PURPOSE
INVESTMENTS

September 30, 2016

VIA EMAIL

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

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- and -

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CSA Consultation Paper 33-404 – Proposals to Enhance the Obligations of Advisers, Dealers, and Representatives toward their Clients (the "Consultation Paper")

We appreciate the opportunity to comment on the Consultation Paper. Capitalized terms used and not defined in this comment letter have the meanings given to them in the Consultation Paper. The Consultation Paper raises important issues for discussion among CSA members, registrants and investors, and we expect that many comment letters will be submitted representing a cross section of views on the proposed targeted reforms and the regulatory best interest standard proposal.

Our comment letter is focused on the proposed targeted reforms and their practical implications which are most relevant to independent investment product manufacturers, namely, the amendment of Part 13 of NI 31-103 to include know your product (KYP) requirements for representatives and firms, and the potential guidance to these requirements set out in Appendices C and D of the Consultation Paper.

We believe that the targeted reforms will have significant consequences if implemented as proposed in the Consultation Paper on the investment industry and as a result on investors. These consequences are not the intention of the Part 13 changes, but are the logical result of them. We believe that the amendments will drive firms towards proprietary platforms; reducing choice for investors and limiting

the development of innovative products that address the real needs of investors. The existing industry challenges facing independent product manufacturers will continue and likely increase: resulting in increased industry concentration and decreased choice for investors.

We strongly support the regulatory best interest standard (BIS) as a preferred alternative to these proposed targeted reforms as it will address the objectives of the Consultation Paper without the consequences that we have highlighted in our responses below.

ABOUT PURPOSE INVESTMENTS

Purpose Investments is registered as a portfolio manager, investment fund manager and exempt market dealer in many CSA jurisdictions. We are focused on managing high quality investment funds in Canada available for all investors, large or small. We use intelligent and disciplined rules-based investment strategies and high quality active strategies to manage our investment products. Our line-up of investment funds covers both traditional long-only investment strategies and risk managed alternative strategies. We launched our first exchange-traded funds (ETFs) and mutual funds in September 2013, and we now offer 37 retail investment funds and manage approximately $2.4 billion in assets under management. Our five core values are intelligent strategies, transparency, risk management, low fees and accessibility. We believe that all Canadians should have access to the best investment products in the world, at the fairest price.

CONSULTATION QUESTIONS AND ANSWERS

7. Is this general approach to regulating how representatives should meet their KYP obligation optimal? If not, what alternative approach would you recommend?

We agree with the proposed requirement for representatives to have sufficient knowledge of a product, together with the KYC information[1] about the client, to support a suitability analysis. We also believe that product knowledge should include an understanding and consideration of the product's investment strategy and all fees, costs and charges connected to the product, and further should include how the product could impact the client's account and long term investment requirements.

We are less supportive of the requirements for a representative's understanding and consideration of the structure, strategies, features, costs and risks of various products, and the comparative analysis of various products, to be tied to the **firm's product list**. We acknowledge that the adoption of product lists has become the norm among large Canadian distribution channels in the financial services sector over the past decade. However, we believe that representatives should be encouraged to explore innovative investment solutions for their clients, which often necessitates departing from firm product lists for the reasons outlined in our answers to Consultation Questions 8 and 9 below.

We acknowledge that the guidance set out in Appendix C permits representatives to recommend or consider products that are not on their firm's approved product list provided that a product review is conducted. However, the representative must have appropriate authorizations and approvals from their

[1] We are not commenting on the proposed amendments to Section 13.2 of NI 31-103 which prescribe the KYC obligations of registrants.

firm before recommending the security. Considering the prescribed KYP requirements applicable to firms, we expect that the process which representatives will be required to complete in order to obtain such authorization from their firm is likely to be tantamount to submitting the security for product list approval.

Moreover, the proposed requirement for each representative to satisfy the KYP obligation for "each security on the firm's product list" will not leave much time for representatives to conduct KYP on new products which are not already on their firm's product lists. We believe that representatives should be familiar with the range of products on their firm's approved lists which might be suitable to their client base, which is often focused on a particular demographic or market segment. This requirement will also limit the time that representatives will be able to devote to fulfilling all of the needs of their clients, including financial planning. Under these time constraints, representatives will have to choose between developing an understanding of the whole product list or a comprehensive understanding of the needs of their clients.

In our view, representatives should have the freedom to conduct KYP on those products which they believe are best suited to their client's needs, regardless of whether such products have been pre-approved by their firm. Representatives' KYC, KYP and suitability obligations should ensure that they are researching and recommending products that meet their clients' investment objectives and risk profiles. Moreover, heightened proficiency requirements[2] should ensure that representatives have the education and experience necessary to fully grasp the structure, strategies, features, costs and risks of various products. This regulatory framework imposes meaningful obligations on representatives to recommend the most suitable securities for their clients, including innovative non-proprietary products. It is in the best interest of investors for their advisers to have the flexibility to consider the widest possible array of products available instead of being hamstrung by the limited number of products available on a firm's approved product list. The proposed regulatory best interest standard (BIS) would support this approach, as discussed in our response to Consultation Questions 36 through 41.

Furthermore, we believe that the focus on approved product lists in the proposed targeted reforms places too much emphasis on product selection in the investment process. The financial advisory community widely accepts, based on a large body of empirical research, that asset allocation is the prime contributor to developing a portfolio that will meet clients' income and return objectives.[3] It is of primary importance for representatives to recommend products which are best suited for client portfolios having regard to the investment objectives and guidelines, including asset mix, set out in their investment policy statements. Specific product considerations such as fees, costs and charges, are relevant and important, but should be a secondary consideration after the product's fit in the client's portfolio. The KYP guidance set out in Appendix C focuses almost entirely on these product-specific considerations, while only making a passing reference to the requirement for the product to be the right

[2] We endorse the proposed amendments to the proficiency requirements in Division 2 of Part 3 of NI 31-103.

[3] See, for example, Lummer, Scott L. and Riepe, Mark W., "The Role of Asset Allocation in Portfolio Management", *Global Asset Allocation: Techniques for Optimizing Portfolio Management*, 1994 and Ibbotson, Roger G.,"The Importance of Asset Allocation", *Financial Analysis Journal*, vol. 66 no. 2, 2010.

fit for the portfolio. The KYP guidance "ignores the forest for the trees" in the investment advisory landscape.

Finally, the product approval process can be lengthy and cumbersome, and representatives seeking to recommend new products may miss investment opportunities for their clients as market conditions shift while the product awaits approval.

8. The intended outcome of the requirement for mixed/non-proprietary firms to engage in a market investigation and product comparison is to ensure the range of products offered by firms that present themselves as offering more than proprietary products is representative of a broad range of products suitable for their client base. Do you agree or disagree with this intended outcome? Please provide an explanation.

We agree that the intended outcome for firms offering mixed/non-proprietary products should be to offer a broad range of products suitable for their client base is desirable. Canadian retail clients should have access to the universe of publicly offered securities in Canada for a relatively low cost. As the financial markets have become more sophisticated, a wide array of products has developed to address specific client needs, and all Canadians should have access to all of these products.

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?

We do not expect the requirement for mixed/non-proprietary firms to engage in a market investigation, as explained in the proposed guidance set out in Appendix D, to achieve this desired outcome. In our view, the market investigation requirement is overly prescriptive and imposes onerous compliance burdens on firms. We expect that many mixed/non-proprietary firms will seek to simplify the KYP process and minimize increased compliance costs associated with the new requirements by: (i) significantly reducing the number of non-proprietary products on mixed product lists; (ii) reducing and limiting the number and type of products offered on non-proprietary product lists; and (iii) switching from mixed product lists to proprietary product lists. Each of these outcomes concentrates the investment selection process in the hands of the firm's product review committee, rather than encouraging representatives to seek creative solutions, ultimately reducing the investment choices available to clients. These outcomes have been observed in the industry already in advance of the implementation of the Appendix D guidance.

There are no proficiency requirements or other guidelines for the composition of a firm's product review committee, which could include individuals who have no portfolio management or investor experience and/or have conflicts of interest, for example, employees from the corporate finance group at a dealer can sit on the product review committee. We do not think, however, that the correct response to this concern is to establish guidelines for product review committees. To the contrary, representatives should be empowered to find products that best meet the needs of their clients, and the firm product approval process should be flexible enough to accommodate the needs of their representatives while at the same time addressing legitimate risk management concerns at the firm level.

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As product approval processes have become institutionalized across Canada, firms have introduced broad quantitative screens such as minimum length track records and/or assets under management which must be satisfied by any product seeking approval. These screens have had a chilling effect on the opportunity for smaller and more innovative investment product manufacturers to gain access to retail distribution channels and thus the availability of these products to all retail investors. The proposed reforms will only accelerate the existing trend to shorter, more proprietary product shelves.

If the market investigation requirement is adopted (particularly with the guidance Appendix D), we expect the approval process for mixed and non-proprietary product lists will become even more restrictive since each approved product will be subject to annual product comparison and optimization procedures. Firms offering mixed product lists will simply remove non-proprietary products from their shelves in order to avoid deploying significant compliance resources to conducting an annual market investigation. It is probable that the shift away from mixed products lists toward proprietary lists will reduce the range of lower-fee, innovative third party products available to investors and restrict representatives to utilizing only proprietary products for their clients.

In addition, in order to simplify the process of selection, firms are likely to define the universe in terms of traditional investment segmentation – Canadian Equities, US Equities, Global Equities, Government bonds, corporate bonds, etc. Most third party product research providers already use these simplistic segments to allocate and assess products. Innovative products that do not fit into one of these segments, but are designed to meet particular needs of clients (e.g. lower volatility, reduce foreign currency exposures, provide exposure to new asset classes) and respond to the changing market and economic environment are often placed into an incorrect segment for this automated investment analysis or relegated to an "Other" category that does not allow for proper analysis. Purpose has experienced these problems firsthand when our funds are subject to analysis by large, well known research providers.

Another possible consequence of the review process is to limit innovation in the Canadian investment community. Once dealers create a rules-based process, new products will be designed by some fund companies, including independents, to match the selection process and not to meet the actual needs of clients. The goal of the product development process will be to get a new product on the shelf, not to develop a product that will meet an observable client need.

In the absence of alternatives, the steps laid out in Appendix D as "one possible approach" to satisfying the market investigation requirement is likely to become the "industry best practice" expected by regulators and recommended by lawyers and compliance professionals as the most straightforward way to comply with the new requirement. The steps are highly prescriptive and rely on techniques such as "client profiling" and "product optimization" based on the application of benchmarking criteria and third party research reports. While these tools are useful for firms seeking to understand market segments and products, they should not be a mandatory part of the approval process for every product recommended by a firm and its representatives. As firms uniformly apply this approach, we anticipate that mixed/non-proprietary lists of different firms will become increasingly similar and innovative products which are not easily benchmarked or covered by external research providers are squeezed off of product shelves even when these products fulfill client's investments requirements.

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In particular, we expect that firms will address the "product optimization" recommendation, the meaning of which is unclear in Appendix D, by applying easy metrics such as mean/variance analysis, instead of the more nuanced lessons of behavioural finance. As a result, products which are not on the "efficient frontier" of rational expectation based finance will be unlikely to receive approval. As an example, product optimization could rely on past performance while ignoring fundamental variables which affect the way certain funds outperform at different points in the investment cycle, such as investment strategy (value versus growth versus momentum) and the use of hedging strategies (currency, duration, market risk)**.**

10. Are there other policy approaches that might better achieve this outcome?

While periodic market investigations are necessary and appropriate for firms to understand the competitive landscape and ensure that their clients have access to the best products, we believe that the frequency, methodology and outcomes of such investigations should be left up to the firms. In our view, firms and representatives should have flexibility to design KYP processes appropriate for the value propositions which they offer to their clients. Suggesting that firms develop "client profiles" for both existing and prospective clients and structure the approved product list around such profiles may end up categorizing retail clients into generic buckets and serve up a limited selection of products to the clients in each bucket. This process should not replace the deep understanding of the needs of each of their clients which representatives are expected to obtain through effective KYC analysis and ongoing personal contact. In contrast, the regulatory best interest standard would require representatives to conduct the due diligence on their clients that is required for them to recommend products that are in their clients' best interests, as discussed in our responses to Consultation Questions 38 through 41 below.

Further, we believe that the creation of client profiles and the concept of limiting a firm's advisory business to only those clients that meet specific profiles could result in certain types of clients, such as those with smaller portfolios or limited income, not having access to advisory services. It is easy to foresee that some of these client profiles could be exactly the types of clients that have the most need for advice.

Market investigations will be most successful if representatives are encouraged to use the KYC and suitability processes to identify specific needs of their individual clients and seek out products which satisfy those needs.. Firms can build upon the collective experience of their representatives to develop mixed/non-proprietary product lists which address the needs of actual clients. Firms should also focus resources on continuing education for the representatives in order to make them aware of all products available. This process is in line with the regulatory best interest standard which is a key reason we support its implementation. To implement the targeted reforms in the absence of a best interest standard is to introduce the consequences we highlight without fully achieving the regulators' objectives.

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11. Will this requirement raise challenges for firms in general or for specific registration categories or business models? If so, please describe the challenges.

If adopted as proposed, we expect that the chilling effect of the market investigation requirement on mixed/non-proprietary product lists will disadvantage independent product manufacturers and independent distribution channels that offer non-proprietary product lists. Most of the creative new products in the Canadian fund industry have been driven by independent players which have played a crucial role in keeping the Canadian market at the forefront of global innovation. Despite this, independent players are already experiencing challenges in accessing large integrated platforms. The increased compliance costs associated with offering non-proprietary products, together with the requirement for representatives to be familiar with every product on their firm's approved list, will further reduce the access of independent product manufacturers to retail distribution channels, and the number of products which independent distributors can comfortably include on their non-proprietary lists.

12. Will this requirement cause any unintended consequences? For example, could this requirement result in firms offering fewer products? Could it result in firms offering more products?

Although some firms might add a few new products to their mixed/non-proprietary lists in order to meet a specific "client profile" category or satisfy the recommendations of a third party research report, we expect the net effect of the market investigation requirement will be to reduce the number of mixed/non-proprietary product lists and the total number of products available on such lists, accelerating existing industry trends. We expect that many firms offering mixed product lists will focus on proprietary products in order to minimize compliance costs and simplify the KYP requirements applicable to the firm and its representatives. The result is likely to be fewer independent product manufacturers and therefore fewer products.

13. Could these requirements create incentives for firms to stop offering non-proprietary products so that they can fit the definition of proprietary firm?

Yes, absolutely and emphatically. Please see our responses to Consultation Questions 7 through 12 for reasons.

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

Yes, all firms should be required to offer non-proprietary products, as it benefits clients to have a broad range of products available to them. A client of a proprietary firm should not be denied access to a third party product, or forced to open an additional investment account in order to make the desired investment.

As explained in our response to Consultation Question 10 above, we believe that firms should maintain discretion to develop KYP and product approval processes which they believe best meet the needs of their clients. We expect that proprietary firms do and will continue to engage in market investigations and product comparisons which meet their specific needs. We do not expect the clients of such firms to

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benefit from a regulatory requirement for such firms to engage in such process, and particularly to adopt the prescriptive approach outlined in Appendix D.

However, we endorse the proposed targeted reform to amend the relationship disclosure requirement in Section 14.2 of NI 31-103 by requiring proprietary firms to disclose that they offer only proprietary products. This disclosure should include a full and plain explanation of what "proprietary" means in this context and the implications for the client. Please see our response to Consultation Questions 15 and 24 below.

15. Do you think that categorizing product lists as either proprietary and mixed/non-proprietary is an optimal distinction amongst firm types? Should there be other characteristics that differentiate firms that should be identified or taken into account in the requirements relating to product list development?

We endorse these categories and believe that an understanding of these categories will offer clients important information regarding the services that are available at different types of firms. For these categories to be effective, disclosure alone might not be sufficient, as suggested in our response to Consultation Question 24. In addition to the requirement to disclose in the relationship disclosure documentation, we recommend that representatives at proprietary firms be required to explain to clients these concepts, and make clients aware that mixed/non-proprietary product lists are available through other distribution channels at equivalent costs. Representatives and firms should be required to maintain records of such discussions.

We also believe that a further distinction should be made for firms that have mixed product lists on which non-proprietary products represent a minority of the available products. The addition of a small number of non-proprietary products does not fully address the issues we have highlighted on customer choice. This factor should also be considered in the designation proposals.

It is also important to distinguish between mixed and non-proprietary lists, which are grouped together in most parts of the Consultation Paper and the Consultation Questions. Mixed product lists are maintained by firms that create and distribute proprietary products but also make third party products available to their clients. These firms are more likely to focus sales and marketing efforts on their proprietary products, including the education of their representatives and clients. Non-proprietary lists are maintained by independent firms that do not create their own products. Consequently, mixed product lists are more likely to migrate toward proprietary lists, while non-proprietary lists will remain independent, but are likely to shrink in size due to the compliance resources and representatives' time which will be required to satisfy the proposed KYP requirements.

* * *

24. Do you agree with the proposed disclosure required for firms that offer only proprietary products? Why or why not?

We agree with the proposed disclosure required for firms that offer only proprietary products. However, we believe that disclosure might not be enough to ensure that clients understand that difference between proprietary and mixed/non-proprietary product lists. Furthermore, we believe that similar

disclosure is necessary for mixed product lists that have only a small number of non-proprietary products. The Consultation Paper cites several empirical research studies when noting that "conflict disclosure, by itself, is generally an ineffective conflict mitigation strategy and may have counter-intuitive results, such as increasing reliance on conflicted advice, which results in sub-optimal outcomes for investors"[4].

Also, firms that offer products with brand names that differ from the firm name should be required to disclose which of their products are proprietary, as clients might get confused by the different branding of the firm and certain of its products.

* * *

36. Please indicate whether a regulatory best interest standard would be required or beneficial, over and above the proposed targeted reforms, to address the identified regulatory concerns.

We believe that the regulatory best interest standard is the preferred means for addressing the key investor protection issues set out in Part 5 of the Consultation Paper, over and above the proposed targeted reforms. The "expectations gap" is the most fundamental concern:

> Most investors incorrectly assume that their registrants must always provide advice that is in their best interest. As a result, clients have misplaced reliance or trust on their registrants, resulting in opportunities for some registrants to take advantage of their clients and creating an expectations gap between clients and registrants. Most investors place too much reliance on their registrants, which exacerbates the agency problem inherent in the client-registrant relationship and can result in sub-optimal investments.[5]

This expectations gap underpins all of the other policy concerns set out in the Consultation Paper, as investors are disappointed by the value and returns of their investments and the outcomes of the regulatory system. Retail investors do not understand the distinction between "suitability" and "best interest" when they discover that a representative has sold them one product, even with the knowledge that another product would be better for the client's portfolio. Information asymmetry and conflicts of interest are interrelated concerns which perpetuate the problem, which is that investors do not realize that their advisers are not required to act in their best interests.

In our view, this expectations gap will be closed most effectively if representatives are required to act in their clients' best interests. No amount of conflicts of interest disclosure or rigorous KYP procedures can replace matching up the expectations of investors with the actual obligations of their advisers.

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[4] Consultation Paper, (2016), 39 OSCB 3951, citing http://www.cbdr.cmu.edu/mpapers/cainloewensteinmoore2005.pdf; Sah et al, The Burden of Disclosure: Increased Compliance with Distrusted Advice (2012), online: http://www.cmu.edu/dietrich/sds/docs/loewenstein/BurdenDisclosure.pdf; Sah & Loewenstein, Nothing to declare: Mandatory and voluntary disclosure leads advisers to avoid conflicts of interest (2014), online: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2289975; Prentice, Moral Equilibrium: Stock Brokers and the Limits of Disclosure (2011), online: http://wisconsinlawreview.org/wp-content/files/1-Prentice.pdf.

[5] Consultation Paper, p. 3956.

37. Please indicate whether you agree or disagree with any of the points raised in support of, or against, the introduction of a regulatory best interest standard and explain why.

We agree with all of the points raised in support of the introduction of a regulatory BIS because it puts the client's best interests first. The proposed targeted reforms prescribe a long list of regulatory changes – some of which are commendable, others of which are too onerous[6] – but all of which are focused on the firm and the representatives. In contrast, the regulatory BIS takes a fundamentally different approach by focusing on the investor. Considering that all of the policy objectives set out in the Consultation Paper centre around investor protection, it makes sense for the investor, and not the adviser, to be at the core of the reform initiative.

We disagree with these points raised against the introduction of a regulatory best interest standard:

> Given the current regulatory and business environment, imposing an over-arching best interest standard may not be workable and may exacerbate one of the investor protection issues identified, that being misplaced trust and overreliance by clients on registrants. Further, the introduction of a regulatory best interest standard over and above the proposed targeted reforms is vague and unclear and will create uncertainty for registrants.[7]

We do not believe the expectation gap between clients and their representatives will be exacerbated by the introduction of a regulatory best interest standard. Retail investors are less likely to base their expectations on regulatory requirements, and more likely to base their expectations on their general understanding of the financial services industry based on advertising, marketing and cultural references and on the personal interactions that they have with their representatives. These are the sources of information that have led to the expectation gap that exists under the suitability regime today, and they will continue to be the primary drivers of investor expectations after reforms are initiated.

In our view, the concern that a regulatory BIS will be vague and unclear and create uncertainty for registrants is also overstated. The existing suitability standard is vaguer, less clear and less intuitive than the BIS, and has resulted in many negative practices that are being addressed in these proposals since registrants are uncertain about where their primary interest lies. The new proficiency requirements in the proposed targeted reforms, as well as other educational initiatives for firms, representatives and investors, will provide ample opportunity for the financial services sector to grasp the concept of the BIS. In addition, the CSA can publish policy guidance, such as is set out in Appendix H, as a means of providing concrete examples of what acting in the best interest of clients means.[8]

* * *

[6] For example, we endorse the enhanced proficiency requirements, consistency in titles and designations and transparent relationship disclosure for proprietary firms which are included in the proposed targeted reforms. We disagree with certain aspects of the new KYC and KYP requirements for the reasons set out in this letter.

[7] Consultation Paper, p. 3948.

[8] We are not endorsing all of the guidance set out in Appendix H, we are making the point that it is possible for regulators to provide definitive parameters for what acting in the best interests of clients means.

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39. What impact would the introduction of the proposed targeted reforms and/or a regulatory best interest standard have on compliance costs for registrants?

40. What impact would the introduction of the proposed targeted reforms and/or a regulatory best interest standard have on outcomes for investors?

As expressed above, the proposed targeted reforms offer a prescriptive, rules-based approach that will result in more compliance requirements, procedure and documentation without fundamentally changing the obligations that firms and representatives have toward their clients. We expect that faced with this administrative burden, firms are likely to reduce the number of products on their shelves, and representatives will be more likely to select proprietary products for their clients as they are pre-approved and widely supported by their firms. This will reduce choice available to investors.

The introduction of a regulatory BIS will also have some compliance costs, as firms will need to educate their representatives on the new requirements. We expect these compliance costs, which may be higher or lower than with the targeted reform, will provide much greater value for clients. Representatives will be able to devote more time to getting to know their clients, developing investment policy statements and identifying products which are in their clients' best interest, rather than participating in client profiling and product optimization processes which are far removed from actual interactions with investors. Clients will have the benefit of receiving advice from representatives who have the proficiency, training and regulatory obligation to act in their best interests.

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We appreciate the opportunity to provide comments on the Consultation Paper and would be pleased to discuss any of the matters raised in this letter further.

Best Regards,

Som Seif
President and Chief Executive Officer

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