

## CSA Staff Notice 31-347

### *Guidance for Portfolio Managers for Service Arrangements with IIROC Dealer Members*

November 17, 2016

#### **Introduction**

This Notice provides information and guidance to registered portfolio managers (**PMs**) that enter into service arrangements with dealer members (**DMs**) of the Investment Industry Regulatory Organization of Canada (**IIROC**). Under these Portfolio Manager – Dealer Member Service Arrangements (**PMDSAs**), a DM typically holds an investor’s cash and securities (**Investments**) in an account over which a PM has discretionary trading authority, and executes and settles the investor’s trades in the account based on instructions from the PM. The investor is thus a client of both the PM and the DM.

Since the PM and the DM have different roles and responsibilities to the shared client, they have different regulatory obligations to the client. However, each has a regulatory obligation to deliver statements of Investment positions and trades (**Statements**) to the shared client, as well as to maintain their own records of each client’s Investment positions and trades. Nonetheless, practices have developed whereby some PMs operating with PMDSAs look to the delivery of a Statement by a DM to satisfy the PM’s Statement delivery obligation, and rely on a DM’s records to satisfy the PM’s books and records obligation. These practices have raised some regulatory concerns.

#### **Substance and purpose**

Staff of the Canadian Securities Administrators (**CSA staff** or **we**) believe that PMDSAs can benefit investors, PMs and DMs, and may be maintained, so long as they are executed in a manner consistent with regulatory requirements. This Notice describes current PMDSAs and provides guidance from CSA staff about acceptable practices when PMs enter into these arrangements so they can comply with their obligations in National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations (NI 31-103)*, including when the only Statements delivered to the shared client come from the DM.

The guidance in this Notice replaces the interim guidance on PM client account statement practices developed by CSA staff that was published in section 4.3.3 of OSC Staff Notice 33-742 - *2013 OSC Annual Summary Report for Dealers, Advisers and Investment Fund Managers*. We encourage PMs to use the information and guidance in this Notice as a self-assessment tool to strengthen their compliance when they have PMDSAs.

### Key points on PMDSAs

- A PM must maintain its own records of its clients' Investment positions and trades, and may not rely on a DM's records as a substitute for its own records.
- We expect the PM and DM to have a written agreement on the PMDSA, which includes the key terms, and the roles and responsibilities of the PM and DM.
- We expect the PM to provide written disclosure to its clients on the PMDSA, which summarizes its purpose and material terms, including the key services provided, and key obligations owed by the PM and DM to the client.
- A PM that holds any Investments for a client must prepare and deliver its own Statements to the client.
- If all of the Investments that a PM is authorized to trade for a client are held by a DM, we are of the view that the PM may satisfy its Statement delivery obligations in NI 31-103 if the DM delivers a Statement to the shared client (covering the same Investment positions and trades) that is compliant with the requirements in IIROC Dealer Member Rules, provided that the PM takes the appropriate steps outlined in this Notice to verify that the DM's Statement is complete, accurate and delivered on a timely basis.

### Background on PMDSAs

Currently, there are many PMDSAs in place where a DM provides custody, trading and potentially other services to a PM and its clients, such as assistance with client reporting. For example:

- Some DMs have a line of business to service many PMs.
- A PM may have one or more PMDSAs.
- Some PMs have arrangements with one DM for efficiency and simplicity.
- Some PMs have arrangements with two or more DMs due to client choice, or business reasons such as competition for fees and service, addressing counterparty risk, and to benefit from different service offerings by DMs. In these cases, typically each client of a PM will use the services and be a client of only one DM.

Although PMDSAs may differ, they generally operate as follows:

- An investor enters into an investment management agreement with a PM to give the PM discretionary trading authority to manage their Investments held at a DM, and thus becomes a client of the PM. The PM also collects and documents the client's Know Your Client information so that it can make suitable investments.
- The PM facilitates their client's opening of one or more custodial/trading accounts at a DM by sending the DM's completed account-opening forms to the DM. Upon the DM's review and approval, the PM client also becomes a client of the DM.
- Each client's account at the DM is opened on a fully-disclosed basis where the DM acting as custodian holds the client's Investments in a separate account for the client and

knows the client's name and address. This allows the DM to directly send the client a Statement.

- The DM executes, clears and settles trades for the client in their account based on trading instructions from the PM. The DM does not make any trade recommendations to the client, and does not have suitability or annual account performance reporting obligations to the client; rather, these are obligations of the PM.

PMDSAs do not include service arrangements:

- that a PM (also registered as an investment fund manager) enters into with service providers for investment funds it manages, or
- with custodians that are not DMs.

In recent years, PMDSAs have become more widespread. They have also changed from PM client Investments typically being held at DMs on an omnibus basis to typically being held on a fully-disclosed basis. This has resulted in DMs maintaining records of Investment positions and trades for each PM client. Further, client Investments managed by a domestic PM that are held on a fully-disclosed basis at a DM are generally protected within specified limits by the Canadian Investor Protection Fund in the event of the bankruptcy of the DM.

We have identified a number of concerns (**Identified Concerns**) with PMDSAs, including:

- some PMs relying on the DM's records for their clients' Investment positions and trades instead of maintaining their own separate records;
- inadequate or inconsistent agreements between the PM and DM;
- inadequate or inconsistent disclosure to clients; and
- some PMs using the DM's preparation and delivery of Statements to their clients to meet their regulatory obligation to prepare and deliver their own Statements, without taking adequate steps to ensure the DM's Statements are complete and accurate.

## **Regulatory requirements**

PMDSAs are not governed by a specific regulatory framework, but there are a number of regulatory requirements that affect them. While not exhaustive, this section summarizes applicable provisions discussed in this Notice, with a focus on requirements for PMs.

### *Books and records*

Under section 11.5 [*general requirements for records*] of NI 31-103, registered firms must maintain records to accurately record their business activities, financial affairs, and client transactions, and demonstrate the firm's compliance with applicable securities legislation. These include records to:

- permit the identification and segregation of client cash, securities and other property
- identify all transactions conducted on behalf of the firm and each of its clients
- provide an audit trail for client instructions and orders and each trade transmitted or executed for a client
- permit the generation of account activity reports for clients, and
- document the opening of client accounts, including any agreements with clients.

### *Client statements*

Under section 14.14 [*account statements*] of NI 31-103, a PM that holds a client's cash or securities in an account for a client, or makes a transaction for a client during the reporting period, must deliver an account statement to the client at least quarterly (or monthly if applicable). The account statement must contain the information required by the instrument. Also, position cost information as outlined in section 14.14.2 of NI 31-103 must be provided to the client at least quarterly and may be included in the account statement or in a separate document.

Further, under section 14.14.1 [*additional statements*] of NI 31-103, a PM that has trading authority over a client's account in which their cash or securities are held or transacted (but does not hold the cash or securities) must deliver an additional statement to the client at least quarterly (or monthly if applicable). The additional statement must contain the information required by the instrument. Also, position cost information as outlined in section 14.14.2 of NI 31-103 must be provided to the client at least quarterly and may be included in the additional statement or in a separate document.

Please refer to NI 31-103 and its Companion Policy for further information on client statements.

Meanwhile, DMs are subject to client statement requirements for their clients under IIROC Dealer Member Rules, which are materially harmonized with the client statement requirements in NI 31-103. IIROC Dealer Member Rule 200 *Minimum Records* covers client account statements in section 200.2(d). IIROC Dealer Member Rules require position cost information to be included in the client account statements at least quarterly.

The Investment positions, trades and other information that are to be included on account statements and additional statements are to be reported separately for each account of the client. The Statements required by NI 31-103 may not be reported on a consolidated basis where information from two or more separate accounts are combined together into a single summary statement as if they were one account or portfolio (**Consolidated Statement**). Of course, Statements for more than one account may be delivered together in one document or package. However, where appropriate, PMs may provide Consolidated Statements to clients in addition to Statements for each of their accounts. For example, it may be appropriate to do this when the client requests this information or consents to this practice, and it helps the client to better understand their overall investment portfolio. In addition, adequate disclosure should be provided with the Consolidated Statement. For example, a heading stating that it is a "consolidated" or "summary" Statement can be used, together with an explanation of the information being presented, and which accounts are included.

Under most PMDSAs, a PM does not hold any of its clients' cash or securities. Instead, the PM clients' cash and securities are held by a DM in accounts over which the PM has trading authority. In these cases, a PM is to prepare and deliver a Statement to each of its clients which includes a list of cash and securities that are held by the DM (under section 14.14.1) and the transactions (including purchases and sales of securities) the PM made for the client (under section 14.14). Thus, the Statement that is to be issued by the PM is a hybrid of an additional statement (for reporting the client's Investment positions held at the DM) and an account

statement (for reporting transactions the PM made for the client, such as trade orders they placed with the DM). In the rest of this Notice, we refer to this Statement as a “**PM Statement**”. Meanwhile, the DM must also send a Statement to the same investor, as they are also a client of the DM. The DM is to prepare and deliver an account statement which must include prescribed information about the cash and securities they hold for the client and the transactions they made for the client (under IIROC Dealer Member Rule 200, section 200.2(d)). In the rest of this Notice, we refer to this Statement as a “**DM Statement**”.

We believe investors served under a PMDSA can benefit by receiving both a PM Statement and a DM Statement, since it can be helpful to reconcile the two and in so doing, confirm the content and status of the Investments in their portfolio. A single Statement prepared and delivered jointly on behalf of both the PM and the DM under both firms’ names is not an option because of investor protection fund concerns with a “joint” Statement. We are not aware of any firms operating with PMDSAs that follow this practice. As noted above, we are aware of the common practice of PMs operating under PMDSAs to look to the delivery of the DM Statement to also satisfy the PM Statement obligation. We believe that this can be an acceptable practice if the PM takes the appropriate steps outlined in section 5 below titled *How a PM may satisfy its PM Statement obligation to a client when the DM prepares and delivers a DM Statement to the client*.

In the rest of this Notice, we provide information and our guidance on PMDSAs to:

- address the Identified Concerns,
- add consistency and clarity, and
- assist PMs in satisfying the applicable regulatory requirements.

## **Requirements and CSA staff’s expectations for PMDSAs**

### **1. PM must maintain its own records of its clients’ Investment positions and trades**

Some PMs operating with a PMDSA do not maintain their own books and records for their clients’ Investment positions and trades and instead rely entirely on a DM’s records (which they have online, read-only access to) as a substitute for the PM maintaining its own books and records.

As indicated above, this is not an acceptable practice. Under section 11.5 of NI 31-103, a PM must maintain books and records to accurately record its clients’ cash, securities and other property, and transactions conducted for each of its clients. Although it may outsource elements of the compilation of books and records to an agent, a PM is responsible to verify the completeness and accuracy of the information and maintain it in an accessible form. Further, a PM may not outsource its books and records maintenance to a DM that acts as custodian for its clients because to do so would effectively create an introducing broker – carrying broker arrangement. Under IIROC Dealer Member Rule 35 *Introducing Broker / Carrying Broker Arrangements*, this is only permitted between two DMs and not between a PM and a DM.

As part of maintaining its own books and records of its clients’ Investment positions and trades, a PM may use information provided from market participants and service providers, including

DMs, financial institution custodians and financial information vendors, provided that the PM takes active steps to ensure that the information is complete and accurate. This should be accomplished, in the case of information on clients' Investment positions and trades, by the PM reviewing and reconciling the information against its other records, such as clients' trade orders and trade confirmations, and by making reconciling adjustments when differences are identified. For example, if the PM's and DM's records for a shared client's Investment positions or trades differ, the PM should research the difference, determine if an adjusting entry is needed, and if so, either make an adjustment to the PM's records or notify the DM so they may adjust their records. It is not an acceptable practice for a PM to simply download or copy information from a DM's or other party's system to its own books and records system, as the PM is responsible for ensuring that its records are complete and accurate.

Note that where a PM makes use of information from DMs or other parties in producing PM Statements or other client disclosure documents, the PM may not include disclaimers as to the completeness or accuracy of the information in the Statement or other disclosure document. The PM is solely responsible for the content of the documents it is required to deliver to clients under NI 31-103.

## **2. PM to have agreement with DM**

We expect all PMs that enter into PMDSAs to have an executed, written agreement with their DM counterparts, as is generally done already. This is consistent with the obligation in section 11.5 of NI 31-103 for a registered firm to maintain records to accurately record its business activities, and with expectations in Part 11 of the Companion Policy to NI 31-103 to have written, legally binding contracts with service providers.

At a minimum, we expect the key terms of the PMDSA to be included in the agreement, along with the roles and responsibilities of the PM and DM under the arrangement. Particularly when signing a standard form agreement with a DM, a PM should ensure that the terms and representations are applicable and accurately describe the arrangement and each party's roles and responsibilities under their specific circumstances.

## **3. PM to provide disclosure to clients**

We expect PMs to prepare and provide each of their clients served under a PMDSA with written disclosure that clearly and concisely explains the arrangement. The disclosure should include:

- the purpose and material terms of the PMDSA,
- the key services provided by the PM and DM to the client, and
- the key obligations owed by the PM and DM to the client.

The PMDSA disclosure is an extension of a PM's obligation in section 14.2 of NI 31-103 to provide relationship disclosure information (**RDI**) to its clients, including a description of:

- the products and services offered to clients, and
- the content and frequency of reporting for each account or portfolio of a client.

Providing this disclosure will help investors to understand who is responsible for each activity or service.

In cases where a PM does not deliver a PM Statement to a client when the client receives a DM Statement (and the PM takes the appropriate steps in this Notice), we expect the PM to inform the client of this practice as part of the PMDSA disclosure to the client. The disclosure should also:

- state that both the PM and DM are responsible for ensuring the information in the client's DM Statement is complete and accurate, and
- provide details for contacting the PM if the client has any questions about information in the DM Statement.

We expect the disclosure to be drafted so that clients receive consistent, complete and accurate information from their PM. If a PM has two or more PMDSAs, we expect the disclosure to be tailored to each arrangement. Also, to avoid investors having to locate and review information from multiple documents, and to help them better understand the PMDSA, we suggest that the PMDSA disclosure be summarized in one document that is provided separately or as part of other RDI.

The disclosure is to be provided to each client before the PM-client relationship begins. When there are any material changes to the PMDSA, we expect the PM to revise the disclosure and notify the client in a timely manner of the changes.

CSA staff have not previously published an indication of our expectation that PMs should provide a client with a summary disclosure of a PMDSA that applies to their account. For clients that are already served under existing PMDSAs, we expect that PMs will take steps to provide this disclosure to their clients in a timely manner (for example within one year of the publication date of this Notice), either separately or as part of another communication to clients.

#### **4. PM must deliver account statements to a client if they hold any of the client's Investments**

Typically, most PMs do not hold any of their clients' Investments. PM client Investments are generally held at a separate entity that provides custodian services, including DMs. However, some PMs hold client Investments, such as cash in a trust account, or share certificates for investments in private companies. A PMDSA will not be applicable to such cases, although there might also be other assets of the same client that are held in an account with a DM that are subject to a PMDSA.

When a PM holds client Investments, it must only do so in accordance with the applicable custody requirements under securities legislation.

Further, a PM that holds client Investments is required under section 14.14 of NI 31-103 to prepare and deliver an account statement to the client at least quarterly (monthly, if requested by the client), which includes information on the Investments held, and transactions made for the

client. Section 14.14(7) of NI 31-103 explains when a security is considered to be held by a PM for a client.

**5. How a PM may satisfy its PM Statement obligation to a client when the DM prepares and delivers a DM Statement to the client**

Many PMs operating with PMDSAs currently issue a PM Statement to their clients, in addition to a DM Statement issued by the DM acting as the client’s custodian. This allows the client to reconcile the two Statements and in so doing, confirm the content and status of their Investments. However, as noted above, some PMs do not issue a PM Statement to their clients. It can be argued that this practice avoids unnecessary duplication, since the client receives a DM Statement that typically contains the same information as the PM Statement would when the PM does not hold any of the client’s Investments. Nonetheless, the PM is responsible for the timely delivery to each of its clients of complete and accurate information about the Investments that the PM is authorized to trade on behalf of the client. It is therefore essential that a PM adequately discharges that responsibility, regardless of whether it delivers PM Statements (in addition to DM Statements) or the client only receives a DM Statement.

The ways that PMs can meet their PM Statement obligations under a PMDSA include:

i)	PMs may continue (or start a practice) to issue a PM Statement to their clients when the DM issues a DM Statement to the client. Under this option, a PM Statement is to be prepared and delivered for each of the client’s custody/trading accounts at the DM in which the PM has trading authority over, that includes all of the information required by sections 14.14, 14.14.1 and 14.14.2 of NI 31-103;
ii)	PMs may decide to stop issuing (or continue a current practice of not issuing) a PM Statement when the DM issues a DM Statement by taking the appropriate steps below; or
iii)	PMs may continue (or start a practice) to issue, where appropriate, a Consolidated Statement to their clients (but not also a PM Statement for each DM account the PM has trading authority over) when the DM issues a DM Statement by taking the appropriate steps below.

If a PM does not issue a PM Statement for each of its clients’ DM accounts that it has trading authority over, we expect the PM to take appropriate steps to verify that the client receives complete, accurate and timely account reporting from the DM that meets all applicable regulatory requirements, as explained below.

In CSA staff’s view, a PM operating with a PMDSA can satisfy its PM Statement obligation to a client when that client’s DM acting as custodian sends a DM Statement to the client (for each of the client’s accounts at the DM), provided that the PM takes all of the following steps, which, taken together, we consider to be appropriate for the PM to meet its related regulatory responsibilities:



	Appropriate steps for PM to take if not preparing and delivering PM Statements
a)	<p>The PM ensures that it does not hold any of the Investments it manages for the client, and verifies that the client's Investments it manages (and has trading authority over) are held at a DM on a fully-disclosed basis for the client (i.e., in a separate account for the client where the DM knows the name and address of the client).</p> <p>If a PM holds any of the client's Investments, or has trading authority over any of the client's Investments that are not held in the client's account at a DM, then the PM may not rely on the DM Statement to satisfy its Statement delivery obligations in NI 31-103 for that client. In this case, the PM is to issue its own Statements covering all of the client's Investments that it holds or has trading authority over.</p>
b)	<p>The PM confirms that, for each of the client's accounts at the DM, a DM Statement is delivered to the client by the DM at the required frequency, and with the required content. This may be done, for example, by the PM receiving a copy of the DM Statement or testing the preparation and delivery practices of the DM.</p> <p>Note that we would not consider a DM to have delivered a Statement to a client if the DM Statement was provided first to the PM for the PM to then send on to the client.</p>
c)	<p>The PM takes reasonable steps to verify that the content (such as transaction and Investment position information, including position cost and market values) of the DM Statements issued to its clients are complete and accurate, including by regularly reconciling its books and records of client Investment positions and trades against the DM's records, and maintaining evidence of the reconciliations.</p>
d)	<p>The PM includes in its written disclosure to the client on the PMDSA:</p> <ul style="list-style-type: none"> <li>• a statement indicating that the PM does not deliver PM Statements to the client since the client receives a DM Statement;</li> <li>• a statement that both the PM and DM are responsible for ensuring the information in the DM Statement is complete and accurate; and</li> <li>• details for contacting the PM if the client has any questions about information in the DM Statement.</li> </ul>
e)	<p>The PM ensures that it complies with any existing or future client requests or agreements to receive PM Statements from the PM, supplemental to a DM Statement from the DM.</p>
f)	<p>The PM ensures that the market value data it uses in the preparation of the client's annual investment performance report under section 14.18 of NI 31-103 is the same as the data presented in the relevant DM Statements delivered to the client.</p>

If a PM does not take all of the appropriate steps a) to f) enumerated above when it does not prepare and deliver its own PM Statements, then CSA staff would take the view that the PM is inappropriately relying on the delivery of DM Statements to satisfy its own obligation to deliver PM Statements.

If a PM decides to satisfy its PM Statement obligation by taking the above appropriate steps, we would expect the PM to establish reasonable written policies and procedures for ensuring that it takes those steps (initially and on a periodic basis) and adequately documents their execution, so that it can demonstrate to CSA staff how it is meeting its obligation.

### **Other PM client reporting obligations**

The discussion above applies to PMs for their PM Statement obligations when they have entered into a PMDSA. It does not deal with a PM's obligations under sections 14.17 and 14.18 of NI 31-103 to issue to its clients an annual report on charges and other compensation and an annual investment performance report, which came into effect on July 15, 2016. These reports should be issued by PMs under the PM firm's name.

A DM operating with a PMDSA will not be required to provide an investment performance report in respect of the securities subject to the PMDSA. Paragraph 14.18(5)(b) of NI 31-103 provides an exemption from the investment performance report delivery requirement where a DM only executes trades directed by a PM. A DM operating with a PMDSA may be required to provide a report on charges and other compensation to the client, depending on how the DM is compensated for its services under the PMDSA.

In any event, to discharge their RDI obligations, we expect both the PM and DM to take reasonable steps to ensure that the client understands the compensation arrangements associated with the PMDSA as it relates to their account. PMs and DMs may also find it helpful to include explanatory notes or reminders in reports on charges and other compensation, if they are concerned that disclosure of payments relating to a PMDSA has the potential to be confusing to a client.

### **Next steps**

Through ongoing compliance reviews of PMs, CSA staff will continue to review PMDSAs, including books and records, client statement practices, agreements and disclosure. CSA staff will apply the information and guidance in this Notice when assessing compliance by PMs with their obligations in NI 31-103.

## Questions

Please refer your questions to any of the following:

Trevor Walz  
Senior Accountant  
Compliance and Registrant Regulation  
Ontario Securities Commission  
416-593-3670  
twalz@osc.gov.on.ca

Edwin Leong  
Senior Compliance Analyst  
British Columbia Securities Commission  
604-899-6682 and 1-800-373-6393  
eleong@bcsc.bc.ca

Paula White  
Deputy Director, Compliance and Oversight  
The Manitoba Securities Commission  
204-945-5195 and 1-800-655-5244 (Toll Free (Manitoba only))  
paula.white@gov.mb.ca

To-Linh Huynh  
Senior Analyst, Securities  
Financial and Consumer Services Commission (New Brunswick)  
506-643-7856  
to-linh.huynh@fcnb.ca

Éric Jacob  
Directeur des services d'inspection  
Autorité des marchés financiers  
514-395-0337, extension 4741  
eric.jacob@lautorite.qc.ca

Curtis Brezinski  
Compliance Auditor, Capital Markets  
Securities Division  
Financial and Consumer Affairs Authority of Saskatchewan  
306-787-5876  
curtis.brezinski@gov.sk.ca

Chris Pottie  
Manager, Compliance and SRO Oversight  
Nova Scotia Securities Commission  
902-424-5393  
chris.pottie@novascotia.ca

Reid Høglund  
Regulatory Analyst  
Alberta Securities Commission  
403-297-2991  
reid.hoglund@asc.ca

Craig Whalen  
Manager of Licensing, Registration and Compliance  
Office of the Superintendent of Securities  
Newfoundland and Labrador  
709-729-5661  
cwhalen@gov.nl.ca

Tom Hall  
Superintendent of Securities  
Office of the Superintendent of Securities, Northwest Territories  
867-767-9305  
tom\_hall@gov.nt.ca

Rhonda Horte  
Securities Officer  
Office of the Yukon Superintendent of Securities  
867-667-5466  
rhonda.horte@gov.yk.ca

Steven Dowling  
Acting Director  
Government of Prince Edward Island  
Superintendent of Securities  
902-368-4551  
sddowling@gov.pe.ca

Jeff Mason  
Superintendent of Securities  
Department of Justice, Government of Nunavut  
867-975-6591  
jmason@gov.nu.ca