

BC Interpretation Note 33-701

Trading by Limited Dealers under Registration and Prospectus Exemptions

This Interpretation Note explains the regulatory standards that apply to limited dealers that trade securities to their clients under certain registration and prospectus exemptions. Limited dealers include mutual fund dealers, exchange contracts dealers, security issuers, real estate securities dealers and scholarship plan dealers.

This Interpretation Note describes:

- registration and prospectus exemptions that limited dealers commonly use,
- conditions of registration for limited dealers who trade securities in reliance on these exemptions, and
- policies and procedures that limited dealers should adopt to ensure compliance with the conditions.

Commonly Used Exemptions

Limited dealers commonly use the following exemptions from the registration and prospectus requirements of the *Securities Act*:

- the \$150,000 exemption (ss. 45(2)(5) and 74(2)(4) of the *Securities Act*) and section 2.10 of National Instrument 45-106 *Prospectus and Registration Exemptions* (NI 45-106)
- the “offering memorandum” exemption (s. 2.9 of NI 45-106), and
- the “accredited investor” exemption (s. 2.3 of NI 45-106).

These exemptions are available to give issuers an opportunity to raise capital from persons who can assess the merits of the investment opportunity without full regulatory protection. Securities offered under these exemptions, particularly securities of non-reporting issuers, are generally risky and illiquid when compared to securities offered by prospectus, listed on an exchange or traded under other exemptions.

Dealers generally cannot sell securities under the private issuer exemption in s. 2.4 of NI 45-106. NI 45-106 sets out the complete definition of a private issuer, but notably it is an issuer whose securities are owned by not more than 50 persons. This exemption is only available to sell securities to principals of the issuer, their family, friends and business associates and accredited investors.

The “know your client”, “suitability of investment”, and “fair dealing” rules apply to all trades that registrants make on behalf of clients. This includes trades in securities being sold under an exemption. These rules require that the registrant:

- make inquiries concerning each client to learn the essential facts about the client and determine the general investment needs and objectives of the client,
- determine the suitability of any proposed purchase or sale for the client and advise the client if it is not suitable, and
- ensure that the client's interests are considered before the interests of the registrant.

In addition to these general requirements, a registrant trading under these exemptions has particular obligations to:

- ensure that all of the conditions for use of the exemption are met, and
- specifically consider the suitability of the investment for the client in light of the risks of this type of investment and such factors as resale restrictions on the securities and lack of liquidity.

A dealer and its salespersons are permitted and required to provide advice to their clients to fulfill the suitability objectives. The scope of the advice must be focused on suitability and can only be provided in discussions with individual clients. For example, a salesperson must assess a client's investment needs and objectives, income and net worth, together with their current investment portfolio, before determining if a particular security matches the client's investment needs and goals.

Advice beyond that required to determine suitability may be provided only by a person registered as an adviser. This refers specifically to the general recommendation on the merits of an investment by the dealer or its salespersons to their clients, without regard to suitability. Examples of instances in which this might take place include client or public seminars; direct mailings to clients or the public; electronic mail promotions; etc. Dealers are reminded that if they conduct this type of promotional activity, they can only provide factual information. BC Interpretation Note 31-701 *Advising under the Securities Act* provides more information on what constitutes advising and on the exemptions from the adviser registration requirement.

The fact that a client may have acknowledged being an "accredited investor" in accordance with NI 45-106 does not absolve the registrant of the obligation to advise on suitability. In many instances, a client may be able, to meet the "accredited investor" definition by virtue of his or her net worth, but may have limited investment experience or conservative investment needs and objectives.

Conditions of Registration

On March 1, 2001, the Director, Registration, first established conditions of registration for all limited dealers that rely on the registration exemptions. These conditions only apply when limited dealers rely on the trade exemptions in s. 45(2)(5) of the *Securities*

Act, and ss. 2.3, 2.9 and 2.10 of NI 45-106 to trade securities outside the scope of their limited registration.

These conditions do not apply to trades in securities for which a limited dealer is expressly registered. For example, the conditions do not apply to a mutual fund dealer for the sale of a mutual fund security under an exemption. Nevertheless, dealers must supervise salespersons and determine suitability for all trades.

The following is a description of the current conditions, along with an explanation of the procedures necessary to comply with them.

Condition

1. *The limited dealer must assess the security to be sold on its merits prior to permitting its salespersons to sell that security and must conduct due diligence on the security being sold under an exemption, or retain a person who is either registered as an underwriter or who is subject to the conditions of registration described in this Interpretation Note to conduct the due diligence on the limited dealer's behalf.*

Explanation

The limited dealer must ensure that it performs due diligence. Limited dealers should generally follow the requirements for underwriters described under securities legislation (s. 45 of the *Securities Rules*) and in BC Policy 31-601 *Registration Requirements* (BCP 31-601). If the limited dealer retains a person to conduct the due diligence on its behalf, the limited dealer must review and assess the results of the due diligence and the adequacy of the procedures used by that person.

Limited dealers are expected to maintain a written description of their due diligence procedures and safeguards. These procedures and safeguards must include:

- proficiency requirements, including corporate finance staff education and experience, commensurate with the requirements and responsibilities of underwriting,
- ensuring that the dealer undertakes due diligence reviews either directly or by contracting with another party (who is either registered as an underwriter or is subject to the conditions of registration described in this Interpretation Note) before the dealer commences trading in the security, and
- ensuring that the proceeds of a distribution are properly held, or disbursed, in accordance with the trust or other governing agreements between the dealer and the issuer making the distribution.

The following are key elements of a thorough due diligence review:

- using a due diligence checklist to document and assign responsibility and track workflow,
- obtaining and reviewing the offering documents,
- preparing and documenting a financial analysis of the offering,
- assessing and documenting the likelihood that the investment will meet its stated objectives,
- obtaining and reviewing material contracts, expert opinions and reports, and the business plan,
- assessing management qualifications and track records,
- reviewing the issuer's financial position and history,
- if reliance is placed on another registrant for part of the due diligence process, assessing the results of its due diligence and the adequacy of its procedures, and
- maintaining a written summary of the results of the dealer's due diligence, including a "risk-rating" and detail concerning the types of investor needs and objectives for which the investment would be suitable or unsuitable.

Condition

2. *The limited dealer must deliver an offering memorandum for the securities sold in reliance on the exemptions in s. 2.9 of NI 45-106, in the prescribed form, to each purchaser before an agreement of purchase and sale is entered into.*

Explanation

The issuer must prepare an offering memorandum for any sale of securities under s.2.9 of NI 45-106 and the limited dealer must deliver the offering memorandum to prospective purchasers. Limited dealers selling the securities cannot simply rely on the offering memorandum. They must comply with the due diligence requirements described in condition 1.

Condition

3. *The limited dealer must assign a responsible individual who is either the compliance officer or a registered trading partner, director or officer who, with respect to a trade in an exempt market security, has not previously acted in furtherance of the trade, to ensure that each prospective purchaser,*
 - *understands the security is sold under an exemption,*
 - *knows whether the security is liquid and if there is an established market for the security,*
 - *knows the dollar amount of the compensation that the salesperson and the dealer receives for the sale and its percentage of the investment,*

- *knows the offering memorandum is not a prospectus, and*
- *knows that they do not have certain protections, rights and remedies provided by the Securities Act for prospectus offerings, including statutory rights of rescission and damages.*

The responsible individual must contact each prospective purchaser prior to the agreement of purchase and sale for the securities being accepted by the issuer, to inquire whether the prospective purchaser understands this information and to ensure that the investment is suitable for this person. The limited dealer must maintain a written record of the inquiries made by the responsible individual. Where the inquiry establishes that the investment is not suitable, the agreement of purchase and sale must not be accepted. Further, the limited dealer must not permit the agreement of purchase and sale to be accepted unless satisfactory responses have been provided by the prospective purchaser to each of the inquiries required to be made under this condition.

Explanation

Inadequate supervision by some dealers has been partly responsible for the sale of unsuitable securities to investors under the exemptions. This condition establishes detailed requirements for supervisory personnel to follow in ensuring that the trade is suitable. It requires the compliance officer, or a registered trading partner, director or officer who had not previously participated in the trade, to contact each client prior to the issuer accepting a purchase. This means that before a purchase order or subscription is sent from the limited dealer or salesperson to the issuer, the responsible individual must contact each prospective purchaser by telephone or in person to make the inquiries set out in the condition. The responsible individual must not be involved in trading that security for any purchaser.

The records of the limited dealer should include detailed notes of the inquiries made by the responsible individual to document compliance with this condition.

Condition

4. *The limited dealer must ensure that the responsible individual described in condition 3 is registered and has successfully completed the Canadian Securities Course and examination, the Conduct and Practices Handbook Course and examination, and any other proficiency requirements necessary for his or her category of registration.*

Explanation

It is important that those responsible for monitoring and supervising trading in securities under an exemption have a sufficient level of proficiency. Programs such as the Canadian Securities Course and the Conduct and Practices Handbook Course together with their examinations appropriately cover the analytical skills necessary to assess a

security in depth. Accordingly, this condition requires at least this level of proficiency from the responsible individual described in condition 3.

Condition

5. *The limited dealer must provide, or arrange to have provided, training to all salespersons that will trade in the security. Training should enable the salesperson to advise prospective purchasers about the risks associated with purchasing securities sold under exemptions, and to ensure the salespersons can adequately assess the security and to ensure that the salespersons can adequately assess suitability.*

Explanation

Salespersons who lack appropriate proficiency have frequently made unsuitable sales of securities under exemptions. The condition does not require any specific course. It would permit a limited dealer either to develop its own training program, or to require its salespersons to take appropriate courses. In either case, the limited dealer should ensure that the training gives its salespersons at least the proficiency needed to analyze and assess the merits of an offering and understand the risks of the investment. Limited dealers could direct their salespersons to existing courses such as those described below or similar programs to ensure that their salespersons have adequate knowledge to properly assess suitability for their clients.

Some examples of currently available programs that limited dealers may wish to consider requiring their salespersons to successfully complete are the Canadian Securities Course and examination together with the Conduct and Practices Handbook Course, or one or more of the financial planning programs. Should a specific course focused on the sale of securities under exemptions be developed in the future, the Commission or the Executive Director may prescribe a particular course.

The limited dealer should also assess whether continuing education is necessary. All proficiency requirements should be set out in its policy and procedure manual.

Condition

6. *The limited dealer must not, in reliance on an exemption, sell securities issued by or held by an associated or connected party of the registrant as described in s. 75 of the Securities Rules.*

Explanation

Particular problems in the sale of securities under exemptions have arisen where the issuer is not at arm's length from the dealer and its salespeople. To limit these conflicts of interest and ensure that limited dealers are better able to fulfill their obligation to act

fairly, honestly and in the best interests of the client, the condition will prohibit them from trading under exemptions in securities of associated or connected issuers. Associated and connected are broad concepts and limited dealers should carefully review the provisions of s. 75 to ensure they comply with these provisions.

Condition

7. *For securities sold under an exemption, the limited dealer must not permit any partner, director or officer, its salespersons or other employees to refer a client or pay or receive a fee or other compensation for a referral, to any person who is not registered.*

Explanation

Limited dealers should comply with both the spirit and the intent of these conditions of registration. For example, changing the limited dealer's organizational structure so that these securities can be sold by a non-registered person would not be permitted. To help ensure that limited dealers do not avoid their responsibilities under these conditions, only the limited dealer and its salespersons or another qualified registrant can trade and advise for their clients.

For example, a mutual fund dealer that is not prepared to develop the systems and procedures to comply with these conditions may refer clients interested in purchasing securities sold under an exemption to an investment dealer. It may also refer clients to another mutual fund dealer, provided that the other mutual fund dealer complies with these conditions of registration. It may not refer them to an unregistered person.

Condition

8. *The limited dealer must provide notice to the commission before it trades in a security in reliance on an exemption. The notice shall include the name of the security, the name of the issuer of the security, and the date on which the limited dealer anticipates commencing trading in the security.*

Explanation

The condition requires limited dealers to notify the Commission if they are using registration exemptions. Notice must be provided before the first trade of each different security being sold under an exemption. A sample notice is attached to this Interpretation Note.

Condition

9. *The limited dealer must ensure that all sales of securities under an exemption by the limited dealer, its partners, directors or officers, its salespersons or other employees are recorded on its books and records.*

Explanation

A limited dealer is required to maintain a daily blotter (s. 29 of the *Securities Rules*). The blotter must show all purchases and sales of securities. This condition confirms that all sales of securities, whether under an exemption or otherwise, must be recorded on the books of the limited dealer. This will require the limited dealer to ensure that all employees are aware that all securities trades are dealer business, and must be recorded with the limited dealer. The limited dealer must then ensure that, if any of those trades are being made under an exemption, all other conditions of registration are being followed.

Condition

10. *The limited dealer must maintain minimum capital in accordance with s. 19(3) of the Securities Rules.*

Explanation

All limited dealers who wish to engage in selling securities under an exemption must maintain a higher level of capital. Limited dealers should review the requirements in s. 19(3) of the *Securities Rules*, but essentially this condition will require limited dealers to maintain at least \$75,000 in capital, rather than the \$25,000 minimum permitted for some limited dealers.

Policy and Procedures Manual

Dealers are required to establish and apply written prudent business procedures for dealing with clients to comply with securities legislation (also see BCP 31-601). Any limited dealer that sells securities under exemptions should ensure that its business procedures provide for compliance with the above conditions of registration. The limited dealer's policy and procedures manual should describe any procedures necessary to:

- ensure that the dealer and its salespersons thoroughly understand any securities offered to clients under the exemptions,
- ensure the salesperson offers the securities only to clients for whom they are suitable,
- comply with all of the conditions of the exemption, and all conditions of registration,

- outline steps the dealer takes to conduct due diligence on any security being sold under an exemption and identify the name(s) of any person(s) who conducted a due diligence review on the dealer's behalf,
- assign a responsible individual to ensure, before trades are accepted, that each prospective purchaser understands,
 - whether the security is liquid and whether there is an established market for the security,
 - any resale restrictions that apply,
 - the dollar amount of any compensation that the dealer and the salesperson receive for the sale and its percentage of the investment,
 - that the offering memorandum is not a prospectus,
 - that they do not have certain protections, rights and remedies provided by the *Securities Act* for prospectus offerings, including statutory rights of rescission and damages,
- explain any training or educational requirements that the dealer will require its responsible individual and salespersons to complete prior to selling any security under an exemption, show how these individuals comply with the educational requirements and maintain records appropriate for that purpose, and
- monitor all referrals from the dealer and its salespersons to ensure that they do not refer a client to any non-registrants to purchase a security.

September 9, 2005

Brenda M. Leong
Executive Director

Ref: *Securities Act*, sections 45(2)(5), 74(2)(4)
Securities Rules, sections 19(3), 29, 45, 75
BC Policy 31-601 *Registration Requirements*
BC Interpretation Note 31-701 *Advising under the Securities Act*
National Instrument 45-106 *Prospectus and Registration Exemptions*

This Notice may refer to other documents. These documents can be found at the B.C. Securities Commission public website at www.bcsc.bc.ca in the section Securities Law & Policy: Policy & Instruments.

Sample Notice to B.C. Securities Commission

Limited Dealer Trading under Certain Registration Exemptions

A limited dealer must file a notice containing the following information before it trades in a security in reliance on the registration exemptions in section 45(2)(5) of the *Securities Act* or sections 2.3, 2.9 and 2.10 of National Instrument 45-106 *Prospectus and Registration Exemptions*.

1. Name, address and telephone number of the limited dealer:

(name of limited dealer)

(address of limited dealer)

(telephone number of limited dealer)

2. Name, address and telephone number of the issuer of the security sold under exemption:

(name of issuer)

(address of issuer)

(telephone number of issuer)

3. Type of security to be sold under an exemption: _____

4. Exemption being relied upon:

5. Date limited dealer anticipates commencing trading in the security sold under exemption: _____

Dated and Signed:

partner, director or officer of limited dealer (name of individual signing and name of limited dealer)

Forms should be forwarded to the attention of:

Manager, Registration and Compliance, Capital Markets Regulation
P.O. Box 10142, Pacific Centre
701 West Georgia Street
Vancouver, BC V7Y 1L2
Fax: (604) 899-6506