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CSA Position Paper 25-404 - New Self-Regulatory Organization Framework

Kenmar welcome the opportunity to provide feedback on the CSA SEO Position Paper. We are pleased to see that the CSA did not opt for a patch to the existing SRO framework. In this submission we outline our "Hot Button" issues and ideas.

Per the position Paper, the IWC will engage and consult with existing SRO and IPF staff, as well as other stakeholders (including advocacy and industry). Integrated Working Committee (IWC) engagement with investors at an early stage is key to the success of New SRO, particularly in respect the objective of underscoring the new organization's public interest mandate. To that end we urge the CSA to include investor representatives/advocates on the IWC.

There is a critical need for the CSA to adopt an accelerated implementation process and avoid deferring other important regulatory initiatives (CFR, OBSI binding mandate) pending the launch of the New SRO. The longer the implementation phase, the more regulatory attention and resources this project will absorb and the higher the probability things will either be deferred or go off the rails.

Bringing IIROC and MFDA registrants into a New SRO requires leadership, a solid plan and particular sensitivity to HR issues. People are the heart and soul of a

regulator so that it is critical the consolidation is effected without a breakdown in organizational morale or increase in staff stress. The careers of many dedicated people could be impacted by the CSA decision. It would not be fair to keep them in a prolonged state of uncertainty. An undue implementation delay will adversely impact investor protection.

The CSA have undertaken a bold and ambitious project. It comes in the middle of a pandemic where people are stressed, normal work patterns are disrupted and work from home remains the norm. In addition, numerous CSA initiatives such as CFR, protection of seniors and vulnerable investors and title reform are underway. In addition, investor demands for improved complaint handling, a binding decision mandate for OBSI and ESG disclosure consume limited CSA resources. Finally, Canada's largest Commission, the OSC, will be undergoing a major structural and organizational change. This is a very challenging environment in which to introduce material changes.

A project management approach must be taken when making any significant changes in an already operating system. A Project Manager should be named who would be responsible and accountable for the project.The project plan should contain publicly disclosed milestones and deadlines for key activities to help ensure timely completion of New SRO foundation and infrastructure.Project management and execution of action plans will require dedicated staff members at various institutions, supported by expert advisors and professionals. A new Board of Directors should be among the first priorities.

A key point we want to make is that for New SRO to work effectively, the CSA and New SRO must work collaboratively in the Public interest so that the overall regulatory system functions well. Together, they form a delicate eco-system that needs constant management attention.

New SRO has the potential to improve investor protection, reduce regulatory complexity and better harmonize and modernize regulation across Canada. However, it is vitally important that all participants involved in the transition process are fully committed to positive results without any counterproductive turf protection and NIH. The CSA must provide the necessary leadership and be prepared to weed out "blockers".

New SRO: Process Risks, Issues and Ideas

While Kenmar generally support the planned New SRO structure, we will be closely monitoring certain features:

- A substantive culture change that prioritizes the Public interest, the appointment of independent Directors and the choice of New SRO leadership team members
- Assessing " acknowledging proportionate regulation" application and its impact on investor protection
- New , improved approaches to dealer compliance oversight

- Robust enforcement intensity and depth generally, especially towards Member Firms
- Level and nature of retail investor engagement
- Dedication to Title reform and CRM3
- The mandate ,composition and transparency of the Investor Advisory Panel
- Evidence that New SRO gains a deeper understanding of the retail investor population via empirical research. Example MFDA Client Research Report https://mfda.ca/wp-content/uploads/2017_MFDA_ClientResearchReport.pdf
- Dealing with criminal activity, fraud, theft, forgery and other unlawful activities such as money laundering
- Establishing clear, high level qualitative and quantitative performance benchmarks for the CSA evaluation / oversight of New SRO.

Kenmar have identified the following concerns/issues:

Clarifying the Public interest: New SRO should clearly articulate how it intends to achieve, and be seen to achieving, its Public interest mandate. Going forward, for all significant decisions (including new or amended rules), New SRO should be required to explain how and why the decision is in the Public interest. The following high-level criteria should be considered :
• The decision would be in the best interest of, or would not negatively impact, investors;
• The decision would not inappropriately stifle innovation or competition;
• The decision would not unfairly discriminate against certain types of dealers , products , services or investors;
• The decision would not inappropriately discourage technology solutions to increase investor access to self-help tools
• Any other criterion that may be appropriate for the subject of the specific decision.

Design risks: Major changes such this SRO re-build carry risk, and the broader the scope of the changes, the greater the risk of problems or even failure. In our view the major risks are:
o ensuring the investor perspective is integrated into the New SRO governance structure in a way that is both meaningful and effective
o The potential for "regulatory capture" of the SRO system by one powerful segment of the industry e.g. bank-owned dealers
o Reduced standards of regulation and supervision under the new system- adopting a lowest common denominator approach
o Overloading the New SRO expanded responsibilities before it has the time to build capacity or mobilize resources.

Transitional risks: Whenever structural changes are made to a regulatory system, important transitional issues must be addressed. These include ensuring that:
o The momentum that currently exists to put this New SRO in place as quickly and efficiently as possible is not dissipated in protracted power struggles and institutional intransigence

o All existing regulatory processes continue uninterrupted, especially supervision of markets and intermediaries and CFR implementation.
o Regulated persons remain within the legal jurisdiction of a regulator at all times.
o Open files and cases are transferred to new bodies without loss of jurisdiction.
o The transition to new management and governance is as seamless as possible.
o Human resources issues are addressed, including maintaining staff morale, retaining staff, and addressing the employment rights of any staff members who are transferred or terminated.
o Complaint/Dispute resolution mechanisms are agreed to address any unforeseen issues that arise during the transition period.

Legal and regulatory risk: If institutions' regulatory responsibilities are changed in the new structure, plans to minimize legal and regulatory risk are needed. Transfers of responsibilities will likely require (1) transfer of rules from one body's rulebook to another's, (2) transfer of responsibility for supervision programs, (3) transfer of experienced managers and staff, and (4) transfer of infrastructure including IT systems and tools. Agreement must be reached on the precise division of responsibilities, and documented in legal agreements or MOUs. Suitable arrangements will be necessary for the transfers of those responsibilities and assets, as well as for handling of open files and cases.

New OSC mandate risk: We note that the Ontario government's Task force recommendations are being adopted to expand the OSC's mandate and alter its structure. An expanded mandate to include capital formation raises investor protection issues. The new mandate could very well be in conflict with investor protection especially with a meddling provincial government in place. Another concern is that OSC budgets will not be increased to accommodate this demanding new mandate, thereby draining the already constrained investor protection resources .We urge the CSA to be cognizant of these concerns in defining the role of the OSC in overseeing New SRO.

Impact on small dealers risk: A reduction in smaller dealers could have an adverse impact on small investor access to advice (such as it is).

Decision Making Capacity: The New SRO must be equipped with a decision-making ability that is more nimble and responsive than those now in place for the two existing SROs and the CSA. In order to be able to achieve its Public interest market in the context of today's dynamically evolving capital markets, the New SRO will require the ability to identify, assess and respond to market disruptions and/or market risks in hours and days, not months and years. The ability to regulate quickly and effectively will go a long way in establishing the credibility and ultimate viability of New SRO.

Governance: The Position paper addresses issues we have raised but how high level principles translate into practice remains to be seen. New SRO governance is a key success factor in bringing about true SRO reform. Our view is straightforward. Positions for industry participants should be reserved who best bring industry-

specific knowledge, experience and issues to the Board table. Similarly, positions should be reserved for individuals with complementary skills such as:

- Financial consumer protection
- Dispute resolution expertise / ombudsman experience
- Professional advice giving e.g. CFA holder
- Academia/securities law expertise
- Technology/IT security/fintech / regtech capability
- Auditing/ compliance experience
- Class action lawyers involved with securities cases
- Behavioural finance practices related to financial services industry regulation
- Criminal law / forensics
- ESG/ crypto currency issue knowledge

To the extent actual and perceived conflicts-of-interest are avoided, it is to that extent New SRO will be accepted by the public as a trusted regulator. The worst possible result would be if power (real and/or perceived) ended up in the hands of a majority of current and former industry Directors.

Firm accountability: Member Firms must be held accountable for the actions of their Representatives. Firm accountability is congruent with client expectations when they open an account with a SRO Member Firm and the G20 High Level Principles of Financial Consumer Protection https://www.oecd.org/daf/fin/financial-markets/48892010.pdf section 6. *Responsible Business Conduct of Financial Services Providers and Authorised Agents: Financial services providers and authorised agents should have as an objective, to work in the best interest of their customers and be responsible for upholding financial consumer protection.* ***Financial services providers should also be responsible and accountable for the actions of their authorised agents*** to which Canada is a signatory. In essence, in any case where the Member Firm's systems, compliance monitoring, supervisory practices, recruitment protocols, Rep training program, risk profiling and other tools, information system and compensation/reward scheme etc. are the root cause(s) of the wrongdoing, the Firm shall be held responsible and accountable.

The contractual relationship is between the client and the Firm. The contract is not between the client and any of its employees/agents. All responsibility for any Rep negligence or wrongdoing is for the Firm to subsequently assess and resolve, consistent with applicable laws. This is not to say that in some cases like OBA or Off-Book, that the registered individual should also not be held accountable. NOTE: OBSI resolve client complaints as against Participating Firms, not individuals representing the Firms.

Domination by the banks and insurance companies :As concentration in the wealth management industry increases, the risks of concentrated power and influence increase as the number of Members decreases and the SRO becomes more dependent on fewer and larger members for its funding. Concrete steps will have to be taken by the CSA to prevent the domination of the SRO by large bank

and insurance company owned dealers. The new SRO Board mandate would need to be designed so that the larger Firms could not dominate Board policy and decisions.

Access to advice: The Position paper refers to rural investors not always having access to fulsome personalized advice. While this may have been a not insignificant issue in the past, we would argue that video conferencing, e-signatures and other technological innovations has pretty well made this a non-issue. One major concern though with New SRO is that retail investors with small account balances will be shut out by New SRO Firms imposing high minimum account balances and/or high minimum annual account fees. We also encourage the Committee to take steps to ensure that DIY investors who cannot afford personalized financial advice, do not trust advisors or simply want to control their investments are not denied access by New SRO to the information, tools, calculators and model portfolios that will allow them to control their own financial destiny. Current discount broker rules and guidance appear to us to be too restrictive especially in light of industry innovations, technology advances, societal changes, social media and the impact of the pandemic.

Mutual fund regulation: Mutual funds are core investments for retail investors with nearly $2 trillion invested, much of which is intended as retirement income security. The fund industry has had a disproportionate share of regulatory issues involving abusive sales practices, document adulteration, mis-selling, account churning, deception, misleading advertising/ marketing, deficient disclosure, market timing, weak governance, closet indexing, fraud etc. Several class actions are underway. OBSI list mutual funds as the investment product that most attracts complaints. Recently, ESG fund mis-labelling ("greenwashing) has been added to the list. The mutual fund is a very unique product with "advice" embedded in the cost of the product, which triggers major conflict- of-interests .We therefore emphasize the critical need for retention of seasoned MFDA (and IIROC) staff with experience in regulating this problematic sector of the industry. We also strongly recommend that a discrete identifiable mutual fund unit of New SRO be established.

Advising the elderly and vulnerable: Providing competent trustworthy financial advice to seniors is one of the greatest challenges facing the wealth management industry today. Seniors/retirees are attractive clients because of accumulated assets but are extremely vulnerable due to the physical and cognitive effects of aging. According to statistics, seniors are disproportionately (38% over age 60) cited as complainants. If one examines how the two existing SRO's have dealt with the challenge, it should be clear that they have fallen far short of what was required. We have raised important questions concerning communication style, KYC capture approach, competency as regards de-accumulating accounts, income tax optimization, understanding the needs of senior investors, robust sanctions against those who exploit the elderly, fair complaint handling including the use of opportunity loss calculation methodology and the use of POA's. Our appeals for meaningful change have not inspired SRO' action.

The only positive change that we've seen concerns the protection of seniors and vulnerable clients from third-party fraudsters and even that came from the CSA and won't come into force until January 2022. If New SRO expects to be taken seriously, it will have to put a high priority for the Board and executives on providing professional advice to our elderly and protecting them from excessive fees, exploitive recommendations, OBA, personal financial dealings and advisor fraud. There is a great opportunity here for New SRO, but when opportunity knocks, someone must actually answer the door.

Information Technology Platforms: IT Systems will need to be combined in order to provide continued meaningful information to the public .These systems include but are not limited to Registration check, unpaid fines report and enforcement records. Lessons should be learned from the time the IDA disaggregated into IIROC and IIAC and the amount of time it is taking the CSA to update its technological framework, including SEDAR. Concrete steps need to be taken to ensure valuable historical information is not lost in the transition process.

Enforcement: The Position paper is somewhat light on indicating direction. As described in our Comment letter, increased emphasis needs to be put on prosecuting Member Firms, meaningful sanctions and addressing the underlying sources of wrongdoing/ lack of detection. Sanction guidelines should emphasize investor compensation as a goal of enforcement. The failure to fully and fairly compensate all clients impacted by the wrongdoing should be an explicit aggravating factor in New SRO sanction guidelines. .Hearing Panels should be more cognizant of underlying systemic issues in their decision making. Root cause analysis is absolutely essential. The emphasis of enforcement should not be limited to the individual case but should focus as well on the broader implications designed to lead to improved systems and prevent recurrence. Deterrence alone is not going to improve the system. Core failure mechanisms must be eliminated as part of a continuous improvement process. Victim impact statements should be permitted at Hearing panel deliberations. Disgorgement should be an explicit sanction option with any funds collected distributed to the impacted investor(s).

Advisors acting as executors/trustees We would want to see the MFDA ban on representatives acting as trustees and executors retained in the New SRO rule book.

Sanctioning guidelines Both existing SRO's have 100% principles-based sanction guidelines. We are concerned that this would continue under the new SRO. Principles –based sanctions coupled with principles-based regulation in a non-fiduciary advising environment is a prescription for weak compliance/enforcement and investor protection.

Directed Commissions The big concerns here involve accountability, investor restitution and fine collection. Legal, regulatory and tax issues impact the directed commission decision. The use of directed commissions also involves labour laws and associated employment standards Acts. A determination needs to be made of the employment status of the registered individuals. Are they employees, temporary

workers, part time employees or independent contractors? The employment classification should be a helpful guide as to the applicability/legality of directed commissions. The CSA also need to decide if mutual fund trailing commissions are sales transaction commissions or fees for personalized investment advice. (trailing commissions are paid directly to dealers who may share the cash received with registered individuals in the form of a sales commission, bonus or other method)

Given the rigid CFR regulatory framework applicable to salespersons, do such persons actually run a professional practice comparable to a doctor or lawyer? Or are directed commissions just a clever scheme to minimize taxation and keep cash insulated from regulators and client claims? Will those salespersons utilizing personal corporations be more incented to transact sales than those who do not? Should registered persons utilizing personal corporations be required to carry E&O insurance?

As an aside, we make the observation that there is a question as to the status of fees earned by an advisor providing professional advisory services under a fee-based account contract. Is such a compensation scheme a sales commission, a professional service fee or regular salary?

Complaint handling. There is a need for a complete overhaul of SRO complaint handling rules. Neither SRO has rules that compare favourably with international best practices or investor expectations Internal "ombudsman "should be explicitly excluded from the complaint handling process as they are not a unregulated entity. The CSA must support New SRO by expanding NI31-103 complaint handling requirements and giving OBSI a binding decision mandate and higher compensation limit ($500K was recommended by Ontario Taskforce) . Consideration should be given to ending IIROC arbitration unless the investor cost is subsidized by New SRO and the compensation limit is increased to at least $1 million.

The OBSI-New SRO relationship: The Position paper obliquely addresses this critical interaction. Our Comment letter explained why it is critical to obtain fair compensation for victims of financial assault or negligence. We urge the Committee to embed this relationship into New SRO DNA. Exploitive, low-ball investor compensation settlements have no place in the New SRO modus operandi. The head of the New SRO Investor Office should be the designated SRO Rep on the CSA OBSI JRC. This would strengthen the capability (and credibility) of the JRC to oversee OBSI.

Investor Protection Funds: Combining the IIROC and MFDA investor protection funds and keeping it independent is a sensible go-forward plan .Kenmar recommend that, as part of the initiative, the CSA take the opportunity to make the existing $1 M cap subject to a periodic inflation adjustment formula.(The CSA should also consider requiring the registration categories not currently covered by any investor protection Fund, to establish an Investor Protection fund as deemed appropriate for those registration categories).

Bifurcated regulation of mutual fund industry: In the Position Paper, the AMF announced that it will recognize the New SRO in the same way as the other CSA members to ensure harmonized oversight of firms registered as investment dealers and mutual fund dealers as well as individuals registered in the categories of investment dealer representative and mutual fund dealer representative on the firms' behalf. However, because the CSF's powers and mandate will not be affected by the recognition of the New SRO, the CSF will continue to have oversight over mutual fund dealer representatives with respect to compliance and disciplinary matters. When one splits the regulation of the individuals from the regulator of the company responsible for their activity, it can create problems particularly when the "regulator" (i.e. Chambre or what Advocis and FP Canada hope to be) is essentially an advisor association. This is an issue that should be addressed by not creating the bifurcation or by clearly defining the respective roles between the parties and their interactions. Since professional financial planners are not regulated by CSA members, it makes sense that a professional association for that profession is in place. From all accounts, it does a good job in that role. That is what should be done in Ontario instead of the Title Protection Act covering financial advisors. CSA title reform should deal with misleading titles and designations.

Gaps, Duplications and Inconsistencies: In our regulatory system, multiple Regulators and market infrastructure entities (and OBSI) have different jurisdictions and may oversee the same or different market participants. Inevitably there are some duplications, inconsistencies and gaps. We recommend that the Integrated Working Committee clarity the respective roles of the various Regulators and market infrastructure entities.

Funding for investor initiatives Depending on how enforcement actions are split as between New SRO and the CSA, there could be a decline in fine revenue for statutory regulator Restricted/ Designated funds. These funds help support investor education, whistleblowing payouts, investor research, grants to consumer groups like FAIR and even investor compensation. Our concern is that if New SRO dominates fine collection, the cash available to statutory regulators for these investor-friendly activities would be significantly reduced unless supplemented by other sources from operating budgets.

CSA oversight of New SRO: K Currently, the CSA Recognizing Regulators have adopted a risk-based methodology to determine the scope of SRO oversight Reviews. In our view, this approach is a weakness - the scope of review should broaden to include governance, rule making, compliance, enforcement and investor engagement (and complaint handling). The oversight process could be focused on achievement of identified, high-level outcomes and mandates, metrics and standards rather than limited to assessing the adequacy and thoroughness of internal processes. Kenmar recommend that this oversight function should be elevated to compliance monitoring with enhanced public transparency of activities, metrics and results.

An annual assessment report card should be made public as a means to report whether the SRO was fulfilling its investor protection and Public interest mandates.

Kenmar also recommend that New SRO oversight should be undertaken by a dedicated unit within the CSA. The SEC has established such a dedicated oversight unit for FINRA; Re *Watching the Detectives: The SEC Launches a Dedicated FINRA Oversight Unit* https://www.lexology.com/library/detail.aspx?g=bf70315c-13d3-428e-87c6- 62d91d5f0c7c The unit should also serve as the formal receptor of any unaddressed investor or Firm complaints against New SRO. This will provide invaluable grass roots insight into New SRO behaviour and performance.

Conclusion

Establishing an accountable New SRO involves more than securities regulation. For millions of Canadians, the investments made via Member Firms are their primary source of retirement income security. The New SRO is therefore an integral part of our socio-economic network.

The establishment of New SRO is a long overdue investor protection improvement. Weak regulation of Firms by SRO's has cost retail investors billions of dollars over the last decade. Examples include the double billing scandal, the fiasco involving discount brokers collecting commissions for personalized advice, exploitive contract terms, abusive low-ball complaint settlements and low proficiency / conduct standards. It is our expectation that the points we have made herein will receive serious consideration and where they are not addressed, appropriately justified.

A single national SRO has the potential to deliver significant benefits to investors by enhancing investor protection and ultimately improving investor outcomes.

Kenmar looks forward to working with the Integrated Working Committee and New SRO Board on the activities to establish a New SRO in an expeditious manner.

Sincerely,

Ken Kivenko, President
Kenmar Associates

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