

**The Canadian
Impact of U.S.
Regulatory
Developments**

“Chaperoning” Exemption

- ❖ Exchange Act Rule 15a-6(a)(3):
- ❖ Canadian Broker-Dealer can solicit and execute transactions for a defined group of U.S. institutional customers

Eligible Institutions

- ❖ Registered U.S. Investment Companies
- ❖ Reg D (Rule 501) defined:
 - ❖ bank
 - ❖ savings association
 - ❖ insurance company
 - ❖ business development company
 - ❖ small business development company
 - ❖ employee benefit plan

Eligible Institutions

- ❖ Reg D (Rule 501) defined:
 - ❖ private business development company
 - ❖ IRC 501(c)(3) organization (\$5 million)
 - ❖ trust (\$5 million, “sophisticated person”)

Eligible Institutions

- ❖ “Major U.S. Institutions”
 - ❖ Assets in excess of \$100 million itself or under management
 - ❖ SEC-registered Investment Advisor with excess of \$100 million under management

Canadian Broker-Dealer

- ❖ Must consent to service of process for any civil proceeding brought by—or before—SEC or SRO (FINRA)
- ❖ Chaperoning U.S. Broker-Dealer must be agent for service

Canadian Broker-Dealer

- ❖ Must provide the SEC, as requested:
 - ❖ documents
 - ❖ information
 - ❖ testimony of associated persons
 - ❖ assistance to obtain testimony of others

Canadian Broker-Dealer

- ❖ No violation if Canadian (or other non-U.S. law) prohibits providing information if “best efforts” used, including
 - ❖ Seeking permission from appropriate Canadian (or other non-U.S.) government authority
 - ❖ Seeking permission, if legally required, from customer for customer information

Canadian Broker-Dealer

- ❖ However, SEC, after notice and hearing, can then prohibit *further* reliance on this exception

Chaperon

- ❖ Must “approve” the Canadian associated person(s) involved
 - ❖ Same standard as own hiring
 - ❖ No U.S. or substantially equivalent “statutory disqualification,” such as:
 - ❖ Conviction
 - ❖ Injunction
 - ❖ Suspension/expulsion/bar from industry
 - ❖ Finding of false statement, etc.

Chaperon

- ❖ Must listen to all telephone conversations with institutional customers EXCEPT
 - ❖ “Major Institutional Customers”
 - ❖ calls before 9:30 a.m. and after 4:00 p.m.
 - ❖ Calls that do not include the acceptance of orders to effect transactions in U.S. securities

Chaperon

- ❖ Must attend all visits by Canadian Broker-Dealer
- ❖ One exception: Visits to “Major Institutional Clients,” PROVIDED:
 - ❖ Visits do not exceed 30 days per year
 - ❖ Orders to effect securities transactions not accepted during unaccompanied visits

Chaperon

- ❖ Technically required to “effect” the transaction, although Canadian firm may negotiate terms and execute in relevant foreign market

Other Points

- ❖ Canadian B-D may print and send confirmations and statements as agent for Chaperon U.S. firm
 - ❖ But SEC will hold Chaperon responsible for inaccuracy/omission

Other Points

- ❖ Canadian B-D can extend credit for transactions within exception, but Chaperon U.S. firm must “arrange” for the extension of credit

Other Points

- ❖ Chaperon U.S. firm must take capital charge if
 - ❖ Failure to settle promptly
 - ❖ Agreement for extended settlement
 - ❖ Exception: Chaperon U.S. firm does not guarantee settlement

Other Points

- ❖ Direct settlement between Canadian B-D and U.S. customer permitted if:
 - ❖ t/a involves “foreign” securities or U.S. Government securities
 - ❖ Agreement to make available all clearance and settlement information
 - ❖ Canadian B-D is not custodian of funds/securities
 - ❖ Canadian B-D not in default on any “material financial transaction”

Other Points

- ❖ Need exemption from state registration requirements

Considerations

- ❖ Due Diligence
 - ❖ Canadian to U.S.
 - ❖ U.S to Canadian
- ❖ Indemnification and Contribution

Proposed Amendment

- ❖ SEC Release 34-58047, June 27, 2008—www.sec.gov
- ❖ Comment period closed September 8
- ❖ Over 40 comments received

Key Changes

- ❖ Solicitation to “Qualified Investor”
 - ❖ Defined in Exchange Act Rule 3(a)(54)
 - ❖ replaces “Major U.S. Institutional Investor” and “U.S. Institutional Investor”
 - ❖ Includes slightly broader categories of investors. For example:
 - ❖ Natural person who owns and invests on a discretionary basis \$25 million in investments
 - ❖ Certain financial institutions, regardless of asset size

Key Changes

- ❖ Provides for direct, unchaperoned contacts
 - ❖ U.S. visits up to 180 days per year

Key Changes

- ❖ Two categories of exempt B-Ds:
 - ❖ If Canadian B-D maintains custody:
 - ❖ Engaged in “foreign business” (85% of t/a’s in non-US securities)
 - ❖ US B-D maintains copies of records
 - ❖ If Canadian B-D does not maintain custody
 - ❖ US B-D maintains custody
 - ❖ No “foreign business” test

RAND Study

- ❖ In March 2007, U.S. Court of Appeals for D.C. Circuit invalidated Investment Adviser Rule 202(a)(11)-1
- ❖ That Rule attempted to clarify distinction between broker-dealers and investment advisers

RAND Study

- ❖ Exception to Investment Advisor Registration
 - ❖ Any broker-dealer whose performance of advisory services is:
 - ❖ Solely incidental to the conduct of its business as a broker or dealer
and
 - ❖ Who receives no special compensation for advisory services

RAND Study

- ❖ For years, the regulators looked to compensation as the decisive feature:
 - ❖ Fees based on assets = Investment Advisers
 - ❖ Transaction-based (commissions/mark-ups/concessions) = Broker or Dealer

RAND Study

- ❖ But, market forces and regulatory-sponsored initiatives eroded that distinction
 - ❖ Discount vs. full service
 - ❖ Tully report, 1995
 - ❖ Commissioned by SEC under Chairman Arthur Levitt
 - ❖ Best practice – align interests of investor, registered representative, and firm
 - ❖ Fee-based accounts highlighted as a best practice

RAND Study

- ❖ Conundrum – fee structure no longer determinative
- ❖ So, Rule 202(a)(11)-1
 - ❖ Broker-Dealer not an investment adviser if it charges asset-based or fixed fee, so long as:
 - ❖ No separate fee for advisory service
 - ❖ Advice not part of financial plan or financial-planning services
 - ❖ No investment discretion
 - ❖ Provides mandated disclosure that account is brokerage, not advisory account

RAND Study

- ❖ Court says Investment Advisers Act of 1940 was very specific on who could be exempted from the definition of investment adviser.
- ❖ Only broker-dealer exemption is for activity “solely incidental” for which no “special compensation” is received.

RAND Study

- ❖ SEC commissions RAND to conduct a study of broker-dealers and investment advisers from two perspectives:
 - ❖ Examine practices of BDs and IAs in marketing, financial products, and services to individual investors; and
 - ❖ Evaluate investors' understanding of the differences between BD and IA financial products, services, duties and obligations.

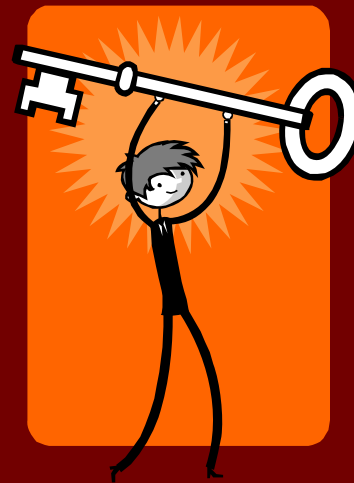
RAND Study

❖ Findings

- ❖ Investors rarely read disclosures
- ❖ Structure of firms varies widely
 - ❖ Broker-Dealers
 - ❖ Investment Advisers
 - ❖ Dual Registrant
 - ❖ Affiliated BD & IA
 - ❖ IA with associated persons affiliated with another BD

RAND Study

- ❖ Findings (cont.)
 - ❖ Access to Investment Advisers
 - ❖ Institutional Investment Advisers
 - ❖ High Net Worth
 - ❖ Retail Customers???



RAND Study

- ❖ Findings (cont.)

- ❖ Investors have difficulty:

- ❖ Distinguishing among industry professionals
 - ❖ Understanding the relationships among service providers



RAND Study

❖ Findings (cont.)

- ❖ View “financial advisers” and “financial consultants” more similar to IA than BD
- ❖ Interchangeable titles and “we do it all” advertisements make it difficult to distinguish IAs from BDs

RAND Study

❖ Findings (cont.)

❖ IA Appeal

- ❖ Compensation structure
- ❖ Disclosure requirements
- ❖ Legal Duties

❖ BD Appeal

- ❖ Account minimums
- ❖ Industry certification
- ❖ Costs



Rand Study

❖ Keys to business relationship

- ❖ Personal service
- ❖ Attention
- ❖ Accessibility
- ❖ Trustworthiness



❖ Less important

- ❖ Expertise
- ❖ Performance (but no evidence on how actual returns may cause impression to vary)
- ❖ Fees
 - ❖ Uncertain
 - ❖ Confusing

RAND Study

- ❖ Findings (cont.)
 - ❖ Fiduciary duty vs. suitability standard
 - ❖ Hard to understand
 - ❖ Investors doubt differs in practice

Nature of Duties

❖ Fiduciary Duty: a heightened duty to act on another's behalf

❖ Good faith

❖ Honesty

❖ Trust

❖ Care

❖ Candor



Nature of Duties

- ❖ Suitability – objective vs. subjective
 - ❖ Objective: suitable for SOME investor
 - ❖ Subjective: suitable for THIS investor
 - ❖ Investment objective
 - ❖ Financial ability to bear risk
 - ❖ Experience/sophistication to understand risk

Broker-Dealer Fiduciary Duties

- ❖ Depends on factual nature of relationship
- ❖ Fiduciary duty as agent from receipt of order until settlement, including execution

Broker-Dealer Fiduciary Duties

- ❖ Nature of control over account
 - ❖ Explicit discretion
 - ❖ De Facto discretion
 - ❖ Past activity as adviser
 - ❖ Extent customer follows advice
 - ❖ Extent broker trades without prior approval
 - ❖ Frequency of communication
 - ❖ Customer sophistication
 - ❖ Degree of customer trust and confidence in broker

Broker-Dealer Fiduciary Duties

❖ If non-fiduciary

- ❖ Recommend security only after sufficient study of nature, price and prognosis
- ❖ Carry out customer orders promptly in manner best suited to customer's interest
- ❖ Inform customer of risk in purchase or sale
- ❖ Refrain from self-dealing: disclose personal interest in recommended security
- ❖ No misrepresentation of material fact
- ❖ Transact business only with prior authorization

Broker-Dealer Fiduciary Duties

❖ If fiduciary

- ❖ Manage account to needs and objectives of customer, as stated in authorization papers or as apparent from customer investment and trading history
- ❖ Keep informed of market changes and respond as in customer's interest
- ❖ Keep customer informed as to each completed transaction
- ❖ Explain forthrightly the practical impact and potential risks in chosen strategy

Investment Advisor Fiduciary Duties

- ❖ Viewed as a “categorical” matter
- ❖ Duties have been held to apply to current and prospective customers – thus, no deceptive advertising
- ❖ Refrain from undisclosed conflict of interest; or freely disclose and receive specific consent
- ❖ Responsible for the portfolio entrusted to advisers
- ❖ Suitability, best execution, personal trading, allocation

Elder Law Issues

❖ SEC Chairman Charles Cox:

❖ “There surely is a special place in Hell for those who would prey on the Greatest Generation, and rip off the life savings of the children of the Depression who defeated Nazism, Fascism, and Communism”



Targeted Issues

- ❖ Seminars
 - ❖ “Free Lunch”
 - ❖ High pressure
- ❖ Senior Specialist Designations
- ❖ Misleading Ads and Marketing Materials
 - ❖ “Early” retirement
 - ❖ “Retirement Secrets of the Rich: What your Accountant and Stockbroker Don’t Want You to Know”



Elder Abuse Statutes and Enhanced Penalties

❖ Suitability

❖ Variable annuities

- ❖ Complexity

- ❖ Fees

- ❖ Used for tax advantage

- ❖ Surrender periods and liquidity needs

- ❖ Long term investment vehicle

❖ Equity-Indexed Annuities

❖ Life Settlements

Elder Abuse Statutes and Enhanced Penalties

- ❖ Some Considerations:
 - ❖ Cooperation with family and other professionals consistent with privacy policy
 - ❖ Senior-friendly written materials
 - ❖ Updating account information
 - ❖ Supervisory participation
 - ❖ Meeting places
 - ❖ Assisted living center – give careful consideration
 - ❖ Offers of gifts
 - ❖ Attention to performance, liquidity needs

Rule 2821 – Variable Annuities

- ❖ Effective May 5, 2008
- ❖ Enhanced suitability review for deferred variable annuities



Rule 2821 – Variable Annuities

❖ Applies to:

- ❖ Purchase of contract
- ❖ Exchange of contract
- ❖ Initial subaccount allocations

❖ Does Not Apply to:

- ❖ Reallocation of subaccounts
- ❖ Subsequent deposits of funds after initial purchase or exchange

Rule 2821 – Variable Annuities

Registered Representative Responsibilities

- ❖ Prior to recommendation, obtain at minimum:
 - ❖ Age
 - ❖ Annual income
 - ❖ Financial situation and needs
 - ❖ Investment experience
 - ❖ Investment objectives
 - ❖ Intended use of annuity
 - ❖ Investment time horizon
 - ❖ Existing assets (including investment and life insurance)
 - ❖ Liquidity needs
 - ❖ Liquid net worth
 - ❖ Risk tolerance
 - ❖ Tax status
 - ❖ Other information used or considered reasonable

Rule 2821 – Variable Annuities

Registered Representative Responsibilities

- ❖ Need to document and sign reasonable basis to believe suitable, including:
 - ❖ Customer informed of features, including
 - ❖ Potential surrender period and charge
 - ❖ Tax penalty if sold/redeemed before age 59½
 - ❖ Mortality and expense fees
 - ❖ Investment advisory fee
 - ❖ Charges and features of riders
 - ❖ Insurance and investment components
 - ❖ Market risk

Rule 2821 – Variable Annuities

Registered Representative Responsibilities

- ❖ Customer would benefit from certain features:
 - ❖ Tax-deferred growth
 - ❖ Annuitization
 - ❖ Death or living benefit

- ❖ Deferred annuity, taken as a whole, including subaccount allocation at time of purchase or exchange, and riders and other product enhancements, are suitable based on customer-specific information above

Rule 2821 – Variable Annuities

Registered Representative Responsibilities

- ❖ Additional considerations for exchange:
 - ❖ Surrender charge
 - ❖ New surrender period
 - ❖ Loss of existing benefits (death, living, or other benefits)
 - ❖ Increased fees / charges
 - ❖ Mortality and expense fees
 - ❖ Investment advisory fees
 - ❖ Rider and other enhancement fees

Rule 2821 Variable Annuities

- ❖ Additional considerations for exchange, cont.:
 - ❖ Whether customer would benefit from product enhancements and improvements
 - ❖ Whether customer has exchanged a deferred variable annuity within the last 36 months

Rule 2821 – Variable Annuities

Principal Review and Approval

- ❖ Within 7 business days of customer signing, and prior to transmitting application, a principal must review suitability factors and approve
- ❖ One exception:
 - ❖ Transaction not recommended
 - ❖ Customer informed of reasons why principal not approving
 - ❖ Customer affirms decision to proceed

Rule 2821 – Variable Annuities

❖ Supervisory Procedures

- ❖ To comply with the Rule
- ❖ To monitor amount of exchanges to see if inappropriate
- ❖ To implement corrective measures

❖ Training

