

## investment funds and asset management group bulletin

August 2008

### INVESTMENT MANAGEMENT UPDATE: REGULATORY ISSUES AFFECTING ADVISER AND DEALER FIRMS

This bulletin is intended to provide a summary and brief analysis of certain regulatory documents released by the Canadian Securities Administrators (the “CSA”) since our last Investment Management Update in March 2008 and which will affect registered advisers and dealers doing business in Canada.

Any of the lawyers identified at the end of this bulletin would be pleased to discuss any of these issues with you in further detail.

#### **Investment Fund Continuous Disclosure – OSC Staff Notice 81-709**

On May 30, 2008, staff of the Ontario Securities Commission (the “OSC”) released Staff Notice 81-709 (“SN 81-709”), which summarizes the findings and comments arising out of the Continuous Disclosure Review Program conducted by the OSC’s Investment Funds Branch.

The findings and comments described in SN 81-709 are based on staff’s review of (i) financial statements and management reports of fund performance (“MRFPs”), (ii) quarterly portfolio disclosure, (iii) annual information forms for investment funds that are not subject to National Instrument 81-101, (iv) proxy voting records, (v) fund managers’ websites and (vi) prescribed regulatory filings on SEDAR. The review covered financial year-ends in 2005 and 2006 and some year-ends in 2007. Although the OSC review was focused on “conventional” mutual funds rather than closed-end funds, labour-sponsored funds or other funds subject to National Instrument 81-106 (“NI 81-106”), SN 81-709 provides important guidance and insight for managers of all investment funds that are required to comply with NI 81-106.

The review covered mutual fund managers representing approximately 45% of the mutual fund industry’s assets under management. Among the findings reported in SN 81-709 were:

- (a) 40% of funds’ financial statements revealed significant changes that were not discussed in the funds’ MRFPs and a further 25% of funds’ MRFPs disclosed significant changes but provided very little explanation or analysis;
- (b) 17% of funds did not break down their investment portfolio into appropriate subgroups in the summary of investment portfolio;
- (c) 65% of fund managers failed to compare the performance of at least one of their funds to a “broad-based securities market index”;

- (d) 75% of fund managers should have provided a more thorough discussion of the relative performance of a fund compared to the index;
- (e) 40% of fund managers did not provide easily accessible links to continuous disclosure documents on their websites;
- (f) 40% of fund managers copied the investment objectives and strategies of their fund directly from the simplified prospectus into their MRFPs, rather than providing a “concise summary” as is required by Form 81-106F1; and
- (g) 40% of fund managers did not provide an adequate discussion of risk.

The commentary in SN 81-709 is generally quite critical of the overall quality of discussion contained in MRFPs, with staff reminding fund managers that the intent of the summary of results of operations in MRFPs is “to put the financial statements into words and provide context for the financial results”. Several examples of “significant changes” over a reporting period are cited in respect of which fund managers indicated to staff that they did not include discussion in the MRFP because they did not believe discussion was legally required or that it was not warranted because it did not add useful information about an investor’s investment. The staff response in SN 81-709 was that, although discussion and analysis is not required in respect of every item in a fund’s financial statements, the results of operations discussion must focus on “significant changes in the fund over the financial period and discuss the reasons for the changes”. Fund managers should pay particular attention to this part of SN 81-709 when preparing MRFPs since it reflects an important difference from Part A, Items 1(d) and (e) of Form 81-106F1 which only require the inclusion of “material” information and “material” changes, with “material” being defined as information that would be likely to influence or change a reasonable investor’s decision to buy, sell or hold the fund’s securities if the information were omitted or misstated.

With respect to deficiencies in the discussion of relative

performance, SN 81-709 indicates that it is insufficient to simply indicate that a fund under- or over-performed its index and that staff expects an explanation as to why the fund under- or over-performed. In addition, SN 81-709 suggests that managers should improve disclosure regarding under- and over-weighted portfolio allocations so that readers have sense of the magnitude of the under- or over-weighting when considering the manager’s explanation of relative performance.

### Capital Calculations for ICPMs – OSC Staff Notice 33-730

The OSC has noticed a slight increase in the number of firms registered as “investment counsel/portfolio managers” (“ICPMs”) that are deficient in meeting the minimum capital requirements under the *Securities Act* (Ontario) (the “Act”).

Accordingly, staff published OSC Staff Notice 33-730 (“SN 33-730”) on June 13, 2008 to remind ICPMs of their obligations under the Regulation under the Act to maintain minimum free capital equal to the maximum amount of the deductible under any clause of the firm’s bonding or insurance policy plus \$5,000, if the firm does not have access to or take possession of clients’ assets<sup>1</sup>, or 25,000, if the firm does have access to or takes possession of clients’ assets. Firms are also reminded that they are required to produce within a reasonable time after the end of each month a reasonable calculation of their minimum free capital and to maintain a record of that calculation. Where a firm does not meet the prescribed capital requirement, they are required to notify the OSC immediately and to take steps to correct the deficiency within 48 hours. Where the OSC becomes aware of a capital deficiency, it will generally impose requirements to, among other things, file monthly unaudited financial statements and capital calculations for a six-month period.

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<sup>1</sup> In our [Investment Management Update](#) in March 2008, we reported on changes to the way the OSC determines whether an ICPM has access to or takes possession of clients’ assets.

Finally, SN 33-730 reminds firms that National Instrument 31-103 will implement important changes to ICPMs' minimum capital requirements, frequency of financial statement filings and the capital calculation formula.<sup>2</sup>

### **Best Execution – Final Amendments to National Instrument 23-101 and the Universal Market Integrity Rules**

#### *National Instrument 23-101*

On June 20, 2008, the CSA published in final form amendments (the "Amendments") to certain sections of National Instrument 23-101 ("NI 23-101") and Companion Policy 23-101CP (the "Companion Policy") which will clarify dealers' and advisers' "best execution" obligations. No substantial changes have been made to the Amendments since they were originally proposed in April 2007. The Amendments will become effective on September 12, 2008.

Currently, NI 23-101 contains no definition of "best execution". Instead, it requires dealers (but not advisers) to make reasonable efforts to ensure that clients receive the "best execution price" when the dealer is acting as agent in respect of purchase or sale of securities and prohibits the dealer from executing a transaction on a marketplace (as defined in National Instrument 21-101) that could be filled at a better price on another marketplace or with another dealer. The Amendments to NI 23-101 will define "best execution" as "the most advantageous execution terms reasonably available under the circumstances" and will require both dealers and advisers to make reasonable efforts to achieve best execution when acting for a client. The Amendments to the Companion Policy indicate that the best execution obligation applies in respect of all securities (i.e. not just equities) and that in seeking best execution, a dealer or adviser may consider a number of elements, including price, speed of execution, certainty of execution and the overall cost of the transaction,

<sup>2</sup> For more detailed information about National Instrument 31-103, please see our earlier bulletins entitled "[Reforming Registration Reform: Canadian Securities Administrators Issue Second Draft of National Instrument 31-103](#)" and "[Reforming Registration Reform: Further Information for Portfolio Managers and Investment Fund Managers](#)".

each of which may be broken down into more specific considerations.

For the purposes of establishing whether they have conducted "reasonable efforts", the Amendments to the Companion Policy also provide that dealers (as well as advisers who retain trading responsibility and trade through "direct market access" arrangements ("DMA arrangements")) should:

- (a) consider whether it is appropriate to consider *all* marketplaces on which a security is listed or quoted (including marketplaces outside of Canada);
- (b) consider information from all *appropriate* Canadian marketplaces (not just marketplaces where the dealer or adviser is a participant); and
- (c) in respect of foreign exchange traded securities, conduct a regular assessment of whether it is appropriate to consider Canadian "alternative trading systems" on which those securities are traded as well as the foreign markets.

The Amendments to the Companion Policy also indicate that dealers and advisers will need to adopt policies and procedures designed to achieve best execution and those policies and procedures should be "regularly and rigorously reviewed". It is important for advisers who do not retain trading responsibility through DMA arrangements to note that they will still have a best execution obligation under NI 23-101; presumably this means that the CSA will expect those advisers to adopt policies and procedures reasonably designed (i) to ensure that the dealers through which they trade have adopted appropriate best execution policies and procedures and (ii) to analyse the extent to which those dealers are obtaining best execution.

#### *Universal Market Integrity Rules*

The Investment Industry Regulatory Organization of Canada ("IIROC", formerly the Investment Dealers Association of Canada (the "IDA") and Market Regulation Services Inc.) published in final form amendments (the "UMIR Amendments") to the Universal Market Integrity Rules ("UMIR") and the policies under UMIR, which are designed to be consistent with the Amendments to NI

23-101 and the Companion Policy. Differences between the Amendments and the UMIR Amendments relate to (i) the use of different defined terms and drafting protocols, (ii) the application of UMIR to orders for securities eligible to be traded on a marketplace that has retained IIROC as its regulation services provider under NI 23-101 and (iii) the fact that UMIR applies only to “Participants” (as defined in UMIR) not to all registered dealers and advisers.

Advisers who do not retain trading responsibility should, nevertheless, be generally familiar with UMIR and the UMIR Amendments in order to ensure that they understand their dealers’ best execution policies and procedures and are, therefore, able to discharge their own obligations under NI 23-101 to seek to obtain best execution for clients; advisers who do retain trading responsibility and execute through DMA arrangements should also be generally familiar with UMIR, the UMIR Amendments and any future amendments to NI 23-101<sup>3</sup> and UMIR that may affect their activities and regulatory obligations under those DMA arrangements.

### Registration Reform

A number of documents have recently been published by the CSA, the Mutual Fund Dealers Association (the “MFDA”) and IIROC in connection with the overhaul of the Canadian registration system. The following is a very brief review of the main instruments that have been published.

#### *Multilateral Instrument 11-102 – Passport System and National Policies 11-202, 11-203 and 11-204*

On July 18, 2008, the CSA published for comment proposed National Policy 11-204 – Process for Registration in Multiple Jurisdictions, together with related amendments to Multilateral Instrument 11-102 and National Policies 11-202 and 11-203 (collectively, the “Passport for Registration System”)<sup>4</sup>. Together, these

<sup>3</sup> In the notice accompanying the Amendments, the CSA indicated that they are still considering the comments received in respect of the April 2007 proposed amendments to NI 23-101 and the Companion Policy relating to DMA arrangements and intend to publish revised proposed amendments at a later date.

<sup>4</sup> For a discussion of Multilateral Instrument 11-102 and National Policies 11-202 and 11-203, please see our client bulletin entitled “[The Passport System: One Step Back, Two Steps Forward?...or the Other Way Around?](#)”.

instruments and amendments would extend the existing passport regime for prospectuses and exemptive relief applications to the registration process and would replace the existing National Registration System.

Like the existing passport systems for prospectuses and exemptive relief applications, Ontario will not be a participant in the Passport for Registration System, although similar interfaces have been developed between Ontario and the other CSA jurisdictions. Implementation of the Passport for Registration System depends on the adoption of National Instrument 31-103.

The CSA is accepting comments on the Passport for Registration System until September 17, 2008.

#### *MFDA Member Regulation Notice MR-0069 – Suitability Guidelines and Proposed Amendments to MFDA Rule 2.2 and Policy 2*

The MFDA published MR-0069 – Suitability Guidelines (“MR-0069” or the “Notice”) on April 14, 2008. The Notice contains extensive discussion about MFDA members’ “know-your-client” (“KYC”) and “know-your-product” obligations, the process for assessing the suitability of a particular trade and the process for assessing the suitability of the use of leverage.

Among many other things, the Notice provides that suitability consists of three separate elements, each of which must be considered separately in determining whether a trade is suitable. The three elements are (i) risk tolerance suitability, (ii) investment objective suitability and (iii) time horizon suitability. The Notice indicates that incorrectly assessing client risk tolerance is one of the most common allegations made in client complaints to the MFDA. Clients allege that the risk tolerance indicated on the KYC form was higher than what the client asserts was his or her actual risk tolerance. Accordingly, risk tolerance suitability is described in the Notice as the **lower** of the investor’s **willingness** to accept risk and the investor’s **ability** to withstand declines in the value of his or her portfolio. Since a client who holds several accounts may have very different objectives and risk tolerances for each of them, the Notice also reminds MFDA members that KYC and suitability obligations must be applied on an account-by-account basis, not on a client-by-client basis.

The Notice goes on to indicate that MFDA members are responsible for assessing the suitability of recommendations made with respect to all business of the member, including investment advice or recommendations for investment products which may not meet the definition of a “security” under securities legislation (for example, PPNs or charitable donations schemes with investment characteristics). It also contains detailed discussion regarding the analysis of suitability in the context of unsolicited trades (i.e. those that are initiated by the client without any recommendation from the MFDA member or its sales staff) and redemption orders.

While the Notice is only directly applicable to MFDA members, investment dealers, limited market dealers and ICPMs should be familiar with the principles discussed in it since it would not be surprising if IIROC were to develop a similar set of guidelines for its members nor to find the OSC and other CSA members applying its principles to registrants they regulate directly.

The MFDA also published proposed amendments to its Rule 2.2 and Policy 2 on June 13, 2008. These amendments are largely designed to provide the regulatory basis for the principles and guidelines set out in the Notice and are part of the ongoing development of the client relationship model (the “CRM”) being conducted by

the MFDA, IIROC<sup>5</sup> and the CSA. Comments regarding these amendments will be accepted by the MFDA until September 11, 2008.

### *Proposed Amendments to MFDA Rules 2.8 and 5.3*

Also as part of the CRM initiative, the MFDA published on June 13, 2008 proposed amendments to the MFDA Rules, which would require MFDA members to provide clients with account performance reporting on an annual basis. These proposed amendments are similar to, but less detailed than, amendments proposed by the IDA (now IIROC) earlier this year in respect of account performance reporting by investment dealers<sup>6</sup>. Comments regarding these amendments will also be accepted by the MFDA until September 11, 2008.

***Written by Mark D. Pratt***

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<sup>5</sup> The IDA (now IIROC) published for comment in February 2008 proposed amendments to certain of its rules in connection with the implementation of the client relationship model, including certain amendments relating to retail client suitability. Although the proposed IIROC amendments are similar in some respects to the proposed amendments to MFDA Rule 2.2 and Policy 2, they do not include the kind of detailed discussion of suitability found in MFDA MR-0069. The comment period in respect of the proposed IIROC amendments ended on May 29, 2008.

<sup>6</sup> The proposed IDA/IIROC amendments, including those referred to in footnote 5, can be found at the following web address: <http://iiroc.knotia.ca/Knowledge/View/Document.cfm?Ktype=445&linkType=toc&dbID=200803361&tocID=22>

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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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