

CANADIAN SECURITIES COMMISSIONS PROPOSE NEW REGISTRATION REQUIREMENT FOR EXEMPT MARKET DEALERS

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INTRODUCTION

The Canadian Securities Administrators (CSA) have republished for comment a revised draft of National Instrument 31-103 – *Registration Requirements* (new NI 31-103 or the instrument), originally published in February 2007, that continues to propose a new registration requirement for “exempt market dealers”. (For a summary of the original proposal, please see the February 2007 Blakes Bulletin on Securities Law – *Proposed Registration Reform Rule Released by Canadian Securities Regulators for Comment*.)

Under new NI 31-103, exempt market dealers will be subject to many of the proficiency, capital and operational requirements applicable to dealers generally. However, certain of the requirements set out in the initial reform proposals will not apply in respect of exempt market dealers that do not handle, hold or have access to client cash or assets. In addition, certain other requirements will not apply to exempt market dealers when dealing with “permitted clients”.

The following is an overview of the principal new requirements proposed by the CSA as they pertain to exempt market dealers.

NEW REGISTRATION REQUIREMENTS

Currently, the requirement to be registered as a dealer is triggered by a person engaging in a “trade” of securities. One key aspect of the registration reform project has been the proposal to replace the “trade” trigger with a so-called “business trigger”, pursuant to which a person would be subject to the requirement to register as a dealer only if that person was in the “business” of trading in securities. The “business trigger” in effect replicates the approach already in existence in the provinces of Ontario and Newfoundland and Labrador, which requires registration by a “market intermediary” – that is, a person engaging or holding itself out as engaging in Ontario or Newfoundland and Labrador, as the case may be, in the business of trading in securities. Although the Companion Policy accompanying the instrument attempts to describe many factors that would be relevant in determining whether or not the definition might apply in any particular case, it is likely that interpreting the definition will often present difficulties.

CONTINUED

HIGHLIGHTS

- Registration requirement generally to apply even to those in the business of trading only in the exempt market
- Exempt market dealers that do not handle, hold or have access to client cash or assets exempted from some “fit and proper” requirements
- Certain requirements will not apply in respect of “permitted clients”
- Six-month transition period proposed to allow compliance with most new rules

The effect of the new regime will be that even persons who intend to be in the business of trading only in reliance on exemptions from the prospectus requirement will be required to register as exempt market dealers. This will affect the private placement market in provinces other than Ontario and Newfoundland and Labrador, in that persons currently engaged in trading in securities only with accredited investors, for instance, will have to become registered. However, a person resident in Manitoba or British Columbia will be able to continue to trade in the exempt market without being registered if he or she trades only with persons resident in Manitoba or British Columbia, as the case may be, and is not otherwise registered in any province.

The instrument will also require an exempt market dealer to have individuals registered in certain specified categories. These categories include those of ultimate designated person (UDP) and chief compliance officer (CCO). In small registered firms, the UDP and the CCO may well be the same individual; that individual may also be registered as a dealing representative to carry out trading activities.

The UDP must be either the chief executive officer or sole proprietor, the officer in charge of the registered activities or an officer acting in a similar capacity. The functions of the UDP will be to supervise the activities of the exempt market dealer directed towards ensuring compliance with securities legislation, both by the firm and by each individual acting on its behalf, and to promote compliance with securities legislation within the firm.

The CCO must be an officer, partner or the sole proprietor of the exempt market dealer. The functions of the CCO will include establishing and maintaining policies and procedures for assessing compliance with securities legislation by the firm and individuals acting on its behalf, monitoring and assessing such compliance, reporting to the UDP if the CCO becomes aware of any non-compliance and reporting annually to the board of directors for the purpose of assessing compliance by the exempt market dealer and such individuals with securities legislation.

One of the welcome initiatives in new NI 31-103 is that there will be no annual or other renewal requirement for registration. Registration will remain effective until it is suspended or terminated. Non-payment of annual fees can lead to suspension.

Fit and Proper Requirements

Unless one of the exemptions referred to below is available, exempt market dealers will be required to meet specified fit and proper requirements which are set out in the instrument. These include proficiency requirements, solvency requirements, and certain requirements relating to financial records.

The proficiency requirements are generally exam-based, rather than course-based. The CCO and any dealing representative of an exempt market dealer must either have passed the Canadian Securities Exam or otherwise meet the proficiency requirements. There is no proficiency requirement mandated for the UDP function.

The solvency requirements will require an exempt market dealer to maintain excess working capital, in accordance with a specified calculation, that is not less than zero and to notify the regulator as soon as practical if it fails to meet that test. The solvency requirements will also mandate maintaining specified levels of bonding or insurance.

The financial records requirement will include the need to appoint an auditor (which must be prepared to conduct any auditor review required by the regulator) and to deliver to the regulator annually and after each quarter specified financial statements and a calculation of excess working capital.

Conduct Rules

The proposed instrument sets out detailed conduct rules which, subject to certain exemptions referred to below, will be applicable to all registrants, including exempt market dealers. These include taking reasonable steps to satisfy the "know your client" rule by obtaining and keeping current specified account opening and other client documentation. A registrant will have to provide a client with certain relationship disclosure information, including, for example, information regarding investment risk factors, conflicts of interest, service fees and charges, and frequency of reporting. Registrants will also be required to comply with suitability rules intended to ensure that a proposed purchase or sale is suitable for the client in question.

An exempt market dealer will be required to hold client assets in trust and separate and apart from its own property. Each client's assets will have to be supervised separately and distinctly from the assets of other clients. The instrument also sets out other requirements relating to record-keeping, account activity reporting and complaint handling procedures.

Conflicts of Interest

The conflict of interest rules set out in the instrument will require exempt market dealers to make reasonable efforts to identify conflicts of interest and will prohibit certain types of transactions. An exempt market dealer will be required to maintain and provide clients with a current issuer disclosure statement which will set out relationships between the exempt market dealer and other related issuers.

EXEMPTIONS

Many exempt market dealers may benefit from one or more exemptions from the various requirements referred to above. For example, the solvency requirements will not apply to an exempt market dealer that does not handle, hold or have access to any client assets, including cheques and other similar instruments. An exempt market dealer which satisfies that test, generally or in respect of specific clients, will also benefit from exemptions from certain of the financial records, account opening documentation, relationship disclosure and account activity reporting requirements.

Certain exemptions will also apply in respect of a "permitted client", which is more narrowly defined than "accredited investor". As defined, a permitted client includes certain specified institutional and corporate clients and very high net worth individuals (financial assets in excess of C\$5-million). The permitted client exemption will apply to certain aspects of the know your client rule, the provision of relationship disclosure information, the suitability requirement and the complaint handling requirement.

Finally, for persons or companies that are registrants on the date the instrument comes into force, the requirements relating to relationship disclosure information, complaint handling and insurance will not apply for six months, and the capital requirements will not apply for 12 months.

TRANSITIONAL ARRANGEMENTS

Part 10 of new NI 31-103 sets out a number of transitional arrangements. For example, a person or company that is a registered firm or individual on the date the instrument comes into force and is a dealer in the exempt market on that date will have six months to apply for registration as an exempt market dealer or dealing representative, as the case may be. Assuming application is made, the person or company can continue to act as an exempt market dealer or dealing representative without registration until such time as registration is accepted or refused under the application.

The requirement for existing registrants to have a UDP and a CCO will not apply if, in respect of each such category, an individual seeks registration on behalf of the existing registrant within one month of the instrument coming into force, until the regulator has accepted or refused the registration.

A person or company that is not registered and that is a dealer in the exempt market on the date the instrument comes into force will be exempt initially from the applicable registration requirements. If the person or company applies to be registered as an exempt market dealer or dealing representative, as the case may be, within six months of the instrument coming into force, the exemption will continue until the regulator has accepted or refused the registration.

Finally, provided that an individual applies within six months of the date the instrument comes into force to be registered as a dealing representative or the CCO of a firm, including an existing limited market dealer, that was a dealer in the exempt market on that date, the requirement for that individual to have passed the Canadian Securities Exam will not apply until 12 months after the instrument comes into force. Except as just noted, individuals who were already registered as a CCO or a dealing representative on the date the instrument comes into force will be exempt from the Canadian Securities Exam requirement. The regulators will be prepared to exempt unregistered individuals who took the Canadian Securities Exam more than three years ago from having to rewrite it, if the individual has at least 12 months' relevant experience in the last 36 months.

Market participants will want to review carefully the specific requirements applicable to them to ensure that they have taken the necessary steps to comply with the new requirements on a timely basis.

OTHER REFORMS

The proposed draft of new NI 31-103 includes many other very significant changes to registration requirements for dealers and advisers in Canada. These changes are summarized in the following *Blakes Bulletins on Securities Regulation* that were recently published and are now available on Blakes Web site, in our Publications – Corporate Finance and Securities Regulation section: *Securities Commissions Propose New Registration Requirement for Investment Fund Managers*, *New Changes Proposed for International Dealers and Advisers* and *Securities Commissions Republish Proposed Dealer Registration Reform*.

OPEN FOR COMMENT

The proposed draft of new NI 31-103 is open for comment until May 29, 2008. Although no implementation date has been proposed yet, it is understood that the CSA is targeting the instrument to come into force at the end of 2008.

FOR FURTHER DETAILS, or if you have any questions concerning this bulletin or would like to discuss submitting a comment letter, please contact Eric Elvidge at eric.elvidge@blakes.com or 613-788-2238, Ross McKee at ross.mckee@blakes.com or 416-863-3277, David Valentine at david.valentine@blakes.com or 416-863-2933, Michael Sharp at michael.sharp@blakes.com or 416-863-2777, or any other member of our Securities Group.

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