STIKEMAN ELLIOTT

Stikeman Elliott LLP Barristers & Solicitors

5300 Commerce Court West, 199 Bay Street, Toronto, Canada M5L 1B9
Tel: (416) 869-5500 Fax: (416) 947-0866 www.stikeman.com

DELIVERED BY E-MAIL

September 30, 2016

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
The Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission (New Brunswick)
Nova Scotia Securities Commission

c/o

Josée Turcotte, Secretary
Ontario Securities Commission
20 Queen Street West, 22nd Floor
Toronto, Ontario
M5H 3S8
comments@osc.gov.on.ca

-and-

Me Anne-Marie Beaudoin
Secrétaire de l'Autorité des marchés financiers
Autorité des marchés financiers
800, rue du Square-Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal, Québec H4Z 1G3
consultation-en-cours@lautorite.qc.ca

Ladies and Gentlemen,

RE: **Request for Comment on the Canadian Securities Administrators' Consultation Paper 33-404 *Proposals to Enhance the Obligations of Advisers, Dealers, and Representatives Toward Their Clients* dated April 28, 2016**

Thank you for the opportunity to comment on Consultation Paper 33-404 *Proposals to Enhance the Obligations of Advisers, Dealers, and Representatives Toward Their Clients* dated April 28, 2016 (the "**Consultation Paper**").

TORONTO
MONTREAL
OTTAWA
CALGARY
VANCOUVER
NEW YORK
LONDON
SYDNEY

This letter represents the general comments of certain members of the Financial Products & Services practice group at Stikeman Elliott LLP (and not those of the firm generally or any client of the firm) and are submitted without prejudice to any position taken or that may be taken by our firm on its own behalf or on behalf of any client.

We are supportive of the Canadian Securities Administrators' ("**CSA**") proposed targeted reforms set out in the Consultation Paper that attempt to clarify aspects of registrant regulation that were unclear and subject to inconsistent market practice. We are also supportive of the CSA's approach in proposing additional detailed guidance in the Companion Policy to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* ("**NI 31-103**") that aims to clarify the intent of various rules and the CSA's underlying policy goals. We have focused our comments on the proposed targeted reforms to NI 31-103 and have only provided minimal comment on the proposed best interest standard. We believe that industry participants are better situated to debate the merits of the various issues raised by and options associated with adopting a best interest standard.

We note, however, that some of the reforms proposed in the Consultation Paper have the potential to impose significant additional burdens, including substantially increased due diligence and record-keeping obligations, on market participants while falling short of achieving the stated policy goals.

Furthermore, we are concerned about the broad scope of these proposals and the pace and breadth of recent regulatory initiatives aimed at registrants. We are particularly concerned about the effect of the proposals on new entrants. Costs borne by investors have been repeatedly cited as an issue of concern. Regulatory measures that add incrementally more cumbersome and costly compliance obligations should therefore be very carefully considered before they are implemented. We do not believe that the compliance burden of regulation (including cost), on its own, is determinative in assessing the merits of regulation. However, in an environment where cost is an important factor, regulatory initiatives that do not have a positive measurable impact on investor protection should be reconsidered and the impact of effective regulation should be studied. We encourage the CSA to carefully: (i) assess the impact of the CRM2 proposals on business conduct; and (ii) study the consequences of international examples (Australia and the United Kingdom, in particular) of regulation similar to that proposed in the Consultation Paper, before finalizing the targeted proposed reforms to NI 31-103.

One of the recurring themes in our comments is that the reforms should be carefully considered in light of the very different circumstances and policy concerns that apply in respect of retail investors as compared to institutional and otherwise sophisticated purchasers. For example, accredited investors dealing with an exempt market dealer have very different needs and expectations compared to retail investors obtaining financial and estate planning advice from a registered dealer. In other words, a "one size fits all" approach to dealer and adviser regulation may give rise to unintended negative consequences. We have explained further in our comments below where this concern is particularly relevant.

In making these observations, we are mindful of the remarks made by Maureen Jensen, the Chair of the Ontario Securities Commission, in her address before the Toronto Region Board of Trade on September 27, 2016. Ms. Jensen noted that regulatory burdens imposed on market participants should be reduced:

> Given the size of the Ontario Securities Act, its rules and regulations, there's no question there is a compliance burden. When considering new regulations, we are cognizant of the need to remove as much as we add. The challenge is to craft regulation that doesn't get in the way of business and still protects investors.
>
> We are committed to re-examining our rules to ensure they are appropriate, necessary and relevant. In short, we are looking to reduce regulatory burden, where possible. This means finding opportunities to streamline requirements for market participants—as long as investors are protected.

We hope other CSA members agree and look forward to this idea informing forthcoming CSA initiatives.

We have provided our responses below to the specific questions posed in the Consultation Paper. Our responses are grouped by theme as set out in Part 7 of the Consultation Paper and the numbering corresponds to the numbering of the questions in Appendix I of the Consultation Paper.

A. Conflicts of Interest – General Obligation

3. Will this requirement present any particular challenges for specific registration categories or business models?

Firms and representatives that advise on proprietary products may have difficulty implementing the proposed guidance on conflicts of interest. The proposed guidance in Appendix A suggests that firms that trade in or advise on proprietary products may have a material conflict of interest. That conflict can result in the firm or representative recommending a proprietary product that is not suitable for a client because of incentives attached to recommending proprietary products. The difficulty with the guidance is that it suggests that disclosure alone is not sufficient and that firms and representatives should adopt controls that mitigate the conflict. This is potentially a significant intrusion into the business model of many registrants that offer securities of a related party. We respectfully submit that disclosure alone should not be ruled out as an effective means of addressing a potential conflict of interest in these situations. Furthermore, we suggest that the CSA provide specific guidance on what "controls" would be appropriate in the circumstances.

44. Is it appropriate that disclosure by firms be the primary tool to respond to a conflict of interest between such firms and their institutional clients?

Appendix A of the proposed guidance provides that disclosure of a conflict of interest, on its own, "may be sufficient" for "institutional clients". We respectfully submit that plain language disclosure alone should be sufficient, in nearly all cases, to address conflicts of interest arising from the sale of proprietary products generally and sales of all products to sophisticated investors in particular. We suggest that the proposed guidance be revised to express this in less equivocal terms. In addition, and as noted below, we believe that this standard should apply to "permitted clients" rather than a new category of "institutional clients".

46. Is this definition of "institutional client" appropriate for its proposed use in the Companion Policy? For example: (i) where financial thresholds are referenced, is $100 million an appropriate threshold?; (ii) is the differential treatment of institutional clients articulated in the Companion Policy appropriate?; and (iii) does the introduction of the "institutional client" concept, and associated differential treatment, create excessive complexity in the application and enforcement of the conflicts provisions under securities legislation? If not, please explain and, if applicable, provide alternative formulations.

47. Could institutional clients be defined as, or be replaced by, the concept of non-individual permitted clients?

We have two recommendations with respect to questions 46 and 47. First, we recommend incorporating exemptions from the proposed targeted reforms for "permitted clients" rather than creating a new category of "institutional clients". We believe that the carve-out would be equally viable but more straightforward from a compliance perspective if it applied to "permitted clients", including high net worth individuals, rather than a new category of "institutional clients". In the broader scheme of NI 31-103, investors who are "permitted clients" are understood to be sophisticated enough to warrant the relaxation of certain key protections. That same logic should be applied to the protections proposed in the targeted reforms.

As the CSA are aware, registrants often have elaborate internal compliance systems and documentation. Each time additional obligations are imposed in respect of a category of client, additional compliance controls and procedures must be implemented by registrants. The result is that registrants will sometimes choose to restrict an offering solely on the basis of regulatory obligations. For example, we have seen individual "accredited investors" excluded from certain offerings so that the requirement to obtain and retain Risk Acknowledgement Forms in Form 45-106F9 will not apply.

Should the CSA determine that retaining the "institutional client" concept is appropriate, we encourage the CSA to consider whether the threshold of $100 million in item (c)(xi) of the definition of "institutional client" is unduly high in the context of the Canadian market. We believe that the $25 million threshold, as set out in the definition of "permitted client", is more appropriate and consistent with other NI 31-103 exemptions, as noted below. We would also encourage the CSA to express the definition of "institutional

client" in relation to the concept of "permitted clients", similar to the manner in which "permitted client" is defined in Multilateral Instrument 32-102 *Registration Exemptions for Non-Resident Investment Fund Managers*. For example, "institutional client" could be defined as having the same meaning as "permitted client", except that it would exclude paragraph (m) and paragraph (n) of the definition, and only include those permitted clients that have waived the suitability requirement in subsection 13.3(4) of NI 31-103. Such an approach could be more sustainable as the definition of "permitted client" evolves over time.

Second, we suggest that additional exceptions from the proposed targeted reforms be included for "permitted clients" or "institutional clients". We have provided some specific suggestions in our comments below but we also encourage the CSA to consider whether there are other proposed targeted reforms that merit an exception.

B. Know Your Client

56. Should additional guidance be provided in respect of risk profiles?

While we do not recommend that a risk profile form be prescribed, we believe that it would be helpful to have additional guidance on: (i) the end product of the risk profile exercise; and (ii) how the risk profile should be used by registrants on an ongoing basis. The draft guidance to NI 31-103 appears to be limited to providing information on the process of developing a risk profile. This leaves registrants with limited practical guidance on using risk profiles for the benefit of their clients. Some questions that could be addressed include whether a risk profile should take the form of a narrative or a completed questionnaire and whether it should be drafted in plain language to allow the client to review and comment as part of the process of developing the risk profile.

It would also be helpful for the CSA to provide guidance on the retention of risk profile documentation. For example, how long should these documents be retained and is it necessary for firms to retain originals? We expect that such documentation should be retained until the client-registrant relationship ceases to exist plus a fixed period of time until the conclusion of any applicable limitations period. We would also expect that originals need not be retained and that the retention of electronic documents is sufficient. Notably, we expect that registrants would welcome guidance on document retention more broadly, for all KYC requirements.

57. Are there circumstances where it may be appropriate for a representative to collect less detailed KYC information? If so, should there be additional guidance about whether more or less detailed KYC information may need to be collected, depending on the context?

The enhanced KYC requirements may very well be appropriate for certain investment dealers and mutual fund dealers who have an ongoing relationship and regularly interact with retail investors. However, exempt market dealers typically have smaller operations and interact with more sophisticated investors, being "accredited investors" or "permitted clients". Section 13.2(6) of NI 31-103 currently provides an exemption from the requirement to obtain information regarding the client's investment needs and objectives, financial circumstances and risk tolerance when dealing with

"permitted clients" in certain circumstances. The Consultation Paper suggests that the enhanced KYC requirements would not apply to dealings with "institutional clients". The interplay between these two exemptions, one for "permitted clients" and the other for a new category of "institutional clients", is unclear and potentially administratively burdensome for registrants, especially smaller exempt market dealers. We encourage the CSA to adopt clear and streamlined exemptions for sophisticated investors, as discussed in our answers to questions 46 and 47. Our strong preference is that an exemption from the proposed enhanced KYC requirements be established on a basis that is consistent with the existing exemption for dealings with "permitted clients" in section 13.2(6) of NI 31-103.

On a more general note, we welcome the CSA's guidance on the frequency with which KYC information should be updated. An obligation to take reasonable steps to update KYC information annually is a reasonable and clear standard that would address inconsistent market practices. However, we question the proposed requirement that KYC information should be updated in response to "material changes in circumstances affecting the client or the client's portfolio". This requirement could be difficult to comply with in practice. It is hard to envision a registered firm or representative knowing when a material change in the financial circumstances of a client has occurred, unless the client has taken proactive steps to advise the representative. Furthermore, the registrant-client relationship is not always of a nature conducive to regular interaction. For example, some clients will consult with their advisors only on a limited basis, and, in certain cases, only in connection with an annual RRSP contribution. It may not always be practical to expect registrants to engage in the KYC process to ascertain that there have been no material changes each time the registrant provides a recommendation and each time the client initiates an order. For example, some trades and/or recommendations may be time sensitive and require a registrant to respond quickly to a market event.

It would also be helpful for the CSA to provide guidance on acceptable practices where a registrant's client refuses to provide updated KYC information or otherwise meet with a registrant's representatives.

C. Know Your Product – Firm

9. Do you think that requiring mixed/non-proprietary firms to select the products they offer in the manner described will contribute to this outcome? If not, why not?

The proposed guidance provides that:

> the mere existence of other products which could be "better" or more suitable for its clients than the products on the firm's shelf would not be considered to be a failure to comply with the KYP requirement related to its mixed/non-proprietary product list, <u>if the firm's product list development process is reasonable, unbiased and based on sound, professional judgment</u>. (emphasis added)

It is not clear how a firm could evidence compliance with this standard and how thoroughly it would be required to document the compliance measures it undertakes.

It also bears noting that requiring firms to undertake a product review procedure could yield unintended negative consequences. Arguably, investors' best interests are served when they have access to a competitive marketplace with many investment options. Market participants responsible for producing and selling those products must be appropriately incentivized – a regulatory environment featuring costly obligations could reduce competition by discouraging emerging managers and compelling existing participants to focus on their profitable business lines, potentially at the expense of innovation and variety.

We acknowledge that the product list identification requirement (and presumably the related investigation, comparison, benchmarking and optimization requirements) do not apply to firms in their dealings with "institutional clients". However, should the CSA elect to proceed with these requirements, we suggest incorporating a broader and simpler "permitted client" exception instead of the proposed exception for "institutional clients". Lowering the threshold of net assets to $25 million and including high net worth individuals as parties in respect of whom the product list identification requirement do not apply would also help alleviate the administrative burden imposed by this requirement.

14. Should proprietary firms be required to engage in a market investigation and product comparison process or to offer non-proprietary products?

For the reasons set out above, we are of the view that requiring proprietary firms to be subjected to the market investigation and product comparison requirements is inappropriate. A firm that only offers proprietary products is, by its nature, specialized in a particular universe of securities. That specialization may in fact offer investors a tangible advantage in the financial marketplace.

D. Suitability

19. Will the requirement to perform a suitability assessment when accepting an instruction to hold a security raise any challenges for registrants?

We expect that conducting a complete suitability analysis may be unhelpful when recommending that a security be held or when accepting an instruction to hold a security. As a practical matter, each time a client consults a registrant and no recommendation is made to sell a security in a portfolio, an implicit recommendation is made to hold such security. For large portfolios, this can be an onerous obligation on a registrant. It may be more feasible to encourage registrants to conduct a suitability analysis in respect of holding securities when practicable or on a periodic basis, rather than each time a hold recommendation is made or a hold instruction is issued.

E. Regulatory Best Interest Standard

65. Should the standard of care apply to unregistered firms (e.g. international advisers and international dealers) that are not required to be registered by reason of a statutory or discretionary exemption from registration, unless the Standard of Care is expressly waived by the regulator?

We would urge the CSA to specifically exempt firms relying on the international dealer exemption ("**IDE**") and the international adviser exemption ("**IAE**") from compliance with the proposed standard of care. The IDE and the IAE are premised on compliance with the securities laws of the exempt firm's home jurisdiction. These requirements are set out in section 8.18(3)(b) of NI 31-103 for the IDE and section 8.26(4)(b) of NI 31-103 for the IAE and they include detailed disclosures to clients. Furthermore, the IDE and IAE require that firms relying on such exemptions restrict their dealings with "permitted clients". By virtue of the disclosures already required under NI 31-103, clients understand the nature and limitations of their dealings with exempt firms. For these reasons, imposing a best interest requirement for firms relying on the IDE and the IAE would be inappropriate, inconsistent with the nature of the exemptions and potentially conflicting with the exempt firm's home jurisdiction requirements.

* * *

We thank the Canadian Securities Administrators for the opportunity to comment on the Consultation Paper and we would be pleased to discuss these issues further.

"Junaid K. Subhan"

Junaid K. Subhan,
on my own behalf and on behalf of

Alix d'Anglejan-Chatillon
Jeffrey Elliott
Ramandeep K. Grewal
Darin R. Renton
Nicholas Badeen
Paul Burd