

NATIONAL INSTRUMENT 31-103

REGISTRATION REQUIREMENTS AND EXEMPTIONS

PURPOSE

On July 17, 2009 the Canadian Securities Administrators (the "CSA") published National Instrument 31-103 – *Registration Requirements and Exemptions* ("NI 31-103"), which is designed to "harmonize, streamline and modernize the registration regime across CSA jurisdictions." NI 31-103 will come into force on September 28, 2009 ("**the Effective Date**").

Among the highlights of NI 31-103 are:

- introduction of a "business trigger" for dealer registration;
- creation of exempt market dealer and investment fund manager registration categories;
- requirement for all registered firms to appoint an "ultimate designated person" and a "chief compliance officer";
- "fit and proper" proficiency and solvency requirements for individuals and firms;
- introduction of new record-keeping, financial reporting and complaint handling requirements in an effort to bolster investor protection; and
- development of an improved system for the identification and management of conflicts of interest.

The CSA anticipate that the revised dealer and advisor registration requirements will "provide protection to investors from unfair, improper or fraudulent practices, and thereby enhance capital market integrity."

THE "BUSINESS TRIGGER"

Currently, in all Canadian jurisdictions except Quebec, there exists a "trade trigger" whereby only those who "trade" in securities are required to register as dealers. NI 31-103 will apply the concept of a "business trigger" to dealer registration, with the result that anyone "in the business" of "trading in securities" will be required to register.

Following the implementation of NI 31-103, "trading in securities" will include dealing in securities as principal or agent and advising others about acquiring or disposing of securities, a much broader concept than the traditional definition of "trading" in securities, which is more narrowly construed as a sale for valuable consideration.

The CSA will consider a variety of factors in determining whether a particular activity is caught by the business trigger, including:

- expectation of remuneration and realization of profit as a result of dealing-related activity;
- solicitation in connection with dealing-related activity;
- frequency of dealing-related activity;
- acting as an intermediary in connection with dealing-related activity; and
- holding oneself out, directly or indirectly, as being in the business of dealing.

In general, registration will not be required for one-time transactions, nor for activities that are incidental to the primary business purpose of an organization. This exception is intended to apply to certain professionals such as lawyers, accountants, and engineers that provide securities advice incidental to their primary businesses, as discussed in Companion Policy 31-103 CP *Registration Requirements and Exemptions* (the "**Companion Policy**").

NEW INVESTOR CATEGORY

The "Permitted Client" investor category is comprised of parties that would be at the upper end of the accredited investor spectrum. The introduction of this category and its exemptions will reduce regulatory burdens for registrants as it will eliminate the requirement for permitted clients' advisors and dealers to make suitability determinations on their behalf.

REVISED REGISTRATION CATEGORIES

NI 31-103 introduces significant reforms to the current slate of registration categories.

Exempt Market Dealer

The exempt market dealer category being introduced essentially mirrors the limited market dealer category already in place in Ontario and Newfoundland and Labrador, except that registrants will be subject to new "fit and proper" requirements relating to individual proficiency and firm solvency (described below). In Ontario and Newfoundland and Labrador, limited market dealers will automatically become exempt market dealers as of the Effective Date. Exempt market dealers will be restricted to dealing in prospectus-exempt securities and with persons to whom prospectus-exempt distributions can be made (such as accredited investors). However, the CSA anticipate that certain limited market dealers, such as M & A advisory firms that do not participate in distributions, may not be considered to be "in the business" of dealing in securities. Such market participants will no longer require registration.

Investment Fund Manager

Another significant reform under NI 31-103 is the registration requirement for investment fund managers. Pursuant to NI 31-103, managers of all investment funds (e.g. domestic, foreign, reporting issuers and non-reporting issuers) other than private investment clubs will be required to register in the jurisdiction of the person or company that directs the fund.

This registration requirement is designed to combat several concerns that are unique to investment funds, including:

- inaccurate or untimely calculation of net asset value;
- inaccurate or untimely preparation of financial statements and reports;
- inadequate record-keeping services; and
- conflicts of interest between fund managers and investors.

The CSA anticipate that these concerns will be mitigated by opening direct lines of communication between regulators and investment fund managers and increasing regulatory supervision.

Other new registration categories

NI 31-103 also introduces a "restricted dealer" category, which applies to limited dealing activities that do not fall into other categories, and a "restricted portfolio manager" category, which applies to those dealers who specialize in particular industries or classes of securities.

In both cases, the applicable restrictions and registration requirements will depend on the nature and scope of the activities described in the application.

Categories being eliminated

NI 31-103 will eliminate the "securities issuer" and "securities advisor" registration categories. As discussed above, most securities issuers outside of the investment industry will not be captured by the business trigger and will not be in need of a registration exemption. Likewise, those who provide generic securities advice – in email bulletins, at conferences or through other channels – will generally be exempt from registering.

NI 31-103 will also eliminate the international advisor category presently available in Ontario for advisors who reside outside of Canada. Entities currently registered as international advisors in Ontario will be exempt from registering with securities regulators, resulting in reduced consumer protection. Accordingly, the variety of clients accessible to international advisors will be narrowed under NI 31-103.

ULTIMATE DESIGNATED PERSON AND CHIEF COMPLIANCE OFFICER

Ultimate Designated Person

Every registered firm will be required to appoint an Ultimate Designated Person ("UDP") responsible for ensuring that policies and procedures under securities legislation are developed and implemented by the registrant. The UDP must be a senior officer with intimate knowledge of relevant policies and procedures and should have the authority to implement reforms where necessary.

Chief Compliance Officer

Each firm will also be required to nominate a Chief Compliance Officer ("CCO") to be registered with securities regulators. In contrast to the global oversight functions of the UDP, the CCO will be responsible for day-to-day activities aimed at ensuring adherence to registrant obligations under securities law (i.e. responding to client complaints and providing appropriate financial disclosure to clients).

The UDP and CCO may be the same individual, depending on the size and structure of the firm. However, the CCO will have to comply with the proficiency element of the "fit and proper" requirements to ensure an adequate background in accounting and finance (see below).

The above provisions have been included in the hope that the UDP and CCO will help foster a firm-wide culture of compliance. In this regard, NI 31-103 expressly requires that the UDP and CCO have direct, ongoing access to the firm's board of directors and senior management.

FIT AND PROPER REQUIREMENTS

Proficiency

Under NI 31-103, dealers will have to comply with proficiency requirements designed to protect the public by ensuring that only qualified persons are eligible to trade in securities. A general proficiency principle will be introduced by NI 31-103 requiring individuals to have the education and experience reasonably necessary to perform an activity that calls for registration.

In general, CSA-approved competency exams will have to be completed within 36 months of applying to become a registered dealer. However, exams completed prior to the 36 month window may be accepted if the applicant was registered or had relevant work experience during the year leading up to the 36 month window.

Advisors will also be subject to the proficiency requirements of NI 31-103; specifically, every advisor will be required to obtain either (a) the Chartered Financial Analyst ("CFA") designation or (b) the Canadian Investment

Management ("CIM") designation plus four years of relevant investment management experience. Typically, advisors of institutional clients obtain the CFA designation while those with retail clients pursue the CIM designation.

As mentioned, CCOs for dealer and advisory firms will be required to comply with the relevant proficiency requirements.

Where a dealer or advisory firm is a member of a recognized self-regulatory organization ("SRO"), such as the Investment Industry Regulatory Organization of Canada ("IIROC"), the relevant proficiency requirements will be determined by the SRO, and compliance with NI 31-103 will not be required.

Solvency

NI 31-103 introduces solvency requirements for the following inter-related reasons:

- to protect client and firm assets;
- to ensure firm liquidity;
- to provide regulators with advanced warning of potential solvency issues;
- to allow regulators sufficient time to facilitate an orderly winding down, if necessary; and
- to help in the assessment of a firm's integrity and fitness for registration.

NI 31-103 attempts to achieve these objectives by requiring that every registrant be solvent and by imposing minimum capital and insurance requirements. The instrument adopts a risk-based approach, establishing capital and insurance targets that reflect the business model of each particular firm and industry in an effort to ensure that a registered firm can meet the demands of its counterparties and, if necessary, wind down its business without loss to its clients.

Each firm will have to maintain excess working capital of greater than zero, as calculated using Form 31-103F1 *Calculation of Excess Working Capital*. To boost investor protection, the minimum capital requirements for the purpose of calculating excess working capital will be set at \$25,000 for advisors, \$50,000 for dealers, and \$100,000 for investment fund managers. Plus, securities regulators will have to be notified immediately in the event of a deficiency in excess working capital.

Capital and insurance requirements will be accompanied by an increase in the frequency of mandatory financial reports to regulators.

SRO-registered firms will be governed by solvency requirements set out in the SRO's by-laws instead of those established by NI 31-103.

CLIENT RELATIONSHIPS

NI 31-103 introduces a number of requirements aimed at enhancing disclosure to and protection of clients.

Know Your Client

Registered firms will be required to identify individuals who, either directly or indirectly, beneficially own more than 10% of a corporate client. The requirement to identify insiders is limited to insiders of reporting issuers and those whose securities are publicly traded.

Client Assets

Adopting the approach currently in place under several provincial statutes, NI 31-103 will require registrants to segregate client assets from the firm's funds and keep transaction records to track the movement of client assets. Additionally, non-SRO firms will be prohibited from providing margin to facilitate purchases of securities by clients. Both reforms are aimed at maintaining an arm's-length, transparent relationship between firm and client.

Record Keeping

NI 31-103 will replace the current record keeping requirements, which dictate the specific types of records that must be kept, with "a general obligation for registrants to maintain an effective record-keeping system." While the Companion Policy offers some guidance on the types of records that registrants are expected to keep, the new approach recognizes that record keeping practices naturally vary across firms and industries and is designed to offer increased flexibility.

Records may be kept in hard copy or electronically, provided that the electronic records are capable of being converted into readable paper format.

Reporting Account Activity

NI 31-103 will require registered dealers to send confirmations of trades to their clients. To lower the cost of compliance and promote efficiency, the rules permit multiple, simultaneous trades to be reported in a single confirmation. Moreover, for clients trading in the securities of certain mutual funds, scholarship plans, and educational trusts, registered dealers will have the option of providing clients with semi-annual summaries of trades following the delivery of an initial trade confirmation. Notably, there is an exemption under NI 31-103 for investment fund managers, to the effect that trade confirmations need not be provided each time a trade of securities takes place within a managed fund.

CONFLICTS OF INTEREST

Referral arrangements

The CSA have uncovered a number of pressing concerns relating to the existing referral fee practices of many dealers and advisors, including:

- client awareness - a client expects advice that is in the client's best interest and is not influenced by the referrer's own financial interest;
- referrer performing activities requiring registration - there is a risk that a referrer lacking the appropriate proficiency or registration may engage in activities requiring registration (i.e. dealing in or advising on securities); and
- supervision and oversight - some of the referral arrangements observed during the CSA's compliance field reviews were informal arrangements that salespersons entered into without the dealer's knowledge or approval.

Under NI 31-103, a registrant attempting to enter into a referral arrangement will be required to take the following steps:

- provide written disclosure to the client with sufficient detail to enable them to evaluate the proposed referral arrangement;
- enter into a written agreement outlining the particular responsibilities of the parties receiving and providing the referral; and

- "establish clear lines of responsibility" within the firm for compliance with securities legislation.

Eliminating restrictions on advisory fees

While dealers are currently permitted to set fees as a percentage of transaction size, securities regulators have traditionally been opposed to advisors charging transaction-based fees for fear of "excessive transactions being done with a client's account to generate fees."

Following the implementation of NI 31-103, advisors will be permitted to charge fees as a percentage of transaction size, provided that clients are adequately informed about the basis upon which fees are charged.

Conflicts generally

The Companion Policy sets out a pragmatic, three-step approach to dealing with conflicts of interest in general:

1. Avoid – certain conflicts are so contrary to another party's interests that merely controlling and/or disclosing them is inadequate. Such conflicts must be avoided even if it means refraining from providing a certain service to a client. Registrants should adopt a proactive approach whereby measures are taken prior to the actual development of conflicts of interest.
2. Control – depending on the given conflict of interest, it may be beneficial to assign the matter to another member of the firm, monitor the situation, or initiate internal or external disciplinary action. In this regard, it is critical that registrants have internal mechanisms – such as accessible stand-alone advice units and internal audit staff with access to officers and directors – which may enable registrants to manage conflicts effectively.
3. Disclose – while disclosure alone will rarely result in effective conflict management, it is a critical component to the successful handling of conflicts of interest. Disclosure must not be generic; registrants should identify which specific elements of the relationship or services in question could give rise to conflicts of interest. Importantly, registrants should disclose potential conflicts as early as possible in order to allow clients a reasonable time to consider how to proceed.

CONCURRENT AMENDMENTS TO THE ONTARIO SECURITIES ACT

The definition of "dealer" under the Ontario Securities Act (the "Act") will be expanded to include the "business trigger" introduced by NI 31-103. Likewise, the Act will be amended to adopt the criteria applied under NI 31-103 in determining whether a person or company is engaged in the business of "trading in securities."

TRANSITIONAL PERIODS

The CSA have recently issued a staff notice setting forth the following transitional periods for the phasing-in of NI 31-103:

Exempt Market Dealers

Firms transitioning into an exempt market dealer category in Ontario and Newfoundland and Labrador will have 12 months to ensure that the designated CCO satisfies the proficiency requirements and to update their National Registration Database filings accordingly.

Registrants in jurisdictions other than Ontario and Newfoundland and Labrador that are active in the exempt market prior to the Effective Date will have 12 months to apply for registration; however, firms in such jurisdictions that are not active in the exempt market prior to the Effective Date will have to apply for regulatory approval prior to carrying on business.

Investment Fund Managers

Investment fund managers that are headquartered in Canada and are active prior to the Effective Date will have 12 months to apply for registration. Those organizations that are not active prior to the Effective Date will require regulatory approval prior to engaging in business.

Investment fund managers that are headquartered outside of Canada will have 24 months to apply for registration, whether or not they are active prior to the Effective Date.

International Dealers

In Ontario and Newfoundland and Labrador, international dealers will be exempt from registration under the new regime, but will be required to file Form 31-103 F2 *Submission to Jurisdiction and Appointment of Agent for Service* ("**Form 31-103F2**") within one month after the Effective Date in each province in which they carry on business.

International Advisors

A firm currently registered as an international adviser in Ontario or as a Portfolio Manager & Investment Counsel (Foreign) in Alberta will have 12 months to file Form 31-103F2.

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This update is intended for general informational purposes only and should not be relied upon as legal advice.

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