The Impact of the Canadian Securities Administrators' Client Focused Reforms on International Sub-Advisers

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US and international firms relying on the international sub-adviser exemption under Canadian securities laws should be aware of the upcoming amendments to National Instrument 31-103 **(NI 31-103)** and its Companion Policy **(NI 31-103 CP)** (referred to collectively as the Client Focused Reforms or **CFRs**). Most international sub-advisers would have obligations under their sub-advisory agreements with a Canadian firm to comply with Canadian securities laws, which would include the new or enhanced CFR obligations. International sub-advisers and the Canadian firms engaging them should turn their minds to how the CFRs will impact them.

What is "Client Focused Reforms" and what is the deadline to comply?

The CFRs were adopted by the Canadian Securities Administrators **(CSA)** with the objective of improving the relationship between clients and registrants and to seek to ensure registered firms and individuals put the best interests of their clients first. The reforms enhance existing obligations and introduce new ones. The deadlines to comply with the conflicts of interest portion of the rules (including referral arrangements) was June 30, 2021 (Phase 1), while the deadline to comply with the rest of the CFRs is December 31, 2021 (Phase 2). The Phase 2 requirements include changes or enhancements to the rules on know your client **(KYC)**, know your product **(KYP)**, suitability, titles, relationship disclosure information, recordkeeping and training systems.

The aspects of the second phase of the CFRs most relevant to international sub-advisers (and the Canadian firms receiving sub-advisory services from them), are:

(1) **KYP**. The KYP obligations in the CFRs state that firms cannot make securities available unless they assess the relevant aspects of the securities, including their structures, features, risks, initial and ongoing costs, and the impact of those costs; approve the securities made available to clients; and monitor securities for significant changes. Similarly, individuals must understand the securities they recommend or trade and only buy or recommend securities approved by their firms. The most challenging of this aspect of the KYP rules is arguably the requirement to "monitor securities for significant changes" - for firms with hundreds, if not thousands, of securities available on their shelf, this can be an onerous and time-consuming exercise, and some firms are investing in technology to assist them with this exercise.

(2) **Suitability**. The CFRs enhance suitability obligations, which require that, for each trade or recommendation, a list of prescribed factors should be considered such as a client's KYC information, the advisor's understanding of the security, the impact of the action on the account including costs on the client's returns and what other alternatives are available, and the advisor must determine that the action is in the best interests of the client. There are now prescribed triggers for when a suitability determination is required (e.g., when there is a significant change in a security), and there are additional requirements for unsuitable client-directed trades. Note, the suitability obligations do not apply with respect to permitted clients[1] if: (a) the permitted client is not an individual, and the client has requested, in writing, that the registrant not make suitability determinations for the client's account; or (b) the client is an individual and the client has requested, in writing, that the registrant not make suitability determinations for the client's account, and the client's account is not a managed account.

1. See section 1.1. of NI 31-103 for the definition of "permitted client".

(3) **KYC.** There are also enhanced KYC requirements, which: expand the list of information firms must collect from clients, such as the client's risk profile; require clients to confirm the accuracy of KYC information; and prescribe minimum timelines for updating KYC information. As a result, sub-advisers have additional KYC factors to consider when making a suitability determination and might receive more frequent updates on KYC information.

(4) In addition, there are enhanced **recordkeeping** and **training** requirements. Firms are required to keep records that document and demonstrate compliance with the CFRs, and provide training on compliance with securities legislation including the CFRs.

Reviewing Sub-Adviser Practices

Some of the questions sub-advisers and the Canadian firms engaging them should be asking are, is the sub-adviser monitoring for significant changes in securities held by a fund or a mandate? How is the sub-adviser assessing the relevant aspects of the securities, including their structures, features, risks, initial and ongoing costs, and the impact of those costs? Does the sub-adviser have policies and procedures that explain what is considered a "significant change"? Does the sub-adviser have adequate records of its due diligence? Is the sub-adviser training the individuals picking stocks for the fund or mandate about these new requirements? Where applicable, is the sub-adviser's assessment of suitability including the new KYC components, such as risk profile, and is each trade or recommendation "in the best interests of the client"?

Canadian registrants should reach out to foreign sub-advisers to make sure they are aware of and intend to comply with the CFRs – especially since it is the Canadian registrant that takes responsibility for losses that arise out of certain failures of the sub-adviser. Canadian firms may consider updating compliance certificates requested from sub-advisers to include a reference to the CFRs, and should have conversations with sub-advisers to ensure they are comfortable with the sub-adviser's approach to compliance with the new rules.

Referral Arrangements

Another area of the CFRs that merits a discussion is referral arrangements. The new rules pertaining to referral arrangements, which is actually a watered-down version of what was proposed in earlier drafts of the CFRs, expand the definition of referral fee to mean any "benefit" – instead of "compensation" - provided for the referral of a client to or from a registrant. Therefore, the new rules on referral arrangements could capture situations where a Canadian registrant is not actually paying money to an RIA or other foreign firm for the referral of clients, but is nonetheless receiving a benefit. One possible example cited by the CSA is a mutual referral arrangement between two firms – this may be a form of benefit that may be captured by the expanded definition, which may not have been captured by the narrower definition of "referral fee" previously in force. Firms engaged in referral arrangements with RIAs or other foreign firms that did not involve monetary benefits should re-assess the arrangements to determine if the arrangements would now be captured by the rules on referral arrangements.

Firms should review the Client Focused Reforms in detail by visiting this website: Client Focused Reforms. If you are unclear as to how the CFRs might impact your firm or situation, or need assistance with implementing the new requirements, please feel free to contact Registrant Law. ■

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