

# CSA Continues to Finesse Registrant Regulation – Proposed Additional Requirements Governing Custody, EMDs and CRM2

July 25, 2016

On July 7, 2016, the Canadian Securities Administrators (CSA) published proposed amendments to National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations and National Instrument 33-109 Registration Information and also to their respective Companion Policies. The proposed amendments have been published for comment with a comment deadline of October 5, 2016.

While there is much regulatory finessing of existing requirements and guidance amounting to clarifications that are non-problematic and helpful, there are more substantive proposals that will, if adopted, affect registrants' custody arrangements made for clients, including any pooled funds they manage, as well as registrants' compliance with the existing "client relationship model" (CRM2) requirements. Additional proposals are intended to provide certainty on the activities that can be carried out by exempt market dealers (EMDs). Finally, the CSA ask questions about expanding the CRM2 requirements that would, if adopted, amount to a third phase of this regulatory initiative.

The amendments to NI 31-103 will affect registered advisers (portfolio managers), investment fund managers, scholarship plan dealers and EMDs, as applicable, but not registered dealers which are members of either of the two self-regulatory organizations (SROs) in Canada, which are expressly exempted from many of the proposals in NI 31-103, given existing SRO regulation.

## Custody Proposals

The custody proposals will have particular impact on advisers and investment fund managers that manage investment funds (pooled funds) that are not reporting issuers and therefore are not subject to the custodial provisions in National Instrument 81-102 Investment Funds or National Instrument 41-101 General Prospectus Requirements. For the first time, the CSA propose to establish custodial provisions for these funds. For

reasons that are not fully explained, the CSA have chosen to develop specialized custody requirements for registrants, including for privately-placed funds, which differ from the requirements set out in NI 81-102 and NI 41-101. It will be important to review these provisions carefully to ensure that they work in ways that are practical and reasonable for privately-placed funds, and advisers.

Generally the custodial requirements will not apply to certain "permitted clients", but each such permitted client must waive the application of the requirements in writing. This waiver provision will not apply to permitted clients that are individuals or investment funds.

With certain exceptions for specific assets noted below, the custody proposals would require:

- All client assets held by the registrant or to which the registrant has access, be held in custody by either a "Canadian custodian" or a "foreign custodian". The two types of custodian are defined in ways that are similar to NI 81-102, but with an important distinction. Canadian custodians will include registered investment dealers that are members of IIROC and that are permitted to hold securities and cash of a client or investment fund. There is no such "registered dealer" category for "foreign custodian", other than affiliates of foreign banking institutions or of Canadian custodians (other than IIROC members).
- If a registrant chooses a "foreign custodian", such arrangement must meet a reasonability test, in that a "reasonable person would conclude that using the foreign custodian is more beneficial to the client or the investment fund than using a Canadian custodian".
- If a registrant directs or arranges for clients to enter into custody relationships with firms, it must do so only if the custodial firm is a qualified Canadian custodian or foreign custodian.
- A registrant will be expected to carry out due diligence in choosing a custodian, in negotiating the custodial relationship and in monitoring the services provided.
- Custodians must be "functionally independent" of the registrant, unless the custodian is a specified type of Canadian custodian and meets specified compliance criteria.
- A registrant cannot itself be the custodian of client or investment fund assets, unless it qualifies as a specified type of Canadian custodian and meets specified compliance criteria.
- Disclosure about the custodial arrangements of the registrant must be provided in the relationship disclosure information of the registrant.

Cash held by a registrant for a client or an investment fund may be held by a Canadian financial institution.

Certain assets are not required to be held under the proposed custodial requirements, including:

- Securities that are registered only in the name of the client or the investment fund on the books of the issuer of the securities
- Customer collateral subject to custodial requirements applicable to derivative instruments
- Certain mortgages.

Similar to existing provisions, cash or other property held by a registrant, for example, cash held in an account in the name of the registrant in transit for delivery to a client or an investment fund, including its custodian, must be held separate and apart from the other assets of the registrant and in trust for the client or investment fund.

The CSA propose a six-month transition period for the custody requirements, which will mean all custodial arrangements for investment funds and other clients, as applicable, must meet the new requirements within that transition period. Further clarity will be required from the CSA as to existing custodial relationships for clients where such custodial relationships were directed or arranged by the registrant for the client, given the CSA's statement that the new custody provisions will not apply "retroactively" to these relationships, but that specified disclosure must be given to these clients if those relationships do not meet the new custodial requirements.

## Further Clarity on EMD Activities

The activities of EMDs have always been restricted to participating in the so-called "exempt markets". However, the language used to define what EMDs can and cannot do has gone through several refinements, with mixed success. The last amendments made to the applicable restrictions came into force in July 2015 and raised more questions than answers. With the additional refinements proposed in this current publication, the CSA are further clarifying their expectations for EMDs and, in the process, have further narrowed the scope of trades in which an EMD may participate.

The CSA have long emphasized that EMDs may not participate in any capacity in offerings of securities made under a prospectus, including as underwriters or selling group members. The CSA once again state that they consider that the appropriate dealer registration for firms wishing to participate in prospectus offerings, or trades in listed securities, is the investment dealer category. EMDs are not to be a competing distribution platform for issuers that wish to make prospectus offerings or for trading in listed securities.

The general concept is that an EMD may only act as a dealer or an underwriter in an "exempt trade". The permitted activities of an EMD are determined by reference to the prospectus exemptions in securities legislation (e.g., the accredited investor, minimum amount investment and offering memorandum exemptions in National Instrument 45-106 Prospectus Exemptions). Under the proposed amendments, the CSA have distinguished between trades that are distributions and secondary market trades (that is, trades that are not distributions) and further clarified their position on what is and is not permissible.

EMDs may trade securities:

- **Distributed under a prospectus exemption – this will include securities of an issuer that is a reporting issuer, so long as there is no prospectus qualifying the distribution**
- In the secondary market that are subject to resale restrictions
- In the secondary market if a prospectus exemption would be available to the seller if the trade were a distribution and the class of securities is not listed, quoted or traded on a marketplace.

EMDs may not:

- Establish an omnibus account with an investment dealer and trade listed securities through the investment dealer on behalf of their clients
- Participate in a distribution of securities offered under a prospectus in any capacity, (including a sale of special warrants convertible into prospectus-qualified securities) as a dealer, agent, finder, selling group member or underwriter, even if a prospectus exemption would otherwise be available (e.g. a sale to an accredited investor).

## **Further Clarity for Advisers Trading in their Own Investment Funds for Managed Account Clients**

Section 8.6 of NI 31-103 today allows a registered adviser and an international adviser (exempt from registration as an adviser) to trade in the securities of investment funds with its managed accounts without dealer registration, if the adviser manages the investment fund and certain other conditions are met. The CSA propose to amend this provision to clarify that this exemption will apply where the adviser or an affiliate of the adviser is the investment fund manager of the applicable funds. The CSA also clarify in the Notice describing the proposed amendments that this exemption will continue to apply to prospectus qualified investment funds of the registrant. We will recommend that this statement be included in the Companion Policy, given that we consider this a welcome clarification.

## **CRM2 Clarifications and Future Proposals**

The CSA propose many minor, as well as some more substantive, amendments to the CRM2 requirements of NI 31-103 and the Companion Policy. Most of these amendments are consistent with prior FAQs provided by the CSA and also the May 2015 "blanket relief" granted by the members of the CSA in respect of the provisions of CRM2 that came into force in 2015. All of the proposed amendments apply only to registered advisers, scholarship plan dealers and exempt market dealers, given that SRO members (members of IIROC or the MFDA) must comply with their own SRO rules, which have been finalized.

There are some proposed amendments which may necessitate amendments to the templates for the CRM2 statements and documents that have already been developed, as well as the registrant's compliance systems. These include:

- As noted above, a requirement to disclose custodial arrangements in the RDI (relationship disclosure information), including the way(s) that the registered firm holds client's assets and the relevant associated risks and benefits to the client.
- A suggestion in the Companion Policy that, if a registered firm exclusively or primarily invests its clients' money in securities issued by a related party, such information should also be disclosed in the relationship disclosure information.
- A clarification in the Companion Policy that the requirement to disclose in the relationship disclosure information the nature of the charges a client might pay during the course of holding a particular investment, includes management fees associated with mutual funds.

- A requirement to designate the security positions (presumably by an asterix or other designation and footnoted disclosure) where "market value" rather than "position cost" was used in the applicable account statement and explain this fact.
- A clarification in the Companion Policy that the required quarterly account statements must be provided to the clients for each account held by that client with the registrant (for example, separate account statements for the client's RSP account, her RESP account and her separately managed account). These statements can be supplemented by consolidated statements if the client requests this.
- A change in how a firm must describe an applicable investor protection fund in certain account statements.
- A suggestion in the Companion Policy that firms must explain to clients that an investment performance report will not be provided because none of the securities held by the clients have a determinable value.
- A suggestion in the Companion Policy that firms compare a client's actual rate of return against his or her "targeted" rate of return.
- A suggestion in the Companion Policy that the report on charges and compensation include **"employee bonuses"** where such payments are made to representatives and are linked to sales or other registrable services to the client receiving the report.
- A clarification in the Companion Policy that position cost is not tax information and that a registered firm may not depart from the defined meaning of "original cost" or "book cost" in order to align position cost with tax cost for a security position; but a suggestion that if the tax treatment of a security is an important part of its marketing to investors, a registered firm should provide tax information as well as position cost information.

The CSA also request comment about two issues that we have long dubbed a potential for a third phase of CRM (CRM3). Similar to, but not as far-reaching as, the consultation launched by the Mutual Fund Dealers Association of Canada in December 2015, the CSA ask for comment on the following two issues that relate to disclosure in report on charges and compensation (now effective as of July 15, 2016 and the first of which is expected to be delivered by registrants by July 15, 2017):

1. Whether the report should include disclosure about "non-cash incentives" that may be paid to the dealer or adviser and its representatives. The CSA give as examples "promotions or other employment benefits, for sales of certain products".
2. Whether the report should contain a general notification that reminds clients who invest in investment funds or "other securities with embedded fees" that management fees are paid by the fund (although the CSA speak of fees paid to the issuer, which we assume is a misstatement) and that these fees may reduce the client's investment returns.

It will be important to consider these questions and provide meaningful feedback to the CSA, particularly in light of the CSA's signalled next steps in connection with examining mutual fund fees. [CSA Staff Notice 81-327 Next Steps in the CSA's Examination of Mutual Fund Fees](#) dated June 29, 2016 is available [here](#).

# Proposed Amendment to Form 33-109F7 Reinstatement of Registered Individuals and Permitted Individuals

The CSA propose to restrict which individuals can use the procedure established under NI 33-109 by using Form 33-109F7, which is the form that must be filed by a registered individual or permitted individual when they are moving between registrants and wish their registration to be reinstated with another firm. In addition to current restrictions, this form and procedure will not be available to individuals who have been denied the benefit of any exemption from registration provided in any securities or derivatives legislation or rules, since the last time the individual's Form F4 was updated. If this question cannot be answered negatively, then the individual must complete an updated Form 33-109F4 and apply for a "reactivation" of registration. Conversely additional registrations or licences will not disqualify an individual from using the reinstatement procedure (which is the situation today).

Please contact the authors of this Bulletin, your usual lawyer in [BLG's Investment Management Group](#) or the leaders of BLG's Investment Management Group noted below, if you have any questions about the proposed amendments to NI 31-103 and how they may affect you, or if we can assist you in providing comments to the CSA by the comment deadline of October 6, 2016.

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## BLG Offices

### Calgary

Centennial Place, East Tower  
520 3rd Avenue S.W.  
Calgary, AB, Canada  
T2P 0R3  
T 403.232.9500  
F 403.266.1395

### Ottawa

World Exchange Plaza  
100 Queen Street  
Ottawa, ON, Canada  
K1P 1J9  
T 613.237.5160  
F 613.230.8842

### Vancouver

1200 Waterfront Centre  
200 Burrard Street  
Vancouver, BC, Canada  
V7X 1T2  
T 604.687.5744  
F 604.687.1415

### Montréal

1000 De La Gauchetière Street West  
Suite 900  
Montréal, QC, Canada  
H3B 5H4  
T 514.954.2555  
F 514.879.9015

### Toronto

Bay Adelaide Centre, East Tower  
22 Adelaide Street West  
Toronto, ON, Canada  
M5H 4E3  
T 416.367.6000  
F 416.367.6749

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