CSA AMENDMENTS TO NI 31-103 AND NI 33-109 TO ENHANCE CUSTODY REQUIREMENTS AND HOUSEKEEPING CHANGES

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On July 27, 2017, the Canadian Securities Administrators ("**CSA**") published final amendments to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* ("**NI 31-103**") and National Instrument 33-109 Registration Information ("**NI 33-109**") along with their respective companion policies (collectively, the "**Amendments**"). At a high level, the Amendments: (i) enhance custody requirements applicable to certain registered firms (the "**Custody Amendments**"); (ii) clarify the activities that may be conducted by exempt market dealers in respect of prospectus-qualified securities; (iii) make permanent certain temporary relief granted by the CSA relating to client reporting requirements (the "**CRM2 Requirements**") and (iv) other changes of a housekeeping nature.

Custody Amendments

The Custody Amendments are only applicable to registered firms that are not members of the Investment Industry Regulatory Organization of Canada ("**IIROC**") or the Mutual Fund Dealers Association of Canada ("**MFDA**"). IIROC member firms and MFDA members will instead comply with the custodial regimes of IIROC or the MFDA.

One significant change is in the area of relationship disclosure information ("**RDI**"). In particular, a new subsection has been added which requires registered firms that hold client assets, have access to client assets or "direct or arrange" custodial arrangements for clients to disclose to clients where and how the client's assets are held as well as any related risks and benefits of such arrangements. The companion policy to NI 31-103 contains specific guidance as to the types of information the CSA expects to be included in RDI.

New requirements have been introduced restricting the type of custody relationships that registered firms can employ as well as the manner in which cash and securities can be held by custodians. Registered firms are now prohibited, except in certain limited circumstances, from acting as a custodian or sub-custodian for cash and securities of its clients or investment funds it manages (i.e. self-custody arrangements) as well as from using a custodian that is not independent of the registered firm.

A registered firm may employ a self-custody arrangement or utilize a custodian that is not independent

provided that the registered firm or the qualified custodian: (i) is a "Canadian custodian" (as defined in NI 31-103) and (ii) has established and maintains a system of controls and supervision that a reasonable person would conclude is sufficient to manage the risks associated with the custody arrangement. Such a system of controls would include a segregation of duties between the custodial function and other functions as well as third party client asset verification.

Where the registered firm: (a) directs or arranges which custodian will hold the cash or securities, or (b) holds or has access to the cash or securities, the cash or securities of the client must be held by a "Canadian custodian". A "Canadian custodian" includes a Schedule I, II or III bank, a provincial or federal trust company with equity of at least $10,000,000 and a member of IIROC that is permitted to hold the cash and securities under IIROC rules.

Registered firms are permitted to use a "foreign custodian" if a reasonable person would conclude, considering all the relevant circumstances, that using the foreign custodian is more beneficial to the client than using a Canadian custodian. Some of the factors to consider in determining whether to use a "foreign custodian" include: the nature of the regulation of the foreign custodian, the sufficiency of the equity of the foreign custodian and the potential difficulty a client may have in enforcing its legal rights in the foreign jurisdiction. In addition, a Canadian financial institution that is independent of the registered firm is permitted to act as a custodian for cash of a client.

The new custody requirements do not apply to investment funds subject to National Instrument 81-102 *Investment Funds* or National Instrument 41-101 *General Prospectus Requirements* or to securities that are recorded on the books of the issuer, or the issuer's transfer agent, only in the name of the client or investment fund.

The CSA has also introduced some guidance for investment fund managers, dealers and advisers in selecting appropriate custodians. Investment fund managers are expected to exercise due skill, care and diligence in the selection of custodians. In particular, managers are expected to put in place detailed written custodial agreements and to conduct periodic reviews of their custodial arrangements. In situations where dealers and advisers have some influence over a client's selection of a custodian, such firms should conduct due diligence and be in a position to understand the material terms of the written custodial agreement and to explain them to their clients.

Registered firms are also required to take reasonable steps to ensure that cash and securities are held in the prescribed manner by verifying that the cash and securities of a client or an investment fund are reported on the custodial account statement of that client or investment fund.

In situations where the new custody requirements do not apply or where a registered firm employs a permitted self-custody arrangement, the firm must hold the assets: (i) separate and apart from its own

property, (ii) in trust for the client or investment fund, and (iii) in the case of cash, in a designated trust account with a Canadian custodian or Canadian financial institution or, if applicable, a foreign custodian.

The Custody Amendments also set out acceptable custodial practices for certain margin and security interests, and short sales, respectively. The permissible activities are similar to the custodial practices for prospectus-qualified funds permitted under National Instrument 81-102 and National Instrument 41-101.

Exempt Market Dealer Amendments

The Amendments also clarify the type of activities exempt market dealers are able to undertake in connection with the trading of securities offered under a prospectus, including as underwriters and selling group members.

More particularly, exempt market dealers are prohibited from participating in offerings of prospectus-qualified securities in any capacity. This includes trading in securities underlying special warrants that are qualified by a prospectus.

With respect to the resale of securities, an exempt market dealer may act as a dealer by trading a security only if all of the following conditions apply:

a. the trade is not a distribution;
b. an exemption from the prospectus requirement would be available to the seller if the trade were a distribution; and
c. the class of security is not listed, quoted or traded on a marketplace.

A second key change concerns the statutory exemption from the dealer registration requirements for registered advisers who trade in the securities of investment funds that they advise and manage. The amendments expanded the exemption from the dealer registration requirement so as to enable registered advisers to trade in the securities of investment funds (including, as is the case today, those distributed under a prospectus) without registering if either the adviser or an affiliate of the adviser advises and manages the investment fund and certain other conditions are met.

Client Relationship Model Phase 2 Amendments

The amendments to the CRM2 Requirements serve two functions: (a) make permanent temporary relief measures from the CRM2 Requirements; and (b) provide clarification on issues that have arisen in the course of implementing CRM2 Requirements.

In particular, for position cost information, the Amendments allow firms to disclose, for security positions opened before July 15, 2015, market value as at December 31, 2015, or an earlier date, if that earlier date is

reasonable based on certain criteria. For example, if: (i) all client accounts or security positions were transferred to the firm at the same time, or (ii) all clients are on the same reporting system of the registered firm, if the firm has more than one reporting system.

With respect to the content of investment performance reports, the Amendments provide enhanced flexibility for firms to disclose market value information and annualized total percentage return information when an account was opened before July 15, 2015. Provided the firm reports on a calendar year basis (i.e., its first reports covered the period from January 1 to December 31, 2016), market value information can be disclosed as at and since: (a) January 1, 2016, or (b) a date earlier than January 1, 2016 if that earlier date is based on reasonable criteria. Where the firm does not report on a calendar year basis (i.e., its first reports cover a 12-month period ending no later than July 14, 2017), the firm can include market value information as at and since: (a) July 15, 2015, or (b) a date earlier than July 15, 2015 if that earlier date is based on reasonable criteria. The same rules apply with respect to the disclosure of annualized total percentage return information. A registered firm may choose an earlier date only if the firm reasonably believes accurate recorded historical market value information is available for the client's account, and it would not be misleading to the client to provide that information as at the earlier date.

Other housekeeping amendments include the following:

- an exemption for IIROC and MFDA members from certain CRM2 Requirements on the condition that they comply with the corresponding IIROC and MFDA provisions;
- an exemption for registered advisers acting as sub-advisers from certain client reporting requirements, including the report on charges and other compensation and the investment performance report;
- guidance with respect to a firm’s pre-trade disclosure obligations in the case of a frequent trader who can reasonably be expected to be familiar with “standard charges”. In such cases, a simple confirmation that the usual charges will apply is acceptable;
- clarification that a registered firm is not required to deliver an investment performance report if: (a) there are no securities of the client with respect to which information is required to be reported, or (b) no market value can be determined for any securities of the client;
- guidance with respect to the requirement that the annual report must include information about all of the firm’s applicable current operating charges in the following 12 months;
- clarification that the number of securities purchased, sold or transferred must be disclosed in account statements and whether the account is eligible for coverage under an investor protection fund;
- clarification that, with respect to determining the market value of a security, if it can be demonstrated through use of a periodic assessment that a "last traded price" valuation approach results in security market values that are materially the same as under the "last bid and ask prices" valuation approach, it

may be acceptable to use current "last traded price" valuation approach for liquid securities for which a reliable price is quoted on a marketplace. If, having applied the prescribed methodology, a registered firm reasonably believes it cannot determine the market value of a security, the firm must then report its value as "not determinable" and exclude it from the prescribed calculations in client statements.

Conclusion

The Amendments represent a number of significant changes to the regulatory regime for dealers, advisers and investment fund managers.

The Amendments, other than the Custody Amendments, are expected to come into force on December 4, 2017. The Custody Amendments will come into force six months later, on June 4, 2018.

Importantly, the CSA clarified that future proposals to revise the Custody Amendments may follow as a consequence of the CSA's ongoing policy work in respect of the modernization of investment fund product regulation under National Instrument 81-102 Investment Funds.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.