

## INVESTMENT FUND MANAGERS

### What You Need to Know Under the New Rules

On July 17, 2009, the Canadian Securities Administrators (the **CSA**) published in final form their reforms to the registration regime in National Instrument 31-103 – *Registration Requirements and Exemptions (NI 31-103)*, along with certain consequential amendments to other securities laws (collectively, the **new rules**). Subject to ministerial approval requirements, NI 31-103 will come into force on September 28, 2009 (the **effective date**).

### New Registration Requirement for Investment Fund Managers

NI 31-103 introduces investment fund manager (**IFM**) as a new category of registration. All provinces and territories across Canada have amended their securities legislation to require a firm or individual that manages an investment fund to register in this new category.

### Did You Know?

- The IFM registration requirement gives the regulators much wider power to regulate the Canadian investment fund industry.
- IFM registration applies broadly — it isn't restricted to managers of conventional mutual funds.
- IFM registration involves capital and proficiency requirements.
- IFMs are required to make filings in respect of NAV adjustments.

These and other important changes in the regulation of the investment fund sector under NI 31-103 are discussed below in this issue.

We can help you navigate your way.

### New Powers for Securities Regulators

Under the current regime, the regulators under securities legislation are largely limited to investment fund rules in regulating conduct in the Canadian investment fund industry. Frequently, that means regulators must wait for a breach of the investment fund rules before action can be taken.

Under the new rules, investment fund managers will now be subject to the same “fit and proper” standard by which registered dealers and advisers are measured, while the investment funds they manage will continue to be subject to the applicable investment

fund rules. The addition of the IFM registration requirement will give the regulators wider powers in regulating this sector by allowing the regulators to exercise the considerable authority they have over registrants.<sup>1</sup>

### **What is an Investment Fund?**

Before you can talk about who needs to be registered as an investment fund manager, you have to know what constitutes an investment fund. Securities legislation in various Canadian jurisdictions defines the term “investment fund” to mean:

- Mutual Fund — an issuer whose primary purpose is to invest money provided by its security holders and whose securities are redeemable on demand, or within a specified period after demand, at an amount computed by reference to the value of the fund’s net assets, or
- Non-Redeemable Investment Fund — an issuer that is not a mutual fund and whose primary purpose is to invest money provided by its security holders and that does not invest for the purpose of seeking to exercise control of an issuer or of being actively involved in the management of any issuer in which it invests.

Whether a particular fund falls within either category of the investment fund definition is determined by analyzing the specific facts of each case.

Investment fund status is not limited to conventional mutual funds. For example, a commodity pool is an investment fund for IFM registration purposes. Similarly, investment fund status does not turn on whether a fund is a reporting issuer under securities legislation. For example, a typical pooled fund is an investment fund and triggers the IFM registration requirement under the new rules.

### **Who is an Investment Fund Manager?**

Once it is determined that a particular fund is an investment fund for the purposes of NI 31-103, then it must be determined which person or entity involved with that investment fund is required to become registered as an IFM.

Securities legislation in various Canadian jurisdictions defines “investment fund manager” to mean a person or company that directs the business, operations or affairs of an investment fund. This is the administrative aspect of managing an investment fund, which is distinct from the management of the investment portfolio of an investment

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<sup>1</sup> For example, the regulators can impose a broad range of terms and conditions on the IFM’s registration at any point in time, including terms and conditions which might materially impact its business.

fund (which requires analysis in connection with the portfolio manager registration requirement — a separate registration category altogether).

The CSA have stated in commentary that the term “manager” should be interpreted broadly and is intended to include, for example, the general partner of an investment fund that is organized as a limited partnership where the general partner acts in the capacity of decision-maker for the fund.<sup>2</sup> How the investment fund is structured will be a significant factor in determining which person or persons may be subject to the IFM registration requirement.

### Registration of Individuals

An IFM must designate, and apply for registration of, an Ultimate Designated Person (**UDP**) and a Chief Compliance Officer (**CCO**). Depending on the size and structure of the firm, the UDP and CCO may be the same person.

Ultimate Designated Person: The UDP’s role is to promote compliance at the firm and oversee the effectiveness of the firm’s compliance system. The UDP does not have to be involved in the day-to-day management of the compliance group. The designated UDP must be: (i) the CEO, sole proprietor or equivalent of the firm; (ii) an officer in charge of the division of the firm, if the activity that requires the firm to register occurs only within that division; or (iii) an individual acting in a capacity similar to that of a CEO or an officer in charge of a division of the firm. No proficiency requirements are specified for the UDP function.

Chief Compliance Officer: The CCO is required to: (i) establish and maintain policies and procedures for assessing compliance by the firm, and individuals acting on its behalf, with securities legislation; (ii) monitor and assess compliance by the firm, and individuals acting on its behalf, with securities legislation; (iii) report to the UDP as soon as practicable if the CCO becomes aware of any circumstances indicating that the firm, or any individual acting on behalf of the firm, is in non-compliance with securities legislation; and (iv) submit an annual report to the board of directors (or similar body or authority in a non-corporate structure) for the purpose of assessing compliance by the firm, and individuals acting on its behalf, with securities legislation. Proficiency requirements are specified for the CCO function.

No other individuals are required to be registered in connection with an IFM.

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<sup>2</sup> In Companion Policy 31-103CP, the CSA comments that where investment funds are organized as limited partnerships, multiple registrations may not be necessary if each general partner in an affiliated group enters into a management contract with a single registered investment fund manager in the group.

## Permitted Individuals

Notwithstanding that only the UDP and CCO of an IFM are required to be registered, all persons involved in an IFM who fall within the category of “permitted individuals” are required to complete and file a Form 33-109F4 under National Instrument 33-109 — *Registration Information (NI 33-109)*, the same form submitted by all individuals who seek individual registration (such as the UDP and CCO).

The following persons are permitted individuals under NI 33-109:

- a director, chief executive officer, chief financial officer, or chief operating officer of the IFM, or a person who performs the functional equivalent of any of those positions, and
- an individual who has beneficial ownership of, or direct or indirect control or direction over, 10 percent or more of the voting securities of the IFM.

The filing requirement for permitted individuals is aimed at the “mind and management” of the IFM (i.e., those who have direct influence or control of the firm). The purpose of the filing requirement is to ensure that permitted individuals are subject to review by the regulator as part of its oversight of an IFM’s fitness for registration.

## Fit and Proper Standard, Conduct, and Conflict of Interest Requirements

The regulators assess a firm’s or individual’s fitness for registration at the time of the initial application for registration. The main elements of “fitness” are proficiency, solvency and integrity. If the applicant does not satisfy the fitness criteria, registration will not be granted, or may be granted subject to terms and conditions. Thereafter, registered firms and individuals must continue to satisfy the fitness criteria. Conduct, conflicts of interest, and compliance procedures are also contemplated in NI 31-103.

### ***(i) Fit and Proper Standard***

IFMs must meet the fit and proper standard. Non-compliance may result in registration being refused, the imposition of terms and conditions by the regulators, or the suspension of registration.

Proficiency Requirements for CCO: The CCO is subject to a proficiency requirement. The CCO must meet one of the following three proficiency options.

#### Option A

- A CFA Charter or professional designation as a lawyer, Chartered Accountant, Certified General Accountant or Certified Management Accountant in a jurisdiction in Canada, a notary in Quebec, or the equivalent in a foreign jurisdiction;

- Successful completion of the following exams —
  - (i) the Canadian Securities Course Exam of CSI Global Education Inc. (**CSI**), and
  - (ii) the “PDO Exam”;<sup>3</sup> and
- Either of the following —
  - (i) 36 months of relevant securities experience while working at a registered dealer, a registered adviser or an investment fund manager, or
  - (ii) provided professional services in the securities industry for 36 months and worked for an investment fund manager for 12 months.

#### Option B

- Successful completion of the following exams —
  - (i) any of
    - (a) the Investment Funds Institute of Canada (**IFIC**) Canadian Investment Funds Exam,
    - (b) CSI’s Canadian Securities Course Exam, or
    - (c) CSI’s Investment Funds in Canada Course Exam; and
  - (ii) the PDO Exam; and
- Five years of relevant securities experience while working at a registered dealer, registered adviser or an investment fund manager, including 36 months in a compliance capacity.

#### Option C

- Meeting the proficiency requirements for a CCO of a portfolio manager.<sup>4</sup>

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<sup>3</sup> PDO Exam means either (a) the IFIC Officers’, Partners’ and Directors’ Exam, or (b) CSI’s Partners, Directors and Senior Officers Exam.

<sup>4</sup> For the proficiency requirements for a CCO of a portfolio manager, please ask for a copy of our portfolio manager commentary.

Exemptions from the proficiency requirements may be obtained in cases where the regulator is satisfied that an individual's qualifications are equivalent to, or more appropriate in the circumstances than, the prescribed criteria.

Capital Requirements: IFMs are subject to capital requirements. An IFM's excess working capital (calculated as prescribed and certified by management) must not be less than zero for two consecutive days, and the IFM must maintain minimum capital of \$100,000 at all times. Negative excess working capital at any time must be reported to the regulator as soon as possible.

Insurance: IFMs must maintain bonding or insurance coverage containing the following clauses — fidelity, on premises, in transit, forgery or alternations and securities. The coverage must include either a double aggregate limit or a full reinstatement of coverage provision, and coverage must be in the greater of the following amounts for each clause:

- 1% of assets under management or \$25,000,000, whichever is less;
- 1% of the IFM's total assets or \$25,000,000, whichever is less;
- \$200,000; and
- the amount determined to be appropriate by a resolution of the directors (or individuals acting in a similar capacity).

Changes to, claims under, or cancellation of such insurance policy must be reported in writing to the regulator as soon as possible.

Financial Reporting: IFMs must have an auditor and must file the following:

- annual filings (within 90 days of its year end):
  - annual financial statements (with an audit report),
  - a completed Form 31-103F1 *Calculation of Excess Working Capital* (showing excess working capital as at the end of the financial year, with the comparative amount as at the end of the preceding financial year), and
  - a description of any net asset value (**NAV**) adjustment made in respect of an investment fund managed by the IFM during the financial year.
- quarterly filings (within 30 days of each quarter end):
  - interim financial statements for the quarter,

- a completed Form 31-103F1 *Calculation of Excess Working Capital* (showing excess working capital as at the end of the quarter, with the comparative amount as at the end of the preceding quarter), and
- a description of any NAV adjustment made in respect of an investment fund managed by the IFM during the quarter.

A description of NAV adjustment must contain prescribed information, including the effect of the adjustment on NAV per unit or share and any correction made to purchase and sale transactions.

All financial statements are to be prepared in accordance with GAAP, but on an unconsolidated basis.

Fiscal year-end changes, together with the reasons for the change, must also be reported to the regulator in writing within seven days following the change.

## **(ii) Conduct Rules**

IFMs are not subject to the know-your-client, suitability, client complaint handling and relationship disclosure requirements applicable to other registrants. IFMs are also exempt from most of the client account handling requirements for registered firms.

However, NI 31-103 contains detailed and technical conduct requirements for all registrants, including IFMs. The regulators consider compliance to be a firm-wide responsibility to be carried out in accordance with a documented compliance system which must address, among other things, the following elements.

Compliance System: IFMs must establish, maintain and apply policies and procedures that:

- create a system of controls and supervision sufficient to provide reasonable assurance that the firm and each individual acting on its behalf complies with securities legislation, and
- manage the risks associated with its business in accordance with prudent business practices.

Client Assets: Client assets that are held by an IFM must be segregated and held in trust for the client (in the case of cash, in a designated trust account at a Canadian financial institution, a Schedule III bank, or a member of IIROC; and in the case of securities, in accordance with certain requirements).

Record-Keeping and Retention: Record-keeping is mandated, and certain client records must be kept for at least seven years from the date the record was created, and

in a manner that permits the records to be provided to the regulator in a reasonable period of time. NI 31-103 does not contain a prescriptive list of records that must be kept. Instead, it requires the retention of all records that demonstrate compliance with securities legislation.

**Referral Arrangements:** NI 31-103 restricts all registrants, including IFMs, from participating in referral arrangements (i.e., referring clients) unless:

- a written referral agreement exists between the IFM and the person or company making the referral; and
- the referred clients are provided with written disclosure setting out the key terms of the referral agreement.

**(iii) Conflicts of Interest**

IFMs are subject to the conflicts of interest provisions of NI 31-103 that apply generally to registered firms, but the application of these provisions depends on whether the investment funds managed by the IFM are subject to NI 81-107 — *Independent Review Committee (NI 81-107)*.<sup>5</sup>

- Where NI 81-107 Applies — For investment funds that are reporting issuers, IFMs are not subject to the conflicts of interest rules of NI 31-103 but are subject to NI 81-107, which sets out extensive conflicts of interest rules.
- Where NI 81-107 Does Not Apply — For investment funds that are not reporting issuers, IFMs are subject to the conflicts of interest provisions of NI 31-103. The CSA provide extensive guidance in Companion Policy 31-103CP on the application of the principals governing the conflicts of interest requirement.

**Registrations in Multiple Categories**

If a firm is registered in more than one category, the firm need only meet the most stringent of the applicable capital and insurance requirements.<sup>6</sup> The capital and insurance requirements are not cumulative.

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<sup>5</sup> NI 81-107 also deals extensively with conflicts of interest matters, so it is necessary to specify which rules govern.

<sup>6</sup> There is an exemption to the rule that a multiple-category registrant must satisfy the most stringent capital requirement, but it is not particularly relevant to an IFM registrant. For a discussion of this exemption, ask for a copy of our Portfolio Manager Commentary.

The business of an IFM may give rise to multiple registration requirements. For example, an IFM that is also managing the portfolio of an investment fund under its management, or is otherwise providing investment advice to the investment fund, will be subject to the adviser registration requirement as well as the IFM registration requirement.

There are dealer registration exemptions for an investment fund (as well as the IFM) in respect of dividend or distribution reinvestment plans or optional investment plans of the investment fund or for certain additional investments by fund security holders.

As an issuer of securities, an investment fund may be in the business of trading in securities and, therefore, subject to the requirement to register as a dealer. The application of the dealer registration requirement in such a situation will depend on the facts and the conclusion will vary from case to case.

### **Participation Fees**

In Ontario, firms registered as an IFM are required to pay the capital markets participation fees under OSC Rule 13-502 — *Fees*. Annual fees are also applicable in other jurisdictions.

### **No Renewal Process for Registration**

Under NI 31-103, registration does not have to be renewed annually, and will remain in effect until surrendered, suspended or revoked.

### **Suspension and Revocation of Registration**

While registration does not have to be renewed annually, an IFM firm's ability to continue carrying on registerable activities is contingent upon the firm continuing to meet the fit and proper standard. Similarly, an individual's ability to continue serving in the capacity of a CCO or UDP is contingent on the individual continuing to meet the fit and proper standard. Under NI 31-103, the regulators have a more immediate ability to suspend registration. In addition, a firm's registration will be suspended automatically if it fails to pay its annual fees within 30 days of the due date.

### **Transition Requirements**

NI 31-103 provides some transitional relief by allowing time after the effective date for meeting the new requirements. The transition periods that apply to IFMs are as follows (with dates shown in brackets based on implementation of NI 31-103 on September 28, 2009 as currently anticipated):

- (i) ***An investment fund manager with its head office in Canada and that is active on the effective date:***
- 12 months (September 28, 2010) for the firm to apply for IFM registration in the jurisdiction in which its head office is located (which application will include compliance with all individual and firm requirements, such as the designation of a UDP and a CCO and filings in respect of all permitted individuals).
  - 24 months (September 28, 2011), being a tentative target date for the firm to register in all other Canadian jurisdictions in which the investment funds managed by the IFM are sold.<sup>7</sup>
- (ii) ***An investment fund manager with its head office in Canada and that is not active on the effective date:***
- NO TRANSITION — If a firm is a new entrant to the investment fund industry, the firm must apply for IFM registration in the jurisdiction in which its head office is located before it can commence operations (which application will include compliance with all individual and firm requirements applicable to the category).
- (iii) ***An investment fund manager with its head office outside Canada, whether it is active or not on the effective date:***
- 24 months (September 28, 2011), being a tentative target date for the firm to register in the applicable Canadian jurisdictions.<sup>8</sup>

## Other Registration Reforms

NI 31-103 and the new rules include other significant changes to registration requirements for dealers, advisers and investment fund managers in Canada.

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<sup>7</sup> The CSA expect to publish a proposal for comment in the next year to explain circumstances under which an IFM that does not have a Canadian head office will need to register, and in what additional provinces and territories an IFM with a head office in Canada will need to register. As currently presented, the registration requirement for IFMs seems at odds with the termination of the so-called “flow-through” rule for portfolio managers (i.e., Ontario will no longer require portfolio managers to be registered in Ontario solely on the basis of providing advice to an investment fund constituted outside of Ontario which is sold to Ontario investors).

<sup>8</sup> Same comment as note 7.

*The Registration & Compliance Alliance has the legal, regulatory, financial and operational experience and expertise to assist you with all aspects of registration and compliance under NI 31-103. Getting the right people for the job will produce the best results.*

*We will be issuing further bulletins on other aspects of NI 31-103 in the weeks to come.*

*For further details, or if you have any questions concerning NI 31-103, please contact:*

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