence (AI) and cryptocurrency (crypto)-related developments in the industry;
- ESG-related guidance pertaining to investment fund managers' (IFMs) sales communications and marketing practices; and
- Emerging issues and possible OSC initiatives moving forward.

While some of the takeaways are unsurprising, such as the growing preference for exchange traded fund (ETF) products on dealers' shelves and the OSC's continued concern over ESG-related disclosure, IFMs and advisers will want to be aware of several novel developments in Ontario's investment fund landscape. These novel developments include the increased integration of AI in investment decision making processes and changes to the crypto regulatory landscape.

Novel products: Artificial intelligence and public crypto asset funds

Artificial intelligence

During the year, the OSC receipted a first-of-its-kind fund that seeks to gain exposure to securities of publicly traded issuers that are expected to benefit from increased adoption of AI. While there are several existing innovation and technology-oriented funds that pursue this type of strategy, this new AI fund is unique because the portfolio manager (PM) will seek to achieve the fund's objectives through use of a proprietary large

language model (LLM). Like other LLMs, such as GPT-4, the LLM can search and read through financial statements, news articles, public company filings, earnings reports and market analyses, analyze vast datasets and learn from new data (meaning its ability to identify relevant issuers that are expected to benefit from increased adoption of AI can evolve over time). The database generated by the LLM must be utilized by the PM as "a data source", rather than being the only data considered in constructing the fund's portfolio. This requirement demonstrates the importance to OSC staff that a PM firm take ownership of, and have full discretion over, investment decisions, by ensuring "human oversight" of any investment decision-making process that uses AI.

Public crypto asset funds

The Canadian Securities Administrators (CSA) are seeking to amend National Instruments 81-102 *Investments Funds* (NI 81-102) to explicitly integrate public investment funds that invest in crypto assets, either directly or indirectly (Public Crypto Asset Funds) into the existing alternative mutual fund framework.

Existing public crypto asset funds are classified as "alternative mutual funds" under NI 81-102 and, accordingly, have a greater ability to borrow cash or provide a security interest over their assets, engage in short selling, or use specified derivatives compared to conventional mutual funds. CSA Notice and Request for Comment – *Proposed Amendments to National Instrument 81-102 Investment Funds Pertaining to Crypto Assets*, which was preceded by CSA Staff Notice 81-336 *Guidance on Crypto Asset Investment Funds That Are Reporting Issuers*, seeks to amend the definition of alternative mutual fund to explicitly capture funds that invest in Crypto assets. In addition, NI 81-102 will be amended to clarify that conventional mutual funds will only be permitted to obtain exposure to crypto assets by investing in underlying alternative mutual funds or non-redeemable funds that invest in crypto assets and will not be permitted to use derivatives to obtain exposure to crypto assets. The proposed amendments will also prohibit the use of crypto assets as the loaned securities, transferred securities or collateral posted in connection with securities lending, repurchase transactions or reverse transactions, as applicable.

Updated ESG guidance

As discussed in our BLG bulletin ESG-related investment fund disclosure in 2024: "Walk your talk", the CSA published *revised* CSA Staff Notice 81-334 *ESG-Related Investment Fund Disclosure* on March 7, 2024 (the ESG Staff Notice) to provide updated guidance on environmental, social and governance (ESG)-related investment fund disclosure and sales communication practices. The ESG Staff Notice highlights that OSC staff remain concerned about IFMs' ESG-related disclosure and marketing materials. Market participants that include ESG-related disclosure should bear in mind the ESG Staff Notice when conducting annual reviews and updates of their offering documents and sales communications.

The number of continuous disclosure reviews performed by the OSC increased by ≈75 per cent from the prior year and the OSC commented that "as the volume of exemptive relief applications and prospectus reviews have remained stable, resources have shifted to performing continuous disclosure reviews of emerging issues and compliance with regulatory guidance", such as the ESG Staff Notice.

The recent publication of an OSC study examining the influence of ESG factors on retail investor decision making found that ESG ratings were one of the most important attributes influencing investor preferences when selecting investment funds (second only to a fund's past performance). In this study, the OSC calls attention to various challenges investors face in evaluating the ESG components of investment funds, identifying issues such as a lack of standardization in ESG definitions and ratings. Taken together with the Staff Notice and the ESG Staff Notice, we expect securities regulators will continue to provide guidance - or potentially engage in rule-making - as the regulatory landscape impacting ESG-related investment funds continues to evolve.

Emerging issues moving forward

SEDAR+ transition for foreign fund managers

SEDAR+ went live on July 25, 2023 following the CSA's adoption of National Instrument 13-103 *System for Electronic Data Analysis and Retrieval +*, which requires filers to transmit electronically through SEDAR+ each document required or permitted to be filed with, or delivered to, a securities regulatory authority (e.g. prospectuses, offering memoranda, and reports of exempt distribution). While there has been an exemption available to foreign IFMs that distribute "eligible foreign securities" to "permitted clients" under Ontario Securities Commission – Coordinated Blanket Order 13-933 (the Blanket Order), this exemption is currently set to expire on **Jan. 21, 2025.** Accordingly, absent an extension of the Blanket Order, SEDAR+ will be used by all market participants in 2025 to effect certain filing and delivery obligations in Canada. The OSC is currently considering whether to extend the Blanket Order.

Review of ETFs

In August 2023, the CSA commenced a review of ETFs. The review assesses whether the current regulations applicable to ETFs remain appropriate, focusing on the unique features of ETFs, *i.e*., secondary market trading, creation and redemption of ETF units by authorized dealers and the arbitrage mechanism that acts to keep the market price of an ETF close to the underlying value of its portfolio. The review (i) analyzes the ETF market, including assessing secondary market activity and factors that may affect ETFs' liquidity and trading and (ii) considers whether the Good Practices Relating to the Implementation of the IOSCO Principles for Exchange Traded Funds published in 2023 are appropriate for the Canadian market. The CSA expects to complete its review this year and the research will be used to inform the CSA's analysis of potential gaps in and enhancements to the regulatory regime for ETFs. The CSA expects to publish a consultation paper in 2025 regarding potential issues and to provide stakeholders with the opportunity to comment on the review and any preliminary policy proposals before proposing rule changes.

Conclusion

As evidenced by the Staff Notice, the investment management industry is constantly responding to changing technology and evolving regulatory concerns. BLG has experience in all aspects of investment management, including: fund formation, listing of ETFs, offering document and continuous disclosure preparation and review, addressing

ESG and Crypto related matters and much more. For more information on any of the above topics please feel free to reach out to the authors listed below.

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Investment Management

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