BRITISH COLUMBIA SECURITIES COMMISSION

THE Registrant

The newsletter for the registrant community Fall 2013 Issue 18

In this issue

Calculation of excess working capital and the use of subordinated loan agreements

by CSA Staff

The purpose of this article is to remind registrants of the obligations surrounding the execution and reporting of subordination agreements as required by Section 12 of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103).

Recently, we observed that firms are not executing and reporting subordination agreements appropriately for the purposes of Form 31-103F1 *Calculation of Excess Working Capital* (Form 31-103F1). This article outlines these obligations.

Continued on page 2…

CSA Staff Notice 31-334 CSA Review of Relationship Disclosure Practices (Staff Notice 31-334)

by CSA Staff

The CSA published Staff Notice 31-334 on July 18, 2013. This notice summarizes the findings of a CSA compliance review and provides guidance on relationship disclosure information practices.

The guidance is based on findings identified during the CSA's review of 124 registered portfolio managers and exempt market dealers that focused on relationship disclosure information.

The notice sets out a series of recommendations to help registered portfolio managers and exempt market dealers ensure their relationship disclosure practices comply with securities law.

The suggested practices relate to the disclosure of the following areas:

- Risks of using borrowed money to finance the purchase of a security
- Information a firm must collect about a client (Know Your Client)
- The obligation to assess suitability prior to executing a transaction
- Content and frequency of reporting for each account or portfolio of a client
- Types of risks that a client should consider when making investment decisions
- Nature or type of client account
- Conflicts of interest
- All costs to a client for the operation of an account, and the costs clients will pay in making, holding and selling investments
- Products or services offered by the firm
- Compensation paid to the firm in relation to different types of products that a client may purchase

The CSA encourage all registered portfolio managers and exempt market dealers to use the guidance contained in the notice to assess their own relationship disclosure practices, and determine the areas where improvements can be made.

Calculation of excess working capital and the use of subordinated loan agreements

Continued from page 1

Executing subordination agreements and delivery to the regulator

When firms subordinate long-term related party loans for the purpose of excluding related party debt from Line 5 of Form 31-103F1 in the calculation of excess working capital, firms are to:

- Execute a subordination agreement in the form and content prescribed in Appendix B of NI 31-103
- Deliver a copy of the agreement to the BCSC

If a copy of the subordination agreement is not delivered to the BCSC, the loan is not considered to be subordinated for the purpose of calculating excess working capital on Form 31-103F1.

When delivering a new subordination agreement, firms should only report the incremental increase of the amount of the related party loan, rather than the full balance. We may request firms to provide a schedule reconciling the total outstanding subordinated loan balance.

Repaying subordinated loans

Section 12.2 of NI 31-103 requires a firm to notify the regulator 10 days before the full or partial repayment of a subordinated loan, or the termination of the agreement. We may request further supporting documentation, such as updated interim financial information and Form 31-103F1, to assess whether the firm will have sufficient excess working capital following the loan repayment. If a repayment is made and the repayment causes the firm to have insufficient excess working capital, we may take regulatory action.

After a partial repayment of a loan, the firm should provide an updated schedule to the BCSC indicating the updated outstanding subordinated loan balance.

Delivering subordination agreements and repayment notices

You can send subordination agreements and repayment notices to examiners@bcsc.bc.ca.

Robert Frey, Senior Registration Administrator

Robert is the newest member of the Registration Branch. He reviews new firm applications and assesses the proficiency of individuals applying for registration. Robert also reviews certain notices filed under NI 31-103. Robert is a graduate of the University of Saskatchewan's Edwards' School of Business and has his CIM designation.

Grace Chan, Compliance Officer

Grace is the newest member of the Adviser/IFM Compliance Team. Grace is a Chartered Accountant and is formerly a manager with Deloitte in Vancouver. Grace has extensive experience in providing accounting advisory and financial reporting services to a number of publicly listed and private companies. Previously at Deloitte, Grace led audit engagements, IFRS conversions, as well as internal control engagements.

Client Relationship Model Phase 2 (CRM2) Requirements – Cost Disclosure, Performance Reporting and Client Statements

by Kate (Lioubar) Holzschuh

Amendments to National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations (NI 31-103) and to Companion Policy 31-103CP (31-103CP)

On July 15, 2013, the amendments to NI 31-103 and 31-103CP relating to cost disclosure, performance reporting and client statements, commonly referred to as CRM2 amendments, came in force in BC and all other Canadian jurisdictions.

The CRM2 amendments are phased in over the next three years, with a first set of amendments in force on July 15, 2013 and the last on July 15, 2016.

The CRM2 amendments apply to all categories of dealers and advisers, with some application to investment fund managers (IFMs). The requirements for members of the IIROC and the MFDA are currently being materially harmonized and will come into effect on the same dates as the corresponding CRM2 requirements.

The amendments ensure that all investors receive the same information about the cost and performance of their investments.

This article provides a brief overview of some, but not all, amendments. This update is not a substitute for a thorough review of the amendments to NI 31-103 and guidance in 31-103CP.

Implementation schedule

July 15, 2013

- Clarifications to the existing requirements to deliver relationship disclosure information (RDI) in s. 14.2
- A new requirement to give prior notification to clients of new or increased operating charges
- A couple of clarifications to the existing requirements to deliver account statements in s. 14.14 (all discussed in more detail below)

July 15, 2014

- Two new items of RDI required to be delivered under s. 14.2
- A new requirement to deliver pre-trade disclosure of charges in s. 14.2.1
- Two new items in the content of trade confirmations in s. 14.12 relating to debt securities (all discussed in more detail below)

July 15, 2015

- New s. 14.11.1 sets out the methodology for determining the market value
- New client statement requirements which include the existing s. 14.14 [account statements], as well as new s. 14.14.1 [additional statements] and new s. 14.14.2 [position cost information].

July 15, 2016

- A new requirement for IFMs to provide information to dealers and advisers in s. 14.14.1
- An amended item in the content of trade confirmations in s. 14.12 relating to charges
- New requirements to deliver an annual report on charges and other compensation and an annual investment report in s. 14.17 through 14.20

We encourage you to familiarize yourself with all of the requirements in advance of the effective dates and consider early adoption.

Exceptions

The following requirements do not apply to permitted clients that are not individuals:

- 14.2 [RDI],
- 14.2.1 [pre-trade disclosure of charges]
- 14.14.1 [additional statements],
- 14.14.2 [position cost information]
- 14.17 [report on charges and other compensation]
- 14.18 [investment performance report]

In addition, dealers who purchase or sell securities only as directed by an adviser acting for clients should note that the RDI requirements in s. 14.2 have a limited application to them and the requirements in s. 14.2.1 [pre-trade disclosure of charges] and s. 14.18 [investment performance report] do not apply to them.

CRM2 requirements in force now

We discuss the clarifications to the existing RDI requirements in s. 14.2 in CSA Staff Notice 31-334 *CSA Review of Relationship Disclosure Practices*. We encourage you to read it, as well as guidance on RDI under item 14.2 of 31-103CP.

Continued on page 4…

Client Relationship Model Phase 2 (CRM2) Requirements – Cost Disclosure, Performance Reporting and Client Statements

Continued from page 3

In addition, please note that:

- new s. 14.2(5.1) prohibits imposing a new or increased operating charge unless 60 days' prior written notice is given to a client
- RDI must now be delivered to permitted clients that are individuals

The old s. 14.2(5) and (6) have been amended and firms are now required to deliver RDI to all individuals, whether or not permitted clients. There is no grandfathering for the individuals who have previously waived the RDI requirements in accordance with the old s. 14.2(6). We expect firms to act reasonably when they determine when to next deliver RDI to such clients. If there is a significant change in respect of the RDI, then the firm should act right away. Otherwise, we would expect RDI to be updated the next time the firm is updating client information or before doing a transaction.

The requirement in s. 14.14(3) applicable to advisers has been clarified to require an adviser to deliver a statement every month if the client has requested.

CRM2 requirements in force on July 15, 2014

New s. 14.2(2)(m) requires firms to provide clients with a general explanation of benchmarks and whether the firm offers any options for benchmark reporting to clients. For greater certainty, there is no requirement to provide benchmarks. 31-103CP provides general guidance on the use of benchmarks (see items 14.2 and 14.19) if a firm chooses to provide benchmarks.

New s. 14.2.1 requires firms to provide specific disclosure of the charges a client with a non-managed account would have to pay when purchasing or selling a security prior to the firm accepting the client's order. This disclosure is not required to be in writing. See further guidance under item 14.2.1 as well as under "Disclosure of charges and other compensation" in item 14.2 of 31-103CP.

There are two new items in the content of trade confirmations in s. 14.12.

1. New paragraph (b.1) requires dealers to report, in the case of a purchase of a debt security, its annual yield. For non-callable debt securities, the yield to maturity would be appropriate. For non-callable securities, the yield to call may be more useful.

2. New paragraph (c.1) requires dealers to report compensation in the case of a purchase or sale of a debt security as follows. Either:

    a. the total dollar amount of compensation to the firm, which may consist of any mark-up or mark-down, commission or other service charge or, alternatively

    b. the total dollar amount of any commission paid to the firm and, if the firm applied a mark-up or mark-down or any service charge other than the commission, provide a prescribed general notification

Note for IFMs

The new requirement for IFMs in s. 14.11.1 to provide information on trailing commissions and deferred sales charges (and any other charges deducted from the net asset value of securities) to dealers and advisers comes in force on July 15, 2016.

We expect IFMs, dealers and advisers to be fully compliant at the end of the three-year transition period.

Trade confirmations should include the information about various charges immediately after the transition period ends and the new information will be included in clients' reports on charges and other compensation for the period that *includes the first day after the end of the transition period.*

For greater certainty, if a dealer or adviser reports on a calendar year basis, it will need to provide a report for the period starting January 1, 2016 and ending on December 31, 2016, which will need to include the information on any trailing commissions paid to the dealer or adviser in that period.

Kate (Lioubar) Holzschuh is Senior Legal Counsel in the Capital Markets Regulation Division

Resources for Registrants

- National Instrument 31-103 *Registration Requirements and Exemptions*
- BCSC Compliance Toolkit – a resource for compliance
- CSA Registration Database – registration type and status of individuals and firms
- BCSC Disciplined Persons List – individuals that have been sanctioned by the BCSC
- BC Securities Act, Regulations and Rules – the securities legislation
- Policies and Instruments – policies and instruments in effect in BC
- Registration Forms – forms specific to dealers and advisers
- BCSC Weekly Report – weekly updates on new policies, news releases and orders
- InvestRight – investor education by the BCSC

Other resources:

- BC Statutes and Federal Statutes
- AIMA Canada – The Alternative Investment Management Association
- Canadian Securities Administrators
- Canadian Securities Institute
- CFA Institute
  - CFA Codes, Standards and Guidelines
  - CFA Standards of Practice Handbook
  - CFA Vancouver
- FINRA Financial Industry Regulatory Authority
- Managed Funds Association – alternative investments
- OSC: Information for Dealers, Advisers and Investment Fund Managers
- Society for Corporate Compliance and Ethics
- Canadian Centre for Ethics and Corporate Policy
- US Securities and Exchange Commission
  - Information for Newly-Registered Investment Advisers

The Registrant

Editor: Edwin Leong

The Registrant is published by the Capital Markets Regulation Division (CMR) of the British Columbia Securities Commission (BCSC).

The BCSC is the independent, self-funded government agency responsible for regulating trading in securities and exchange contracts in the province of British Columbia. Its CMR Division oversees the registration and conduct of all dealers and advisers in securities and exchange contracts that are not either MFDA or IIROC members.

Newsletter Services: Please contact examiners@bcsc.bc.ca to add your email address to our distribution list, or to send comments to the editor.

Other Legal Matters: *The information published in this newsletter involves general concepts only. You should not construe the information as providing, suggesting or offering a definitive, legal or binding opinion of the BCSC, or its Capital Markets Regulation Division about the subjects or concepts involved, nor is there any legal liability, warranty or responsibility implied by its publication or the subsequent use of the information.*