

MEMO# 22347

March 14, 2008

Canadian Securities Regulators Re - Propose Revised Registration Requirements for Investment Advisers and Fund Managers

[22347]

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TO: INTERNATIONAL COMMITTEE No. 9-08 INVESTMENT ADVISERS COMMITTEE No. 5-08
RE: CANADIAN SECURITIES REGULATORS RE - PROPOSE REVISED REGISTRATION
REQUIREMENTS FOR INVESTMENT ADVISERS AND FUND MANAGERS

The Canadian Securities Administrators (CSA) has proposed for comment revised registration requirements for dealers, advisers, and investment fund managers ("Registration Proposal").[\[1\]](#) The Registration Proposal, which was originally published for consultation in February 2007, would introduce harmonized registration requirements across all CSA jurisdictions.[\[2\]](#)

The Registration Proposal, among other things, would impose new provisions to require registration of both "investment fund managers" and key compliance and supervisory personnel, including the ultimate designated person ("UDP") and the chief compliance officer ("CCO"). Comments on the Registration Proposal are due by May 29, 2008. If you have any particular concerns on which you would like the Institute to comment, please let us know as soon as possible.

The Registration Proposal is divided into ten parts, including a definition section, categories of registration and permitted activities, fit and proper requirements, conduct rules, conflicts

of interest provisions, and exemptions from registration. This memorandum highlights some of the significant aspects of the Registration Proposal for investment advisers and fund managers.

Changes from the 2007 Registration Proposal

In Part 1 (Definition Section), the CSA would introduce a new category of investors – the “permitted client.” These clients would be a subset of “accredited investors” and would consist primarily of institutions, corporations, and very high net worth individuals. The permitted clients of advisers would have the ability to waive the requirement for the adviser to make investment suitability determinations for them.[\[3\]](#)

Under Part 2 (Categories of Registration and Permitted Activities), the CSA would require an investment fund manager to register only in the jurisdiction where the person or company that directs the management of a fund is located, which in most cases will be the location of the manager’s head office.

In Part 5 (Conduct Rules), a new provision would require registered firms to establish the identity of any individual who is the beneficial owner of more than 10% of the shares of a corporate client. The CSA also replaced the previously proposed requirement to provide a relationship disclosure document to clients with a requirement that registered firms provide information that a reasonable client would consider important with respect to the client’s relationship with the firm.

The CSA also has clarified that registered firms would be required to have a compliance system of controls and supervision. The CSA also prescribes the compliance functions of the UDP and the COO.

Under Part 6 (Conflicts of Interest), the CSA would add an exemption for an investment fund manager of an investment fund that is subject to National Instrument 81-107 – Independent Review Committee for Investment Funds. The CSA also would add a provision prohibiting a registered firm from acting as an adviser with respect to its own securities or the securities of a related issuer and, in the course of a distribution, a connected issuer of the firm. Finally, the CSA would require disclosure of an adviser’s financial or other interests when making a recommendation.

In Part 8 (Exemptions from Registration), the CSA would expand the list of permitted clients for international dealers and advisers and remove the prohibition on international advisers from soliciting new business.

In Part 10 (Transition), the CSA would require a person who or company that is acting as an investment fund manager to apply for registration within six months of the effective date of the new rule. Investment fund managers also would have a one-year transition period to comply with capital and insurance requirements. Individuals designated as UDP or CCO would be required to apply for registration one month after the effective date of the rule.

Below is a more detailed description of the registration requirements for advisers and investment fund managers.

Registration for Advisers

Persons or Entities Required to Register

Under the Registration Proposal, a person who or company that is “in the business” of advising in securities would be subject to the registration requirements. The CSA would look to various factors to determine whether a person or company is in the business of advising in securities. For an adviser, these factors would include: (1) holding itself out, directly or indirectly, as being in the business; (2) directly or indirectly carrying on the activity with repetition, regularity or continuity, (3) being (or expecting to be) remunerated or otherwise compensated for the activity; or (4) directly or indirectly soliciting others in connection with the activity.[\[4\]](#)

Generally, a person who or company that holds itself out as advising in securities would be considered to be in the business of advising in securities. The other factors, each alone, however, would not necessarily be determinative of whether a person or company is in the business of advising in securities. For an investment fund manager, the CSA would consider any person or entity carrying out that activity as being in the business.

Categories of Registration

According to the CSA, a firm or individual must be registered in all applicable categories if it performs more than one type of activity requiring registration. For example, if a portfolio manager manages an investment fund in addition to advising in securities, it may be

required to register as a portfolio manager and an investment fund manager.

Portfolio Manager. A person who or company that is in the business of advising in securities must register either as a “portfolio manager,” which is an adviser that is permitted to advise in any security or a “restricted portfolio manager,” which is an adviser that is limited by conditions of its registration to advising in specified securities, classes of securities, or the securities of a class of issuers.

Investment Fund Manager. The “investment fund manager” registration category would permit a person or company to direct the business, operations or affairs of an investment fund. An investment fund manager generally organizes the fund and contractually accepts responsibility for its management and administration.

The CSA would not expect an investment fund manager located outside of Canada to register in Canada unless it is directing the management of a fund from inside Canada.

Dealer. Investment fund managers also would have to register as a “dealer” if they carry on marketing and wholesaling activities, such as advertising the fund to the public, promoting the fund to registered dealers, or distributing the fund to registered dealers that in turn sell fund securities to investors.

Investment fund managers do not have to register as dealers if their marketing and wholesaling activities are incidental to their activities as investment fund manager. These activities would be incidental if the marketing and wholesaling activities relate to investment funds managed by the investment fund manager (not a third party) and the funds are distributed to investors through a dealer and not directly by the investment fund manager.

Individual Registration. For individuals, a person may register as an “advising representative,” “associate advising representative,” “ultimate designated person” (UDP) or “chief compliance officer” (CCO). A registered firm must have an individual registered as an UDP, who is the chief executive officer or sole proprietor of the registered firm, an officer in charge of a division of the registered firm, or an individual acting in a similar capacity. A registered firm also must have an individual who is registered under the securities laws in the category of CCO. The individual may not act as CCO unless the individual is an officer or partner of the registered firm or the firm’s sole proprietor.

Exemptions from Registration

International Advisers

An international adviser means an adviser that has its head office or principal place of business, is registered (or exempt from registration), and is engaged in the business of an adviser in a foreign jurisdiction. The adviser would be required to provide written notice to the regulator within five business days of its first use of the exemption.

Moreover, the adviser registration requirement would not apply to an international adviser that advises a permitted client if it satisfies certain conditions. The adviser must deliver to the securities regulatory authority an executed form (Submission to Jurisdiction and Appointment of Agent for Service) and must not advise clients in Canada regarding Canadian issuers. Moreover, not more than 10% of the aggregate consolidated gross revenue of the international adviser and its affiliated partnerships must be derived from the portfolio management activities of the international adviser, its affiliates and its affiliated partnerships in Canada. Finally, before advising its clients, the international adviser must disclose that it is not registered in Canada, the jurisdiction of the international adviser's residence, the name and address of the adviser's agent for service of process, and that there may be difficulty enforcing legal rights against the international adviser because it is resident outside Canada and all or substantially all of its assets are situated outside of Canada.

Sub-advisers

The adviser registration also would not apply to a person or company, not ordinarily resident in the jurisdiction, acting as an adviser for a registered adviser or for a dealer acting as a portfolio manager under certain conditions. These conditions include that: (1) the obligations and duties of the sub-adviser are set out in a written agreement with a registered firm; (2) the registered firm contractually agrees with its client to be responsible for any loss that arises out of the failure of the sub-adviser; (3) the registered firm cannot be relieved by its clients from its responsibility for loss; (4) the sub-adviser, if a resident of a jurisdiction, is registered as an adviser in the jurisdiction; and (5) the sub-adviser has no direct contact with the registered firm's clients unless the registered firm is present.

Fit and Proper Requirements

Under the Registration Proposal, regulators would not register an applicant if the applicant does not appear to be fit and proper or suitable for registration.^[5] The CSA provides three

fundamental criteria for assessing a person's or company's suitability for registration. These criteria include: (1) integrity and honest character of the applicant; (2) the education and experience of the applicant; and (3) financial situation, specifically solvency, of the applicant.

As part of the evaluation and on-going monitoring of a registrant's financial condition, the Registration Proposal would impose initial and ongoing capital requirements. A registered firm must ensure that its excess working capital, which is calculated according to Form 31-103F1, is not less than zero. The minimum capital required is \$25,000 for an adviser and \$100,000 for an investment fund manager. In addition, registered advisers and registered investment fund managers would be required to maintain bonding or insurance in certain enumerated amounts.

Registered advisers and investment fund managers also would be required to deliver certain financial information, including a calculation of excess working capital, to the regulator. If a firm is registered in multiple categories, the CSA would require the firm to meet the highest capital requirement of its various categories of registration.

Conduct Rules

The Registration Proposal would impose on registered firms know-your-client and suitability obligations and would prescribe the contents of the relationship disclosure information for clients. These conduct rules, however, would not apply to an investment fund manager.

The CSA also would impose certain safekeeping and recordkeeping requirements on registered firms. Registered firms would be required to maintain accurate records of their business activities, financial affairs, and client transactions, and records to demonstrate compliance with applicable requirements of the securities laws.

The CSA also would require a registered adviser to send or deliver to each client not less than once every three months a statement of the portfolio of the client under the adviser's management.

Compliance

The Registration Proposal would require a registered firm to establish and maintain a compliance system of controls and supervision. The system of controls must be

documented in written policies and procedures.

Under these new registration requirements, the CSA would require a registered firm to designate an UDP to supervise the activities of the firm to ensure compliance with the securities laws. The CSA also would require the designation of a CCO of the registered firm: (1) to establish and maintain policies and procedures for assessing compliance with the securities laws; (2) to monitor and assess compliance with the securities laws; (3) to report to the UDP if the CCO becomes aware of any circumstances of substantial non-compliance with the securities laws; and (4) to submit an annual report to the board of directors or partnership.

Complaint Handling

The Registration Proposal also sets forth requirements regarding complaints made against a registered firm about any products or services offered by the firm or a representative of the firm. The CSA would require firms to document and respond to each complaint and to participate in an independent dispute resolution service unless they are required to use the dispute resolution service provided by a securities regulatory authority.

The Registration Proposal also would require a registered firm to have policies and procedures on documenting and responding to complaints and to deliver a report containing information regarding complaints to the securities regulatory authority. The complaint handling requirements would not apply to an investment fund manager.

Non-Resident Registrants

The Registration Proposal would require a registered firm whose head office is not located in the local jurisdiction to provide certain information to its clients in the local jurisdiction. The Registration Proposal also includes provisions regarding the non-resident registrant's obligation to comply with requests by local securities regulatory authorities and imposes certain requirements for the custody of client assets.

Conflicts of Interest

In the Registration Proposal, the CSA would require a registered firm to identify and respond to conflicts of interest between the firm, including individuals acting on behalf of the firm, and its clients. If a client would expect to be informed of a conflict of interest that has been identified by a registered firm, the firm must disclose the nature and extent of the conflict of interest to the client. This section would not apply to an investment fund manager of an investment fund that is subject to National Instrument 81-107 Independent Review Committee for Investment Funds.

The CSA generally expects registered firms to use three mechanisms to respond to conflicts of interest: (1) avoidance; (2) control; and (3) disclosure. According to the CSA, registered firms should avoid all conflicts that are prohibited by law and avoid others if they are sufficiently contrary to the interests of clients for which there are no reasonable response. If a registered firm does not avoid a conflict of interest, it should consider what internal structures or policies and procedures it should use or have to respond to the conflicts of interest reasonably. Finally, if a registered firm does not avoid the conflict of interest, it must consider if it is required to disclose the conflict.

The Registration Proposal also sets forth prohibited transactions for certain managed accounts. A registered adviser is prohibited from causing an investment portfolio that it manages: (1) to purchase or sell a security of an issuer in which an adviser or one of its affiliates (as defined in the requirements) is an agent unless this fact is disclosed to, and a written consent is obtained from, the client; (2) to purchase or sell a security in which an adviser or one of its affiliates (as defined in the requirements) is a beneficial owner or exercises control or direction unless this fact is disclosed to, and a written consent is obtained from, the client; (3) to purchase or sell a security from or to another investment portfolio managed by the adviser or one of its affiliates (as defined in the requirements); or (4) to provide a guarantee or loan to the adviser or one of its affiliates (as defined in the requirements).

The Registration Proposal also would prohibit a registered firm from acting as an adviser with respect to a security of the registered firm, a related issuer of the registered firm, or, in the course of a distribution, a connected issuer of the registered firm. This prohibition would not apply if the registered firm is acting as an adviser with respect to a fully-managed account and the transactions are made in accordance with subsection 4.1(4) of National Instrument 81-102 Mutual Funds. This prohibition also would not apply to a registered firm that is acting as an adviser with respect to an account that is not fully-managed and the registered firm, before or concurrently with providing advice, makes a statement to the client of the relationship between the registered firm and the issuer of securities.

For conflicts of interest among clients, the Registration Proposal would require a registered adviser to ensure fairness in allocating investment opportunities among its clients. To this end, the registered adviser would be required to provide a client with a copy of the adviser's written compliance policies and procedures when the adviser opens an account

for the client or when there has been a significant change to the policies.

Finally, the Registration Proposal includes conditions for a registered firm participating in referral arrangements and prescribes the disclosure required of the arrangement to clients.

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If you have any questions or comments on the Proposal, please contact Susan Olson at (202) 326-5813 or solson@ici.org.

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[1] Notice of Proposed NI 31-103 Registration Requirements, Proposed Companion Policy 31-103CP and Proposed Consequential Amendments (February 28, 2008) available at www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part3/rule_20080229_31-103_rfc-reg-reg.pdf.

[2] Although the Registration Proposal would impose the primary requirements for registration, local provincial regulators may impose additional requirements.

[3] Suitability obligations also would not apply to exempt market dealers when dealing with permitted clients.

[4] For dealers, the CSA would consider a person or company acting in an intermediary capacity or as a market maker to be in the business of trading in securities.

[5] The Registration Proposal also would impose certain proficiency requirements on the personnel of portfolio managers and investment fund managers, including the COO.

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