

## **PUBLIC MARKETS GROUP BULLETIN**

*March 2008*

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

In addition to the recent publication of a revised version of National Instrument 31-103 – Registration Requirements<sup>1</sup>, there have been a number of other regulatory developments since the beginning of 2008 which may affect or be of interest to registered advisers and dealers involved in the Canadian investment management industry. This bulletin is intended to provide our clients with a summary of those developments.

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.

#### **OSC IMPLEMENTS CHANGES TO CAPITAL AND INSURANCE REQUIREMENTS FOR ICPM FIRMS WITH ‘CUSTODY’ OF FUND ASSETS**

The amount of insurance and capital required by a registered investment counsel/portfolio manager (a “ICPM”) depends on whether it takes possession of clients’ funds or securities. The Ontario Securities Commission (the “OSC”) has recently revised the checklist used to determine whether an ICPM has possession of clients’ funds and securities. The checklist now includes the following question:

**YES/NO    Having the ability to gain access to clients’ assets, e.g. you or your responsible persons act as the fund manager or general partner for your investment funds.**

As a result of the change to the OSC checklist, an ICPM may now be deemed to take possession of clients’ funds or securities if it is also the manager or general partner of an investment fund. Accordingly, the ICPM must, as soon as possible, increase its insurance coverage to \$200,000 in the form of a Financial Institution Bond 14, with coverage extending to insuring agreements D and E, and maintain a working capital of \$25,000 plus any deductible on insurance.

In connection with any required increase in insurance and working capital requirements, an ICPM must file a completed Form 33-109F5 indicating the change and attach an unaudited balance sheet (showing net working capital), a certified resolution of the directors confirming the increased amount of insurance coverage, a notice to the OSC regarding the handling of clients’ funds and a rider to the insurance policy indicating the amount of coverage and deductible.

#### **NATIONAL INSTRUMENT 41-101 EFFECTS CHANGES TO PROSPECTUS REQUIREMENTS FOR NON-CONVENTIONAL INVESTMENT FUNDS**

National Instrument 41-101 – General Prospectus Requirements (“NI 41-101” or the “Instrument”) came into force on March 17, 2008. NI 41-101 replaces Ontario Securities Commission Rule 41-501 – General Prospectus Requirements and local adopting rules in all other Canadian jurisdictions.

NI 41-101 is designed to harmonize and consolidate existing prospectus requirements and policies across Canada for all issuers, including investment funds (other than mutual funds filing a simplified prospectus), exchange-traded investment funds and labour sponsored investment funds. The general provisions of NI 41-101 also apply to short form prospectuses,

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<sup>1</sup> For more detailed information on 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”.

shelf and post-receipt pricing (PREP) offerings.

All investment funds subject to NI 41-101 that file a long-form prospectus will be required to file a prospectus in Form 41-101F2 (the “Form”). Unlike current investment fund prospectuses which generally attempt to follow the prospectus rules for operating companies, the Form requires investment funds to use prescribed headings and to present items in a specified order. Investment funds in continuous distribution will also be required to incorporate financial statements and management reports of fund performance by reference. In addition, NI 41-101 requires issuers to comply with the plain language principles set forth in its companion policy.

Prospectus certificates are required to be signed by specified parties. The companion policy to NI 41-101 provides guidance on when a regulator will exercise its discretion to refuse a receipt for a prospectus and when a regulator will require a person or company to sign a certificate. NI 41-101 includes specific rules relating to certificates required by corporate, trust and limited partnership issuers.

NI 41-101 includes a specific list of investment fund material contracts which must be filed on SEDAR. Of note is a statement in the companion policy that a material contract generally includes a schedule, side letter or exhibit referred to in the contract. Provisions in the material contracts may be redacted if an executive officer reasonably believes disclosure would be seriously prejudicial to the interests of the issuer or would violate confidentiality provisions, subject to the specified list of provisions in NI 41-101 which cannot be redacted. If a provision is omitted, the description of the type of information omitted must be included immediately after the provision in the copy of the filed contract.

While NI 41-101 is aimed at prospectus filing matters, it also addresses such matters as permitted advertising, specifying legends that may be placed in advertising materials, both during and after the waiting period for a receipt for a final prospectus, as well as prescribing permitted information that may be included in advertising materials.

There are also substantive provisions in NI 41-101 regarding the custodianship of portfolio assets of funds that have filed a prospectus under the Instrument. In essence, the rules mirror those applicable to conventional mutual funds subject to National Instrument 81-102, including specifying permitted custodians and provisions that must be included in custodian contracts.

Funds planning to file a prospectus under NI 41-101 should begin the process of completing new personal information forms (“PIFs”) early in the process, as one will be required for each director and executive officer of an issuer, manager and promoter if the issuer has not previously delivered an expanded PIF, or, prior to NI 41-101 coming into force, has not previously delivered a PIF or an authorization to collect personal information.

## **UPCOMING CHANGES TO OBLIGATIONS UNDER ANTI-MONEY LAUNDERING LEGISLATION AND REGULATIONS**

Effective June 23, 2008, all securities entities in Canada, including registered dealers and advisers as well as unregistered dealers who deal only in the exempt markets, will be subject to new compliance, client identification (including identification of “politically exposed foreign persons” and third parties), suspicious transaction reporting and record-keeping requirements under the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* (the “AML Act”) and the regulations (the “Regulations”) passed under it.

The AML Act and Regulations will significantly increase the client identification burden on affected firms, particularly in respect of transactions that are not conducted “face-to-face” with clients. For example, when opening an account for a client that is a corporation or other entity, firms will now be required to take reasonable measures to obtain the names, addresses and occupations of all persons who own or control 25 percent or more of the corporation or entity. When opening an account for an individual, firms will also be required to take reasonable steps to determine whether the client is a “politically exposed foreign person”. With respect to non-face-to-face account openings, firms will be required to ascertain clients’ identities using prescribed combinations of 2 identification methods.

ICPM firms that would otherwise be required to perform client identification procedures will be exempt in respect of “the opening of an account for the sale of securities of mutual funds”, provided that the firm has reasonable grounds to believe that client identity is being ascertained by another affected firm, generally an investment dealer or a mutual fund dealer. Although the terms “account” and “mutual funds” are not defined in the Act or the Regulations, the Financial Transactions and Reports Analysis Centre of Canada (“FINTRAC”) takes the view that the term “account” should be interpreted broadly to include, for example, entering into a subscription agreement and the term “mutual fund” should be interpreted in accordance with securities legislation, such that it would not apply to non-redeemable investment funds. FINTRAC has indicated, however, that managers of exchange listed non-redeemable investment funds would not be subject to the client identification rules because the client would not be considered to be opening an “account” with the manager. Accordingly, while this exception will be available to managers of conventional mutual funds, it will not be available to managers of hedge funds and other non-publicly traded investment funds whose securities are not “redeemable on demand or within a specified period after demand”, even if their funds’ securities are sold only through registered dealers who apply appropriate “know-your-client” and anti-money laundering client identification procedures at the opening of a client account<sup>2</sup>.

All firms subject to the AML Act will be required to implement a comprehensive anti-money laundering compliance program consisting of (a) the appointment of an anti-money laundering compliance officer, (b) the assessment and documentation of the risks that the firm might be used for money laundering and terrorist financing purposes and the measures the firm intends to take to mitigate any high risks, (c) the preparation of written policies and procedures for complying with the AML Act and Regulations, (d) the implementation and documentation of an ongoing anti-money laundering training program and (e) the conduct and documentation of a review of the effectiveness of the firm’s policies and procedures, training program and risk assessment at least once every two years.

In addition, at the end of 2008, FINTRAC will receive new powers to levy administrative fines on firms that it determines are not in compliance with the requirements of the AML Act and the Regulations.

#### **REVISIONS TO PROPOSED “SOFT DOLLAR” RULES**

On January 11, 2008, the Canadian Securities Administrators (the “CSA”) published for comment an amended version of proposed National Instrument 23-102 - Use of Client Brokerage Commissions as Payment for Order Execution Services or Research Services (“NI 23-102”) along with corresponding revisions to proposed Companion Policy 23-102 CP (the “Companion Policy”). The earlier versions were first published in July 2006 (the “2006 Proposal”)<sup>3</sup>. NI 23-102 and the Companion Policy are intended to establish a general framework for the use of brokerage commission dollars by advisers to pay for goods and services in addition to order execution.

NI 23-102 and Companion Policy will replace existing policies in Ontario and Québec and will clarify the types of goods and services that may be acquired with client brokerage commissions and set out enhanced disclosure requirements for soft dollar arrangements. The implementation of the new regime will put into effect uniform, enforceable rules across Canada and a degree of harmonization with regulatory developments in the US and UK, which have recently amended their respective soft dollar regimes.

The comments received on the 2006 Proposal resulted in the following substantive changes:

- (1) application to a narrower range of transactions;
- (2) a clarification of the definitions of “order execution services” and “research services”; and
- (3) a shift of focus towards narrative disclosure over quantitative disclosure.

<sup>2</sup> The Regulations provide a separate exemption from the client identification requirements in respect of “the opening of an account that is opened solely in the course of providing customer accounting services to a securities dealer”. Although FINTRAC has not yet issued clear guidance on the matter, they have suggested that managers of privately placed, non-redeemable investment funds distributed through dealers might be able to rely on this provision to be exempt from the client identification requirements.

<sup>3</sup> For details of the 2006 Proposal, please see our August 2006 Securities Law Bulletin entitled “[Proposed Amendments to Permitted “Soft Dollar” Arrangements](#)”.

### *Application*

NI 23-102 will apply to both advisers and dealers by restricting advisers' ability to pay (and dealers' ability to receive) client brokerage commissions as payment for anything other than order execution services or research services. It will apply in respect of trading being done for an investment fund, a fully managed account or any other account or portfolio over which an adviser exercises investment discretion on behalf of third-party beneficiaries.

The types of transactions to which NI 23-102 and the Companion Policy will apply has been narrowed in scope from the 2006 Proposal, which would have extended to transactions in securities where there is no independent pricing mechanism, such as over-the-counter ("OTC") trades and principal transactions. The changes reflect commenters' concerns that a lack of pricing transparency in respect of OTC and principal transactions would make it difficult for advisers to determine the amount of fees charged. For trades that do not fall within the scope of application (primarily OTC trades), advisers will still be subject to a general fiduciary duty to clients.

### *Definition of "Order Execution Services" and "Research Services"*

NI 23-102 will restrict the use of soft dollar arrangements to "order execution services" and "research services".

The definition of order execution services remains unchanged from the 2006 Proposal, and includes order execution and goods and services that are directly related to order execution, which would include goods and services related to custody, clearing and settlement. Changes have been made to the temporal standard that is applied to the definition, which includes goods and services provided or used between the point at which an adviser makes an investment decision (rather than "an investment or trading decision") and the point when the resulting transaction is completed. Order execution services may therefore include post-trade analytics from prior transactions and order management systems. This amendment clarifies the CSA's position that the standard for determining whether order execution has taken place turns on the extent to which a good or service assists the adviser in deciding how, when or where to place an order or effect a trade.

The definition of research services has been extended to include databases and software that support research. In giving guidance on eligibility, the Proposed Policy has placed greater emphasis on the adviser's use of research services rather than the characteristics of research. The non-exhaustive list of examples includes publications marketed to a narrow audience, raw market data from feeds or databases that has been or will be analyzed or manipulated, and seminar and conference fees. For mixed-use items, only that portion that benefits clients may be paid for with client brokerage commissions.

### *Disclosure Requirements*

The disclosure requirements in NI 23-102 have been also amended from the 2006 Proposal to increase the scope of the narrative disclosure required and decrease the scope of quantitative disclosure. Additional narrative disclosure to be provided to clients includes: the names of dealers and third parties that provided goods and services other than order execution and the types of goods provided; descriptions of the process and factors considered in selecting dealers; descriptions of the procedures in place to ensure that clients receive reasonable benefits from soft dollar arrangements; and the methods used to determine the overall reasonableness of the commission in relation to the order execution services or research services provided. Advisers will be obliged to ensure that soft dollar arrangements benefit their clients by being able to demonstrate how order execution and research services purchased with client brokerage commissions are used to assist in making investment decisions or in carrying out transactions. The Proposed Instrument clarifies that the reasonableness of value received is to be based on a good faith determination by the adviser.

The proposed quantitative disclosure requirements, though narrower and less onerous than in the 2006 Proposal, will still require disclosure to each client of the total brokerage commission paid by the client during the reporting period, and disclosure on an aggregated basis of the total client brokerage paid during the period and a reasonable estimate of the portion paid for goods and services other than order execution. Advisers may determine the appropriate level of aggregation based on their business structure and client needs, with guidance provided in the Proposed Policy.

The definition of "client" has been clarified for reporting purposes as the party with whom the contractual arrangement to provide advisory services exists. The Proposed Policy also states that where an adviser is also the trustee or manager of

an investment fund to which National Instrument 81-107 applies (or is an affiliate of the trustee or manager), disclosure may need to be made to the investment fund's Independent Review Committee as the relationship with the fund may present a potential conflict of interest.

### *Timing and Implementation*

The CSA have proposed a six month transition period from the effective date of the implementation of NI 23-102 and the Companion Policy, responding to a general concern with the lack of a transition period under the 2006 Proposal. No implementation date has been proposed.

Comments on NI 23-102 and the Companion Policy may be provided to the CSA by April 10, 2008.

### **PROPOSED AMENDMENTS TO NATIONAL INSTRUMENT 45-106**

Proposed National Instrument 45-106 - Prospectus and Registration Exemptions ("NI 45-106") was published for comment by the CSA on February 29, 2008. NI 45-106 has been restructured to separate the prospectus and registration exemptions, as it is intended that registration exemptions will be contained in National Instrument 31-103 ("NI 31-103"). Six months after NI 31-103 comes into force, the registration exemptions in Part 3 of NI 45-106 will become inoperative (except in certain cases in B.C. and Manitoba).

Of particular interest to managers of pooled funds and to those who will be "exempt market dealers" under NI 31-103, a person acting on behalf of a fully managed account managed by that person will still not be considered an accredited investor in Ontario when purchasing a security of an investment fund. Accordingly, when pooled fund securities are sold to a registered adviser acting on behalf of a fully-managed account in Ontario, pooled fund managers will still have to ensure that the underlying owner of the account is himself, herself or itself an "accredited investor" or rely on the \$150,000 prospectus exemption.

The proposed changes to NI 45-106 contemplates two changes to the current adviser registration exemption for investment dealers acting as portfolio managers. The first is to clarify the rules and policies of the Investment Dealers Association of Canada that a registered investment dealer must follow in order to rely on the exemption. The second is to remove the Ontario-only requirement to provide the securities regulatory authority with certain information in respect of registered investment dealers.

Ontario has also published proposed OSC Rule 45-501 ("Proposed Rule 45-501"). Proposed Rule 45-501 has been restructured to mirror the structure of Proposed NI 45-106, in that the prospectus and registration exemptions will become independent of each other. In addition, Proposed Rule 45-501 provides that the dealer registration exemptions (with the exception of the commodity futures option or contract exemption) will become inoperative six months after the implementation of NI 31-103.

Comments on Proposed NI 45-106 and Proposed Rule 45-501 may be provided to the CSA and the OSC by May 29, 2008.

### **SEC CHARGES HEDGE FUND ADVISER IN SUB-PRIME RELATED INVESTMENT FRAUD**

On March 4, 2008, the United States Securities and Exchange Commission (the "SEC") filed an enforcement action in the U.S. District Court for the District of Utah, charging a registered investment adviser (the U.S. equivalent of an ICPM) and three of its principals with violating the antifraud provisions of securities legislation by making undisclosed high-risk investments that resulted in the near-total loss of the assets of two hedge funds under its management<sup>4</sup>. Thompson Consulting Inc. ("Thompson") allegedly deviated from its stated investment strategy by engaging in much riskier trading strategies than those described to investors in its private placement memorandum and presentations to clients. The SEC is seeking the imposition of civil penalties and disgorgement as well as enjoining the defendants from future violations of securities laws.

<sup>4</sup> A copy of the press release in this matter can be obtained from the SEC's website at the following address: <http://www.sec.gov/news/press/2008/2008-28.htm>

Although this action will have no direct impact in Canada, it should be noted that Canadian investment fund managers owe the same fiduciary duties to clients as their U.S. counterparts and, accordingly, are potentially subject to similar regulatory action for failure to adhere to the investment objectives and strategies communicated to investors through prospectuses or offering memoranda, regardless of whether a fund's investors have a higher level of risk tolerance and sophistication.

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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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