

EXEMPT MARKET DEALERS

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 Rules for the “Exempt Market”

Securities legislation across Canada divides the distribution of securities into two broad categories: (i) distribution pursuant to a prospectus; and (ii) distribution pursuant to a prospectus exemption. The prospectus exemptions map out what is commonly known as the “exempt market”. Securities legislation also provides for a number of exemptions from the dealer registration requirement which roughly track the prospectus exemptions. Under the current rules, only Ontario and Newfoundland and Labrador impose a registration requirement upon those who trade in securities in the exempt market — the limited market dealer (**LMD**). No registration is currently required in the other provinces and territories.

Under NI 31-103, a new dealer registration category is introduced in all jurisdictions across Canada to regulate trading in the exempt market — the exempt market dealer (**EMD**). In Ontario and Newfoundland and Labrador, the EMD category replaces the LMD category, making the EMD registration category uniform across the country.

Did You Know?

- Existing LMDs automatically become EMDs on September 28, 2009. You don't have to apply.
- EMDs have capital and proficiency requirements. LMDs had none.
- Not all LMDs will require registration as EMDs under NI 31-103. It's up to you to make the determination.
- The EMD registration requirement will apply differently in certain parts of the country.

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

We can help you navigate your way.

EMDs Replacing LMDs Automatically

In the prior version of NI 31-103 published for comment in 2008, LMDs were required to apply to become registered as EMDs. This is not the case under the final version of NI 31-103. Effective September 28, 2009, all LMDs registered on that date will automatically become registered as EMDs.

Business Trigger

A fundamental change under NI 31-103 is the introduction of the “business trigger” for dealer registration. Currently, the requirement to be registered as a dealer is triggered by a person engaging in a “trade” of securities. Under the new rules, the traditional “trade trigger” is replaced by the narrower “business trigger”, so the dealer registration requirement will only apply to those whose trading in securities amounts to carrying on the business of trading in securities.

This isn’t news for the exempt market in Ontario and Newfoundland and Labrador. The new business trigger in effect replicates the approach already taken in those jurisdictions in relation to a “market intermediary” – that is, a person engaging or holding himself out as engaging in the business of trading in securities. This definition has been difficult to interpret in the past. While Companion Policy 31-103CP provides more guidance than had been available previously, there will continue to be questions about this threshold test under the new rule.

With the benefit of additional regulatory guidance on when the business trigger is pulled, it is possible to identify existing LMDs which may not need to continue being registered as EMDs under the new rule. Much will depend on the LMD’s business model.

Harmonization and Simplification of the Rules Across Canada

The CSA have always presented harmonization and simplification of the registration rules among the jurisdictions of Canada as a key goal of the registration reform project. Generally, the new regime will provide uniform requirements and categories of registration across the country. For example, NI 31-103 introduces consistent rules concerning proficiency, conduct, capital and compliance requirements.

Increased Requirements for EMDs

EMDs are subject to many of the proficiency, capital and operational requirements applicable to other categories of dealers — unlike LMDs, which are generally not subject to such requirements.

Permitted Clients

NI 31-103 makes it very clear that EMDs are subject to the same know-your-client (**KYC**) and suitability requirements as other dealer categories, which has been a common deficiency among LMDs in the past.

In a particularly practical move, the CSA have decided to exempt EMDs and all other categories of registrants from the suitability requirement in dealing with “permitted clients” (a new subset of the accredited investor — effectively, “super-accredited investors”). EMDs still have to “know” their super-accredited clients (the KYC requirement), but the suitability assessment in respect of each trade is unnecessary for this special category of clients, provided the client first waives the requirement in writing. EMDs will also be exempt from the requirement to provide relationship disclosure information when dealing with permitted clients, again if the client waives the requirement in writing.

Exemption from EMD Registration in Certain Jurisdictions

A number of registration exemptions are being maintained in certain jurisdictions. This has the effect of creating an uneven playing field in the application of the EMD registration requirement, effectively continuing to divide the country along geographic lines. Alberta, British Columbia, Manitoba, the Northwest Territories, Nunavut and the Yukon Territory¹ have indicated that they will each pass a blanket order (**Blanket Order**) as of the effective date, exempting individuals and firms from the EMD registration requirement. As presently cast, the Blanket Order would provide an exemption where a firm or person trades in securities under one of the following capital-raising exemptions in National Instrument 45-106 – *Prospectus and Registration Exemptions*²:

- accredited investor;
- family, friends and business associates;
- offering memorandum; and
- \$150,000 minimum purchase.

¹ Saskatchewan is presently not included with the other north-western jurisdictions but is widely anticipated to join their ranks to form a comprehensive north-western block.

² Certain of these prospectus exemptions reflect pre-existing regional differences in the exempt market.

However, to rely on this exemption, a firm or person must meet certain conditions, including:

- not being registered in any category of registration in any jurisdiction;³
- not providing suitability advice about the trade to the client;
- except in British Columbia, not otherwise providing financial services to the client;
- not holding or having access to the client's assets;
- providing risk disclosure in the prescribed form to the client; and
- filing an information report with the regulator.

Those who rely on the Blanket Order must confine their trading activities to (i) their local jurisdiction or other jurisdictions in the north-western block, and (ii) trades within the specified capital raising exemptions.

Registration of Individuals

(i) Trading

Individuals engaged in the business of trading at EMDs must register as “dealing representatives”. Registered dealing representatives of an LMD will have their registrations automatically transitioned into the EMD dealing representative category under NI 31-103. Registered dealing representatives of an LMD will have 12 months to satisfy the proficiency requirements applicable to dealing representatives of an EMD. An individual who was entitled to rely on an exemption from registration requirements before the effective date will be exempt from any substantially similar proficiency requirements in NI 31-103.

(ii) Compliance

In addition to dealing representatives, an EMD 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

³ It is not clear that the “jurisdiction” referred to is a “Canadian jurisdiction”. It may include registrations under similar legislation outside of Canada.

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.

Permitted Individuals

All persons involved in an EMD 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 EMD, 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 EMD.

The filing requirement for permitted individuals is aimed at the “mind and management” of the EMD (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 EMD’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, as described below, 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

EMDs 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: EMD personnel must satisfy proficiency requirements.

- Dealing representatives must qualify by passing any of:
 - the Canadian Securities Course Exam,
 - the Investment Funds Institute of Canada (**IFIC**) Exempt Market Products Exam, or
 - satisfying the proficiency requirements applicable to an advising representative of a portfolio manager.⁴
- The CCO of an EMD must qualify by passing:
 - the “PDO Exam”⁵, and
 - either of the Canadian Securities Course Exam or the Exempt Market Products Exam, or satisfying the proficiency requirements of a chief compliance officer of a portfolio manager.
- There are no proficiency requirements for the UDP.

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: EMDs are subject to capital requirements. An EMD's excess working capital (calculated as prescribed and certified by management) must not be less than zero for two consecutive days, and the EMD must maintain minimum capital of \$50,000 at all times. Negative excess working capital at any time must be reported to the regulator as soon as possible.

⁴ An advising representative of a portfolio manager must have earned a CFA Charter and have 12 months of relevant investment management experience in the 36-month period before applying for registration, or have received the Canadian Investment Manager designation and have 48 months of relevant experience, 12 months of which was in the 36-month period before applying for registration.

⁵ PDO Exam means either (a) the IFIC Officers', Partners' and Directors' Exam, or (b) CSI Global Education Inc.'s Partners, Directors and Senior Officers Exam.

Insurance: EMDs 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 total clients assets held or accessible by the dealer or \$25,000,000, whichever is less;
- 1% of the dealer's total assets or \$25,000,000, whichever is less;
- \$50,000 per employee, agent and representative or \$200,000, whichever is less; and
- the amount determined to be appropriate by a resolution of its board of directors (or individuals acting in a similar capacity).

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

Financial Reporting: EMDs must have an auditor and must file, within 90 days of its year end, the following:

- annual financial statements (with an audit report), and
- 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).

EMDs are not required to make quarterly filings.

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

NI 31-103 contains detailed and technical conduct requirements for all registrants, including EMDs. 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: EMDs 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.

Account Opening and Client Documentation: Account opening and client documentation (including for KYC 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). An exemption from the suitability requirement is available in respect of permitted clients who have provided a written waiver of the requirement.

Relationship Disclosure Information: EMDs must provide "relationship disclosure information" to clients. All information that a reasonable investor would consider important about the client's relationship with the EMD must be disclosed.⁶ Relationship disclosure information is not required to be given to permitted clients who have provided a written waiver of the requirement.

Leverage Disclosure: Where a client is using borrowed money to finance any part of the purchase of a security, a written statement of the risks of leverage must be provided to client, with certain exceptions (including for permitted clients or where the proposed purchase is on margin and the client's margin account is maintained at a registered firm in accordance with SRO 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 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).

Margin: EMDs may not lend money, extend credit or permit clients to purchase securities on margin.

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

⁶ For example, relationship disclosure information would include a discussion that identifies which products or services are offered by the firm, a discussion of the types of risk a client should consider when making an investment decision, a description of the conflicts of interest that the adviser is required to disclose under securities legislation, and disclosure of all costs for the operation of an account.

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.

Account Activity Reporting: EMDs must promptly deliver to a client a written confirmation of a transaction, quarterly statements, and monthly statements (the latter only if a client requests monthly statements or if, during the month, a transaction was effected in the account of a client).

Complaint Handling: EMDs must document, and effectively and fairly respond to, each complaint made about any product or service offered by the firm or its representatives. EMDs must also ensure that independent dispute resolution services or mediation services are made available to clients at the EMD's expense.

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

- a written referral agreement exists between the EMD 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

NI 31-103 consolidates a number of conflicts of interest requirements that previously appeared in various places in securities legislation. It requires an EMD to make reasonable efforts to identify material conflicts of interest or potential conflicts of interest and, where the client, acting reasonably, would expect to be informed of such a conflict of interest, to disclose the nature and extent of the conflicts of interest to the client. 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.⁷ The capital and insurance requirements are not cumulative.

⁷ 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 EMD registrant. For a discussion of this exemption, ask for a copy of our Portfolio Manager Commentary.

Participation Fees

In Ontario, firms registered as an EMD 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 EMD 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 dealing representative, CCO, or UDP is contingent on the individual continuing to meet the applicable 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 EMDs are as follows (with dates shown in brackets based on implementation of NI 31-103 on September 28, 2009 as currently anticipated):

(i) Registered LMD — Ontario and Newfoundland and Labrador only

- A firm registered as a LMD on the effective date will automatically have its LMD registration converted to an EMD registration.
- 3 months (December 28, 2009) for the firm to designate its UDP and to apply for registration of the individual as UDP.
- 3 months (December 28, 2009) for the firm to designate its CCO and to apply for registration of the individual as CCO.
- 6 months (March 28, 2010) for the firm to satisfy bonding or insurance requirements.
- 6 months (March 28, 2010) for the firm to comply with referral arrangements requirements.

- 12 months (December 28, 2010) for the firm to deliver relationship disclosure information.
- 12 months (December 28, 2010) for an individual registered as a dealing representative to satisfy formal proficiency requirements, and the National Registration Database (**NRD**) record must be updated to reflect that proficiency requirements have been met.
- 12 months (September 28, 2010) for an individual designated as the CCO to satisfy formal proficiency requirements, and the NRD record must be updated to reflect that proficiency requirements have been met.
- 12 months (September 28, 2010) for firms to satisfy capital requirements.
- 24 months (September 28, 2011) for firm to ensure that independent dispute resolution or mediation services are made available to clients to resolve complaints.

(ii) Firms — Outside Ontario and Newfoundland and Labrador

- If a firm can rely on the Blanket Order, the transition rules are not relevant and the firm does not need to register as an EMD.
- However, if a firm cannot rely on the Blanket Order, and the firm is **active** as a dealer in the exempt market on the effective date, the firm has 12 months (September 28, 2010) to apply for registration as an EMD and must comply with all of the requirements at the time of application.

(iii) No Transition for New Entrants:

- A firm not registered as an LMD in Ontario or Newfoundland and Labrador on the effective date must be registered as an EMD in those jurisdictions before commencing operation as a dealer there and must comply with all of the requirements at the time of application.
- Outside of Ontario and Newfoundland and Labrador, if a firm cannot rely on the Blanket Order and is **not active** as a dealer on the effective date, the firm must apply for registration as an EMD before commencing operation as a dealer and must comply with all of the requirements at the time of application.

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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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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