October 5, 2016

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
The Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission of New Brunswick
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Superintendent of Securities, Yukon Territory
Registrar of Securities, Nunavut

comments@osc.gov.on.ca and consultation-en-cours@lautorite.qc.ca

Re: Canadian Securities Administrators Notice and Request for Comment – Proposed Amendments to National Instrument 31-103 – *Registration Requirements, Exemptions and Ongoing Registrant Obligations*, the Companion Policy to NI 31-103, National Instrument 33-109 – *Registration Information* and Related Forms

The Portfolio Management Association of Canada ("**PMAC**"), through its Industry, Regulation & Tax Committee, is pleased to have the opportunity to provide comments on the Canadian Securities Administrators' ("**CSA**") Proposed Amendments to National Instrument 31-103 – *Registration Requirements, Exemptions and Ongoing Registrant Obligations*, the Companion Policy to NI 31-103 (the "**CP**"), National Instrument 33-109 – *Registration Information* and Related Forms (the "**Proposed Amendments**").

Capitalized terms used in this letter but not defined here have the same meaning given to them in the Proposed Amendments.

Overview

PMAC represents investment management firms registered to do business in Canada as portfolio managers. PMAC members encompass both large and small firms managing total assets in excess of $1.5 trillion for institutional and private client portfolios[1].

PMAC advocates for the highest standard of unbiased portfolio management in the interest of the investors served by our members and is appreciative of the efforts of the CSA to continue to refine the instruments underlying the client-registrant relationship.

[1] Many of PMAC's members are also registered as investment fund managers that offer a variety of investment products to institutional investors and private clients. For more information about PMAC and our mandate, please visit our website at: www.portfoliomanagement.org.

PMAC is generally supportive of the Proposed Amendments as they are designed to improve investor protection and reduce intermediary risk through the Custody Amendments; to provide additional transparency and clarification of the CSA's thinking around the appropriate use of the exempt market dealer ("**EMD**") registration; and to codify and streamline CRM2 requirements.

PMAC members have raised certain questions and comments about various aspects of the Proposed Amendments and these are set out in further detail below.

1. Custody Amendments

Custodians are crucial service providers who help ensure the safeguarding of client assets. Given the importance of the role that custodians play in fostering investor protection and confidence in Canada's capital markets, we believe that ensuring that client and investment fund assets are held by independent and qualified custodians can help guard against the types of financial frauds that have made headlines in recent years.

PMAC supports the creation of rules around the custody of client and investment fund assets by registrants that go beyond the segregation of client assets to address potential intermediary risks. Subject to our comments below, we are also generally supportive of the prohibition on self-custody and the use of a custodian that is functionally independent of a registered firm, as well as the required disclosure to investors proposed in the Custody Amendments with respect to where and how client and investment fund assets are held and accessed. PMAC commends the CSA for proposing a Canadian solution for this matter.

We would, however, appreciate further guidance and clarification on the matters relating to the Custody Amendments set out below in order to better understand the proposed requirements, their impact on our membership and their clients.

Streamlining Regulation

We recognize that the CSA have explicitly decided against adopting the same custodial requirements that apply to prospectus-qualified funds under National Instrument 81-102 – *Investment Funds* ("**NI 81-102**") for this context, citing differences in the current regulatory framework for prospectus-qualified and prospectus-exempt investment funds as well as differences in existing business practices. However, in spite of these differences, PMAC believes there may be benefits in terms of simplicity, transparency and reduced regulatory burden if the CSA were to streamline all of the applicable custodial requirements into one instrument, carving out and modifying the requirements applicable to institutional/non-retail funds from the general requirements, as necessary.

Custody for non-traditional assets

Subsection 14.14(7) of NI 31-103 currently sets out when a security is considered to be held by a registered firm for a client:

> (a) if the firm is the registered owner of the security as nominee on behalf of the client; or
> (b) if the firm has physical possession of a certificate evidencing ownership of the security.

The amendments to Companion Policy 31-103 – *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (the "**CP**") state that the CSA consider the terms "hold" or "held" [client or investment fund securities or cash] to include the situations identified in the above-referenced subsection. In order to fully understand the impact of the Custody Amendments, as well as to ensure compliance with these requirements, we believe that additional guidance and clarity is required regarding when a firm will be deemed to have physical possession of the securities or cash of a client or an investment fund. For instance, how will the CSA view the obligations of firms that hold subscription receipts? For firms who purchase investment funds that are not available on CDS,

would there be a different interpretation of whether that firm has custody over the securities which are held by the transfer agent of the investment fund manager? Firms may also purchase foreign investments for their clients and PMAC suggests that these holdings should be treated the same as Canadian investments.

We believe that further clarification regarding firms as registered owners of securities as nominees on behalf of a client is also required. For instance, if a firm is listed as a registered unit holder of a security on behalf of a beneficial owner or client, we would appreciate clarification that the firm is not deemed to "hold" the security pursuant to Section 14.14 (7)(a) of NI 31-103.

In providing this important clarity, we request that the CSA also set out the types of assets that will be exempt from the restriction on self-custody and subject to the qualified custodian requirements. We recognize that the unique asset space is constantly evolving and, to this end, in addition to a list of existing assets that are excluded from the Custody Amendments, general and principles-based guidance as to when a unique asset may be deemed to be custodied by a firm would be helpful.

PMAC looks forward to reviewing the additional exclusions from the Custody Amendments that will be introduced in response to new derivatives legislation in the future.

We believe that some outreach may be needed to ensure that registered firms are able to have non-traditional assets custodied by a qualified custodian for their clients and investment funds. We understand that there have been some instances where custodians – for valid reasons – have been reluctant to hold unique assets. A prohibition on self-custody for registered firms, will, however require certainty that such unique assets will have a qualified custodian available to fulfill the requirements of the Custody Amendments. The guidance in the CP around the processes that registered firms should apply when it is not feasible for certain assets types (i.e. bullion) to be held at a qualified custodian is helpful. The guidance in the CP around the reasons for which certain mortgages are exempt from the Custody Amendments is similarly helpful. However, we would appreciate further clarification that the mortgage exemptions in Subsection 14.5.2(7)(f) of NI 31-103 are meant to reflect the current industry practice (whereby the parties administering the mortgages are usually the parties holding the mortgages and not necessarily a qualified custodian used by a registered firm) and that such exemptions are not intended to change this current practice. Overall, we believe more such guidance is needed to better understand which assets the CSA expect qualified custodians to be able to hold.

Permitted Transactions

We note that the Custody Amendments do not include certain provisions similar to those contained in Section 8.6 of NI 81-102.We would appreciate clarification that the CSA would view the types of derivatives transactions, securities lending transactions and the use of depositories allowed under NI 81-102 as being permitted transactions under the Custody Amendments.

"Direct or arrange" and "influence over" client's custody arrangements

We thank the CSA for clarifying that the Custody Amendments do not apply retroactively. We do, however, note the CSA's expectation that registered firms that have directed or arranged clients' custodial arrangements in the past must inform clients of the new custodial requirements and, in cases where the custodian that was previously directed or arranged does not meet the requirements of the Custody Amendments, must make the client aware of such fact and direct the client to a qualified custodian. We would appreciate confirmation of the time by which such client notification is expected to take place and whether this is required prior to the implementation of the Custody Amendments. For certain firms who have directed or arranged still-existing custodial relationships many years ago, the process of assessing their obligations and reaching out to all clients may be lengthy.

PMAC believes that additional clarity around the CSA's expectations of behavior that will amount to "directing or arranging" for clients to enter into custodial arrangements would be beneficial in order to determine which past activities will trigger the requirement to understand and explain such arrangements to their investors in the relationship disclosure information[2] (the "**Custody Disclosure Requirements**"). The same applies with respect to which registrants will be considered to be currently directing or arranging which custodian will hold a client's securities and therefore have an obligation to ensure that such a custodian is a qualified custodian. We also request similar guidance around the concept of having "influence over"[3] a client's selection of a custodian which triggers the need for a registrant to understand and disclose the material terms of the written custodian agreement – even in the absence of contractual privity between the registrant, the client and custodian – and to explain the main terms of the agreement to the client.

For example, would the CSA expect that the Custody Disclosure Requirements are triggered by way of a simple referral by a registered firm to a non-affiliated Canadian Custodian upon the request of a client? If that is the case, we request that the CSA consider exempting firms from the Custody Disclosure Requirements when they are performing a simple referral to a non-affiliated custodian that meets the definition of a Canadian Custodian. We believe this would ease the disclosure burden without compromising investor protection.

The interpretation of these concepts will be important for registrants to fulfill the requirements of the Custody Amendments. Absent additional guidance, it may not be practical for registrants to determine whether they have in the past directed or arranged for such custodians and it may also be difficult to assess where a client ultimately determined to have his or her assets custodied. Additionally, this sort of a determination may prove especially difficult in cases where initial client onboarding may have occurred in the distant past.

As a general matter, PMAC believes that the obligations accruing to registrants as a result of the Custody Amendments should only be triggered where the registrant has played an active role in arranging for the custodian and that the bar for concluding that a registrant has "directed or arranged" or had "influence over" the client's custodian should be a high one.

It should be noted that clients with separately managed accounts have the ability to select and engage the custodian of their choosing and this is of crucial importance because the client is then selecting and managing the relationship with the custodian. In such cases, we do not believe that it is appropriate for the registrant to have an obligation to disclose and monitor the terms of that relationship.

Additionally, in the interest of investor protection and efficiency, PMAC does not believe that registrants should bear the responsibility for monitoring the actions and effectiveness of custodians, beyond compliance with the Custody Amendments. As such, we believe that it is important for the CSA to work with the other relevant regulators, such as the Office of the Superintendent of Financial Institutions ("**OSFI**"), to ensure that custodians are regulated and monitored in an appropriate way to ensure the effectiveness of the Custody Amendments and to achieve the desired investor protection outcomes. For example, custodians should be subject to modern, appropriate yet rigorous cybersecurity and disaster recovery obligations (among others) and these requirements are more appropriately assessed and overseen by regulators instead of by individual registrants.

Extent of diligence obligations

CP Subsection 14.5.2 states the expectation that investment fund managers ("**IFMs**") will conduct a periodic review of custodial arrangements for their investment funds to consider whether the custodian they appoint uses all reasonable diligence, care and skill in the selection and monitoring

[2] Subsection14.2 (a.1) and Subsection 14.5.2(2)(a).
[3] CP Section 14.5.2.

of its sub-custodians, whether the sub-custodians would meet the definition of a "qualified custodian" and whether the appropriate segregation arrangements are observed throughout the custody chain of the portfolio assets of the investment fund.

PMAC believes that further guidance is required around the scope of this expected due diligence to understand the level of scrutiny the CSA will hold IFMs to in this regard. We note that in particular, it may be challenging for IFMs to exercise influence over the sub-custodians as custodians often have their own established networks of sub-custodians in place prior to entering into a custodian agreement with an IFM. IFMs are unlikely to have input into this network, nor privity of contract with the relevant sub-custodians, to influence their activities. For these reasons, we believe that IFMs should be entitled to rely on custodians to ensure that their sub-custodians will meet the definition of a "qualified custodian" and to ensure appropriate segregation agreements for the purposes of the Custody Amendments. We reiterate our belief of the importance of regulatory coordination between the CSA and OSFI, especially with respect to ensuring that sub-custodians are appropriately appointed and overseen. Guidance from the CSA for IFMs conducting due diligence that will satisfy this component of the Custody Amendments should be clear, principles-based, proportional to the level of investor protection that the CSA believe will be derived from the IFM's diligence and take into account existing regulation and oversight of custodians by their appropriate regulators.

Scope of application of the Custody Amendments

Instances may arise where a non-Canadian registered firm could be caught by the disclosure requirements that are triggered when "directing" or "arranging" which custodian will hold client assets[4] when dealing with non-Canadian clients or non-Canadian based investment funds. For instance, as currently drafted, a U.K. firm that is registered in Canada appears to be required to comply with the Custody Amendments when dealing with both Canadian and non-Canadian clients. We believe that a non-Canadian firm that is registered in Canada should have an exemption from complying with the requirements in the Custody Amendments when not dealing with Canadian clients or investment funds. We therefore ask the CSA to consider providing an exemption for such non-Canadian registered firms from the requirements of the Custody Amendments with respect to non-Canadian clients and non-Canadian based investment funds. We believe that in situations where there is an absence of any real nexus to Canada other than the firm's registration, the Custody Amendments need not apply.

Foreign Custodians

In reviewing the proposed definitions for "Canadian custodian" and "foreign custodian", we note that the definition of "foreign custodian" does not extend to the foreign equivalents of Canadian investment dealers. Certain alternative funds have assets custodied with foreign equivalents of investment dealers as a result of engaging such entities to provide prime brokerage services. It is our recommendation that the definition of "foreign custodian" be expanded to include a company registered under the securities legislation of a foreign jurisdiction as the equivalent of an investment dealer, to allow for greater flexibility in the custody of client and investment fund assets.

"Functionally Independent"

The CSA have stated that the Custody Amendments are not expected to have a significant impact on a client's choice of custodian, given that the majority of custodians currently used by clients of registered firms would meet the definition of "qualified custodian". The CSA have also stated that they expect the Custody Amendments to have minimal impact on most registered firms.

[4] Subsections 14.2 and 14.5.2.

In order to confirm our understanding of the scope of the application of the Custody Amendments, PMAC is requesting further clarity in respect of when a firm will be found to be functionally independent from a custodian. This further clarity will assist in providing the necessary comfort that certain existing arrangements will not be found to violate this requirement.

To this end, it would be helpful for the CSA to expand on CP Subsection 12.4 to provide assurance that firms that meet that criteria[5] and that have appropriately discharged their duty to manage any conflicts of interest fairly and effectively will still be considered to be functionally independent from their custodians, even if certain back office functions are shared with the custodian. For instance, would a firm and a custodian that share an entity that performs account opening functions, trade processing and statement processing be considered to be functionally independent? When looking at the independence of mind and management of a firm and a custodian, would they be considered to be functionally independent if they are affiliates that ultimately report up to the same Chief Executive Officer? Additional clarity is also requested regarding the scope and nature of the system of controls and supervision to manage the risk to the client or investment fund associated with the custody of their securities or cash.[6]

As a matter of accessibility, the guidance around what constitutes functional independence may be more appropriately located under another subsection of the CP (such as under new CP section 14.5.2), as it is not intuitive for registrants to search for this guidance under CP Subsection 12.4 – Insurance.

"Client asset verification examination performed by a third party"

PMAC understands that the CSA do not intend to move towards a U.S.-style custody audit process and we believe that this is the right outcome for Canadian investors and the Canadian market.

On this issue, PMAC is requesting that CP Subsection 14.5.2 – Restriction on self-custody and qualified custodian requirement - "Prohibition on self-custody and the use of a custodian that is not functionally independent" - be revised to clarify that the requirement under Subsection 14.5.2(5)(b) of NI 31-103 – client asset verification examination by a third party – is an audit of the *custodian* and not an audit of the registered firm.

Additionally, we believe that it would be helpful for the CSA to explicitly note that the Statement on Standards for Attestation Engagements No. 16, Reporting on Controls at a Service Organization (SSAE 16), the International Standards on Assurance Engagements (ISAE) 3402, "Assurance Reports on Controls at a Service Organization" issued by the international Auditing and Assurance Standards Board and the Canadian equivalent, the CSAE 3416, will meet the standard expected by the CSA in respect of such a third party verification.

Use of Omnibus Accounts

PMAC would appreciate confirmation that Subsection 14.5.3 of NI 31-103 does not preclude registrants who hold client assets at a qualified custodian from continuing to be able to use omnibus accounts to hold client assets on an aggregated basis, whether at the custodian or sub-custodian level. PMAC members have noted that an inability to continue to use omnibus accounts under the Custody Amendments would create significant timing delays in the implementation of and compliance with the new rules resulting from the need to unwind the accounts, renegotiate new custodial agreements and to re-paper each such account.

[5] Where these firms do not share the same mind and management; where the custodial activities are performed by personnel that are separate from and able to act independently from personnel of the registered firm; and where there are adequate systems and controls to ensure the functional independence of personnel performing the custodial function.

[6] Subsection 14.5.2(5)(b).

Guidance and Contractual Terms with Custodians

The CSA have asked whether there should be prescribed key terms for custodial agreements in NI 31-103, similar to the requirements found in NI 81-102 and NI 41-101 – *General Prospectus Requirements and Related Amendments* ("**NI 41-101**"). In particular, the CSA have asked whether there should be a requirement for such custodial arrangements to include a prescribed standard of care and responsibility for loss for the custodian. PMAC believes that guidance around key terms, substantially similar to those in NI 81-102 and NI 41-101, would help establish a baseline upon which firms and custodians can negotiate their agreements. We also believe that a prescribed standard of care and responsibility for loss for the custodian may be useful, but that the imposition of any such standard should be the subject of discussions with all affected stakeholders to ensure that a workable standard that is proportional to the level of investor protection provided is implemented. Where a qualified custodian is a member of IIROC, PMAC would recommend that the CSA work with IIROC to ensure alignment of expectations as IIROC does require member firms to follow rules regarding contracts with clients which include registered advisers.

PMAC requests that any such proposed contractual terms would apply only to custodial contractual relationships entered into by registrants after the implementation of the Custody Amendments. Any requirement for existing custodial contracts to be renegotiated would be unrealistic and cause disruption to existing relationships to the detriment of investors.

Timing of implementation of new custody rules

PMAC members will work diligently to the implement the Custody Amendments, however, we understand that, from an operational perspective, the proposed six month implementation date may not provide sufficient time for firms to implement all of the necessary operational amendments (for instance, in the event of the need to unwind omnibus accounts or to assess past custodial relationships that may have been arranged or directed) and that a rushed process in this respect could risk compromising investor protection.

2. Exempt Market Dealer clarification

EMDs selling prospectus qualified funds in the exempt market

PMAC understands the general policy rationale underlying the overall clarifications made to Subsection 7.1(2)(d) of NI 31-103. We thank the CSA for including additional and significant guidance around the scope of permitted activities that can be carried out by an EMD in the CP. However, PMAC believes that certain additional clarification is necessary around the restriction on EMDs participating in a distribution of securities offered under a prospectus in any capacity, even if a prospectus exemption would otherwise be available. From a policy and practical perspective, it should be made clear in the instrument itself (and not just in the CP[7]) that EMDs are permitted to sell prospectus-qualified funds to the exempt market.

This is important to ensuring that firms that are registered as both portfolio managers and EMDs can continue to use their EMD registration to distribute securities of reporting issuers to their clients' accounts.

Investment fund trades by adviser to managed account

PMAC believes that the proposed changes to Section 8.6 of NI 31-103 are beneficial and provide more latitude for use of this exemption. We believe that this exemption would be rendered more useful, while maintaining the policy objective informing its purpose, with the following additional amendment underlined:

[7] See CP Subsection 7.1.

The dealer registration requirement does not apply to a registered adviser, or an adviser that is exempt from registration under Section 8.26 [international adviser], in respect of a trade in a security of an investment fund if all of the following apply:

(a) The adviser or an affiliate of the adviser acts as the fund's adviser;

(a.1) the adviser or an affiliate of the adviser acts as the fund's investment fund manager; and

(b) the trade is to a managed account of the client of the adviser.

This amendment would permit an adviser to invest a client in a fund if the registrant's affiliate is the investment fund manager of such fund, or simply the adviser of such fund. This would remove ambiguity in the situation when an affiliate is hired as a sub-adviser to a fund. This amendment would also allow a registrant to invest her client in an affiliate's pooled fund where the affiliate is both the investment fund manager and the adviser of the related fund. This is important for clients of portfolio managers as there are times when a related pooled fund is the most suitable and preferable choice for a particular client. We believe this additional clarity and flexibility will benefit investors.

3. CRM2 codification and amendments

PMAC is supportive of measures that simplify and streamline regulatory obligations and thanks the CSA for undertaking this project. We are pleased to see the codification into NI 31-103 of the temporary relief granted by the CRM2 Orders and believe that making such CRM2 Orders permanent is beneficial.

We believe that the various clarifications and additional guidance in the CP are helpful to registrants and that these provide transparency and consistency for the benefit of registrants and investors. Portfolio managers are especially appreciative of the guidance and indicia regarding acceptable methods for determining market value and when market value is likely not determinable when calculating investment performance.

We thank the CSA for including additional exemptions from certain of the 2013 CRM2 requirements in Subsection 13.17 of NI 31-103 for a registered adviser who is acting as a sub-adviser to a registered adviser or registered dealer. We agree that such reporting requirements may not be necessary and are highly supportive of measures that reduce the reporting and regulatory burden where there would be no commensurate benefit to investors.

We believe the CSA should include a reference to the availability of discretionary exemptive relief from certain of the CRM2 requirements[8] for institutional clients that are "accredited investors" but do not qualify as "permitted clients". The CRM2 reporting requirements include an exemption for permitted clients that are not individuals, based on the policy rationale that such clients are considered to be sophisticated institutional investors and already receive similar reporting to what is required under the CRM2 reporting requirements. However, there are various types[9] of institutional accredited investors or non-permitted institutional clients that are not individuals but still fall outside of the permitted client definition and financial thresholds in NI 31-103 and, as a

[8] Namely, Subsections 14. 2 – Relationship Disclosure Information; Section 14.2.1 – Pre-Trade Disclosure of Charges; Subsection 14.14.1 – Additional Statements; Subsection 14.14.2 – Position Cost Information; Section 14.17 – Report on Charges and Other Compensation; and Subsection 14.18 – Investment Performance Report.

9 Health and welfare trusts (distinct entities under the Income Tax Act (Canada)); Unions and union-related benefit plans; Multi-employer benefit plans; Some foundations and registered charities; Some overflow pension accounts (associated with pension plans, but not pension plans themselves); Supplemental employee retirement plans; Disability Plans; First Nations trust vehicles (i.e., for government monies); and Retirement Compensation Arrangements.

result, are required to receive CRM2 reporting. For the most part, these clients are already receiving reporting similar to CRM2 reporting and they have the ability to request further tailoring, as needed. Similar to permitted clients, the institutional accredited investors require and receive reporting content that is highly detailed, transparent and customized to their specific needs. PMAC believes that reference to the availability of such an exemption, upon application by registrants and subject to conditions from the CSA, would be beneficial for clarity and transparency. In the absence of such exemptive relief, registrants may incur significant costs and resource-strain to comply with the CRM2 reporting requirements and the cost of doing so would outweigh the potential investor benefit.

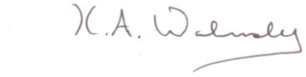
4. Concluding Comments

We believe that the client-registrant relationship is of utmost importance to the integrity and efficient functioning of our capital markets, the Canadian economy and to the well-being of Canadian investors. We thank the CSA for the dedication they have demonstrated through the Proposed Amendments to ensuring that this relationship and the underpinning legislation is responsive to new investor protection issues, contains additional guidance and codification of previously issued orders.

We would be pleased to speak with you further about the remarks in our letter.

Sincerely,

PORTFOLIO MANAGEMENT ASSOCIATION OF CANADA



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