

## STRUCTURED PRODUCTS BULLETIN

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### THE CSA GET DOWN TO BUSINESS - REGISTRATION REFORM AND HOW IT WILL IMPACT YOU

The Canadian securities administrators (“CSA”) have recently released for comment the much-anticipated National Instrument 31-103 - Registration Requirements (“NI 31-103” or the “Instrument”), a new rule that is designed to nationally harmonize and streamline the registration regime for firms and individuals. Once in force, NI 31-103 will replace the multiple sets of rules contained in individual provincial securities acts, regulations, rules and policy statements with one consolidated national rule. It is important to note that in order to be completely effective, NI 31-103 must be implemented in concert with several proposed legislative amendments which are still under review by various provincial governments. These proposed legislative amendments were not published with NI 31-103.

#### A NEW “BUSINESS” REGISTRATION TRIGGER

NI 31-103 establishes a new threshold for determining whether a firm or individual is required to be registered as a dealer. Currently, registration as a dealer is required for those who “trade” in a security. The CSA have proposed to replace this “trade” trigger with a “business” trigger, which is similar to the current registration threshold for advising in securities. The result is that anyone who is “in the business” of dealing in securities as principal or agent must register as a dealer in the applicable category, and persons “in the business” of advising in securities must register as an adviser (as currently required). In addition, NI 31-103 introduces an important new category of registration – investment fund manager – which is discussed in further detail below.

In determining whether or not a person is “in the business” and therefore required to register as a dealer or adviser, factors such as (i) the frequency a person or company undertakes an activity, (ii) the expectation of remuneration for the activity, (iii) solicitation in connection with the activity and (iv) the mere holding out as being willing to engage in dealing or advising in securities, will all be taken into consideration. A person or company acting as an investment fund manager will always be considered to be conducting that activity as a business.

#### FEWER CATEGORIES OF REGISTRATION

Once implemented, NI 31-103 will significantly reduce the overall number of categories of registration. The current categories of registration which would be eliminated once NI 31-103 is in force include international dealer, limited market dealer (to be replaced by the exempt market dealer category, discussed below), foreign dealer, international adviser, securities adviser, security issuer and investment counsel.

The following is a brief description of the categories of registration that will be available under NI 31-103:

#### Dealers:

- Investment Dealer - permitted to deal in any security.
- Mutual Fund Dealer – restricted to dealing solely in a security of a mutual fund.
- Scholarship Plan Dealer – restricted to dealing solely in a security of a scholarship plan, educational plan or educational trust.
- Exempt Market Dealer - restricted to dealing in prospectus-exempt securities and with persons to whom prospectus-exempt distributions can be made (e.g. accredited investors). Unlike current limited market dealers, an exempt market

dealer would be permitted to trade in prospectus-qualified securities to accredited investors. The Province of British Columbia is still examining whether or not this category of registration will be adopted in that jurisdiction.

- Restricted Dealer - limited to dealing activities that do not fall within the other firm categories (i.e. dealers that trade only in specified securities or class of securities such as real estate).

#### Advisers:

- Portfolio Manager – permitted to advise with respect to any security.
- Restricted Portfolio Manager - restricted to advising others with respect to specified securities or class of securities (e.g. oil and gas issuers).

#### New Category:

- Investment Fund Manager - a new category which will apply to managers of all investment funds (both public and private) other than private investment clubs.

In addition to the types of registration categories available to firms, NI 31-103 will require each registrant to have an individual registered as an Ultimate Designated Person (“UDP”). The UDP must be a senior officer responsible for ensuring that policies and procedures for the discharge of the registrant’s obligations under securities legislation are implemented. Registrants under NI 31-103 must also have an individual registered as the Chief Compliance Officer (“CCO”) who will be responsible for the day-to-day monitoring of the registrant’s adherence to compliance policies and procedures. In order to obtain registration as a CCO, the designated individual must meet the proficiency requirements for this designation set out in the Instrument. The UDP and the CCO may be the same person, provided that the person meets the requirements for each designation.

The new Instrument will also require senior executives (e.g. the CEO, CFO, COO and persons performing similar functions) and directors of a registrant to be registered. Currently, in the Province of Ontario, all directors, officers and holders of more than 10% of the voting shares of a registrant need to be registered, even if such persons do not perform any activities that would individually require a registration.

Firms and individuals carrying on more than one type of activity requiring registration will generally be required to obtain registration in each of the applicable categories, however such person will generally only have to meet the most stringent insurance and capital requirements (i.e. the requirements are not cumulative).

#### REGISTRATION OF INVESTMENT FUND MANAGERS

NI 31-103 introduces a proposed new category of registration for fund managers to be known as the “investment fund manager” designation. This category of registration is being introduced to respond to a number of issues identified by the CSA with respect to investment funds including (i) incorrect/untimely calculation of net asset values; (ii) incorrect/untimely preparation of the financial statements; (iii) incorrect/untimely provision of transfer agency or record-keeping services; and (iv) potential conflicts of interest between an investment fund manager and its clients.

The registration of investment fund managers will permit the CSA to directly regulate fund managers instead of imposing restrictions directly on the investment funds. The term “manager” is not defined in NI 31-103, rather, the Instrument relies on the definition of “manager” contained in National Instrument 81-102 – *Mutual Funds* where “manager” is defined as “a person or company that directs the business, operations and affairs of a mutual fund”. A fund manager will only need to be registered in the jurisdiction in which the fund is located.

Under NI 31-103, persons registered as investment fund managers will be subject to minimum capital and insurance requirements and will be responsible for ensuring that any management functions which are outsourced are performed by qualified entities and that an adequate level of supervision is exercised over these service providers. In addition, investment fund managers are expected to adopt policies and procedures which are designed to avoid or manage potential conflicts of interest.

## ENHANCED COMPLIANCE REQUIREMENTS FOR REGISTRANTS

To further strengthen the CSA's goal of ensuring that qualified firms and individuals are providing advising and trading services in the Canadian capital markets, NI 31-103 will introduce comprehensive "fit and proper" standards for persons to obtain registration. These standards are intended to address the integrity, competency and financial solvency of each registrant.

Under NI 31-103, the minimum proficiency requirements for registrants will change from a course-based to an exam-based approach when possible, in recognition of the fact that a proposed registrant's past experience may have adequately prepared them to successfully complete an examination without the necessity of completing the accompanying course.

While there are currently no mandated proficiency requirements to obtain registration in the category of limited market dealer, NI 31-103 will require that all dealing representatives of an exempt market dealer pass the Canadian Securities Exam and one of the Conduct and Practices Handbook Exam or the Partners, Directors and Senior Officers Exam (or the U.S. equivalents). Similar requirements are imposed for the CCO of an exempt market dealer.

The CCO of a registered investment fund manager must generally meet the same requirements as those required for a chief compliance officer of a portfolio manager, namely, previous registration as an advising representative of a portfolio manager or alternative qualifications which involve previous employment with a registered dealer or adviser and successful completion of the exams noted above.

Registered investment dealers and portfolio managers will be familiar with the requirements to maintain minimum capital and insurance coverage under existing securities legislation. NI 31-103 will expand these requirements to exempt market dealers and investment fund managers, and change the requirements for all registrants to reflect a more "risk-based approach". The new minimum capital requirements under NI 31-103 will generally increase for most registrants, other than portfolio managers that hold client assets. This could have a significant impact on smaller exempt market dealers and investment fund managers and act as a barrier to entry for new participants in these markets. For example, the proposed minimum capital requirements for an exempt market dealer will be \$50,000 and the minimum capital for an investment fund manager will be \$100,000. With respect to insurance, the method of determining the minimum amount of insurance coverage required is proposed to be based on a formula, rather than a flat amount.

With respect to books and records, NI 31-103 does not prescribe the exact form to be maintained by a registrant. The current record-keeping requirements will be replaced with a general obligation to maintain an effective record-keeping system to accurately record business activities and client transactions and demonstrate compliance with applicable laws. Records must be kept for a prescribed period of time and include material contracts, reconciliations of bank statements and securities positions, as well as all client correspondence.

The CSA have also proposed that registrants file their financial statements with the regulators on a more frequent basis than is currently the case (and now on an unconsolidated basis). For example, persons registered as investment fund managers will be required to file annual audited financial statements within 90 days of their fiscal year end and unaudited quarterly financial statements within 30 days of the end of the applicable quarter. Investment fund managers will also be required to include in their reports a description of any net asset value adjustment made during the year (or relevant quarter).

Other conduct rules for advisers and dealers (including exempt market dealers) relate to know-your-client obligations, which requires a registrant to learn about each client and keep the information current, including information related to investment objectives, investment knowledge and experience, risk tolerance, investment timeframe, employment status, income level and net worth. The CSA note that registrants should collect information concerning the nature of a prospective client's business, control structure and beneficial ownership for clients that are not individuals.

NI 31-103 also introduces requirements and procedures for the handling of complaints. All registrants must maintain policies and procedures that specifically provide for the recording and investigation of complaints and the resolution of disputes. Registrants must document all complaints (or legal actions or other proceedings) for potential review by the

regulators. Registrants must provide the regulators with an annual report with respect to their complaint procedures and details of complaints made.

Another new requirement for registrants (other than investment fund managers) is the requirement to prepare and deliver to non-accredited investor clients a 'relationship disclosure document' that must include 12 different elements including how an adviser will ensure that investments are suitable for each client. The document may also describe a prospective client's responsibilities, such as providing accurate information to the registrant firm and informing the registrant of changes that could reasonably result in a change to the type of investments that are appropriate for that client.

The proposals contained in NI 31-103 are intended to harmonize rules relating to conflicts of interest and impose an overarching standard that registrants must identify and deal with all conflicts. Conflicts may be adequately dealt with in certain instances through client disclosure or through control mechanisms such as an independent review committee. Some conflicts, however, may be of such a nature that they should be avoided altogether, such as those that will lead to actual or a high risk of harm occurring to either clients or the capital markets.

#### IMPACT OF NI 31-103 ON NON-RESIDENTS

The proposed rules, if adopted in their current form, will also have a significant impact on international advisers carrying out advisory activities in Ontario, both those that are registered as an international adviser and those that rely on exemptions from the registration requirement.

As noted above, the CSA propose to eliminate the category of international adviser under NI 31-103. This will mean that all persons performing advisory activities in Ontario, even if resident outside of Canada, will need to register as a full portfolio manager unless they are able to rely on an exemption from registration for international advisers contained in NI 31-103. The exemptions contained in the Instrument will only be available to companies that have no establishment, officers, employees or agents in Canada. In addition, an "international portfolio manager" must be registered under the securities legislation of the jurisdiction in which its head office or principal place of business is located, and must engage in the business of a portfolio manager in that jurisdiction. The exemptions from registration set forth in NI 31-103 greatly reduces the types of "permitted clients" for whom an international adviser is permitted to provide services, decreases the percentage of revenue that an international adviser is permitted to derive from Canadian clients, and imposes restrictions on further solicitation of Canadian clients. A limited exemption is also proposed for non-resident dealers carrying out functions similar to those currently permitted by registered international dealers. In addition, the CSA have proposed additional requirements that apply solely to non-resident advisers and dealers, including the requirement to make specified disclosure to Canadian clients.

The manager of an international investment fund will be exempt from the requirement to register as an investment fund manager under NI 31-103 if (i) the fund manager has no establishment in Canada or officers, employees or agents resident in Canada, (ii) the fund manager engages in the business of a portfolio manager in the jurisdiction in which its head office or principal place of business is located; and (iii) securities of the investment fund managed by the fund manager are primarily offered outside of Canada and are only offered in Canada through a registrant pursuant to an exemption from the prospectus requirement (e.g. securities offered only to accredited investors on a private placement basis).

#### REFERRAL ARRANGEMENTS

NI 31-103 will also introduce harmonized requirements relating to referral arrangements for registrants. Registrants wishing to enter into a referral arrangement will be required to provide specified written disclosure of the arrangement to clients and enter into a written agreement clarifying the roles and responsibilities of both the referring party and the recipient of the referral.

The CSA have reiterated their concerns expressed in other publications relating to referral arrangements, including the risk that a referrer will only refer clients to a registrant that pays for the referral, and the risk that clients might be confused about who they are dealing with and to whom they should approach for advice. It is noted that once a client is referred

to a person or company, it is considered to be the client of the person or company receiving the referral for the purposes of the services being provided, and as such if registered, it is that company which must satisfy all requirements, including KYC. The proposals will require registrants to disclose specific information about referral arrangements, including the method of calculating the referral fee, but also mandates disclosure of any information about the referral arrangement that a reasonable investor would consider important in order to evaluate the referral arrangement.

#### NEXT STEPS

The CSA have indicated that they will continue to seek public input with respect to the sweeping changes proposed in NI 31-103. The period to submit comments on the Instrument is open until June 20, 2007, and we encourage all affected parties (including, current or proposed registrants, persons who would be required to register under NI 31-103 and international advisers and dealers) to consider providing input on how the proposals will affect your business.

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*The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.*

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*For advice on how to make your views known to the CSA or for more information about the new proposed requirements, please contact your McMillan Binch Mendelsohn lawyer or one of the lawyers in our structured products practice listed below:*

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