

## SECURITIES & PUBLIC MARKETS BULLETIN

March 2008

### REFORMING REGISTRATION REFORM: FURTHER INFORMATION FOR PORTFOLIO MANAGERS AND INVESTMENT FUND MANAGERS

Earlier this month, we issued a Public Markets Bulletin<sup>1</sup> to advise clients about the publication of a revised draft (the “Revised Draft Instrument”) of National Instrument 31-103 (the “Instrument” or “NI 31-103”) and to provide some insight into the changes that have been made since the original draft (the “Original Draft Instrument”) was published on February 20, 2007. With respect to the Revised Draft Instrument’s impact on firms that will be “portfolio managers” and/or “investment fund managers”, we reported the following:

- no change has been made to the proposed \$100,000 minimum capital and \$200,000 bonding or insurance requirement for investment fund managers;
- investment fund managers would be exempt from the specific complaint handling regime contemplated by the Instrument, although they may still have a general obligation to handle client complaints promptly, i.e. within 3 months;
- portfolio managers and investment fund managers will be required to appoint an “ultimate designated person” (“UDP”) and a “chief compliance officer” (“CCO”) and establish compliance systems;
- UDPs will have to have the education and experience reasonably necessary to perform the job and CCOs of investment fund managers will have to meet proficiency requirements different from those for CCOs of portfolio managers; and
- firms currently registered as an ICPM will be automatically transferred to registration as a portfolio manager and existing portfolio manager UDPs and CCOs will be exempt from the new proficiency requirements; firms currently acting as investment fund managers will be required to apply for registration in that category within six months of the rule coming into force.

This bulletin is intended to provide portfolio managers and investment fund managers with additional information and analysis of the content of the Revised Draft Instrument.

### Legislative Amendments and Amendments to Existing Regulations, National Instruments and Companion Policies and Local Instruments

Regardless of whether the Revised Draft Instrument is implemented in its current form, the changes that NI 31-103 will bring about are very far reaching and the CSA have provided a long list of other National Instruments and Companion Policies that will need to be revoked or amended as a consequence. In addition, each of the provincial securities regulators has published a long list of the existing provincial regulations that will be revoked and local instruments that will be revoked or amended.

It is very important to note that most of the CSA jurisdictions are also proposing to make amendments to provincial securities acts to, among other things, (a) amend detailed registration provisions in the legislation which relate to or will

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<sup>1</sup> See “Reforming Registration Reform: Canadian Securities Administrators Issue Second Draft of National Instrument 31-103”.

be replaced by provisions in NI 31-103 and (b) require registration of investment fund managers, UDPs and CCOs. Without these amendments to the underlying legislation, many of the important elements of NI 31-103 cannot be implemented.

None of the legislative amendments has yet been made public and it is not clear from the notice (the “Notice”) accompanying the Revised Draft Instrument what the timing for such amendments is likely to be.

## **Investment Fund Manager Registration**

The CSA have indicated in the Companion Policy to the Revised Draft Instrument (the “Companion Policy”) that investment fund managers will generally only need to register in the jurisdiction in which the manager’s head office is located. This principle will be applied to Canadian and non-Canadian investment fund managers, such that non-Canadian managers will not require any registration in Canada unless the management of a fund is directed from a Canadian jurisdiction.

The Companion Policy provides that investment fund managers will not be required to register as a dealer when they are engaged in marketing and wholesaling activities relating to the investment funds they manage if the funds are distributed through a dealer, and not directly by the manager itself.

## **Compliance System**

All registered firms, including portfolio managers and investment fund managers, will be required to establish, maintain and apply a system of controls and supervision in the form of written policies and procedures. The Companion Policy indicates that a firm’s effectiveness in identifying and remedying compliance deficiencies is an important element in assessing its continuing suitability for unrestricted registration.

The Revised Draft Instrument and Companion Policy both emphasize the concept of “supervision” which did not exist in the Original Draft Instrument. The Revised Draft Instrument indicates that a firm’s policies and procedures must be sufficient to provide reasonable assurance that the firm *and each individual acting on its behalf* complies with securities legislation. The Companion Policy indicates that a firm’s compliance system should ensure that everyone in the firm, whether or not they are registered, understands the standards of conduct for their role. It also provides that managers and others with authority to supervise registered individuals must take reasonable measures to ensure compliance by their staff with securities legislation and firm policies and procedures. Although the obligation to supervise staff has always existed, it has not previously received this kind of detailed attention. These provisions reflect a U.S.-style approach to compliance systems and will require firms to establish written supervisory policies and procedures, explicitly indicating who reports to whom. They will also, presumably, strengthen the CSA’s ability to cite firms for failure to supervise their staff.

## **Chief Compliance Officer Proficiency**

As indicated in our previous bulletin, the Revised Draft Instrument provides that investment fund manager CCOs will have to meet different proficiency requirements than portfolio manager CCOs. While this seems appealing (and, in fact, some commenters on the Original Draft Instrument argued that investment fund manager CCOs should not have to meet the same requirements as their portfolio manager counterparts), the requirements in the Revised Draft Instrument are much more flexible for portfolio manager CCOs than investment fund manager CCOs. For example, a person applying for registration as a portfolio manager CCO will be qualified if he or she has passed certain exams and worked for either a registered dealer or adviser for a specified length of time; applicants for registration as an investment fund manager CCO must have worked for an investment fund manager, i.e. not for any other type of registered firm. In addition, applicants for registration as an investment fund manager CCO must have “consecutive” years of experience working for an investment fund manager, whereas applicants for registration as a portfolio manager CCO must only have satisfied the prescribed length of working experience, but it need not be consecutive. Since the Revised Draft Instrument was amended to broaden the proficiency requirements applicable to portfolio manager CCOs and to remove the requirement

for consecutive years of work experience, it is not clear why the CSA has taken a different approach for investment fund manager CCOs or whether they intended to do so. The CSA have indicated in the Companion Policy that firms holding more than one category of registration may have a single CCO, provided that he or she meets the more stringent of any applicable proficiency requirements. However, if the Revised Draft Instrument is adopted in its current form, the more stringent requirements applicable to investment fund manager CCOs may make it difficult for firms to find qualified candidates.

The Revised Draft Instrument's transitional provisions will also be of interest to CCOs of firms that are both portfolio managers and investment fund managers. Portfolio manager CCOs who are registered as such on the date the Instrument comes into force will be "grandfathered" and, therefore, exempt from the new portfolio manager CCO proficiency requirements although it is not completely clear whether these CCOs' registrations will be automatically converted or whether they will need to reapply for registration within one month of NI 31-103 coming into force. Portfolio manager CCOs who are not registered on the date the Instrument comes into force (presumably this means people in jurisdictions that currently have no CCO requirement) will be exempt from the proficiency requirements if they apply for registration within one month. Investment fund manager CCOs who apply for registration within six months after the Instrument comes into force will need to apply for registration within six months of the Instrument coming into force, but will be exempt from the investment fund manager CCO proficiency requirements until the first anniversary of the Instrument coming into force. Because the full proficiency regime will apply to investment fund manager CCOs after the first anniversary date of the Instrument, the delayed implementation would only seem to be helpful to anyone who needs time to complete the applicable exams or to "season" their investment fund manager work experience, but it will not help anyone who either has never worked for an investment fund manager before or who will not have the applicable "consecutive" years of experience working for an investment fund manager by the first anniversary of the Instrument.

### **Conflict of Interest and Self-Dealing Provisions**

The Instrument contains a number of sections that will supercede current sections of the Regulation (the "Regulation") under the *Securities Act* (Ontario) (the "OSA").

#### *Statements of Policy and Limitations on Advising and Recommendations*

The Statement of Policies previously required under section 223 of the Regulation (which the Ontario Securities Commission (the "OSC") is proposing to revoke) will be replaced by an "issuer disclosure statement" required under section 6.4 of the Instrument. Similarly, the Limitations on Advising and Limitations on Recommendations currently set out in sections 227 and 228 of the Regulation will be revoked and replaced by sections 6.5 and 6.6 in the Instrument. These sections have not been significantly changed from the Original Draft Instrument.

#### *"Responsible Persons" and Inter-Fund Trading*

The most significant change in this area from the current Regulation is under section 6.2 in the Revised Draft Instrument. This section is very similar to section 118 of the OSA and corresponding provisions of other provincial securities acts, although there are some important differences. Both section 6.2 of the Revised Draft Instrument and section 118 of the OSA are designed to prohibit portfolio managers from causing the portfolios they manage to invest in securities of an issuer in which a "responsible person" has an active role (for example as an officer or director) or securities in which a "responsible person" has a beneficial interest. However, under section 118 of the OSA and the Original Draft Instrument, every partner, director or officer of a portfolio manager (among others) is a "responsible person" with respect to the portfolio manager's clients, regardless of whether that person participates in investment decisions on behalf of a particular client or not; under the Revised Draft Instrument, partners, directors and officers would only be "responsible persons" if they have access to, or participate in formulating an investment decision made on behalf of a client or advice given to the client, although "employees" who have such information would also be captured by the definition. This change seems generally positive, since it would likely reduce the number of prohibited transactions.

In addition, whereas the OSC has interpreted section 118(2)(b) of the OSA as prohibiting trades between portfolios managed by the same manager in certain circumstances, the Revised Draft Instrument will now make that prohibition explicit and much broader. For example, section 118(2)(b) of the OSA prohibits inter-portfolio trading if the relationships between the portfolio manager and the two portfolios are such that each of the portfolios is an “associate” of either (a) the portfolio manager or (b) an affiliate of the portfolio manager that has information about investment management decisions prior to their being executed. In practice, this prohibition should rarely apply to trades between separately managed accounts because of the way the definitions of “responsible person”, “associate” and “affiliate” work, but the prohibition frequently applies to investment funds where the portfolio manager or an affiliate of the portfolio manager is also the funds’ trustee. Section 6.2(2)(c) of the Revised Draft Instrument will create an absolute prohibition on the purchase or sale of securities between any two portfolios managed by the same portfolio manager (i.e. not just between two funds). Investment funds that are subject to National Instrument 81-107 (“NI 81-107”) will be exempt from the prohibition if they obtain the “approval” of their Independent Review Committee (discussed further, below), however, unlike sections 6.2(2)(a) and (b), section 6.2(2)(c) does not provide separately managed accounts with an exemption from the inter-portfolio trading prohibition, even if the portfolio manager obtains the consent of both portfolios.

To the extent that it introduces across the country a self-dealing conflict of interest provision that previously only existed in certain jurisdictions, section 6.2 is understandable; however, it is currently unclear why the changes to the Revised Draft Instrument have been proposed. It is also unclear how revised section 6.2 will or should interact with section 118 of the OSA and the corresponding sections of certain other provinces’ legislation. This issue is made more confusing by the fact that the CSA are also proposing to amend Schedule B of NI 81-107 (i.e. the list of legislative and regulatory provisions that prohibit inter-fund trading unless the Independent Review Committee’s “approval” has been obtained) to (a) remove section 118(2)(b) of the OSA and (b) add a reference to section 6.2(2) of the Instrument. However, Schedule B will not be amended to remove references to the provisions of other provinces’ legislation that correspond to section 118(2)(b) of the OSA. Nothing in the Notice indicates whether section 118 will be repealed or amended as part of the amendments to the OSA that are mentioned or whether the OSC simply no longer thinks that section 118(2)(b) prohibits inter-fund trading.

### **Registration of “Advising Representatives”**

The Revised Draft Instrument carries forward the “advising representative” and “associate advising representative” concepts. Although there has been no change in this regard from the Original Draft Instrument, it is important to note that the CSA have indicated in the Companion Policy that, in addition to being a form of “junior” advising representative category, the “associate advising representative” category is also designed to accommodate individuals who have a client relationship role that does not involve managing clients’ assets. For many portfolio management firms, this may require them to consider registering certain of their sales staff in this category who have not previously been registered.

### **Financial Statement Delivery Requirement**

As was proposed in the Original Draft Instrument, registered investment fund managers will be required to prepare annual and quarterly financial statements and annual and quarterly calculations of excess working capital. They will also be required to prepare a description of any net asset value adjustment made during the fiscal year.

Some commenters on the Original Draft Instrument objected to the requirement to provide a description of net asset value adjustment and suggested, at least, that the CSA adopt a materiality threshold for such disclosure. The CSA have indicated that multiple errors in an investment fund manager’s calculation of net asset values (whether material or not) may represent an operational problem that the CSA would want to know about and may also impact the investment fund manager’s financial situation. Accordingly, the CSA have not made any changes to the Revised Draft Instrument in response to the earlier comments.

### Trading in Pooled Fund Securities to Managed Accounts

The Revised Draft Instrument relieves a portfolio manager from the requirement to obtain registration as a dealer when it trades securities of pooled funds it manages to managed accounts which it also manages, but only if the portfolio manager provides written notice to the regulators that it will be relying on the exemption. However, if a portfolio manager distributes its pooled funds to clients who do not have a managed account or to third parties, registration as a dealer would be required. It is important to note that this exemption will not be available if the pooled fund or the managed accounts were used or created primarily for the purpose of avoiding the dealer registration requirement.

### Multiple Categories of Registration

The Companion Policy has been amended to provide clearer guidance regarding firms' responsibilities when they hold more than one category of registration. For example, the Companion Policy makes it clear that the capital and insurance requirements are not cumulative, but that a firm registered in more than one category must meet the highest requirements of its various categories.

The Companion Policy also clarifies that when firms carry on a registrable activity, they must comply with the conduct requirements applicable to that activity. This does not represent a change from firms' current responsibilities, but it is much more explicit. Accordingly, firms that are registered as portfolio manager, investment fund manager and exempt market dealer will find that they have very different obligations under the Revised Draft Instrument's complaint handling provisions. For example, a firm holding those three categories of registration and that receives a complaint regarding a fund's performance or investment strategies will have to decide whether the complaint is a portfolio manager complaint (in which case the Revised Draft Instrument's complaint handling procedures will apply) or an investment fund manager complaint (in which case the complaint handling procedures will not apply). If the same firm receives a complaint that the fund in which the client is invested is not and never was suitable for the client, the complaint would likely be an exempt market dealer complaint, in which case the complaint handling procedures would not apply if the client is a "permitted client", but would apply if the client is not a "permitted client".

Firms registered in multiple categories will need to pay close attention to these types of issues when drafting their compliance policies and procedures.

### Suspension of Registration for Failure to Pay Fees

Under the Revised Draft Instrument, registered firms' registration will be automatically suspended if they fail to file their annual fees with the appropriate regulator within 30 days of the due date. If a firm's registration is suspended, the registrations of all of its registered staff will also be suspended.

*Written by Mark Pratt and Kimberly Poster.*

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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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