



THE INVESTMENT
FUNDS INSTITUTE
OF CANADA

L'INSTITUT DES FONDS
D'INVESTISSEMENT
DU CANADA

IFIC Submission

Client Focused Reforms

Proposed Amendments to National
Instrument 31-103 and Companion
Policy 31-103 CP





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Delivered By Email

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British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission of New Brunswick
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Registrar of Securities, Yukon Territory
Superintendent of Securities, Nunavut

Attention:

The Secretary
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Me Anne-Marie Beaudoin
Corporate Secretary
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Dear Sirs and Mesdames:

RE: Client Focused Reforms – Proposed Amendments to National Instrument 31-103 and Companion Policy 31-103 CP

Introduction

The Investment Funds Institute of Canada (**IFIC**) appreciates the opportunity to comment on the proposed amendments to National Instrument 31-103 *Registration Requirements, Exemptions*

and Ongoing Registrant Obligations (NI 31-103) and to Companion Policy 31-103 CP Registration Requirements, Exemptions and Ongoing Registrant Obligations (31-103 CP and, together with NI 31-103, the **Proposals**). IFIC supports the Canadian Securities Administrators' (CSA) objectives to:

- better align the interests of securities advisers, dealers and representatives (**registrants**) with the interests of their clients;
- improve outcomes for clients; and
- make clearer to clients the nature and terms of their relationship with registrants.

IFIC is the voice of Canada's investment funds industry. IFIC brings together 150 organizations, including fund managers, distributors and industry service organizations to foster a strong, stable investment sector where investors can realize their financial goals. The investment funds industry has a long-standing history of supporting measures to enhance investor protection and increase transparency in the adviser-client relationship while continuing to preserve investor choice. We continue to support these initiatives.

We note that our membership represents a variety of different business models. There may be issues unique to each business model that are not part of our submission, but will be addressed by our Members through other avenues, including their own submissions.

Executive Summary

As detailed in our submission, areas of the Proposals can be clarified or enhanced to enable registrants to implement the Proposals in a practical and efficient manner. We believe our recommendations for clarification or modification are consistent with the intent of the Proposals and will address three key concerns:

- first, we seek to preserve choice for investors. As discussed below, aspects of the Proposals could have the unintended consequence of reducing investor choice. This would apply both to choice of product and choice of services. We continue to believe that preserving access to the financial advice and products investors want, at a price they can afford, should be the goal of any regulatory intervention;
- second, we strive for a balance between the cost to investors and the value of the advice and products they receive. Advice is highly valued by investors, the vast majority of whom agree that their adviser is worth the fees and encourages better savings and investment habits¹. It is important that regulation recognizes the valuable service registrants provide; and
- third, we seek a workable approach to addressing conflicts of interest in the best interests of clients. We believe that disclosure can be an effective mitigant in some circumstances.

General Comments on the Proposals

It is our view that the following overarching concerns must be addressed in the final rule:

1. Reduced Investor Choice

We believe that certain of the Proposals will result in lessening investor choice. The know your product requirement to compare products on the registered firm's product shelf with similar products in the market will cause registered firms to narrow their product shelves in order to manage the firm's compliance obligations. Similarly, the requirement for registered individuals to

¹ See Canadian Mutual Fund Investors' Perceptions of Mutual Funds and the Mutual Fund Industry, 2017 (<https://www.ific.ca/wp-content/uploads/2017/11/Pollara-Investor-Survey-Final-Report-English.pdf/18460/>); and Canadian Mutual Fund Investor Survey, 2018 (<https://www.ific.ca/wp-content/uploads/2018/09/2018-Pollara-Mutual-Fund-Investor-Survey-September-2018.pdf/20751/>).

compare a product with similar products on the firm's product shelf will lead to a narrowing of product shelves to assist registered individuals to manage their compliance obligations.

We note that this is a recognized potential unintended consequence of the Proposals. The regulatory impact analysis statement of the Ontario Securities Commission, set out in Appendix E of the Proposals, notes that there "may be the potential for an unintended consequence as some dealers may choose to move to a proprietary-only model."² We believe that any lessening of choice, whether intended or not, does not benefit investors.

Recommendations: We request that the CSA reconsider those aspects of the Proposals that may have the unintended consequence of reducing investor choice. In particular, guidance related to the know your product obligations, as discussed further below, should be aligned with existing guidance from the self regulatory organizations (**SRO**).

In addition, the implementation costs of the Proposals will be significant for the industry. The nature of the costs and requirements will differ based on the business model and size of the firm. A disproportionate impact will be felt by smaller firms, and may result in reducing competition and investor choice if they exit the market or a segment of the market. As a result, it is imperative to make the implementation costs more manageable through certain critical changes and clarifications to the Proposals, as discussed below.

2. Overemphasis on Cost

The Proposals put a heavy emphasis on cost in the know your product and suitability determination requirements. The premise appears to be that better investment outcomes for clients can be achieved only through lower cost products and services.

The goal of most investors is to build wealth over time with a portfolio that delivers favourable returns and that is consistent with their risk profiles and financial objectives. However, implicit in the Proposals is that client outcomes are not achieved through long-term savings or wealth accumulation, but are rather driven by the cost of investment products. While we agree that costs affect client returns, we do not agree that costs are the sole or primary determinant of good outcomes. We are concerned that the overemphasis on costs does not ascribe value to the advice clients receive and may have the unintended outcome of reducing investor choice. For example, the proposed guidance states under 13.3 *Suitability determination – Potential and actual impact of costs*:

Registered individuals must put their client's interest first when selecting between multiple suitable options available to the client.

Unless a registrant has a reasonable basis for determining that a higher cost security will be better for a client, we expect the registrant to trade, or recommend, the lowest cost security available to the client in the circumstances that meets the requirements of subsection 13.3(1). However, we recognize that there may be reasons why a specific higher cost security available at the firm may be better for a client than other suitable securities available at the firm. [emphasis added]

This language may be misinterpreted as the CSA directing registrants to choose the lowest cost product when selecting between multiple suitable product options. This creates ambiguity about how a registrant should consider costs in making a suitability determination, and may cause registrants, due to regulatory concerns, to avoid recommending products that may be suitable for a particular client but have higher costs. Products that are not the lowest cost may offer other benefits, such as the nature and quality of the product provider's services (including the advantage to the client of consolidating investments at a single product provider to obtain fee

² See Appendix E *Ontario Local Matters - Schedule I Conflicts*

discounts or other services that may be offered), minimum initial investments, ease of doing business and the reputation of the product provider.

The heavy emphasis on cost does not take into account product structure, purchase options and other features, alignment with investors' risk profiles, return history and the non-monetary benefits to clients of receiving financial advice. The value of financial advice over the long term is well documented.³ Research demonstrates that investors who receive advice build more wealth over time. In addition to assisting clients in choosing appropriate investment products to meet their investment goals, advisers also serve as financial coaches who help investors develop disciplined savings habits, avoid common behavioural pitfalls and make optimal use of tax sheltered savings options (such as RRSPs and TFSAs) to maximize returns. Investment advice also gives investors higher levels of confidence in their ability to make financial decisions.

This overemphasis on cost is also inconsistent with the regulatory recognition that certain of the one-time and on-going costs registrants will incur in complying with the Proposals will be passed on to clients in the form of increased product costs or service fees. The Ontario Securities Commission notes in Appendix E that the compliance costs to registrants will be significant in many cases. It then, correctly, notes that some of these costs will be borne by clients⁴, presumably through increased costs of products and/or services. We believe the Proposals should achieve a better balance between the valuable advisory services provided by registrants, who must remain profitable, and the desire for lower cost products and services.

Recommendations: We request the CSA:

- explicitly recognize the value provided to clients by advisers and that there is a cost for that advice; and
- clarify that a registrant may consider legitimate, subjective factors in addition to costs to meet the suitability obligation.

3. Companion Policy Guidance

The guidance provided by the CSA is a helpful aid to registrants in implementing the changes to NI 31-103. We appreciate the CSA's recognition that firms will tailor their implementation of the know your client elements of the Proposals based on their specific business models. However, we believe it is important that the CSA also recognize the need for registrants to have flexibility to implement the other new requirements of NI 31-103 in a manner suited to their specific business model. Regulatory compliance reviews must not require strict adherence to the guidance in the 31-103 CP. Rather, compliance reviews must consider the effectiveness of a registrant's implementation of the requirements in NI 31-103.

The decision of the Ontario Court of Appeal in *Ainsley Financial v. Ontario Securities Commission* (**Ainsley**) specifically stands for the principle now enshrined in section 148.3(1)(d) of the *Securities Act* (Ontario): that "a non-statutory instrument cannot impose mandatory requirements enforceable by sanction; that is, the regulator cannot issue *de facto* laws disguised as guidelines."⁵

In our view, certain elements of the 31-103 CP have been cast as regulatory expectations against which compliance with NI 31-103 will be judged. This is inconsistent with the role of policy

³ See PricewaterhouseCoopers LLP, *Economic Impact Assessment of Banning Embedded Commissions in the Sale of Mutual Funds*, May 2017, annexed as Appendix G to IFIC's submission on CSA Consultation Paper 81-408 *Consultation on the Option of Discontinuing Embedded Commissions* (<https://www.ific.ca/wp-content/uploads/2017/06/IFIC-Submission-CSA-Consultation-Paper-81-408-Consultation-on-the-Option-of-Discontinuing-Embedded-Commissions-June-9-2017.pdf/17416/>) at p 27 to 29 and Appendix D to the IFIC submission.

⁴ See Appendix E Ontario Local Matters at *Regulatory Impact Analysis of the Reforms to Enhance the Client-Registrant Relationship (Client Focused Reforms)* "We anticipate that the one-time and on-going costs likely to be imposed by the proposed amendments will be borne directly by registrants, indirectly by their service providers and, to a certain extent, passed on to clients." [emphasis added]

⁵ See decision of Doherty, J.A. at <http://canlii.ca/t/6kcc>

guidance as confirmed by the Ainsley decision. We provide the following examples of the 31-103 CP, which raise these concerns:

- the know your product requirement in s. 13.2.1(1)(a) requires a registered firm to take reasonable steps to understand a security. In contrast, the 31-103 CP sets out expectations for product due diligence which, in our view, are not reasonable and impose onerous and impractical product due diligence obligations on registered firms.⁶
- the apparent prohibition on relying solely on the issuer of a publicly listed company found in the product due diligence guidance in the 31-103 CP. Under Canadian securities legislation, the offering documents of the issuer must contain full, true and plain disclosure, with liability for misrepresentation. There is also a continuous disclosure record. As a result, registered firms must be able to rely on this information.⁷
- the definition of conflict of interest in the 31-103 CP⁸ rather than within NI 31-103. This is in contrast to the approach taken to National Instrument 81-107 *Independent Review Committee for Investment Funds* in which the CSA included the definition of a “conflict of interest matter” within the instrument itself.
- guidance related to internal compensation arrangements and incentive practices attempts to regulate, through the 31-103 CP, how registered firms manage the performance of their registered individuals. While we agree that registered firms must properly address the conflict of interest created by internal compensation arrangements and incentive practices, we believe they must also have the ability to manage the performance of their registered individuals without the risk that performance management matters become regulatory compliance matters.
- guidance that clients holding securities with embedded commissions in a fee-based account creates a conflict of interest that can be managed by either using a security that does not contain embedded commissions or making the client whole. This expectation articulates the outcome of various settlement agreements dating back to 2014. This suggests that this is, in fact, a regulatory requirement that is better placed in new section 13.4.4 *Conflicts that must be avoided* of NI 31-103.

Recommendations: We request that the CSA amend the Proposals as follows:

- specifically state in the 31-103 CP that the guidance is provided to assist registrants in their compliance with NI 31-103, but registrants have flexibility to tailor their implementation of the requirements of NI 31-103 to their particular business model;
- specifically reference the scalability in implementation of the client-focused reforms more broadly, particularly as they apply to the know your client and know your product requirements; and
- incorporate into NI 31-103 any aspects of the 31-103 CP that are requirements (e.g. the guidance related to embedded commissions in fee-based accounts).

We also request the deletion of any mandatory language from the 31-103 CP that otherwise suggests a requirement or standard that must be complied with.

⁶ See discussion below “Know Your Product Requirements 1. Product Due Diligence” at page 6.

⁷ See discussion below “Know Your Product Requirements 1. Product Due Diligence” at page 6.

⁸ See 31-103 CP Division 2 *Conflicts of Interest – Responsibility to identify conflicts of interest – What is a conflict of interest?*

4. Regulatory Consistency

We believe certain elements of the Proposals can be informed by existing SRO guidance. This will make the regulatory expectations in the Proposals consistent with well-understood, recognizable standards already in place in the industry. Examples include:

- risk based due diligence on products under the know your product requirements, as more specifically set out below;
- collection of know your client information for multiple accounts in the appropriate circumstances; and
- addressing material conflicts of interest.

We also believe it is important to use consistent language in the Proposals when intending to convey the same meaning. For example, in the know your client requirements in the 31-103 CP, there is reference to “thoroughly understanding the client” as well as “meaningful understanding of client’s investment needs and objectives”. In both cases, we understand this to mean that registrants must fulfill their know your client obligations by obtaining a sufficient understanding of the client in order to make a suitability determination. Similarly, in the know your product guidance, there is a reference to both an understanding of the product shelf at a “general level” and a “high-level” understanding of each product. Again, we understand this to mean that a registered individual must have a sufficient understanding of the products made available to clients to enable him/her to compare them.

Recommendations: We request that the CSA:

- reflect existing SRO guidance in the Proposals, with any necessary and appropriate additions and enhancements. This will make the Proposals more manageable from an implementation and compliance perspective. Such an approach will also enable registrants to utilize existing systems, policies and procedures to more efficiently and cost effectively meet the new requirements of the Proposals; and
- use consistent language when intending to convey the same meaning within the Proposals.

Know Your Product Requirements

IFIC supports the inclusion of explicit know your product requirements in NI 31-103. These requirements must strike an appropriate balance between the gatekeeper role of the firm in assessing and selecting the products it will make available to clients and the obligation of the individual registrant in selecting products that will meet a client’s needs. We also support the requirement for firms to maintain a product offering that is consistent with how they hold themselves out.

We urge the CSA to enhance the clarity of certain aspects of the Proposals to create consistency both within the 31-103 CP and with existing SRO guidance.

1. Product Due Diligence

We appreciate the extensive guidance provided by the CSA on the product approval process, including recognition of the varying levels of review required for different types of securities that is consistent with existing SRO guidance. Specifically, the 31-103 CP provides that:

“The extent of the KYP process required for a security will depend on the structure and features of that security, and a firm’s policies and procedures should set out the different levels of review for different types of securities, as appropriate. For example, complex investment products, including those that are novel, not transparent in structure, or involve leverage, options or other derivatives, may require a more extensive review than more straightforward securities. Securities sold under a prospectus exemption may require a more

extensive review because of the limited disclosure available about them and the less liquid nature of the securities.”⁹

However, the guidance on product due diligence is inconsistent with the risk-based approach contemplated in the above-quoted guidance. In fact, the guidance significantly expands a firm’s product due diligence obligations beyond information made publicly available by an issuer:

“Firms must document their independent analysis of the security’s structure, features, returns, risks and initial and ongoing costs of the security as well as the impact of those costs. We expect firms to undertake an in-depth analysis of the security where any issues are identified during the review process.

A security cannot be approved based solely on ... representations, information, documentation, analyses or reports received from issuers...”¹⁰ [emphasis added]

Securities legislation creates an expansive disclosure framework under which a public issuer must provide full, true and plain disclosure with respect to a security. We are concerned that the language in the 31-103 CP quoted above creates ambiguity as between the obligation of the issuer and the obligation of the distributor.

It is our view that existing SRO guidance strikes the appropriate balance between the obligations of the issuer and the obligations of distributors in this regard. IIROC Notice 09-0087 *Best practices for product due diligence* explicitly states at page 6 that:

“Dealer members are entitled to rely on factual information and disclosure documents provided by issuers or manufacturers of products under review, unless there are obvious reasons to question their validity. However, in doing so the dealer member will have to judge whether the disclosure document answers all the relevant questions and whether it provides sufficient, balanced disclosure or is overly promotional in nature.” [emphasis added]

This approach allows firms to exercise their professional judgment to determine when further inquiry is necessary based on the information provided by an issuer. This is also consistent with the approach in MFDA Staff Notice MSN-0048 *Know Your Product* that sets out a process that begins with an independent and objective assessment of the issuer’s offering documents and marketing materials.

We also believe such onerous product due diligence obligations for investments transferred in or purchases through client-directed trades will result in clients being unable to consolidate assets with a registrant of their choice, thus missing opportunities for any available fee reductions from tiered pricing, or being limited to order execution only firms for those investments. This may be particularly problematic for aging clients seeking to consolidate their assets.

In the absence of clarification, an impractical situation will result for both product manufacturers and the firms distributing those products. Manufacturers will receive a myriad of inquiries from distributors endeavouring to evidence an independent process that does not rely solely on issuer documentation. The result will be an inefficient process for public issuers such as conventional mutual funds and exchange-traded funds, which are already subject to a robust and standardized disclosure regime. This cannot be what the CSA intended.

Recommendations: We request the CSA amend the Proposals to support explicitly a risk-based product due diligence process. Standard products, such as conventional mutual funds and exchange-traded funds, should require less in-depth inquiry, with greater reliance on

⁹ See 31-103 CP 13.2.1 *Know Your Product – Firm KYP process*

¹⁰ See 31-103 CP 13.2.1 *Know Your Product – Due diligence process*

public issuer documents, unless there are reasons to question their validity. Where a review of information provided by an issuer raises questions about the product, firms must make an inquiry and follow up until the firm is satisfied that it has a clear understanding of the product. In contrast, complex or non-transparent products require a more comprehensive review. This would harmonize the expectation set out in the 31-103 CP with the existing SRO guidance and create consistency within the 31-103 CP.

2. Security vs. Product

As drafted, the know your product requirements apply only to securities. In contrast, existing SRO guidance on registrants' know your product obligations uses the term "product" in recognition of transactions in investment products that are not securities (e.g. GICs, principal protected notes). As NI 31-103 regulates the conduct of registrants when acting in a registrable capacity, the Proposals should clarify this intent. In the absence of this clarification, an ambiguity exists, creating opportunities for regulatory arbitrage.

Recommendation: We request the CSA amend the Proposals to clarify the intent to regulate the registrable activities of registrants in respect of all investment products.

3. The Impact of Costs

The proposed amendments to NI 31-103 require firms to understand the impact of costs. The 31-103 CP clarifies that firms must assess "the initial and ongoing costs of acquiring, owning and disposing of a security, as well as the impact of those costs on performance, client returns or otherwise...".¹¹ Similarly, in making a suitability determination, registrants must consider the potential and actual impact of costs on the client's returns. Given the interconnectedness of the know your product and suitability determination, these provisions should be made consistent.

Recommendation: We request the CSA amend the Proposals as follows to specify that firms must consider the impact of costs on the performance of the product as part of the know your product obligation:

13.2.1(1) A registered firm must not make a security available to clients unless the firm

(a) takes reasonable steps to understand the security, including all of the following:

(ii) the initial and ongoing costs of the security and the impact of those costs on acquiring, owning or disposing of the security and on the performance of the security;

4. Firm's Obligation to Provide Training

The Proposals create an explicit obligation on a registered firm to provide training to its registered individuals on prescribed elements of each product on the firm's product shelf. They also require registered firms to ensure registered individuals have the necessary information to comply with their know your product obligation. The guidance in the 31-103 CP suggests firms provide "product training to ensure their registered individuals have a sufficient understanding of the securities and their risks."¹² Firms must also "assess whether any additional training or proficiency requirements are necessary in order for their registered individuals to understand the securities and make appropriate suitability determinations".¹³

¹¹ See 31-103 CP 13.2.1 *Know Your Product – Understanding the securities made available to clients*

¹² See 31-103 CP 3.4.1 *Firm's obligation to provide training – Compliance training*

¹³ See 31-103 CP 3.4.1 *Firm's obligation to provide training – Training to support the know your product obligation*. See also 31-103 CP 13.2.1 *Know Your Product – Training and compliance system requirements*

Registered firms should be able to take a flexible approach to product training. Investment funds are already subject to comprehensive, standardized disclosure obligations. The CSA has expended great effort in ensuring that fund information, including fees, is clear and comparable across funds. The registered firm should therefore direct its registered individuals to these disclosure documents as the authoritative source of information about the fund. Registered individuals can use a fund's prospectus, together with a Fund Facts document or ETF Facts, to understand the structure, features, returns, risks and costs of a fund and to compare funds. Any suggestion to the contrary could result in inconsistent disclosure, potential errors, lack of comparability among funds and could undermine the CSA's efforts to create specific and comparable information on funds.

We also note that it is well-accepted practice for investment fund managers to assist distributors in the product training process. National Instrument 81-105 *Mutual Fund Sales Practices (NI 81-105)* specifically recognizes the role of investment fund managers in the registrant education process and sets out acceptable educational practices. We believe this practice can continue to assist distributors to meet their product training obligations.

Recommendation: We request that the CSA confirm that registered firms can fulfill the know your product training obligations by:

- directing registered individuals to available disclosure documents for conventional mutual funds and exchange-traded funds; and
- continuing to work with investment fund managers in a manner consistent with the requirements of NI 81-105.

5. Know Your Product Obligation of Registered Individuals

The proposed rule requires registered individuals to understand the product shelf at a general level, including how the securities compare. Guidance in the 31-103 CP clarifies that registered individuals must compare securities to one another. We understand this to mean that the know your product training provided by the firm fulfills the obligation for registered individuals to understand, at a general level, the products available through the firm. Registered individuals can then focus on a smaller universe of products and access additional information available from the firm on these products. We further understand that the selected universe of products chosen by a registered individual will depend on the skills (e.g. years of experience, proficiency, etc.) of the individual. This approach will enable a registered individual to satisfy his/her know your product obligation with respect to the firm's product shelf.

We understand that the obligation to compare products requires registrants to compare similar products. The comparison must be contextual, taking into consideration the client's requirements, the firm's product shelf and the proficiency of the registered individual. In addition, we understand a comparison of similar products to be between products that have the same fundamental features and attributes to make the comparison meaningful. For example, in the context of investment funds, in choosing an actively managed Canadian equity fund, the appropriate comparison is to funds that have a similar actively-managed Canadian equity mandate.

Recommendation: We request that the CSA amend the guidance in the 31-103 CP to make clear our understanding set out above with respect to the fulfilment of a registered individual's know your product obligation through the training provided by the firm. The guidance should also clarify that product comparisons should look at factors including investment strategy, product features and product quality.

Know Your Client Requirements

IFIC generally supports the enhancements to the know your client requirements of NI 31-103. In particular, we appreciate the CSA prescribing the categories of information to be collected while providing firms with flexibility to tailor their processes to reflect their particular business models

and client needs. This approach recognizes the personal nature of the client/registrant relationship and allows for tailored information collection.

We also appreciate the reasonable approach proposed to obtaining a client's confirmation of the accuracy of the information collected and the periodic review of the information collected. We are supportive of the requirement to take reasonable steps to update KYC at the intervals specified in proposed section 13.2(4.1). We note that the 31-103 CP clearly recognizes the integral role of the client in this process, stating "the registrant should review and update the information on record after having a meaningful and documented interaction with the client in order to keep the information current."¹⁴ [emphasis added]

However, this recognition in the guidance is contradicted by subparagraph 13.2(4.1)(a)(i) of NI 31-103, which requires a registrant to review the information collected if the registrant "reasonably ought to know" of a significant change in the client's information.

Recommendation: We request that the CSA amend subparagraph 13.2(4.1)(a)(i) of NI 31-103 by deleting the words "or reasonably ought to know".

Suitability Determination

IFIC supports the enhanced suitability obligations set out in the Proposals. In particular, we agree with the specific suitability factors registrants must consider when recommending or taking any investment action for a client. The extensive guidance provided by the CSA in respect of the specific factors will assist registrants in complying with the requirements of the suitability determination. The move to an overall portfolio-level suitability analysis is also appropriate where clients have multiple accounts with the same registrant. This is even more important for aging clients who seek to consolidate their assets with a single registrant. However, we caution that portfolio-level suitability may not be appropriate in all circumstances. For instance, a client may have certain accounts that have a discrete investment purpose that is not relevant to the management of the client's other accounts (e.g. a discrete account which may be purely for speculative investing). In such circumstances, it would not be appropriate to include that account in the overall portfolio suitability analysis. Finally, we agree with the triggering events that require a registrant to reassess suitability, and recognize the CSA's harmonization of these suitability triggers with the suitability triggers currently in place in the SRO rules.

1. Putting Client's Interest First

We agree with the principle that the suitability determination must put the client's interest first. While the 31-103 CP provides extensive guidance on the specific suitability factors, there is limited guidance on how a registrant demonstrates that an investment action puts the client's interest first. The guidance provided focuses on a registrant's residual self-interest that may affect client outcomes with specific reference to remuneration, financial gains or other incentives as examples of such residual self-interest. In our view, any self-interest, residual or otherwise, creates a conflict of interest which is properly addressed under the conflicts of interest obligations of the Proposals. In adopting a best interest standard in the management of conflicts, the CSA explicitly recognizes that such a standard "has been given clear meaning in relation to conflicts of interest, which will assist in effective compliance with our expectations"¹⁵. In contrast, the lack of guidance with respect to the "client first" element of the suitability determination creates uncertainty for registrants in demonstrating compliance.

Recommendation: We request that the CSA create a regulatory safe harbour such that if a registrant meets his or her obligations under the specific suitability factors and manages material conflicts of interest in the best interests of the client, the registrant is deemed to have put the client's interests first in the suitability determination. This

¹⁴ See 31-103 CP 13.2 *Know Your Client – Keeping KYC information current*

¹⁵ See CSA Notice and Request For Comments at page 8 *Summary of Proposed Amendments – Conflicts of Interest – Part 13: Division 2 [Conflicts of interest]*

approach will provide regulatory certainty on compliance with the obligation to put the client's interests first in the suitability determination.

This would be similar to the approach taken by the United States Securities and Exchange Commission (**SEC**) in its proposed Regulation Best Interest. Regulation Best Interest provides that the best interest standard is deemed satisfied if the care obligation (akin to the suitability determination), disclosure obligation (akin to the mandated disclosures under NI 31-103) and the conflicts of interest obligations (akin to the conflicts of interest obligations under the existing rule) are met.

2. Reassessment of Suitability

Proposed section 13.3(2) of NI 31-103 will require a review of the suitability determination promptly upon the occurrence of the specified events. We do not believe it is practical to require a prompt review of suitability. Rather, suitability should be reviewed within a reasonable time that is appropriate in the circumstances surrounding the event that causes a suitability review to be conducted.

Recommendation: We request that the CSA explicitly amend the rule to require a review of suitability within a reasonable time in the circumstances.

Conflicts of Interest

IFIC supports the adoption of a best interest standard in the management of conflicts of interest that is consistent with existing SRO rules. We agree that registrants must identify all conflicts of interest and address them by applying a risk-based approach. Conflicts that are not material, consistent with the guidance in the 31-103 CP, can be addressed through appropriate policies and procedures or codes of conduct that guide registrant behaviour. We also agree that disclosure of conflicts must be provided in plain language that is easily understood by investors.

As further detailed below, we understand the disclosure obligation to apply only to material conflicts of interest rather than all conflicts of interest. We also believe that disclosure alone can effectively address conflicts of interest in the best interest of clients in some circumstances.

1. Disclosure of Material Conflicts of Interest

We agree that a registrant must identify and address all conflicts of interest in the best interests of clients. However, we understand the obligation to disclose all conflicts of interest where a reasonable person would expect to be informed of such conflict requires only material conflicts of interest to be disclosed. The alternative would result in overloading investors with disclosure, which will not ultimately affect their investment decision, and may serve to dilute the effect of disclosure related to material conflicts of interest. Providing investors with information related to all conflicts of interest is also not helpful to informed or timely decision-making. We believe the requirement in section 13.4.5(1) should include the word "material" to limit the conflicts disclosure to material conflicts of interest. This would be consistent with the approach taken by the CSA in National Instrument 81-107 *Independent Review Committee for Investment Funds* wherein the CSA applied a "reasonable person" test to define a conflict of interest matter and explained in the related commentary that the CSA does not expect this "to capture inconsequential matters"¹⁶.

In determining which conflicts a reasonable client would expect to be made aware of, it would be useful to incorporate the additional guidance provided in the current SRO rules¹⁷. In particular, we suggest that the CSA incorporate guidance to the effect that registrants address conflicts in a fair, equitable and transparent manner through the exercise of responsible business judgment.

¹⁶ See Commentary 2 at section 1.2 *Definition of "conflict of interest matter"* of National Instrument 81-107 *Independent Review Committee for Investment Funds*

¹⁷ See IIROC Dealer Member Rule 42 and MFDA Rule 2.1.4(b)

Recommendation: We request that the CSA amend section 13.4.5(1) to require disclosure of material conflicts of interest of which a reasonable client would expect to be informed. We also request the CSA incorporate guidance that registrants should address conflicts in a fair, equitable and transparent manner through the exercise of responsible business judgment.

2. Recognize Disclosure as an Effective Mitigant

The Proposals state that disclosure is not, in itself, sufficient to satisfy the obligation to address conflicts of interest in the best interest of the client. This is a significant departure from the current acceptance of disclosure as an effective mitigant in some circumstances. The proposed approach applies a different standard to registrants in the management of conflicts of interest than the standard applicable to fiduciaries under the common law fiduciary duty. A regulatory provision that stipulates that disclosure alone is not sufficient would therefore set a higher duty on registrants in managing conflicts of interest than is expected of a fiduciary at common law.

An approach that recognizes that disclosure is an effective mitigant in the appropriate circumstances is consistent with the approach adopted in other areas of NI 31-103. The following examples point to the role of disclosure in enabling investors to make informed decisions:

- the obligation to disclose a registered adviser's policies related to the fair allocation of investment opportunity (section 14.3 of NI 31-103),
- the disclosure of referral arrangements which the Proposals specify create a conflict of interest (section 13.10), and
- the inclusion of disclosure related to fees and conflicts in the relationship disclosure information.

We also note that the SEC's proposed Regulation Best Interest requires broker-dealers to identify and at a minimum disclose all material conflicts of interest associated with recommendations. This is a tacit acknowledgement that disclosure can be an effective mitigant.

Recommendation: We request the CSA amend the Proposals to state explicitly that disclosure can be an effective mitigant in some circumstances. Registrants must exercise their professional judgment to determine which material conflicts cannot be properly addressed through disclosure alone and implement appropriate controls for those conflicts.

Alternative Recommendation: If the CSA continues to believe that disclosure alone is not sufficient to manage material conflicts of interest related to financial incentives, we request, in the alternative, that the Proposals include a requirement to disclose all material conflicts of interest other than those arising from financial incentives associated with investment decisions. Conflicts of interest that arise specifically from financial incentives associated with investment recommendations must be both disclosed and mitigated¹⁸. This would create a limiting principle on which material conflicts must be mitigated beyond disclosure alone. Given financial incentives are the largest source of material conflicts in the adviser-client relationship, we believe this strikes an appropriate balance in the management of material conflicts of interest.

3. Proprietary Product Only Firms

The Proposals will require registered firms that only offer proprietary products to manage conflicts of interest associated with this business model by disclosing their business model to clients and conducting product comparisons with non-proprietary products to assess whether they are

¹⁸ This approach aligns with IIROC Notice 17-0093 – Rules Notice – Dealer Member Rules – Guidance Note – *Managing Conflicts in the Best Interest of the Client – Compensation-related Conflicts Review* that focused on disclosure alone being insufficient to manage compensation related conflicts.

competitive with such alternatives available in the market. We agree with these examples of how conflicts related to a proprietary product only business model can be controlled.

However, we understand this guidance to apply only in the context of retail clients. Sophisticated, institutional clients, in contrast, choose registered firms specifically for their proprietary products, often with the assistance of their own advisers and consultants.

Recommendation: We request the CSA amend the Proposals to clarify that the management of conflicts of interest by proprietary product only firms applies to retail client distribution, and not to services provided to permitted clients.

4. Third-Party Compensation

The Proposals introduce a definition of third-party compensation into NI 31-103. Registered firms must provide a general description of third-party compensation that may be received in relation to different types of products available through the firm in the relationship disclosure information and under the new duty to provide information in section 14.1.2. In addition, there is extensive guidance in the 31-103 CP on conflicts arising from third-party compensation and how to address such conflicts. IFIC agrees with and supports the need to control conflicts related to third-party compensation.

We believe registrants can and do manage the material conflicts of interest posed by third-party compensation through appropriate disclosure, clear policies and procedures regarding the suitability of selling products with embedded compensation and supervisory processes for identifying and querying the suitability of such transactions. Moreover, given the combined effect of CRM2 and Point of Sale disclosures, these payments have become more transparent to investors. This new information has been making a measurable difference in investor understanding and awareness.¹⁹

However, the broad definition of third-party compensation, which includes both monetary and non-monetary benefits, raises questions as to the interplay between the requirements under the Proposals and NI 81-105, which has regulated mutual fund sales practices in the investment funds industry since its introduction in 1998.

Recommendation: We request the CSA amend the Proposals to clarify that the Proposals apply to investment products not subject to NI 81-105 and that NI 81-105 continues to regulate mutual fund sales practices.

5. Registered Individual's Responsibility to Address Conflicts of Interest

The Proposals introduce an explicit obligation for registered individuals to identify and address conflicts of interest in the best interest of clients. Proposed paragraph 13.4.3(3)(b) requires a registered individual to obtain the consent of the registered firm before proceeding with any dealing or advising activity that involves a conflict of interest. This may create an operational challenge as it implies that registered individuals must obtain the consent of the registered firm to proceed with each investment action that involves a conflict of interest. This suggests, for example, that each purchase of a security that pays embedded compensation requires the consent of the registered firm before the registered individual can proceed. That would have the effect of making the transaction process cumbersome and impractical for both the client and the registrant.

We believe registered firms must be permitted to provide a "standing approval" for recurring conflicts such as in the example involving a security with embedded compensation once the firm has appropriately addressed the conflict of interest matter at the firm level. This approach would

¹⁹ See Canadian Mutual Fund Investors' Perceptions of Mutual Funds and the Mutual Fund Industry, Pollara, 2017; Canadian Mutual Fund Investor Survey, Pollara, 2018; and BCSC, Investor Readiness for Better Investing: 2016-2017 Panel Study.

allow registrants to identify and address recurring conflicts without negatively impacting the client experience.

Recommendation: We request that the CSA clarify the Proposals to provide that recurring conflicts of interest between the registered individual and the client can be addressed through standing approvals.

Applicability of Client Focused Reforms to Permitted Clients

While IFIC generally supports the enhanced know your product, know your client and suitability requirements of NI 31-103, we believe the CSA must clarify that they do not apply to institutional clients.

CSA Consultation Paper 33-404 *Proposals to Enhance the Obligations of Advisers, Dealers, and Representatives Toward their Clients* included an exemption from the enhanced know your client and suitability requirements for a newly defined category of institutional clients. Similar to that proposal, we believe an exception to the enhanced know your product, know your client and suitability requirements of the Proposals should be made for “permitted clients”. In the absence of such an exception, the Proposals would require registrants dealing with institutional clients to collect information which is unnecessary given the nature of the relationship and which the institutional client may not want to provide.

Currently, under NI 31-103, exemptions from the know your client and suitability requirements exist for permitted clients provided the client does not have a managed account. We believe the Proposals should include an exemption from the enhanced know your product, know your client and suitability requirements for permitted clients irrespective of whether the client has a managed account. Permitted clients are sophisticated clients that employ their own advisers to assist them in understanding the risks and benefits associated with investment products. They generally conduct their own, robust due diligence before making an investment. Their relationship with a registrant is governed by an investment management agreement in which the client negotiates the necessary terms and protections. They do not require the benefit of these enhanced requirements.

For example, under the Proposals as currently drafted:

- a portfolio manager retained by an investment fund to manage its investments must fulfill the enhanced requirements despite the investment fund being a permitted client. Moreover, because the arrangement fits within the definition of a “managed account”, the arrangement cannot come within the exemptions set out in sections 13.2(6) and 13.3(4); or
- a pension plan with its own internal and external advisers that seeks to invest in an investment fund offered by a portfolio manager must be subjected to the full spectrum of enhanced requirements even where the pension plan has chosen the particular investment fund with the assistance of its own advisers.

We do not believe this was the CSA’s intention for these types of clients.

Recommendation: We request the CSA amend the Proposals to include an exemption from the enhanced know your product, know your client and suitability requirements for all permitted clients, including where the account is a managed account. In the alternative, we request the Proposals be amended to provide the exemption for non-individual permitted clients.

Referral Arrangements

The Proposals will prohibit the payment of a referral fee to a non-registrant. While a client referral may still be received from a non-registrant, the registrant is not permitted to provide a referral fee in consideration for that client referral. The rationale for the introduction of limits on referral

arrangements is found in Appendix E Ontario Local Matters and includes regulatory arbitrage concerns, concerns about non-registrants engaging in registrable activity where they receive the bulk of the revenues and market power concerns.

We agree that referral arrangements should not create opportunities for regulatory arbitrage, permit non-registrants to collect the bulk of the fees from a client's account when they do not (or are not permitted to) provide a service to the client, or increase the cost borne by the client. However, the breadth of the Proposals will also capture existing and appropriate arrangements under which non-registrants refer clients to registrants. These arrangements can provide an effective way to manage an investor's financial interests collaboratively. Non-registrants such as accountants or lawyers often work with registrants to manage an investor's financial interests for optimal outcomes. These types of non-registrants have their own self-governing bodies and are subject to professional codes of conduct/ethics and disciplinary hearings. Provided the client is receiving a value-added service from the non-registrant, the payment of a referral fee that is transparent and does not constitute registrable activity should be permissible. The ability of registrants to compensate non-registrants with a one-time referral fee would also be prohibited under the Proposals. Such arrangements can result in clients being referred to registrants who are better suited to meet client needs and should continue to be permissible. Given many existing referral arrangements do not raise the concerns outlined in Appendix E Ontario Local Matters, we believe further clarity on the objectives the CSA seeks to achieve with this broad prohibition is necessary.

The Proposals also introduce new section 13.8.1, which provides that a referral fee cannot continue for longer than 36 months, exceed more than 25% of the compensation received from the client by the party that received the referral or increase the fees otherwise payable by the client. Given the significant impact these changes will have on existing business arrangements between registrants, we believe further consultation is required to understand the rationale for the specific choice of a 36-month time limit and a 25% cap.

Recommendation: As Appendix E correctly notes, these proposed changes may have unintended consequences on referral arrangements that benefit the client. Given this possibility and the impact on existing business arrangements, we request further clarity on acceptable referral arrangements and further consultation on the appropriate limits on referral fees.

Duty to Provide Information

The Proposals introduce a new duty for registered firms to make publicly available information that a reasonable investor would consider important in deciding whether to become a client of the registered firm. The requirement also includes a prescribed list of information that must be made available. In our view, registered firms already provide this in the relationship disclosure information under section 14.2. Rather than requiring duplicative disclosure, the duty to provide information in section 14.1.2 should require registered firms to make their relationship disclosure information publicly available.

Although the requirements in section 14.2 may appear narrower than in the new duty, we understand that in practice firms currently provide information about the types of accounts offered, account minimums, minimum charges and restrictions on the types of clients to whom certain products or services are available in their relationship disclosure information.

We note that both the new duty and the relationship disclosure information require a registered firm to provide a general description of the charges and other costs to clients associated with its products, services and accounts. However, the new duty also includes a reference to "including any current fee schedule" which suggests that registered firms must make the actual fees charged available publicly. A registered firm's fees are sensitive, competitive information, which they should not have to make publicly available. Unlike order execution only firms and robo-advisers, which compete primarily on price, other registrants compete on the basis of providing a fulsome advisory relationship and access to a broader range of products and services. This

significantly reduces the comparability of the fees associated with these different business models. In addition, such disclosure could be misleading to investors as it would not contemplate any available discounting due to, for example, account size or a client's total relationship with the firm. It also does not ascribe any value to the advice and other services provided to clients.

Recommendation: We request that the CSA amend the duty to provide information to require firms to make their relationship disclosure information publicly available and remove reference to "including any current fee schedule".

Misleading Titles

IFIC supports the introduction of section 13.18 *Misleading communications* in NI 31-103. In particular, we agree with a prohibition on the use of a title, designation, award, or recognition that is based partly or entirely on a registrant's sales activity or revenue generation, or the use of a corporate officer title unless their sponsoring firm has appointed that registrant to that corporate office pursuant to applicable corporate law. This change will improve investors' understanding of the role of the registered individual within an organization and is a good start towards the CSA's longer-term project of reviewing titles and designations.

IFIC's recent submission on title reform, intended to assist the CSA as it begins its review of titles, complements, and is a logical next step to, the changes related to titling in the Proposals.²⁰

Transition Timeline

The CSA Notice and Request for Comments indicates that the CSA is considering a phased implementation for the final rule implementing the Proposals. Specifically, it suggests an immediate implementation for referral arrangements (other than pre-existing arrangements which must be brought into conformity in three years), one year to provide publicly available information and two years for all other new requirements, including know your client, know your product, suitability and conflicts of interests. We do not believe two years is a sufficient timeline to comply with the Proposals given the need for significant systems and compliance changes and the staff training that will be necessary.

Recommendation: IFIC requests that the CSA provide a transition timeline of three years after adoption of the final rule. With respect to the proposed amendments to referral arrangements, as noted above, we request further consultations which would include a discussion of the appropriate transition timelines.

Conclusion

IFIC appreciates the opportunity to comment on the Proposals. We would be pleased to provide further information or answer any questions you may have. Please feel free to contact me by email at pbourque@ific.ca or by phone 416-309-2300.

Yours sincerely,

THE INVESTMENT FUNDS INSTITUTE OF CANADA



By: Paul C. Bourque, Q.C, ICD.D
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²⁰ See English: <https://www.ific.ca/wp-content/uploads/2018/09/IFIC-Submission-CSA-Title-Reform-Proposal-September-14-2018.pdf/20672/>; French: <https://www.ific.ca/wp-content/uploads/2018/09/Soumission-de-l%E2%80%99IFIC-ACVM-Proposition-sur-la-r%C3%A9forme-des-titres-14-septembre-2018.pdf/20672/>