

Registration Reform

IN CANADA
The Finish Line is Here

Section B of Stikeman Elliott's Report on Canada's New Registration Regime
JULY 2009

**Impact on Limited Market Dealers
and Unregistered Dealers
Trading in the Exempt Market**



Impact on Limited Market Dealers and Unregistered Dealers Trading in the Exempt Market

Requirement to Register as a Dealer

Under National Instrument 31-103 – *Registration Requirements and Exemptions* (31-103), dealer registration in Canadian provinces and territories (jurisdictions) is required when an individual or firm conducts trading activity as a business or holds itself out as being in the business of trading. This is called the “business trigger” for registration. To determine whether registration is required, a firm or individual must consider whether its activities amount to trading, and then determine whether it is carrying out those activities as a business.

Companion Policy 31-103CP – *Registration Requirements and Exemptions* (31-103CP) outlines a number of factors to be considered in determining whether a “business” is being conducted. These include factors such as whether the individual or firm is engaging in activities similar to a registrant, intermediating trades between sellers and purchasers, conducting the activity repeatedly, receiving compensation or directly or indirectly soliciting clients.

A number of dealer registration exemptions currently available for trading in securities pursuant to National Instrument 45-106 – *Prospectus and Registration Exemptions* (45-106) will be repealed upon implementation of 31-103 including the exemption for trades with “accredited investors”. Currently, in jurisdictions other than Ontario and Newfoundland and Labrador, dealer registration exemptions are generally available for trades that are exempt from prospectus requirements (the exempt market). After 31-103 most of these dealer registration exemptions will be repealed and accordingly unregistered dealers trading in the exempt market who are in the business of trading will be required to register as “exempt market dealers” (EMDs).

In Ontario and Newfoundland and Labrador, currently persons who act as “market intermediaries” in respect of trades in the exempt market are required to register as limited market dealers. Upon implementation of 31-103, limited market dealers will be registered as EMDs and will be subject to capital, insurance and proficiency requirements and other ongoing compliance requirements.

Earlier versions of 31-103 incorporated different regulatory requirements for EMDs, depending on whether or not the EMD handled, held or had access to client assets. This distinction has been eliminated.

Exemptions from Registration

Exemptions from the requirement to register as a dealer will be much more limited upon the implementation of 31-103. However, some of the principal exemptions contemplated by 31-103 include:

Trades through a Registered Dealer

There is an exemption for a trade being conducted solely through a registered dealer. The Canadian Securities Administrators (CSA) note in 31-103CP that this exemption is not available for trades where an intermediary is involved and that it is only available where a person trades their own securities directly with a registered dealer.

Mobility Exemption

31-103 includes a new “mobility exemption” which would in some circumstances allow a registered firm and representative to continue to deal with a small number of clients who move to another jurisdiction without the need to register in that other jurisdiction. The mobility exemption allows a firm to deal with up to 10 “eligible” clients (the client who relocated and his or her spouse and children) or an individual to deal with up to five eligible clients in a jurisdiction without being registered. Certain client notices and regulatory filings are required to rely on this exemption.

Northwestern Jurisdictions

Alberta, British Columbia, Manitoba, the Northwest Territories, Nunavut and the Yukon Territory will introduce orders exempting individuals and firms from the dealer registration requirement when they trade in securities that have been distributed under one of the following prospectus exemptions in 45-106:

- accredited investor;
- family, friends and business associates;
- offering memorandum; or
- minimum \$150,000 purchase of a security in one transaction.

To rely on this order, an individual or firm in one of those provinces or territories must:

- not be registered in any category of registration in any jurisdiction (including any non-Canadian jurisdiction);
- not provide suitability advice about the trade to the purchaser;
- except in British Columbia, not otherwise provide financial services to the purchaser;
- not hold or have access to the purchaser's assets;
- provide risk disclosure in the prescribed form to the purchaser; and
- file an information report with the securities regulatory authority.

Saskatchewan is considering whether it will adopt this exemption.

Exemptions Where Another Regulatory Regime Applies

There are dealer registration exemptions for certain trades conducted by persons subject to other regulatory regimes, such as trades in mortgages, trades conducted pursuant to personal property legislation, trades in variable insurance contracts and trades in evidences of deposits by Schedule III banks and co-operative associations.

Certain Types of Plans

Issuers and administrators in respect of certain employee or reinvestment plans, are exempt from dealer registration requirements in respect of those trades.

Portfolio Managers

A portfolio manager may trade securities of non-prospectus qualified funds (pooled funds) for which it acts as the adviser and the fund manager with discretionary accounts it manages without registering as a dealer. Written notice of reliance on this exemption is required to be given to the applicable regulator.

Other Investment Fund Exemptions

There are other exemptions from the dealer registration requirement for certain types of trades in investment fund securities by an investment fund or its manager such as trades pursuant to certain reinvestment plans, and additional investments where the investor holds securities of the fund with a value or acquisition cost of \$150,000 or more.

International Dealers

This exemption allows non-resident dealers to operate in Canada, with limitations. See the discussion under the topic Impact on International Dealers and Non-Canadian Dealers Trading in the Exempt Market.

Permitted Activities for EMDs

Under 31-103, EMDs will be restricted to:

- i) acting as a dealer by trading a security that is distributed under an exemption from the prospectus requirement, whether or not a prospectus was filed in respect of the distribution;
- ii) acting as a dealer by trading a security that, if the trade were a distribution, would be exempt from the prospectus requirement;
- iii) receiving an order from a client to sell a security that was acquired by the client in a circumstance described in subparagraph (i) or (ii), and acting or soliciting in furtherance of receiving such an order; and
- iv) acting as an underwriter in respect of a distribution of securities that is made under an exemption from the prospectus requirement.

Registration of UDPs and CCOs

31-103 will require EMDs to register an ultimate designated person (UDP) and a chief compliance officer (CCO). The UDP's role is to supervise the activities of the registrant that are directed toward ensuring compliance with applicable securities regulations and promote compliance within the firm. While the actual form of compliance system to be implemented is not prescribed in 31-103, 31-103CP gives guidance on what the CSA view as an effective compliance framework. The designated UDP should be the CEO of the EMD or an officer in charge of the applicable division, but does not necessarily need to be someone who is involved in day-to-day compliance matters. No proficiency requirements are specified for the UDP function.

The CCO is required to establish and maintain compliance policies and procedures, monitor and assess compliance, report non-compliance to the UDP and annually report on compliance matters to the firm's board of directors. Accordingly, the CCO (who must be an officer or partner of the EMD) will be subject to certain proficiency requirements as described below. Firms must designate only one CCO and large firms will need to apply for an exemption to appoint more than one CCO, for example, where there are multiple distinct operating divisions within a firm. Both the UDP and the CCO must be able to access the firm's board of directors at such times as they consider necessary or advisable.

Proficiency and Financial Condition

EMDs will be required to meet the following proficiency and financial condition requirements. Non-compliance may result in the imposition of terms and conditions by the securities regulators, or revocation or suspension of registration:

- **Proficiency** – EMD sales representatives will need to satisfy proficiency requirements, which will generally be exam-based, rather than course-

based. Representatives can qualify, among other ways, by passing the Canadian Securities Course Exam or the Exempt Market Products Exam. While a UDP does not need to satisfy specific proficiency requirements, a CCO of an EMD can qualify, among other ways, by passing the Partners, Directors and Officers Exam and either the Canadian Securities Course Exam or the Exempt Market Products Exam.

- **Capital requirements** – EMDs will have to satisfy capital requirements. This means that their excess working capital (calculated as prescribed, via Form 31-103F1 - *Calculation of Excess Working Capital*, and certified by management) must not be less than zero for two consecutive days, and the minimum capital must be \$50,000.

The working capital position of a registrant is required to be known at all times. Negative excess working capital at any time must be reported to the regulator as soon as possible. Under Form 31-103F1, "excess working capital" is calculated according to the following formula:

- adjusted current assets (those readily convertible into cash), less
 - adjusted current liabilities (current liabilities plus 100% of unsubordinated long-term related party debt), less
 - the required minimum capital which, in the case of EMDs is \$50,000, less
 - an amount on account of market risk (based on owned securities, applying Investment Industry Regulatory Organization of Canada margin rules), less
 - the insurance deductible for the financial institution bond, less
 - the amount of any guarantees by the firm, less
 - "unresolved differences" (both firm and client, and securities shortfalls must include the applicable margin amount).
- **Insurance** – EMDs will need to have specified insurance, namely a financial institution bond (with fidelity, on premises, in transit, forgery or alterations and securities coverage, and either a double aggregate limit or a full reinstatement of coverage provision) in the greater of: (1) \$50,000 per employee, agent and representative or \$200,000, whichever is less; (2) one percent of total clients assets held or accessible by the dealer or \$25,000,000, whichever is less; (3) one percent of the dealer's total assets or \$25,000,000, whichever is less; and (4) the amount determined by its board of directors. Changes, claims or cancellation of such insurance policy will need to be reported in writing to the regulator as soon as practicable.
 - **Financial records** – EMDs will need to have an auditor (for annual purposes and to be on standby to deliver an audit or review report as and when requested by the regulator), and will be required to deliver annual financial statements with the audit report and a completed Form 31-103F1 within 90 days of year end.

All financial statements are currently required to be prepared in accordance with GAAP but on an unconsolidated basis. The CSA have indicated they intend to require registrants to adopt international financial reporting standards for financial years beginning on or after January 1, 2011.

Compliance and Dealing with Clients

31-103 and 31-103CP contain detailed and technical conduct requirements for all registrants, including EMDs. The CSA consider compliance to be a firm-wide responsibility to be carried out in accordance with a documented compliance system which should address, among others, the following elements:

- internal controls;
- supervision (both day-to-day and systemic monitoring);
- a visible commitment to compliance by the board of directors or partners;
- sufficient resources and training;
- detailed policies and procedures; and
- detailed records of activities.

In addition, EMDs will be subject to a number of specific rules for dealing with clients, including the following:

Know your client and suitability obligations – 31-103 outlines the requirements for fulfilling know your client and suitability obligations. Account opening and client documentation (including for know your client and suitability purposes) must be maintained and kept current. Unsuitable trades (in the firm's opinion, acting reasonably) at a client's direction can be executed only if the client is first informed of their unsuitability (in the EMD's opinion). Know your client and suitability exemptions are available for certain specified institutional clients.

Leverage disclosure – Where an EMD is recommending using borrowed money to finance any part of the purchase of a security, written disclosure of the risks of leverage must be provided to the client, with certain exceptions (including for "permitted clients" or where the proposed purchase is on margin and the client's margin account is maintained in accordance with certain margin rules).

Client assets – Client assets that are held by an EMD must be segregated and held in trust for the client (in the case of cash, in a designated trust account with certain types of Canadian financial institutions, and in the case of securities in accordance with certain requirements).

Margin and prohibition on lending – EMDs may not lend money, extend credit or provide margin to clients.

Record keeping and account activity reporting – Record-keeping is mandated, and certain records must be kept for at least 7 years. 31-103 does not contain an exhaustive list of records that must be kept, instead requiring maintenance of records that accurately record a registrant's business activities,

financial affairs and client transactions and that demonstrate compliance with securities legislation. Client statements are required to be provided at least once every three months and at the end of each month during which a transaction was effected. Trade confirmations are required, with related party disclosure, if applicable, and other specified disclosure.

Complaint handling – EMDs will also be required to document and, in a manner that a reasonable investor would consider fair and effective, respond to complaints about products and services, and must make an independent dispute resolution or mediation service available at the EMD's expense.

Conflicts of Interest

Material conflicts of interest and potential material conflicts of interest must be identified and responded to, and conflict of interest disclosure is prescribed in certain cases, including with respect to trades and offerings involving securities of related entities or recommendations to buy, sell or hold such securities. Client "relationship disclosure information" will also be required. Referral arrangements are also regulated as are "tied selling" and unnecessary mandatory financial institution settlement arrangements.

For further compliance requirements see the discussion under the topic New Compliance Requirements for Registrants.

Registration Reform in Canada:

The Finish Line is Here

Canada's new registration rule was published by the Canadian securities administrators in final form on July 17, 2009.

The new regime is expected to be in force September 28, 2009 with transition periods for implementation of aspects varying. The new regime, which has been several years in the making, is intended to harmonize, streamline and modernize registration requirements and exemptions across all Canadian jurisdictions. It regulates dealers and advisers, effectively eliminating the dealer registration exemption for trading in the exempt market in Canada, and imposes a new registration requirement for investment fund managers.

The new regime has significant implications for Canadian and non-Canadian market participants, particularly those now doing business on an unregistered or exempt basis.

This document is one part in a series that details the regime and its impact on particular types of market participants and their business activities. The complete document includes the following sections:

- A** Overview of Canada's New Registration Regime
- B** Impact on Limited Market Dealers and Unregistered Dealers Trading in the Exempt Market
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