Annex B

Summary of comments on the July 2016 Proposal and responses

This annex summarizes the written public comments we received on the July 2016 Proposal and our responses to those comments.

This annex contains the following sections:

1. Introduction
2. Responses to comments received on the Custody Amendments
3. Responses to comments received on the Exempt Market Dealer Amendments
4. Responses to comments received on the Client Relationship Model Phase 2 Amendments
5. Responses to comments received on the Housekeeping Amendments

Please refer to Annex A *Summary of changes to the Instrument* for details of the changes we made in response to comments.

1. INTRODUCTION

Drafting suggestions

We received a number of drafting suggestions and comments. While we incorporated many of these suggestions, this summary does not include a detailed list of all the drafting changes we made.

Categories of comments and single response

In this annex, we consolidated and summarized the comments and our responses by the general theme of the comments. We have included section references for convenience.

2. RESPONSES TO COMMENTS RECEIVED ON THE CUSTODY AMENDMENTS

General

Overall, commenters were supportive of enhancing custody requirements for Non-SRO Firms to strengthen the Canadian client asset protection regime. Two commenters specifically commended the CSA for proposing a tailored solution for our Canadian market on this matter.

One commenter thought that registered firms should not be responsible for monitoring the actions and effectiveness of custodians, beyond ensuring compliance with the Custody Amendments. The commenter suggested that the CSA co-ordinate with other regulators such as the Office of the Superintendent of Financial Institutions to ensure that custodians are regulated and monitored appropriately.

The CSA does not expect registered firms to supervise the actions and effectiveness of custodians beyond their obligations under NI 31-103.

One commenter asked why the CSA feels that there is no adequate protection when firms that hold or have access to client assets are already subject to a higher insurance coverage requirement.

NI 31-103 requires registered firms to maintain certain coverage under a financial institution bond or insurance which insures the registered firm against losses under certain situations. However, the bonding or insurance does not insure the firm's clients or investment funds managed by the firm, and does not protect these clients or funds directly against the loss of assets resulting from inappropriate custodial arrangements.

Custody Amendments are different from the custodial requirements under NI 81-102

Some commenters asked for insight as to why the CSA chose to develop custodial provisions for registered firms that are different from those found under NI 81-102. One commenter believes that custodial provisions for prospectus-qualified investment funds should apply to all investment funds.

NI 81-102 sets out the operating requirements and a specific regulatory regime for prospectus-qualified investment funds, while NI 31-103 sets out the obligations of registered firms. Registered firms have a different level of involvement in their clients' custodial arrangements, depending on their registration category and business activities. The CSA is of the view that it is more appropriate to develop custodial provisions that are tailored to the business models and regulatory framework applicable to registered firms. Therefore, the CSA examined the NI 81-102 custodial provisions and adapted them accordingly as prospectus-

exempt investment funds have historically been subject to a different regulatory regime, including custodial requirements and practices, when compared to prospectus-qualified investment funds. Imposing the same custodial requirements found in NI 81-102 on prospectus-exempt investment funds would, for instance, have limited the ability of these funds to use the range of IIROC member firms they use as custodians today.

The CSA developed the Custody Amendments in order to codify existing custodial best practices applicable to registered firms and enhance investor protection without causing major disruption to these registered firms. We believe that our approach achieves the desired regulatory outcome and provides necessary flexibility to various existing business models and regulatory frameworks.

Definition of "foreign custodian"

Two commenters suggested that we broaden the definition of "foreign custodian" to include the foreign equivalent of a Canadian investment dealer because certain client or fund assets are currently custodied at foreign dealers that do not meet the definition of "foreign custodian". One commenter also suggested that we lower the minimum equity threshold requirement for affiliates of a foreign banking institution or trust company under paragraph (b) of the definition of "foreign custodian" from $100 million to $10 million, similar to the condition specified under paragraph (b) of the definition of "Canadian custodian".

In respect of the current custodial practices of our registered firms, we understand that only a small number of clients or investment funds are currently using a foreign dealer to hold their assets, and these foreign dealers are primarily large and reputable dealers that are affiliated with a large foreign or Canadian financial institution. We expect that these foreign dealers will meet the definition of "foreign custodian", and do not foresee a significant impact to the existing custodial arrangements of our registered firms' clients or investment funds.

Limitation on the use of a "foreign custodian"

The Custody Amendments only allow for the use of a "foreign custodian" where a reasonable person would conclude that using the "foreign custodian" is more beneficial to the client or investment fund than using a "Canadian custodian". We received comments suggesting that the "reasonable person" test is not necessary because custodial provisions in other areas of securities legislation (for instance, NI 81-102) do not employ a "reasonable person" test when providing for the use of a foreign custodian to hold assets. Two commenters submitted that it should be sufficient to have prescribed requirements to use a qualified foreign custodian without the "reasonable person" test to be consistent with the approach in NI 81-102. One commenter also suggested that there should not be any restriction on holding cash directly through a qualified "foreign custodian".

The Custody Amendments do not intend to replicate the custodial requirements in other areas of securities legislation, including NI 81-102. There are key differences, based on our policy objectives, between the Custody Amendments and the custodial framework under NI 81-102. For example, NI 81-102 requires that, except in very limited circumstances, portfolio assets of prospectus-qualified investment funds be held with a single Canadian custodian and cannot be held with a foreign custodian directly. Prospectus-qualified investment funds can only use foreign sub-custodians under the custodianship of a single Canadian custodian. To meet our policy objectives, we did not propose a requirement to use a single Canadian custodian and we allow for the use of a foreign custodian to directly hold assets of a client or investment fund of a registered firm. However, we recognize that there may be additional risks when a foreign custodian holds assets instead of a Canadian custodian. For instance, there may be difficulties in gaining legal title and repatriating assets from overseas in the event of an insolvency of the foreign custodian. As such, we are of the view that the "reasonable person" test for the use of a foreign custodian to hold cash or securities is necessary under our proposal in order to meet our policy objectives of enhancing client asset protection while codifying existing custodial best practices. Under the "reasonable person" test, we expect registered firms to assess the risks and benefits of using a foreign custodian against the risks and benefits of using a Canadian custodian and determine if using a foreign custodian is more beneficial for the client than using a Canadian custodian.

One commenter pointed out that registered firms' obligations under Part 11 of NI 31-103 and 31-103CP in dealing with third party service providers would apply equally in the context of selecting a qualified "foreign custodian". We agree that registered firms are subject to a standard of care and obligations under Part 11 and 31-103CP when dealing with third party service providers. However, these standards do not specifically require registered firms to consider if their client or investment fund may be better served by using a Canadian custodian instead of a foreign custodian.

One commenter asked for clarity about the statement in section 14.5.2 of 31-103CP: "Where a foreign custodian is used, we will assess this practice on a case-by case basis". In overseeing registered firms' compliance, CSA staff will assess the use of a foreign custodian on a case-by-case basis by determining whether a reasonable person would conclude that the use of the foreign custodian is more beneficial to the client or investment fund than using a Canadian custodian. CSA staff will make this determination by, among other things, reviewing the risks and benefits considered by the registered firm as well as any risks and benefits associated with using that custodian.

Permitted custodial practices for certain transactions under NI 81-102

Two commenters requested clarification as to whether custodial practices for certain derivative and short sales transactions as permitted under sections 6.8 and 6.8.1 of NI 81-102, and the use of depositories as permitted under subsection 6.5(3) of NI 81-102, are allowed under the Custody Amendments.

It is our intent to allow for custodial practices similar to those permitted under sections 6.8 and 6.8.1 of NI 81-102, and subsection 6.5(3) of NI 81-102 in our Custody Amendments. Including similar provisions in NI 31-103 reflects our policy objective of codifying existing custodial best practices. We revised the Custody Amendments to reflect our intent.

Implication on non-resident clients of non-resident registered firms

Two commenters suggested that non-resident clients of non-resident registered firms be exempted from the Custody Amendments given the absence of any real nexus to Canada other than the firm's registration, and the possibility of disruption to existing custodial arrangements. The commenters are concerned that certain aspects of the Custody Amendments may be too onerous for non-resident registered firms with respect to their non-resident clients.

Registered firms with a head office outside of a jurisdiction of Canada were historically subject to custodial requirements under section 14.7 of NI 31-103 (which we are now repealing). Section 14.7 requires these firms to hold client assets in the client's name, or at a custodian or sub-custodian that meets certain criteria, similar to the criteria outlined in the definition of "qualified custodian" under the Custody Amendments. Section 14.7 applies to assets of all clients of non-resident registered firms, regardless of whether the client was Canadian or not. Therefore, it is our view that the Custody Amendments do not create substantial new requirements for non-resident registered firms and we do not expect major disruptions to existing custodial arrangements of clients of non-resident registered firms.

The CSA recognizes that, under the Custody Amendments, non-resident registered firms will be subject to certain new disclosure requirements regarding where and how client assets are held or accessed and the rationale for using a foreign custodian. At the same time, the CSA are mindful of the potential adverse consequences to clients of non-resident registered firms if these clients are placed in an inappropriate custodial arrangement. Currently, we are not aware of any specific examples where compliance with the new requirements will create a significant issue for non-resident registered firms. Therefore, we do not recommend adding an exemption for non-resident clients of non-registered firms, but we will consider granting exemptive relief on a case-by-case basis.

Interpretation on "holding or having access" to client cash or securities, and on "directing or arranging" the custodial arrangement

One commenter asked for further guidance on when a registered firm is deemed to "hold" the cash and securities of clients or investment funds, specifically when firms are registered owners of securities as nominees on behalf of a client.

The CSA is of the view that the existing guidance under section 14.5.2 of 31-103CP is sufficiently clear. We also believe that subsection 14.14(7) of NI 31-103 is useful in respect of this comment. Under subsection 14.14(7), a security is considered to be held by a registered firm for a client if the firm is the registered owner of the security as nominee on behalf of a client.

One commenter asked if the guidance on "holding or accessing client assets" in the context of insurance requirements for advisers under section 12.4 of 31-103CP serves as general guidance on "holding or accessing client assets" in other contexts. There was also a question as to whether having "view-only" authority on a client's broker account would be considered as "having access" to client assets.

The CSA expects all registered firms to consider the examples listed in section 12.4 of 31-103CP in determining whether they hold or have access to client assets for the purposes of Division 3 of Part 14. If a registered firm has "view-only" authority on a client's broker or custodial account without the ability to withdraw or transfer funds from the account, the CSA generally does not consider this circumstance to constitute "having access" to client assets.

Two commenters asked for clarity as to whether referring clients to a specific custodian would trip the "directing or arranging custodial arrangement" trigger.

When a registered firm refers its clients to a specific custodian or provides its clients with a list of custodians to choose from, the CSA generally considers these actions to constitute "directing or arranging" which custodian will hold the cash or securities of its clients. The Custody Amendments, which include the new relationship disclosure requirements relating to custody, will apply.

Restriction on self-custody

One commenter asked for more insight on the restriction on self-custody.

When a registered firm also acts as the custodian or sub-custodian for its clients or investment funds ("self-custody"), there is heightened custodial risk if the firm does not have the proper controls and supervision in place, including segregation of duties to mitigate such risk. Therefore, the CSA is restricting "self-custody" practices to certain "Canadian custodians" provided that they

have established and maintain a system of controls and supervision that a reasonable person would conclude is sufficient to manage the custodial risk.

Interpretation on "functionally independent" custodian

Two commenters suggested that more clarity on the concept of "functionally independent" custodian would be helpful in providing comfort that certain existing arrangements will not be found to violate the requirement.

Under the heading "Prohibition on self-custody and the use of a custodian that is not functionally independent" of section 14.5.2 of 31-103CP, we reference section 12.4 of 31-103CP. Section 12.4 of 31-103CP discusses situations where a registered firm will be considered to have access to client assets through the use of a non-functionally independent custodian. The CSA is of the view that the current guidance is sufficient.

One commenter thought that there was an inconsistency in the requirement for a functionally independent custodian between client securities and client cash. Subsection 14.5.2(6) states that a Canadian financial institution that is the custodian of cash of the client or investment fund must be functionally independent of the registered firm. However, subsection 14.5.2(5) exempts a qualified custodian of cash and securities from the functional independence requirement if the custodian meets certain requirements.

The CSA confirms that there is no inconsistency in the requirement for a functionally independent custodian between client securities and client cash. For instance, a bank or trust company that is not functionally independent of the registered firm, but meets the requirements under paragraphs (a) and (b) of subsection 14.5.2(5), can hold both client securities and client cash as permitted under subsection 14.5.2(2). Subsections 14.5.2(4) and 14.5.2(6) are designed to allow a Canadian financial institution that does not meet the definition of a "Canadian custodian" to hold client cash provided that it is functionally independent of the registered firm.

Interpretation on "systems of controls and supervision" requirement

One commenter asked for clarity on the scope and nature of the requirement to have a system of controls and supervision in order to "self-custody" under subsection 14.5.2(1) or use a qualified custodian that is not functionally independent under subsection 14.5.2(5).

Under the heading "Prohibition on self-custody and the use of a custodian that is not functionally independent" of section 14.5.2 of 31-103CP, the CSA stated that we would consider a system of controls and supervision for the purposes of paragraphs 14.5.2(1)(b) and 14.5.2(5)(b) to include:

- segregation of duties between the custodial function and other functions
- client asset verification examination performed by a third party

In our view, the wording of paragraph 14.5.2(5)(b) is sufficiently clear; i.e., the qualified custodian needs to establish and maintain the "system of controls and supervision" that a reasonable person would conclude is sufficient to manage risks associated with the custody of client assets.

The same commenter also suggested that we 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 and the Canadian equivalent, the CSAE 3416, will meet the standard expected by the CSA in respect of a third party verification.

The CSA does not object to the use of the above-mentioned third party examinations when a registered firm is considering whether a qualified custodian has established and maintains a system of controls and supervision that a reasonable person would conclude is sufficient to manage custodial risks to the client or investment fund for the purposes of paragraphs 14.5.2(1)(b) and 14.5.2(5)(b).

Use of multiple custodians

One commenter noted that the wording "the custodian" under subsection 14.5.2(2) seems to suggest that a single custodian must be used.

The CSA does not intend to prohibit the use of multiple custodians in the Custody Amendments. We amended subsection 14.5.2(2) to clarify our intent.

Use of sub-custodians

One commenter suggested that we explicitly address the requirements for using sub-custodians in the Custody Amendments.

The CSA recognizes that registered firms are typically not a party to the custodial agreement between their clients and the custodian selected by the client to hold their assets. We believe that it would be too onerous for registered firms to impose

requirements on custodians regarding the use of sub-custodians because most firms do not have the contractual power to control or influence the custodian's use of sub-custodians. We have set out our expectations on the use of sub-custodians under the heading "Custodial Arrangements" in section 14.5.2 of 31-103CP.

Holding non-traditional assets

One commenter suggested that we set out the types of assets that will be exempt from the restriction on self-custody and the qualified custodian requirements, given that custodians have been reluctant to hold unique assets in some instances.

The Custody Amendments are primarily applicable to cash and securities of clients and investment funds. Assets other than cash and securities are not subject to the restriction on self-custody and the qualified custodian requirements. Section 14.6 will still apply in these circumstances. In addition, under the heading "general prudent custodial practices" in section 14.5.2 of 31-103CP, we set out our expectations for assets other than cash and securities.

Carve out for securities recorded in client name on issuer's books

One commenter asked for the reasons for the carve-out for securities recorded only in the name of the client or investment fund under paragraph 14.5.2(7)(c) of NI 31-103.

One of the policy objectives of the Custody Amendments is to mitigate intermediary risks when Non-SRO Firms are involved in the custody chain. When a security is recorded only in the name of the client or the investment fund on the books of the security's issuer or the transfer agent of the security's issuer, custody risk posed by intermediaries is largely reduced, and therefore the CSA does not think that it is necessary to impose the new custody requirements under these circumstances.

However, if a registered firm determines that it is prudent for a custodian to record a security on book-basis, a custodian should be used and this exemption does not suggest otherwise.

Carve out for certain mortgages

One commenter asked us to clarify that the exemption under paragraph 14.5.2(7)(f) of NI 31-103 for certain mortgages is meant to reflect current industry practices.

It is our understanding that the situations described under paragraph 14.5.2(7)(f) reflect current industry practices for holding mortgages. However, if a registered firm determines that it is prudent to have a custodian record any mortgages on book-basis, a custodian should be used and this exemption does not suggest otherwise.

Use of omnibus accounts

One commenter asked for clarity as to whether section 14.5.3 of NI 31-103 would preclude registered firms who hold client assets at a qualified custodian from continuing to use omnibus accounts to hold client assets on an aggregated basis.

Under paragraph 14.5.3(c), registered firms can continue to hold client cash and securities in omnibus accounts on behalf of clients on an aggregated basis, but only on a temporary basis to facilitate bulk trading. Client cash and securities must be transferred to the applicable client's or investment fund's own custodial account as soon as possible following the trades.

The CSA understands that it is uncommon for registered firms to use omnibus accounts other than for bulk trading purposes, therefore we do not foresee a major transition issue.

Holding client assets and investment fund assets in trust

One commenter asked for an explanation on how the new section 14.5.3 interplays with the revised section 14.6. One commenter suggested that the requirement under subsection 14.6(2) should be moved to section 14.5.2 from section 14.6.

The new section 14.5.3 requires registered firms subject to subsections 14.5.2(2), (3) or (4) to ensure that cash and securities of clients and investment funds are held in a particular manner by a qualified custodian or Canadian financial institution, as applicable. Paragraph 14.5.3(a) requires that cash and securities of a client or an investment fund be recorded by the qualified custodian or, with respect to cash, the Canadian financial institution to show that the beneficial ownership is vested in that client or investment fund. Paragraph 14.5.3(b) seeks to preserve the status quo with respect to cash held by a registered firm in a designated trust account in trust for clients or investment funds as was historically permitted under section 14.6 as it appeared prior to the Custody Amendments. To facilitate bulk trading, paragraph 14.5.3(c) permits the use of omnibus accounts to hold cash and securities of clients and investment funds, but only on a temporary basis such that the cash and securities are transferred to the client's or investment fund's own custodial account as soon as possible following the trade.

In situations where the new custody requirements under sections 14.5.2 and 14.5.3 do not apply, revised section 14.6 maintains the minimum client asset protection standards of segregation and holding client and investment fund assets in trust for the client or investment fund. For instance, sections 14.5.2 and 14.5.3 do not apply to client assets that are not cash or securities, or when one of the exemptions under subsection 14.5.2(7) is relied upon. Revised section 14.6 will still be applicable in those situations in order to preserve our previously existing client asset safeguards. Subsection 14.6(2) seeks to achieve consistency with the

approach taken under section 14.5.2 in allowing for the use of a foreign custodian for cash only when it is more beneficial to the client or investment fund to use the foreign custodian as opposed to a Canadian custodian.

Transition period and application

A few commenters requested that the CSA consider extending the six-month transition period, suggesting that material changes may be required to existing longstanding and otherwise secure custodial and sub-custodial arrangements to comply with the new requirements. They also suggested that it is time-consuming for registered firms to determine if a firm has directed or arranged custodial arrangements for clients in the past. They asked for clarity as to when the expected client notifications on existing custodial arrangements, as outlined in the July 2016 Proposal, should take place.

The Custody Amendments are designed to codify existing custodial best practices, therefore the CSA does not foresee any material changes to existing custodial arrangements for the vast majority of our registered firms. We believe that a six-month transition period is sufficient for registered firms to implement any necessary changes to comply with the new requirements, especially given that there were no major implementation challenges raised through the public comment process.

Since the Custody Amendments do not apply retroactively, the six-month transition period does not apply to existing custodial relationships that were previously directed or arranged by a firm. For existing custodial relationships that were directed or arranged by a firm before the Custody Amendments come into force, we expect that registered firms make reasonable efforts to inform their clients of the new custodial requirements within a reasonable time frame. Registered firms should make their clients aware if their existing custodial arrangements do not meet the requirements of the Custody Amendments and direct them to an alternative custodian that meets the new requirements.

Prescribed terms on custodial contracts

In the July 2016 Proposal, the CSA sought feedback on whether our proposed guidance for investment fund managers is sufficiently clear in respect of key terms that they should consider when entering into a written custodial agreement on behalf of the investment funds managed by them, and whether prescribed key terms for custodial agreements in NI 31-103, similar to the requirements found in NI 81-102 and NI 41-101, should be imposed.

A few commenters thought that the guidance was sufficiently clear and that there was no need to impose prescribed terms for custodial agreements. One commenter thought that having prescribed terms would be helpful but also highlighted the challenges of proposing such rules given the broad spectrum of stakeholders involved.

The CSA decided not to make any changes concerning this matter. We will monitor the operation of the new custody requirements once they are in force and assess whether mandating key terms for custodial agreements is necessary.

Due diligence expectations

One commenter asked for clarity on the CSA's expectations regarding investment fund managers' obligations in the ongoing monitoring of the custodian for the investment funds managed by them, in particular, relating to the appointment of a sub-custodian by the custodian.

The CSA expects investment fund managers to conduct a periodic review of custodial arrangements for their investment funds, and consider whether the custodian uses all reasonable diligence, care and skill in the selection and monitoring of its sub-custodians, and whether the sub-custodians would meet the definition of a "qualified custodian".

We expect investment fund managers to consider the selection criteria and monitoring processes of sub-custodians when conducting their initial review and ongoing monitoring of the custodians for the funds.

One commenter asked for clarity on the expectations of a registered firm, other than an investment fund manager, to conduct due diligence and periodic reviews of custodians with which only its client, but not the firm itself, has a contractual arrangement.

The CSA considers it prudent for registered dealers and advisers that have influence over a client's selection of a custodian to conduct due diligence similar to that expected of an investment fund manager. The CSA expects that reasonable efforts be made by these firms to meet this expectation if they are to exert influence over a client's selection of a custodian.

One commenter asked for guidance on situations when clients refuse to use a custodian in a manner contemplated by the Custody Amendments.

Most of the new requirements under the Custody Amendments are triggered by the registered firm directing or arranging the custodial arrangement for clients or investment funds, or holding or having access to the cash or securities of the client or investment fund. If a registered firm does not undertake any of these activities, most of the new requirements under the Custody Amendments, including the requirement to use a "Canadian custodian", would not apply.

Implications for mutual fund dealers in Québec that are not MFDA members

One commenter asked for more details on the implications of the Custody Amendments on firms registered in Québec in the mutual fund dealer (MFD) category who are not members of the MFDA. The commenter expressed concern that MFDs that operate throughout Canada may face administrative and technological challenges due to differences in regulation.

As pointed out in the July 2016 Proposal, the Custody Amendments will prohibit a firm registered in Québec in the MFD category, and that is not a member of the MFDA, from holding cash and securities in nominee form. In the context of the Custody Amendments, not being a member of the MFDA means that a firm is registered as an MFD in Québec only. Therefore, the Custody Amendments will not apply to MFDs that are registered in multiple jurisdictions, including Québec, because such MFDs registered in Québec would also be members of the MFDA. In this regard, we believe that there will not be any inconsistency in regulation.

Before the publication of the July 2016 Proposal, the AMF conducted a survey on the custodial practices of MFDs registered only in Québec. According to the responses received, the Custody Amendments would not have significant impact on their current custodial practices. The CSA also did not receive any comments from MFDs that are only registered in Québec on the Custody Amendments.

Other comments on guidance

One commenter thought that the guidance under "General prudent custodial practices" in 31-103CP, in particular under the headings "Delivery of custodial statements" and "Reconciliation with custodians" are important expectations of the CSA that should be built into the Rule instead of guidance. The commenter also asked for clarity on account statement delivery expectations on registered firms and custodians.

The CSA believes that this guidance essentially confirms our long-standing expectations instead of setting new expectations. Most of these expectations fall under the requirement to have a system of controls and supervision to manage business risks under section 11.1 of NI 31-103, which would include having adequate internal control procedures to mitigate risks associated with safeguarding client assets. The CSA issued CSA Staff Notice 31-347 *Guidance for Portfolio Managers for Service Arrangements with IIROC Dealer Members* on November 17, 2016 which provides guidance to portfolio managers on service arrangements with IIROC member firms, including our expectations on account statement delivery.

3. RESPONSES TO COMMENTS RECEIVED ON EXEMPT MARKET DEALER AMENDMENTS

General

In general, the commenters that provided comments on the July 2016 Proposal were critical of the proposed amendments to Part 7 of NI 31-103 but were supportive of the proposed amendments to s. 8.6 of NI 31-103.

In particular, several commenters suggested that the proposed amendments to Part 7 would have a negative impact on firms registered in the investment fund manager (IFM), portfolio manager (PM) and EMD categories, and that the CSA had not provided any policy rationale for these new restrictions. Several of the commenters also noted that the proposed amendment to broaden the dealer registration exemption in section 8.6 would not, by itself, address the negative impact of these changes.

As explained below, many of the comments appear to reflect a general concern that the Exempt Market Dealer Amendments go beyond what was intended and in fact have the effect of restricting the ability of EMDs to participate in distributions of securities of issuers, including reporting issuers, made under exemptions from the prospectus requirement. This is not the case. We have included additional guidance in the response to comments below and in the Companion Policy to clarify this.

Overview of Comments

One commenter supported the proposed amendments.

Two commenters supported clarifying the scope of permissible activities for EMDs but questioned the policy rationale for prohibiting EMDs from distributing prospectus-qualified securities to the exempt market.

Four commenters requested clarification that firms registered as EMDs, including firms that are registered as IFM/PM/EMDs, could continue to distribute prospectus-qualified securities to the exempt market.

Eight commenters opposed the changes (either outright or if it means firms that are registered as IFM/PM/EMDs cannot continue to distribute prospectus-qualified securities to the exempt market).

Seven commenters indicated either that they relied on their EMD registration to distribute prospectus-qualified securities to investors or suggested the changes would have a significant impact on existing market practice by other firms that do this.

Four commenters noted that the proposed amendments to section 8.6, while welcome, would not resolve this issue since

- it is limited to a managed account context,
- it is limited to distributions by an investment fund that is advised by the adviser and managed by the adviser or an affiliate of the adviser, and
- it is unclear whether a firm registered as an EMD could rely on this exemption because of s. 8.01 of NI 31-103.

Two commenters questioned whether the proposed changes represented a "clarification" of the scope of activities of an EMD and suggested that the proposed amendments represented significant new restrictions on the activities of EMDs.

Six commenters stated that the CSA had failed to provide any policy rationale or evidence of investor harm for further limiting the permissible scope of activities of EMDs.

Four commenters argued EMDs provide a valuable capital-raising function in the exempt market and should be allowed to act as selling group members (but not underwriters) in prospectus offerings.

One commenter argued that a number of dealers (primarily EMDs) provide a service to clients that wish to participate in offerings of flow-through shares for charitable giving purposes. Most flow through offerings are conducted by junior exploration companies which have limited financing options. Removing this segment of the market from participating in prospectus offerings is a significant limitation on these issuers' access to capital.

One commenter did not oppose restricting EMDs from acting as selling group members (but not underwriters) in prospectus offerings but believes investment funds are different and suggested that the new restrictions should not apply to prospectus distributions of investment funds.

Two commenters were concerned that the proposed changes would have an impact on the ability of EMDs to participate in private placements of securities of reporting issuers/public funds.

Five commenters argued the amendments do not further the purposes or principles of securities legislation.

Three commenters argued it is not a valid purpose of securities legislation to suppress competition/or investor choice (by limiting prospectus offerings to IIROC members).

Two commenters suggested the proposed amendments were contrary to the best interest initiative (that is, the targeted reforms discussed in CSA Consultation Paper *33-404 Proposals to Enhance the Obligations of Advisers, Dealers and Representatives Towards their Clients* (CP 33-404)) in that they restricted the scope of products that EMDs could offer their clients.

CSA Response

The Exempt Market Dealer Amendments do not have any impact on the ability of an EMD to act as a dealer or underwriter in a distribution by an issuer, including a reporting issuer, if the distribution is being made under an exemption from the prospectus requirement (a prospectus-exempt distribution).

The Exempt Market Dealer Amendments are intended to clarify that an EMD may not act as a dealer or underwriter in a distribution that is being made under a prospectus (a prospectus distribution). The CSA takes the view that the investment dealer category or, in the case of a mutual fund prospectus distribution, the investment fund dealer or mutual fund dealer categories, are the appropriate dealer registration categories for prospectus distributions.

Clarification of the term "prospectus-qualified" securities

A number of the commenters questioned whether a firm that holds an EMD registration may distribute "prospectus-qualified securities" to accredited investors or other investors who are otherwise eligible to purchase securities on a prospectus-exempt basis (collectively, exempt market purchasers).

For clarity, an EMD is not permitted to distribute "prospectus-qualified securities" to an exempt market purchaser in the sense that the specific securities that are being distributed to the exempt market purchaser are being distributed under a prospectus and are therefore "prospectus-qualified" securities.

However, an EMD may distribute "prospectus-qualified securities" to an exempt market purchaser in the sense that the specific securities that are being distributed to the exempt market purchaser in reliance on a prospectus exemption are of the same class of securities as are being distributed to other investors through, for example, an investment dealer in a contemporaneous prospectus offering.

In this summary, we use the term "prospectus-qualified securities" to mean securities that have been distributed to an investor (including an investor that may be considered an exempt market purchaser) under a prospectus. If the distribution is made under a prospectus, the issuer of the securities has filed a prospectus with the securities regulatory authorities and obtained a receipt for it. Investors purchasing prospectus-qualified securities have statutory prospectus rights under securities legislation, such as rights of rescission or damages in the event of a misrepresentation in the prospectus, and the securities will be freely trading. If the distribution is made under an exemption from the prospectus requirement, such as the accredited investor exemption in s. 2.3 of NI 45-106 *Prospectus Exemptions* (NI 45-106), the securities will not be prospectus-qualified, investors do not have statutory prospectus rights under securities legislation in the event of a misrepresentation in the prospectus, the securities will typically be subject to resale restrictions and the issuer or underwriter may be required to file a report of exempt distribution under Part 6 of NI 45-106.

Adviser firms that also hold an EMD registration

A person or company registered as an adviser in the category of PM may also obtain registration as an EMD in order to act as a dealer or underwriter in prospectus-exempt distributions. The CSA takes the view that obtaining registration as an EMD does not restrict the activities the adviser may otherwise conduct in the capacity of a PM. For example, a PM may purchase securities on behalf of a managed account in a prospectus offering. If the PM is making the purchase solely in its capacity as a PM (that is, it is simply acting as an investor in a prospectus offering) and the PM is not also acting as a selling group member or receiving a commission or other fee from the issuer or another dealer in connection with the offering, the CSA would not consider the PM to be "acting as a dealer" in a prospectus distribution.

Can a PM/EMD rely on the exemption in section 8.6 of NI 31-103 (or does s. 8.01 preclude this)?

The exemption in section 8.6 is available to an adviser that has obtained registration as an EMD in connection with dealer activities that are not permitted by an EMD registration.

Section 8.01 provides that the exemptions in Division 1 of Part 8 are not available to a person or company if the person or company is registered in the local jurisdiction and if their category of registration permits the person or company to act as a dealer or trade in a security for which the exemption is provided. As described above, under Part 7, an EMD may not act as a dealer or underwriter in a prospectus distribution. Accordingly, an adviser that also holds an EMD registration is not precluded from relying on the exemption in section 8.6 in connection with a prospectus distribution by virtue of its EMD registration.

4. RESPONSES TO COMMENTS RECEIVED ON THE CLIENT RELATIONSHIP MODEL PHASE 2 AMENDMENTS

Non-cash Incentives

There was little support for amending section 14.17 of NI 31-103 to require disclosure of non-cash sales incentives as suggested in the first of the two questions we posed along with the July 2016 Proposal. Several commenters suggested it would be more appropriate for the CSA to address this matter through the targeted reforms discussed in CP 33-404. We also received comments that it would be premature to make further changes to the CRM2 Requirements before the CSA has completed its work to assess the impact of CRM2. Commenters also suggested that existing requirements for the disclosure of conflicts of interest adequately address the issue. Two commenters argued that including non-cash incentives in a report on charges and other compensation would not be meaningful to clients or would be confusing. Others argued that disclosure would not be an effective way of managing conflicts of interest arising from a sales incentive.

We have not amended section 14.17 to include a requirement to disclose non-cash incentives at this time. The CSA will, however, continue to consider issues related to non-cash incentives and their associated conflicts of interest. In 2016, as well as publishing CP 33-404, the CSA published a report on the compensation arrangements and incentive practices that firms use to motivate their representatives and the potential conflicts of interest (CSA Staff Notice 33-318 *Review of Practices Firms Use to Compensate and Provide Incentives to their Representatives*). Further changes to registered firm conduct requirements may be made in the context of this work.

Embedded Fees

There was also little support for amending section 14.17 of NI 31-103 to require disclosure of embedded fees paid to the issuers of securities. As was the case with the question about adding disclosure of non-cash incentives, several commenters suggested it would be more appropriate for the CSA to address this matter through the targeted reforms discussed in CP 33-404, and that it would be premature to make further changes before the impact of CRM2 has been assessed. We also received a number of comments suggesting that this requirement would be duplicative in light of the information required to be included in the Fund Facts of a mutual fund. It was suggested that it would be more appropriate to consider the issue of embedded fees through the regulatory initiatives set out in CSA Discussion Paper and Request for Comment 81-407 *Mutual Fund Fees*. One commenter felt that, because embedded fees are disclosed in other issuer materials, a general notification of the existence and nature of such fees could lead to confusion regarding the total amount of fees being paid.

Single commenters expressed objections that disclosure of this kind

- could leave the investor with a false impression that mutual funds are more expensive to own than competing products with embedded fees that are subject to other regulatory regimes,

- would place an undue emphasis on the effect embedded fees have on investment returns, and
- would be redundant in light of requirements for high-level disclosure of investment costs at account-opening and specific disclosure at point-of-sale.

A small number of commenters felt that disclosure, in some form, would be useful to investors. One commenter recommended a cross industry working group be formed to assess embedded fee disclosure alternatives and provide recommendations to the CSA.

We have not amended section 14.17 to include a requirement to provide information about embedded fees at this time. The CSA will, however, continue to consider issues related to embedded fees and the associated conflicts of interest.

Relationship disclosure information

There were comments that the results would not be meaningful to clients and/or would require changes to information firms are currently providing, if we expanded the guidance in section 14.2 of the Companion Policy to state our expectation concerning disclosure of the following information:

- a firm's relationship to the issuer of investment products,
- management fees associated with mutual funds,
- commissions paid by issuers, and
- bonuses from affiliated companies.

These are not new expectations: they are all consistent with the principle set out in subsection 14.2(1): "A registered firm must deliver to a client all information that a reasonable investor would consider important about the client's relationship with the registrant". Nonetheless, we have clarified the guidance about costs and other information that we believe a reasonable investor would consider important and which we would therefore expect to be included in relationship disclosure. We have included guidance as to the level of detail expected at the relationship disclosure stage and at the point-of-sale. We have also added references to the requirements to which this guidance applies.

We did not agree with a suggestion that "related party" should be defined for these purposes. We intend "related party" to have its plain language meaning. An overly technical use of the term would be inappropriate in the context of this guidance.

Pre-trade disclosure of charges - Frequent trader

We received a request for guidance on when a client would be a "frequent trader" as referred to in the proposed addition to section 14.2.1 of the Companion Policy. A bright line test would not be appropriate in the context of this guidance.

Account statements and additional statements

Dividend or Interest Payment

One commenter requested that the proposed addition of the words "dividend or interest payment" to subsection 14.14(4) of NI 31-103 be expanded to read "dividend, distribution or interest payment". We have decided not to make the proposed addition at all. Upon further consideration, we do not wish to imply a prescriptive requirement that might introduce new costs to firms without commensurate benefits to investors. Firms continue to be free to provide more specific information than the currently prescribed minimum.

Investor Protection Fund Disclosure

One commenter found paragraphs 14.14(5)(f) and 14.14.1(2)(g) to be problematic. The commenter did not see value in investors being informed as to whether or not their accounts are covered by an investor protection fund (IPF). We disagree and consider it to be important information for investors. We also note that IIROC and the MFDA require their member firms to be members of specified IPFs and to disclose that fact to clients.

The commenter also thought these proposed amendments would impose new requirements on registered firms. Both provisions were included in the original CRM2 amendments to NI 31-103 published in March 2013. The amendments, which we will be making, are technical and address the fact that it may not always be possible to say that an account *is* covered by an IPF, only that it is *eligible* for coverage. The CRM2 Orders provided certain temporary relief from the coming into effect of IPF disclosure for non-SRO member firms, with an indication that we would be publishing amendments to the requirements. We did so in the July 2016 Proposal, including the technical changes and also a provision introducing permanent relief (new subsection 14.14.1(2.1)) for arrangements where another firm holds or controls the client's securities. As explained in the July 2016 Proposal, this was done to avoid the possibility that a client might receive inaccurate information about the extent of IPF coverage from a registered firm that is not itself a member of the IPF. This was a concern expressed by the Canadian Investor

Protection Fund (CIPF) and it relates to the common arrangement whereby a PM has discretionary authority over a client's account at an IIROC member firm. In this situation, the IIROC firm is better placed than the PM to explain CIPF coverage to the shared client. The net effect of these amendments will be that IIROC members, MFDA members, and PMs in the arrangement described above will all see no change to their current practices with respect to IPF disclosure, while the gap in IPF disclosure for the (relatively small) number of clients who are not served within those channels will now be closed.

The same commenter also described as problematic what they thought was a new requirement in subsection 14.14.2 (2.1). This is not a new requirement. It was previously in subparagraphs 14.14.2(2)(a)(ii) and 14.14.2(2)(b)(ii). It was turned into a stand-alone provision, without any change in substance, because shortening these provisions made them easier to read. The commenter also expressed difficulty with the related guidance proposed for the CP. The guidance was originally included in our CRM2 FAQs and we received no further questions on the topic after it was published. We therefore believe the CP guidance is sufficient.

Security position cost

One commenter suggested that the sentence in section 14.14.2 of the Companion Policy that states that the definition of book cost or original cost must be included in the client statement should be revised to add clarity by adding "or in the separate document". We agree and have done so.

Report on charges and other compensation

Employee Bonuses

We received comments on the proposed addition of guidance in section 14.17 of the Companion Policy about our expectation that firms disclose employee bonuses linked to sales. One industry association expressed concern that it would be extremely challenging to identify the quantum of the employee bonus on a per-client basis for the purpose of reporting it as a line item on the annual report. The same commenter expressed that, on the other hand, disclosing an employee's entire bonus would be misleading to clients as it would not be specifically linked to any client transaction and may also raise privacy concerns.

We generally agree with the comments and have removed the language that was proposed.

Investment performance report

Comparison of Actual Rate of Return to Target Rate of Return

We received comments about the proposed addition of guidance in section 14.19 of the Companion Policy to the effect that a client's personal rate of return should be compared to their target rate of return. Commenters noted that registered firms are not required to provide clients with a target rate of return.

We have revised the guidance to clarify that a client's personal rate of return should be compared to their target rate of return, if they have one, so that progress toward that goal can be assessed.

Inception Date

One commenter asked if firms will be subject, on a compliance review, to an additional standard beyond accuracy of the data used when selecting a "deemed inception date" for their investment performance reports for accounts that were opened before July 15, 2015. We have clarified the requirement: firms must reasonably believe accurate, recorded historical information is available for the client's account, and it must not be misleading to the client to provide that information as at the chosen date. Generally, firms will use the same date for all of their clients. In the Companion Policy, we give examples of situations in which we would think it reasonable for a firm to use different dates for different groups of clients.

Other matters

"Permitted Client" Definition

One commenter requested that we revise the definition of "permitted client" in NI 31-103 to include what the commenter considers to be a commonly thought of "institutional client". This would be outside the scope of the Client Relationship Model Phase 2 Amendments and would involve material rule changes that would have to be published for comment.

Exempt Market Dealers

One commenter requested that we add guidance to the Companion Policy about when an EMD would be required to provide various client statements to its clients. We have added guidance on how the client reporting requirements in Part 14 of NI 31-103 apply to an EMD who is not also registered as an adviser or in another category of dealer. This is substantially the same as the guidance that was included in CSA Staff Notice 31-345 *Cost Disclosure, Performance Reporting and Client Statements – Frequently Asked Questions and Additional Guidance*.

Exemptive Relief

One commenter asked that we include a reference in the Companion Policy to the availability of discretionary exemptive relief from certain of the CRM2 Requirements for institutional clients that are "accredited investors" but do not qualify as "permitted clients". We have not done so, as general guidance presented in the Companion Policy is not the forum to discuss narrowly targeted relief.

5. RESPONSES TO COMMENTS RECEIVED ON THE HOUSEKEEPING AMENDMENTS

International advisers

We received comments on our proposed amendment to clarify subsection 8.26(3) of NI 31-103. The comments suggested that further clarification was necessary to clarify the intended scope of the exemption and ensure that the proposed amendment was consistent with the stated policy objective. In response to these comments, we made further clarifying changes, including eliminating potential confusion associated with double negatives. One commenter suggested that we not make any changes to the current provision. We did not follow the suggestion since the clarifying changes help eliminate potential ambiguity associated with the fact that the current provision refers to a "Canadian issuer" without including a specific definition for that term. We also declined to pursue at this time the suggestions of one commenter that the CSA provide guidance on what it would consider to be "incidental" in the context of the proposed amendment to subsection 8.26(3) (who also reiterated previously expressed concerns about restricting the availability of the exemption for advice on securities of Canadian issuers). The reason for not pursing the suggestion is that it was outside the scope of what we published for comment in the July 2016 Proposal.

Form 33-109F6 Firm Registration

Item 4.2 Exemption from securities registration

Firms that are seeking registration under securities legislation, derivatives legislation, or both, are required to complete and submit a Form 33-109F6 *Firm Registration* (Form 33-109F6). Item 4.2 of Form 33-109F6 requires the firm to provide information on exemptions from registration or licensing to trade or advise in securities or derivatives.

The July 2016 Proposal included a proposed amendment to Item 4.2 to eliminate this information requirement if the firm has already notified the securities regulator or, in Québec, the securities regulatory authority, in accordance with the applicable exemption.

One commenter recommended that the CSA further narrow the scope of Item 4.2 of Form 33-109F6 to state that the only exemptions which must be disclosed under this heading are those for which the firm has previously obtained from a securities regulator a discretionary exemption or other decision-based relief. We have not added this further clarification on the basis that this change was outside of the scope of the proposed amendment, and would also not be consistent with the objective of obtaining appropriate information to understand the nature of the trading and advising activities being undertaken by the firm.

The same commenter also proposed that, if the firm was relying upon a discretionary exemption previously granted by a securities regulator, there should be no late fee payable for a late filing of a Form 33-109F5 *Change of Registration Information* relating to the disclosure of that exemption in Item 4.2 of Form 33-109F6. We have declined at this time to pursue this comment on the basis that this is outside the scope of what was published for comment in the July 2016 Proposal.

Another commenter supported 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, on the basis that this avoids redundancy and unnecessary administrative burden. The commenter suggested that this approach of avoiding redundancy and unnecessary administrative burden 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). While we did not pursue this comment at this time, on the basis that it is outside the scope of what was published for comment in the July 2016 Proposal, we have taken it under advisement.

Form 33-109F4 Registration of Individuals and Review of Permitted Individuals

Although we did not include in the July 2016 Proposal any proposed amendments to Form 33-109F4 *Registration of Individuals and Review of Permitted Individuals* (Form 33-109F4), one commenter proposed changes to NI 33-109 and Form 33-109F4 to more specifically address in Form 33-109F4 individual trustees and other individuals that have direction or control over voting securities of a registered firm carrying 10 per cent or more of the votes carried by all outstanding voting securities. While we did not pursue at this time these proposed changes, on the basis that these changes are outside of the scope of what was published for comment in the July 2016 Proposal, we have taken them under advisement.