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October 5, 2016

The Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1900, Box 55
Toronto ON M5H 3S8

Via email to comments@osc.gov.on.ca

Re: Response to Canadian Securities Administrators ("CSA") Notice and Request for Comment re Proposed Amendments to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* ("NI 31-103"), Companion Policy 31-103CP *Registration Requirements, Exemptions and Ongoing Registrant Obligations* ("31-103CP"), National Instrument 33-109 *Registration Information* ("NI 33-109") and Related Forms (collectively, the "Proposed Amendments") Published on July 7, 2016

Dear Sirs/Mesdames:

AUM Law is a boutique securities law firm with offices in Toronto and Montreal, providing regulatory compliance, fund formation and corporate finance advice. We deliver practical and forward-thinking advice and services to our clients, primarily consisting of portfolio managers, fund managers and exempt market dealers.

We appreciate the opportunity to provide the CSA with our comments on the Proposed Amendments, as they directly impact the registrants we service. The comments in this letter represent the personal views of the undersigned lawyers and are not necessarily the views of AUM Law. This comment letter is submitted without prejudice to any position that has or may in the future be taken by AUM Law on its own behalf or on behalf of its clients.

We believe that the Proposed Amendments are a welcome development in providing additional protection of client assets, further clarity on permitted EMD activities and codification of key components of the CRM2 framework.

We are concerned, however, that more consideration should be been given to the cumulative effect of the administrative burden on smaller registered firms arising from the flood of recent regulatory reforms and related requests for comment. While the burden of any one specific initiative may not tip the administrative balance, when initiatives such as CRM2, fund facts, best interest and fund fees are reviewed in the aggregate, they place a disproportionate administrative burden on smaller firms over a relatively short period of time.

In particular, smaller registered firms are often not as well-positioned to absorb the significant cost of implementing and ensuring reasonable compliance with these new regulatory initiatives, which may lead to consolidation in the industry or higher barriers to entry for potential new entrants. We strongly advise the CSA to take these issues into consideration when studying the efficacy of "back-

office" platform-type models that facilitate the "scaling" of compliance while, in our view, enhancing the compliance oversight function relative to traditional captive dealer models.

With regard to the Proposed Amendments, set out below is our response to the questions posed in the Notice (replicated for ease of reference); we have also provided additional comments on certain of the Amendments that we hope the CSA will find useful.

1. Custody Amendments

Question 1: We invite specific comment on whether this guidance is sufficiently clear and whether it would be helpful when negotiating contract terms with custodians for investment funds that are not subject to NI 81-102 and NI 41-101. Should there instead be prescribed key terms for custodial agreements in NI 31-103, similar to the requirements found in NI 81-102 and NI 41-101? In particular, should there be a requirement for such custodial agreements to include a prescribed standard of care and responsibility for loss for the custodian?

Response 1: The guidance in s. 14.5.2 of 31-103CP is sufficiently clear; our view is that there should not be prescribed key terms for custodial agreements in NI 31-103, including a prescribed standard of care. One reason relates to the point made in the guidance: registered firms are often not a party to the custodial agreement between the custodian and their client; consequently, imposing contractual requirements in such a situation would not be appropriate or practical. Further, some of these elements are indirectly caught by the proposed amendments to client disclosure relating to custodial arrangements (e.g., 14.2(2)(a.1) and (a.2)). If the CSA concludes that such prescribed key contract terms are critical, we suggest that the CSA consider applying them directly to custodians, rather than to registered firms.

Additional Comments on Custody Amendments

The following sets out our additional comments regarding custody amendments:

- **Use of multiple custodians not explicitly addressed**: By referring to "the custodian", subsection 14.5.2(2) seems to contemplate a single custodian for a client. However, depending on the client's portfolio(s), a single custodian may not be ideal. We suggest that multiple custodians be explicitly addressed.
- **Use of sub-custodians not explicitly addressed**: Unlike the approach in NI 81-102 and NI 41-101, where sub-custodians are explicitly addressed, sub-custodians are not explicitly addressed in the Proposed Amendments. While subsection 14.5.2(1) refers to sub-custodians (also mentioned in 31-103CP), the key subsections 14.5.2(2) and (3) do not. We suggest that the use of, and requirements for, sub-custodians be explicitly addressed.
- **Unintentional bias against foreign custodians**: As currently drafted, there seems to be an unintentional bias against the use of foreign custodians. Subsection 14.5.2(3) suggests that for a registered firm to recommend a foreign custodian, the selection of the foreign custodian must be "more beneficial to the client … than using a Canadian custodian" (underline added). We do not understand why the recommendation to use a foreign custodian must be restricted to situations where it would be *more* beneficial to the client than using a Canadian custodian. We suggest redrafting this subsection to remove this unintentional bias.

- **Client decision not to use custodian**: In those cases where, despite the requirement in section 14.5.3, the client refuses to use a custodian in a manner contemplated by the Proposed Amendments, additional guidance regarding the "reasonable steps" that the registered firm should take in this situation would be helpful.
- **Further guidance on "functionally independent"**: As paragraphs 14.5.2(5)(a) and (b) allow certain Canadian custodians (e.g., schedule banks and trust companies) to *not* be functionally independent to the registered firm of the client, we are unclear as to why Canadian financial institutions are not permitted to act as the client's custodian in respect of the client's cash even if they are not functionally independent from the client's registered firm, since the definition of "Canadian financial institution" seems to substantially overlap with paragraphs (a) and (b) of the definition of "Canadian custodian" in the Proposed Amendments. We suggest that the CSA clarify this requirement.
- **Foreign custodian's custody of client cash**: We think that the location of subsection 14.6(2) is confusing as section 14.6 is generally about holding assets in trust, which is not the focus of subsection 14.6(2). We suggest the CSA consider incorporating this subsection into subsection 14.5.2(3).

2. EMD Amendments

Question 2: If you are an adviser that is also registered as an exempt market dealer, are you currently using your dealer registration to distribute securities of reporting issuers, either to managed accounts or to other client accounts? If so, please indicate the types of securities (i.e., securities of investment funds or non-investment funds, whether listed or otherwise).

Response 2: We trust the responses to this question will not change the CSA's proposal to continue to allow EMDs to act as a dealer in a private placement in respect of securities of reporting issuers that are not listed, quoted or traded on a marketplace.

Question 3: Will advisers use the proposed section 8.6 to distribute prospectus-qualified securities of investment funds, including mutual funds, directly? Are the conditions of this exemption appropriate? If not, why not?

Response 3: Under the conditions of this exemption, it seems that advisers would be entitled to distribute prospectus-qualified securities of investment funds (including mutual funds). In our view, this does not pose any policy concerns. In light of the expansion of the IFM condition related to the exemption and our understanding above, the conditions of this exemption seem reasonable in light of the exacting proficiency standards for advising representatives under NI 31-103.

More generally, we would encourage the CSA to provide additional guidance on whether firms that are registered both as PMs and EMDs can rely on the exemption in section 8.6 in light of section 8.0.1 of NI 31-103. For example, would such firms be expected to trade an "exempt" investment fund (i.e., a security that could be traded pursuant to their EMD registration) in the context of a managed account (which EMD registration, by itself, does not permit EMDs to provide) through their dealing representative(s) or can such firms rely on the exemption in section 8.6 and trade such funds through their advising representative(s)?

Additional Comments on EMD Amendments

The following sets out our additional comments regarding the EMD amendments:

- **Interaction with CSA approaches to distributions outside of Canada:** We suggest that the CSA ensure there is no confusion arising from the EMD amendments and the various CSA approaches to distributions outside of the CSA jurisdictions, for example as set out in proposed OSC Rule 72-503, BCSC Rule 72-503 and ASC Rule 72-501. In light of the distribution concept being key to the EMD amendments and the fact that EMDs are often involved in securities transactions with investors from various jurisdictions, we encourage the CSA to be clear and consistent about the interpretation of distributions outside of Canada (as well as outside of the respective CSA jurisdictions but otherwise within Canada) as it relates to the restrictions in paragraph 7.1(2)(d) of NI 31-103.
- **Ongoing policy concerns**: We continue to be unsure of the policy rationale in prohibiting EMDs from participating in a distribution of securities offered under a prospectus if a prospectus exemption could have been relied on with respect to trades in the security involving the EMD's clients (e.g., if the clients are accredited investors). As an EMD's clients often invest in products that can be higher risk and/or more complex than those offered under a prospectus, we do not see the risk of allowing EMDs to offer their clients prospectus-offered products. These products typically do not pose higher risk than "exempt" products, are more highly regulated (e.g., investment funds subject to NI 81-102) and are issued by issuers subject to substantial continuous disclosure requirements. In fact, by allowing EMDs to participate in a distribution of securities offered under a prospectus **if a prospectus exemption could have been relied on**, this could provide EMDs with access to more products, thereby resulting in more robust and efficient portfolio construction for their clients. Moreover, this could better position EMDs *vis a vis* stocking their product shelf (per the pending heightened standard contemplated in the CSA Consultation Paper 33-404 (**CSA Advisor Enhancements Initiative**).

3. CRM2 Amendments

Question 4: The report does not extend to non-cash incentives that may be paid to the dealer or adviser and its representatives, such as promotions or other employment benefits, for sales of certain products. We are considering ways of making clients aware of these kinds of incentives. We invite specific comments on the potential usefulness of adding a new requirement that, where a firm or its representatives received or may receive incentives not captured by the existing provisions, the annual report must specifically list all additional sales incentives and must include prescribed text to the following effect: "In addition to the payments specified in this report, [the firm] or its representatives may also receive other sales incentives related to the securities that you have purchased through us. These incentives can influence representatives to recommend one investment over another".

Response 4: First, as a general matter, we believe this proposal is premature as it overlaps with (i) the subject matter of the CSA's mutual fund fees policy initiative that began with CSA Discussion Paper 81-407 Mutual Fund Fees and Request for Comment (**CSA Fund Fees Initiative**), and (ii) proposals set out in Appendix A of the CSA Advisor Enhancements Initiative relating to conflicts of interest and sales practices. Our view is that the more appropriate venue to consider reforms dealing with non-cash incentives is in the context of both of these policy projects.

Second, the CSA already have legislative tools to address certain non-cash incentives, such as National Instrument 81-105 *Mutual Fund Sales Practices*.

Third, assuming some general level of disclosure is required going forward, we suggest that the identification of each individual sales incentive is inadvisable given that level of detail may be confusing to clients or simply lead to lengthier disclosure that adds nothing over and above what more general disclosure would address.

Question 5: The report does not extend to the ongoing costs of owning securities with embedded fees paid to issuers, such as mutual fund management fees. We are considering ways of making clients more aware of such fees. We invite specific comment on the potential usefulness of adding a general notification in the annual report that would remind clients invested in mutual funds, or other securities with embedded fees about the following:

- management fees are paid to the issuer, whether or not the dealer or adviser receives any trailing commissions or other payments tied to those fees, and
- these fees may reduce the client's investment returns.

Response 5: First, this proposal also seems to overlap with the subject matter of the CSA Fund Fees Initiative and the CSA Advisor Enhancements Initiative. Our view is that the more appropriate venue to consider reforms dealing with embedded fees paid to issuers is in the context of both of these CSA initiatives.

Second, we understand that the CSA's Fund Facts initiative was meant, in part, to directly address this issue. For example, Item 1.1 under Part II of Form 81-101F3 includes prescribed disclosure as follows:

> "The following tables show the fees and expenses you could pay to buy, own and sell [name of the class/series of securities described in the fund facts document] [units/shares] of the fund. The fees and expenses – including any commissions – can vary among [classes/series] of a fund and among funds. Higher commissions can influence representatives to recommend one investment over another. Ask about other funds and investments that may be suitable for you at a lower cost."

We are unclear what value this additional relationship disclosure information will add over and above the Fund Facts requirements. Furthermore, if the CSA prefers additional or different disclosure than as set out in the Fund Facts requirements, our suggestion is to revise the Fund Facts requirements.

Third, we note that the proposed amendments to section 14.2 of 31-103CP (under the heading "Disclosure of charges and other compensation") states that disclosure regarding "all amounts a client might pay during the course of holding a particular investment, including management fees associated with mutual funds" is expected for compliance with paragraphs 14.2(f), (g) and (h). Again, as per the point above, similar disclosure in the annual report or the RDI requirements seems redundant in light of the Fund Facts prescribed disclosure (which applies to public funds) but also because of the proposed guidance relating to RDI disclosure requirements (which presumably would apply in respect of both public and private funds).

Additional Comments on CRM2 Amendments

- **Additional guidance or examples re: "frequent trader"**: We suggest the CSA provide additional guidance and/or examples of when a client would meet the meaning of "frequent trader" when used in section 14.2.1 of 31-103CP.

4. NI 33-109 Amendments

We laud the CSA's proposal to not require separate disclosure of reliance on an exemption in item 4.2 of Form 33-109F6 if the firm is already required to notify the regulator in accordance with the applicable exemption. This avoids redundancy and unnecessary administrative burden. We suggest this approach also be applied to streamline the information that must currently be inputted repeatedly into the system through various channels (e.g., updates to forms F4, F5 and F6.). Any of the undersigned would be happy to discuss this point with you in greater detail.

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We thank you for the opportunity to comment on the Proposed Amendments. Please do not hesitate to contact any of the undersigned should you have any questions or wish to discuss our comments further.

Sincerely,

AUM LAW PROFESSIONAL CORPORATION

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