Canadian Securities Regulators Finalize New Requirements for Canadian Registrants

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On July 27, 2017, the Canadian Securities Administrators (CSA) published the final version of amendments to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations, National Instrument 33-109 Registration Information* and their respective Companion Policies. These amendments were originally published on July 7, 2016 with a comment deadline of October 5, 20161.

As with the 2016 proposals, the final rule changes fall into four categories:

- Changes affecting registrants' custody arrangements made for clients, including any pooled funds they manage.
- Changes affecting registrants' compliance with the existing “client relationship model” (CRM2) requirements.
- Changes to clarify the activities that can be carried out by exempt market dealers (EMDs).
- Non-controversial housekeeping amendments.

The CSA made some key modifications and clarifications, including dropping some of the more controversial proposals, in response to the comment letters submitted, including the comments of Borden Ladner Gervais LLP.

All amendments come into force December 4, 2017, except for the amedments relating to the new custody requirements, which come into force on June 4, 2018.

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 Amendments

As we noted in our comment letter on the 2016 proposals, the custody amendments will have particular impact on advisers and investment fund managers that manage investment funds that are not reporting issuers (pooled funds) and therefore are not subject to the custodial provisions in National Instrument 81-102 *Investment Funds* or National Instrument 41-101 *General Prospectus Requirements*. The CSA did not fully

explain why they chose to develop specialized custody requirements for privately-placed funds, although it appears that the primary driver was to permit such funds to continue to use IIROC member firms as custodians for such funds, as is the wide-spread industry practice today.

Overall, the custody amendments remain largely unchanged from the July 2016 proposals, although the CSA have provided some further guidance in order to assist registered firms in understanding them and discharging their new obligations.

The custodial requirements will generally not apply to certain "permitted clients" (though not including individuals or investment funds) but each such permitted client must waive the application of the requirements in writing.

With certain exceptions for specific assets noted below, the custody amendments will 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).
- There are modified custodial requirements in respect of certain derivative and short sale transactions with dealers outside of Canada.
- 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 custodial firms, it must do so only if the custodial firm is a qualified Canadian custodian or foreign custodian. The CSA have provided guidance on what "directing or arranging" means in this context and, interestingly, have noted that if, among other things, a registered firm provides its clients with a list of custodians to choose from, it will be deemed to have directed or arranged the relationship.
- 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. This will include the circumstances where the registrant directs or arranges for its clients to enter into custody relationships with a custodial firm.
- 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 in a designated trust account with 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 registered firm's client or the investment fund on the books of the issuer of the securities, because the custody risk posed by intermediaries is ‘largely reduced'.
- 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. Cash or securities held by the registrant in trust for clients for the purpose of bulk trading must be returned to the clients' custodial accounts as soon as possible.

The CSA rejected requests from commenters for a longer transition period for the custody requirements, noting that the custody amendments "are designed to codify existing custodial best practices". The CSA explains that they do not foresee the necessity for any material changes to existing custodial arrangements for the vast majority of registrants. Nonetheless, registrants must assess custody arrangements against the new requirements and expectations as soon as possible, so as to be in compliance with them when they come into force on June 4, 2018.

For existing custodial relationships that were directed or arranged by the registrant for the client before the custody amendments come into force, the CSA expect all registered firms to inform their clients of the new requirements within a “reasonable period of time” and to help them engage a new custodian if the existing relationship does not meet the new custodial requirements.

No doubt further analysis of the new custody provisions will be required to ensure appropriate understanding of the new requirements and their implications for existing and new custodial requirements. Existing custody arrangements must be examined closely to determine if changes are necessary, including new due diligence and compliance procedures. For example, arrangements with non-Canadian prime brokers will need to be carefully reviewed by investment fund managers.

We also recommend firms registered as portfolio managers become familiar with the position of CSA regarding so-called service arrangements between portfolio managers and IIROC firms, which may include custody arrangements, detailed in CSA Staff Notice 31-347 *Guidance for Portfolio Managers for Service Arrangements with IIROC Dealer Members* [available here]. This CSA notice is not referred to in the new amendments, but it remains active guidance for portfolio managers (and IIROC firms).

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 2016 proposals

raised more questions than answers. With these final amendments, in response to comments, the CSA appear to have finally got it right.

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 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*). With the expanded guidance and changes under the final 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 (including investment funds subject to NI 81-102), so long as there is no prospectus qualifying the distribution of the exempt securities. This means that an EMD may trade the same class of securities of a reporting issuer that are issued pursuant to a prospectus, so long as the specific exempt trade is being done pursuant to a prospectus exemption (and reported as such).
- Securities in the secondary market that are subject to resale restrictions.
- Securities 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 still 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 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).

Amendments 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, but only if the adviser is both the adviser and investment fund manager of the investment funds (and certain other conditions are met). The CSA have amended this provision to permit use of the exemption where the adviser or *an affiliate of the adviser* is the investment fund manager and/or the portfolio manager to of the applicable funds. This change will mean that an adviser can purchase investment funds for which an affiliate is the investment fund manager for its managed accounts without dealer registration, as long as either it or one of its affiliates is the adviser to the investment fund. Importantly, the CSA have clarified, in response to comments, that this exemption is available to a portfolio

manager, even if it is otherwise registered as an EMD, although the CSA have not provided for this clarification in the Companion Policy, which we consider disappointing.

CRM2 Clarifications and Future Proposals

The final amendments that relate to CRM2 remain largely unchanged from the July 2016 proposals, although some further guidance has been provided on the changes, in response to comments received.

The CSA have formally codified 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 relating to, among other things, client reporting and account statements. All of the CRM2 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.

These changes will necessitate some amendments to the templates for the CRM2 statements and documents that have already been developed for CRM2 compliance purposes. These include:

- A requirement to disclose custodial arrangements in the relationship disclosure information (RDI), including the way(s) that the registered firm holds client's assets (as well as the relevant associated risks), whether a qualified custodian holds any or all of the client's assets and (if applicable) the rationale for having the client's assets held by a foreign custodian or foreign dealer (as well as the relevant associated risks).
- 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 RDI.
- A clarification in the Companion Policy that the requirement to disclose in the RDI 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 where “market value” rather than “cost” of the position was used in the applicable account statement and explain this fact (the CSA suggests footnoted disclosure).
- A clarification in the Companion Policy that the required quarterly account statements must be provided to a client 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, for example). 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 in cases where 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, if the client has one, in order to assist the client in determining the current progress of the account towards this goal.

- 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 have dropped any notion of requiring disclosure about employee bonuses, non-cash incentives, or "embedded fees", all of which we advocated against in our comment letter.

CSA Guidance on Compliance with NI 31-103 — Reminders

Regulatory expectations for compliance with NI 31-103 and related regulation remain very high. In addition to carefully reviewing the Companion Policy to NI 31-103, we remind registrants to not lose sight of the matters outlined in various CSA notices, including the individual commission's staff notices about compliance, often published on an annual basis. In addition to CSA Staff Notice 31-347 *Guidance for Portfolio Managers for Service Arrangements with IIROC Dealer Members* noted above, we commend the following as being important guidance for firms:

- The 2017 Annual Report prepared by the Compliance and Registrant Regulation branch of the OSC.
- CSA Staff Notice 31-350 *Guidance on Small Firms Compliance and Regulatory Obligations*.
- CSA Staff Notice 33-320 *The Requirement for True and Complete Applications for Registration*.
- The ASC Staff Notice 33-705 *Exempt Market Dealer Sweep.*

Please contact the authors of this Bulletin, your usual lawyer or the leaders of BLG's Investment Management group, if you have any questions about these and other amendments to NI 31-103, enhanced regulatory expectations and how they may affect you.

[1] Please see our Investment Management Bulletin CSA Continues to Finesse Registrant Regulation — Proposed Additional Requirements Governing Custody, EMDs and CRM2 Borden Ladner Gervais LLP July 2016.

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