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Financial and Consumer Affairs Authority of Saskatchewan
The Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission of New Brunswick
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
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Re: CSA Notice and Request for Comment – Proposed Amendments to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*, *Companion Policy 31-103CP Registration Requirements, Exemptions and Ongoing Registrant Obligations*, National Instrument 33-109 *Registration Information and Related Forms* (collectively, "the Proposed Amendments")

Dear Sirs/Mesdames,

We are writing in response to the Canadian Securities Administrators' (CSA's) above-noted *Notice and Request for Comment* published on July 7, 2016.

The CSA's Proposed Amendments – which range from technical adjustments to substantive reforms – will impact the current regulatory framework for portfolio and investment fund managers, dealers, including those in the exempt market, and advisors. Their purpose, as stated by the CSA, "is to promote stronger investor protection, to clarify certain regulatory requirements and to enhance certain market efficiencies."[1] While Advocis generally believes that most of the suggested amendments while realize this purpose, our own analysis concludes that several of the proposals require further review.

EXECUTIVE SUMMARY & SITUATING THE CSA'S PROPOSALS IN THE CONTEXT OF CURRENT REFORM EFFORTS

From the practice-based perspective of Advocis members, the proposed changes must work in ways which are both reasonable and practicable for dealers, advisors, and consumers. Advocis is supportive of the CSA's Proposed Amendments insofar as they are designed to improve investor protection by reducing custodial intermediary risk and clarifying and enhancing CRM2 disclosure requirements. Most of the amendments meet this criterion of practicality. However, our members have specific concerns about several of the Proposed Amendments, concerns which are summarized below and given greater articulation in the main body of this submission. First, however, we wish to comment on the CSA's proposals when they are considered as part of the larger set of various reform initiatives currently being examined or already underway in Ontario and in other provinces.

I. SITUATING THE CSA'S PROPOSALS IN THE CONTEXT OF CURRENT REFORM EFFORTS

Observers of the regulatory authorities which oversee Canada's retail financial services sector are now concluding that, whether by happenstance or design, one or more regulatory bodies seem to have committed to reform projects which, when implemented, will see certain products and distribution channels flourish, and others lose ground. In this latter group, particular prominence must be given to the mutual fund distribution channel. Regardless of one's position on the efficacy of a ban on embedded third party compensation, what is especially problematic is the timing of current calls for such a ban: not only is the CSA continuing to examine the issue of commissions, it is also clear that now is simply not the time to "dial up" efforts which call for a commissions ban, given that at long last, the much-anticipated centrepiece of Phase 2 of the Client Relationship Model (CRM2) – the annual statements to investors – will soon become a reality.

At times, regulators seem to be of the position that disclosure is, a priori*, not curative measure*

Many jurisdictions – including the United States – have concluded that disclosure of a conflict of interest to an investor can be a sufficiently curative measure. It is puzzling that while Canada lacks the massive mis-selling scandals seen in Australia and the United Kingdom, we seem bent on

[1] Canadian Securities Administrators, *Notice and Request for Comment*: *Proposed Amendments to National Instrument 31-103 and Its Policy, National Instrument 33-109 and OSC RULE 33-506 (Including Related Forms*). From the Ontario Securities Commission, Supplement to the *OSC Bulletin*, July 7, 2016, Volume 39, Issue 27 (Supp-2) (2016), 39 OSCB, pp. i- 426.

importing a foreign solution to those scandals – i.e., the banning of embedded third-party compensation such as trailing commissions. It is puzzling to many industry observers and stakeholders that there is at present so much advocacy for the outright elimination of any conflict of interest – regardless of whether it is potential or actual – even before the basic features of CRM2 can be brought into existence. Perhaps no other industry is subject to so stringent a demand to eliminate *all* conflicts of interest, even though it is a common enough feature in the retailing of most professional or technical services to Canadian consumers.

The CSA's bold proposal on additional sales disclosure deserves to be supported

Advocis therefore commends the CSA for its Proposed Amendments to CRM2, which would result in the disclosure to investors of performance-based compensation schemes which are directly related to the dealing representative's sales results. Further, we would also observe that if such disclosure is curative for the conflict created by the bonus arrangements instituted for compensating a bank's sales force of dealing representatives, then surely the same form of disclosure must be just as curative for the advisor who works on a commission basis or the advisor who is employed by a small dealer firm.

All of this leads Advocis to comment on a pair of related questions: (1) why are so many parties pressing the CSA to heedlessly push ahead with several highly controversial reform proposals, even though CRM2 is very much a work-in-progress?; and (2) where is the commitment by these parties to responsive and evidence-based regulation, an approach which has been so often articulated by our various regulators, including CSA members?

The need to foster responsive regulation remains a challenge

Before the CSA undertakes further action on mutual funds and embedded compensation, we would again ask that a proper assessment be made of the impact of recent and ongoing regulatory reforms – in particular, of CRM2 and its interaction with the Point-of-Sale/Fund Facts reforms. These projects were initiated as carefully crafted responses to the informational imbalances and potential conflicts of interest which arose from opaque fee and performance reporting to investors, and from the information asymmetry inherent in the advisor-client relationship. We feel compelled to note that such asymmetry is not unusual; indeed, it is inherent in almost any professional relationship and in many principal-agent financial relationships.

Yet these same concerns about potential conflicts of interest and informational imbalances – *which are presently very much in the process of being addressed* – are once again being advanced. But now they are being advanced in an effort to justify additional measures which go well beyond CRM2: the banning of embedded commissions *and* the creation of a regulatory best interest duty.[2] The repeated trotting-out of concerns by advocates of a commissions ban about conflicts of interest and

[2] This is now being characterized as a best interest obligation, one which, though it is somehow more than the current standard of suitability requirements, is also less than a fiduciary standard – even though its proponents often speak of it supplanting the somehow inadequate common law fiduciary duty.

imbalances in the advisor-client relationship – while simultaneously dismissing the perfectly reasonable desire of industry actors that we wait to assess current industry-wide efforts to address those imbalances – reveals a distressing lack of support for the CSA's commitment to conduct its regulatory enterprise in a methodical, rigorous manner, one which involves the careful collection and evaluation of evidence.

On the eve of launching the final piece of CRM2 disclosure, we must not heed calls to reform which would render most of CRM2's disclosure irrelevant

Advocis believes that until CRM2 is fully implemented and assessed, and its impact measured and analyzed, fundamental fairness to industry stakeholders dictates that the other major reform proposals contemplated by the CSA be placed on hold. It is not unreasonable "foot-dragging" to suggest that we wait until the industry and the CSA can evaluate the impact of CRM2 and administer whatever fixes are necessary. To do otherwise undercuts the ability of regulators to commit to evidence-based regulation in general and to accurately and neutrally measure CRM2's impact in particular. And it reveals that any statements about stakeholders' commitments to responsive regulation to be mere rhetoric. *Truly* responsive regulation gives stakeholders and regulatory authorities alike the necessary time to respond – most importantly, the time to permit a project like CRM2 to be fully implemented and then properly evaluated in relation to its stated objectives.

Let's wait until the verdict is in on CRM2

Time is a valuable resource, and a rush to judgment squanders it. Even worse is the rush to *avoid* judgment – especially on CRM2. Regulators and industry need to be able to properly assess the impact of the annual statements to investors. Instead of *responsive* regulation, we are witnessing a push by some industry actors that the CSA adopt a sort of *pre-emptive* regulation, in which CSA members are expected to forego an orderly roll-out and analysis of CRM2 and instead simply introduce a series of contentious regulatory measures which arose in response to problems experienced in a handful of foreign jurisdictions. At present, the case has not yet been made that measures like a statutory best interest duty or a commissions ban are in the end the only possible actions which will improve consumer outcomes for Canadian retail investors *en masse*.

What is the role of the regulator?

While it may or may not be useful and productive for a regulator to propose innovative or even unusual approaches from time to time, such as suggesting that, perhaps, our fledging "fintech" industry should participate in developing its own regulations, it does seem unusual not to extend the same opportunity to significant stakeholders in our well-established mutual fund industry. It is at this point that we come to the crux of the issue: the role of the regulator.

Advocis believes that regulators should respond to developments in our capital markets, rather than attempting to lead those markets. Regulators should ensure that consumers are treated fairly and that our capital markets operate in a fair, competitive and efficient manner. Regulators should work toward the goal of enhancing the welfare of all Canadians; in doing so, they should be agnostic in regard to the features and benefits of individual financial products, and not favour or disfavour any

particular business model or service offering. Such privileging is best left to the political branch and is best accomplished through the use of other policy tools, such as budget announcements and the tax system. We continue to hope that all CSA members will give a project as massive as CRM2 the chance develop and to succeed, rather than letting it become a casualty to something as draconian as a ban on embedded compensation, or become lost in the noise sure to be generated by the introduction of a statutory best interest duty.

II. THE SPECIFIC ISSUES RAISED BY THE CSA IN ITS *NOTICE AND REQUEST FOR COMMENT*

We now offer in summary form our view of the specific issues raised by the CSA in its *Notice and Request for Comment.*

The Custody Amendments

The proposed custody amendments will make custodial requirements applicable to registered firms more clear. It may be the case the custody amendments will not have a significant impact on a client's choice of custodian, given that the majority of the custodians currently used by clients of registered firms would meet the definition of a "qualified custodian". And it may be the case that the Proposed Amendments will have only a minimal impact on most registered firms, since they by and large simply codify existing business practices. The CSA's intentions are laudable, but the proposals as currently drafted mean the potential exists for unfortunate market outcomes if exempt market dealers are forced to rely solely on traditional "qualified custodians." In addition, Advocis disagrees with the position of the CSA that disclosure of a potential conflict of interest, even to a highly sophisticated party such as an investment fund, is not a sufficiently curative measure.

Consequences for custodial services

We also query whether the CSA has fully considered the potential consequences of the proposed custodial amendments on custodial practices which are unique to the exempt market. From a fairness standpoint, a possible consequence of the custody proposals could be an undue privileging of the already secure position of Canada's Schedule I, II and II banks.

Custody in the exempt market

If independently own firms are disadvantaged by the proposals, then Advocis must wonder if the impact on access to exempt market products by retail investors will be a negative one.

The Exempt Market Dealer Amendments

The CSA has emphasized that the only appropriate dealer registration category for participating in prospectus offerings is the investment dealer category. While we support this general proposition, we would also ask the CSA to resolve several areas of ambiguity relating to the scope of an exempt market dealer's permitted activities.

Principles-based regulation

With regard to principles-based regulation, the CSA's proposals on the activities of exempt market dealers are potentially troublesome. There is always a tension between principles-based regulation

and the proscriptive rules which characterize much contemporary securities regulation. Much of the regulation in the exempt market has the quality of principles-based regulation. The CSA's Proposed Amendments *ma*y be read as indicating that the CSA is seeking to limit the application of principles-based regulation in the exempt market; in essence, the CSA states in this *Notice and Request for Comment* that unless an exempt market dealer is *expressly* permitted to do something, then it is forbidden. This is a narrow and restrictive mode of legal interpretation which is not conducive to flexible and responsive regulation – a stated goal of several CSA members – because it can impede the application of sensible regulatory principles to novel situations.

The Client Relationship Model Phase 2 Amendments

A number of the Proposed Amendments are essentially technical adjustments to CRM2, However, there are also several substantive changes, most often in the form of "additional guidance" contained in the *Companion Policy* to National Instrument 31-103. New requirements regarding the content of mandatory Relationship Disclosure Information have been proposed, as well as additional disclosure of non-cash incentives and sales bonuses in the *Annual Report on Charges and Other Compensation*. Advocis strongly supports the disclosure of non-cash incentives, of educational conferences, and of the various other sales and bonus arrangements which are tied directly to an advisor's sales performance. Finally, while the idea of including a comparative target rate of return in an *Annual Investment Performance Report* is commendable, now is simply not an appropriate time for its introduction.

Advocis: Who we are

Advocis is the largest and oldest professional membership association of financial advisors and planners in Canada. Through its predecessor associations, Advocis proudly continues over a century of uninterrupted service of Canadian financial advisors and their clients. A voluntary not-for-profit organization established by a legislative act of Canada's Parliament, Advocis is committed to professionalism among financial advisors. Advocis members adhere to our published *Code of Professional Conduct*, uphold standards of best practice, participate in ongoing continuing education programs, maintain professional liability insurance, and commit to acting in their clients' best interest. Our 12,000-plus members, organized in 40 chapters across the country, are variously licensed to sell insurance products, mutual funds, as well as other securities, including exempt market products.

Advocis members provide comprehensive financial planning and investment advice, retirement and estate planning, risk management, employee benefit planning, disability coverage, and long-term care and critical illness insurance to millions of Canadian households and businesses. Across Canada, our members spend countless hours working one-on-one with individual Canadians on a gamut of financial matters. In addition, Advocis advisors are committed to educating clients about financial issues that are directly relevant to them, their families and their future.

Advocis' values and principles of protecting and promoting client service, client education and client freedom of choice are not merely ends in themselves – they also underwrite the overriding theme of our advocacy efforts: that governments and regulators must and should foster the development of the advisor-client relationship. Our values and principles inform much of the following analysis and argument; this submission reflects the interests and priorities of Advocis' advisor members and their clients, who are Canadians from all walks of life.

The Proposed Amendments which are of concern to our members and their clients break down into three thematic areas, which will be examined in turn:

1. altering custodial arrangements for registered firms which are not members of IIROC or the MFDA;
2. revising the permitted activities of exempt market dealers, particularly in regard to trades of prospectus-qualified securities; and
3. augmenting the existing reporting and disclosure requirements of the Client Relationship Model, Phase 2 (CRM2).

Part I. The CSA's Proposed Custody Amendments

1. Where is the CSA's evidence of client/consumer harm from custodial intermediary risk which the Proposed Amendments would reduce or eliminate?

Safety of client assets is a fundamental element of the CSA's investor protection mandate. Current custody requirements under NI 31-103 focus primarily on the segregation of client assets and do not establish a detailed custodial regime. We agree with the CSA's position that current MFDA and IIROC requirements in this area are sufficient.

The CSA's Proposed Amendments which deal with custody issues affect investment funds such as pooled funds which are not reporting issuers and therefore are not subject to the custodial provisions in National Instrument 81-102 *Investment Funds* or National Instrument 41-101 *General Prospectus Requirements*. The CSA now proposes to establish a more detailed custodial regime for these funds. However, the CSA has not provided evidence to support its proposal to create distinct and specialized custody requirements for these registrants, including for privately-placed funds, which differ from the requirements set out in NI 81-102 and NI 41-101.

The CSA's concern is therefore not with the adequacy of NI 31-103 per se, but with the actions of Canadian exempt market dealers. To use the CSA's terminology, "Canadian resident Non-SRO Firms" – that is, Canadian firms which are not members of IIROC or the MFDA – are under no specific CSA or SRO requirements regarding where and how client assets and investment fund assets must be held. The CSA's concern is over two specific forms of risk exposure:

1. risks arising from a registrant's reliance on self-custody: NI 31-103 does not place any restrictions on registered firms acting as custodian or sub-custodian;
2. risks arising from a registrant's use of a non-independent custodian: NI 31-103 similarly fails to govern the use by non-SRO firms of a "non-independent" custodian to hold the assets of both clients and investment fund.

Advocis' analysis and response	It is a truism that properly qualified custodians of client investment assets play a crucial role against financial fraud. The CSA's proposed custody amendments are directed at prospectus-exempt investment funds and the clients of exempt market dealers. With some exceptions[3] – e.g., IIROC and MFDA dealers who comply with the relevant IIROC or MFDA custody provisions – the CSA seeks to prohibit self-custody by registered firms and prohibit the use of a custodian which is not functionally independent of the registered firm. *What is the problem the CSA is trying to address?* The CSA's intentions are admirable, but it has not provided evidence of ongoing harm to clients. Registrants whose status is solely restricted to the exempt market dealer category do not, in our experience, handle client cash or act as custodians for any private issues. The securities are generally held at the issuer, though a small set of issuers will use a service provider such as Computershare Trust. A review of exempt product failures over the last half-decade or so indicates that the failures stemmed from mismanagement, inadequate business models, and the vicissitudes of the market. Such a review also indicates that custodial risk was not a factor. It is therefore not clear what present and ongoing harm the CSA is attempting to address with the Proposed Amendments. It would seem that the CSA has simply decided that now is an appropriate time to eliminate self-custodial risk once and for all. Finally, the CSA's position seems to be that the Proposed Amendments will not exert a significant impact on the choice of custodian by a client of a registered firm, since the majority of custodians currently relied on by clients easily meet the definition of a "qualified custodian." That will be true as a general matter, since the definition includes:

[3] See CSA *Notice and Request for Comment, supra* note 1. In addition to IIROC and MFDA member firms being exempted, the proposed custody amendments would also exclude:

- investment funds currently subject to existing custodial requirements under National Instrument 81-102 *Investment Funds*;
- investment funds currently subject to existing custodial requirements under National Instrument 41-101 *General Prospectus Requirements*; and
- customer collateral that is to be made subject to custodial requirements under the proposed National Instrument 94-102 *Derivatives: Customer Clearing and Protection of Customer Collateral and Positions*.

	1. an IIROC member investment dealer permitted under IIROC rules to hold the securities and cash of a client or investment fund; 2. any Schedule I, II or III Canadian bank, and 3. any Canadian trust company with equity of not less than $10,000,000 and which assumes responsibility for all of the custodial obligation. However, Advocis believes that the CSA should give additional consideration to the impact of the Proposed Amendments on smaller registrants which, though they may pose no risk to clients – will be detrimentally affected by them.

2. Advocis' Response to the CSA's Proposed Custody Arrangements

Advocis' overall position	Advocis believes that it would be better to introduce these Proposed Amendments in the form of recommended best practices. The vast majority of exempt market dealers already adhere to these standards as part of their usual business practices; in cases where a dealer departs from these practices, it is usually as a matter of convenience and the prospect of client harm is minimal. However, if the concerns we articulate in the remainder of this section are effectively addressed by the finalized set of amendments, (please see the text accompanying subheads numbers 4 to 11, below), then Advocis would be pleased to support the introduction of the CSA's proposed changes to custodial arrangements.

3. The CSA's proposed amendment regarding the treatment of permitted clients

For the most part, the CSA's proposed custodial requirements will not apply to most "permitted clients" – provided that the permitted client has waived the application of the requirements in writing.

Advocis' response	In the event that the proposals become CSA requirements, Advocis would suggest that the treatment of the "permitted client" be revised. We note that the waiver provision does not apply to permitted clients who are natural persons. Nor does it apply to permitted clients which are investment funds. We question what the impact will be on these permitted clients – especially those who are natural persons – and who will potentially lose a measure of control over their custodial arrangements. In order to achieve effective, targeted and proportionate regulation, without inhibiting market efficiency or reducing client choice, we believe that the CSA should revise this amendment.

4. Mandating use of a qualified custodian and additional client disclosure

A registered firm will have to use a "qualified custodian" to hold a client's securities and cash, or an investment fund's securities and cash. The firm will also have to receive confirmation of how the qualified custodian is holding the securities and cash of a client or investment fund. The firm will also be required to provide disclosure to clients explaining where and how the client's assets are held and how they may be accessed (proposed sections 14.2(2)(a.1) and 14.2(2)(a.2) in NI 31-103).

Advocis' analysis and response	*Similar National Instruments but different definitions: what is a "reasonable" person?* Based on our reading of the Proposed Amendments, the new custody requirements will stipulate that all client assets held by the registered firm or to which the firm has access must be held in custody by either a "Canadian custodian" or a "foreign custodian". These types of custodian are defined terms with slightly different meanings than they have in NI 81-102. Proposed definition of "Canadian custodian": The suggested definition in NI 31-103 replicates the definition in NI 81-102, but also adds a provision which would categorize as a "Canadian custodian" all registered investment dealers who are IIROC members and are permitted to hold the securities and cash of a client or of an investment fund under IIROC rules. Proposed definition of "foreign custodian": This definition departs from the one for Canadian custodians by omitting the "registered dealer" category. In addition, while the existing "foreign custodian" definition in NI 81-102 includes affiliates of foreign banking institutions as well as Schedule I, II and II Canadian banks and sufficiently-capitalized trust companies, the definition proposed for NI 31-103 involves a reasonability test. The result is that when a "foreign custodian" is chosen by the registrant firm, the arrangement must meet a reasonability test: that is, whether or not a "reasonable person would conclude that using the foreign custodian is more beneficial to the client or the investment fund than using a Canadian custodian."[4] We are not sure why a reasonability test for "foreign custodian" was chosen for NI 31-103, given that NI 81-101 already has a well-delineated definition. The proposed test raises a number of questions. It is not clear to us what the term "reasonable person" means in this context. Is it a reasonable exempt market dealer? Or is it a reasonable IIROC-registered dealer? Will the test allow for differences in reasonableness based on the form of the dealer's registration?

[4] *Ibid*., p. 20.

	Presumably the content of the test is the *actual information* the decision-maker actually had at hand at the time of the decision. Finally, it is not clear if the proposed reasonableness standard is equivalent to, lesser than, or greater than the standard "prudent person" test. To help resolve these uncertainties, Advocis urges the CSA to provide further clarity regarding the nature of its proposed reasonability test. *Disclosure of a possible conflict of interest should be curative* The CSA quite properly wants to address a common form of custodial risk – the non-arm's length conflict of interest. Under the Proposed Amendments, a registered firm cannot itself be the custodian of the assets or cash of a client or investment fund, unless it qualifies as a Canadian custodian and meets specified compliance criteria. And even if the firm qualifies for self-custody, the CSA sounds a strong note of warning, saying in the proposed changes to NI 31-103's *Companion Policy* that the: > relationship between a registered firm and a non-independent custodian can give rise to serious conflicts of interest. We remind registered firms of their obligations under section 13.4 to identify and respond to conflicts of interest. If the conflicts of interest cannot be managed fairly and effectively, the registered firm should consider using an independent custodian to hold client assets instead.[5] In addition, the *Companion Policy* states that "[e]ven when a registered firm is not required to use a qualified custodian … or a Canadian financial institution… we consider it prudent for the registered firm to use a custodian that is functionally independent of the registered firm." Advocis disagrees, as we believe that disclosure of a possible conflict of interest should be curative – especially to a party as sophisticated as an investment fund. It should be presumed that such an entity has the ability to evaluate the prudential qualities of a custody arrangement for itself.

[5] *Ibid*.

5. The dealer obligation to monitor Canadian custodians

Custodians must be "functionally independent" of the registrant, unless the custodian is a Canadian custodian and the registered firm ensures that the Canadian custodian has established and maintains a system of controls and supervision sufficient to manage the risks to the client or investment fund. The problem here is the practically all-enveloping term "system of controls and supervision sufficient to manage the risks." The only guidance provided is in the Proposed Amendments to the *Companion Policy* of NI 31-103, which state the CSA will consider "a system of controls and supervision" to "manage the risks to the client or investment fund associated with the custody of the client's or investment fund's securities or cash to include the:

- segregation of duties between the custodial function and other functions
- client asset verification examination performed by a third party."[6]

Advocis' response	The dealer obligation to monitor Canadian custodians is too onerous. Advocis believes that the decision to select a Canadian custodian by the dealer will in and of itself almost certainly result in a sufficient level of client protection. There is no need for a further and onerous requirement that the dealer must also establish and maintain a system of controls and supervision in order to manage the risk to the client or investment fund. It should be recalled that the dealer firm must carry out due diligence in choosing the custodian, in negotiating the custodial relationship, and in monitoring the services provided. To add the additional requirement that the dealer have an ongoing system of control and supervision that a dealer simply because it is not functionally independent of a qualified Canadian custodian such as a Schedule I bank is perhaps excessive.

6. Proposed exemptions of cash, name-only securities and other assets

The CSA is proposing that cash held by a registrant for a client or for an investment fund can be held by a Canadian financial institution. It also considers exemptions from the proposed custodial requirements in the case of securities which are registered on the issuer's books and are *only* in the name of the client or the investment fund. Finally, the CSA proposes exemptions for certain mortgages and customer collateral which will be subjected to either current or proposed custodial requirements for derivative instruments.

Advocis' response	Advocis agrees that cash held by a registrant for a client or for an investment fund may be held by a Canadian financial institution. We also support the exemptions from the proposed custodial requirements for those securities registered on the issuer's books which are only in the name of the investment

[6] *Ibid.*

	fund or client. We would appreciate more guidance with regard to the exemptions for mortgages. Finally, we agree with the CSA that the exemptions for certain mortgages and customer collateral which will be subjected to either current or proposed custodial requirements for derivative instruments are also appropriate, although the actual information on the mortgage exemption still needs to be elaborated.

7. Cash and property to be held in trust

The Proposed Amendments stipulate that cash and other property held by the custodian, such as cash held in an account in the name of the registrant in transit for delivery to the client, must be held separate and apart from the other assets of the registrant and in trust for the client or investment fund.

Advocis' response	Advocis supports this requirement as being in the consumer interest.

8. Mandatory review of adequacy of past custodial arrangements

Firms which have in the past directed or arranged a custodial relationship for their clients' cash and securities will be expected to inform clients of the new custodial requirements. In the event that the custodian selected fails to meet the independence requirement, the registered firm must inform the client of this inadequacy and then direct the client to an alternative custodian that does fulfill the requirements of a "qualified custodian."

The six-month transition period and non-retroactivity

The CSA has proposed a six-month transition period for firms to comply with the custody requirements relating to *all* clients and *all* investment funds. The CSA also states that the new custody provisions will not be applied "retroactively" to these existing relationships. Registered firms must review all custodial relationships in which the custodial relationship was directed or arranged by the registered firm for the client. Should one of these custodial relationships fail to meet the new custodial requirements, the firm will have to take further action, in the form of disclosure to the client, and in the re-directing of the client to a suitable custodian.

Advocis' position and response	Advocis' position is that the CSA should provide a timeframe which indicates when it expects client notification and, when necessary, re-direction of a client to a qualified custodian, to occur. The process of assessing custodial relationships for existing clients will require the locating and reviewing of documents connected to relationships which may have been formed years or even decades ago. It would be re-assuring if the CSA made this "client review" provision an explicit exemption from the requirement that *all* clients *must* be transitioned within six months to a new custodian when necessary.

9. The CSA's specific request for comment on custodial agreements

We reproduce for the reader's ease of reference the text of the CSA's specific request for comment regarding possible guidance on key terms to be considered by fund managers before entering into custodial agreements:

> 1. Proposed section 14.5.2 of 31-103CP includes guidance for investment fund managers in respect of key terms that they should consider when entering into a written custodial agreement on behalf of the investment funds managed by them. (1) We invite specific comment on whether this guidance is sufficiently clear and whether it would be helpful when negotiating contract terms with custodians for investment funds that are not subject to NI 81-102 and NI 41-101. Should there instead be prescribed key terms for custodial agreements in NI 31-103, similar to the requirements found in NI 81-102 and NI 41-101? In particular, should there be a requirement for such custodial agreements to include a prescribed standard of care and responsibility for loss for the custodian?

Advocis' position and response	*Mandating a standard of care into custodial contracts is excessive* In regard to the CSA's question of whether there should be a requirement for custodial agreements to include a prescribed standard of care and responsibility for loss by the custodian, we would suggest that for Canadian custodians the CSA abandon the idea of legislating the content of private contracts and simply follow the example of NI 81-101. This instrument sets out the due standard of care as follows: 6.6 (1) (a) the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances; or (b) at least the same degree of care as they exercise with respect to their own property of a similar kind, if this is a higher degree of care than the degree of care referred to in paragraph (a). We believe that this sort of flexible provision is a better solution than the CSA's proposal to create a set of defined terms – including "standard of care" – which are to be included in private custodial contracts. And if the proposal to introduce regulator-approved boilerplate terms into private contracts means that the CSA now believes that the approach of NI 81-101 is insufficient to the needs of the exempt market, then it should make public the reasoning behind that position. However, the mandatory use of defined terms in a custodial contract may be of value in the case of foreign custodians. The responsibilities reflected in existing business practices in Canada may be somewhat opaque to certain foreign issuers, and the guidance set out in the *Companion Policy* may be mis-

	interpreted through the lens of another jurisdiction's regulatory paradigm. Foreign custodians may benefit from terms which articulate and provide examples of the necessary standard of care.

10. The CSA's Cost-Benefit Analysis of the Proposals and their Impact of Registrants

The CSA states that the anticipated costs and benefits of its proposed changes to custodial requirements will make those requirements "more clear while at the same time strengthening our regulatory regime and enhancing investor protection," and "will provide CSA staff with a more precise regulatory tool to use when we identify improper custodial practices." Further, the CSA states that:

> We do not expect that the Custody Amendments will have a significant impact on a client's choice of custodian given that the majority of the custodians currently used by clients of registered firms would meet the definition of a "qualified custodian". We expect that the Custody Amendments will have minimal impact on most registered firms as we understand that the Custody Amendments generally codify existing business practices.[7]

Advocis' position and response	While the CSA may very well have a more precise regulatory tool if the Proposed Amendments are implemented, Advocis is not convinced that the requirements will have "only a minimal impact on most registered firms." *What will be the impact on smaller exempt market dealers?* Many smaller firms that specialize in corporate finance deals with institutional clients and typically conduct several such deals a year have now dropped their IIROC registration and become strictly exempt market dealers. For these smaller-scale firms, the costs of operating an IIROC-registered and compliant firm are, in light of their business model, prohibitively expensive. These exempt market firms often restrict themselves to private placements of private securities – and, occasionally, with prospectus-qualified public securities with institutions, but pursuant to their exempt market dealer registration. While these firms simply cannot afford to be IIROC registrants they nonetheless continue to provide an in-demand service for the exempt market. The CSA's analysis does not seem to account for the impact of the Proposed Amendments on these firms. *Will the CSA proposals give qualified custodians an unofficial gatekeeper role over product approval and distribution?* At times, dealers are forced to use non-qualified custodians after being rejected by qualified ones. Occasionally, qualified custodians reject a dealer's offer for

[7] *Ibid.,* p. 9.

	competitive reasons or after being refused control of an offering. In essence, these qualified custodians have already taken on the role of determining which exempt markets can be sold in the marketplace. Eliminating the role of non-qualified custodians will give qualified custodians a *de facto* gatekeeper role. The CSA needs to address this issue, and to consult with stakeholders on the possibility and desirability of introducing conflict avoidance measures. *Will the CSA proposals negatively affect the economics of the market for custodial services?* Also of concern are the potential consequences of the Proposed Amendments on the functioning of the custodial services market: • Effects on pricing and supply: Price points for services from qualified custodians can at times be less favourable for exempt market dealers than those for services provided by non-qualified custodians. In light of the Proposed Amendments, Advocis now wonders if "qualified custodians" are going to be under any guidance that they must provide services for exempt market dealers at the same cost as they do for their bank-owned affiliates. Reducing the number of custodians in the marketplace will reduce competition and, quite possibly, the ability of exempt market dealers and their clients to access custodial services. Given that qualified custodians sometimes reject a dealer's offer after being refused control of an offering, we again wonder if qualified custodians will be subject to guidance that indicates that, *ceteris paribus,* a qualified custodian is obligated to accept a reasonable request from a dealer. Otherwise, the Proposed Amendments may further entrench this troubling aspect of the *status quo ante*. Absent some form of protection for smaller dealers, the proposals may simply permit qualified custodians to continue to demand that certain exempt offerings pass through their distribution channels, or they will refuse their custodial services to the exempt market dealer. • Consequences for future registrants: Larger custodians all began as smaller custodians. The potential negative impact of the CSA's Proposed Amendments on the number of future qualified custodians in the marketplace must be carefully considered in any cost-benefit analysis.

	• Impact on market structure: The proposals may create two tiers of exempt market dealers and custodians. Also of concern will be the position advantage enjoyed by large financial institutions. While Canada's Schedule I, II and III banks can be both custodians and dealers, the proposals – by restricting the ability of dealers to practice self-custody – may disproportionately impact smaller-scale dealers. In summary, there is a risk that the CSA is inadvertently determining in advance which sort of registrant can survive and prosper under the custodial regulatory framework. And it should be noted that this is a framework which the CSA is seeking to revise – despite the lack of evidence of consumer or client harm.

Part II. Proposed Amendments regarding Exempt Market Dealers

1. Understanding an exempt market dealer's permissible scope of activities

The last restrictions on the activities of exempt market dealers came into force in July 2015. Earlier this year, the CSA published advance notice of possible amendments to NI 31-103 which would further restrict the activities that exempt market dealers may conduct. Those intentions are now set out in the Proposed Amendments; as a general observation, it seems that the CSA's intention is to further narrow the scope of trades in which an exempt market dealer may participate.

An exempt market dealer's permissible activities must be expressly stated

The CSA's general position is that an exempt market dealer may only act as a dealer or an underwriter in an exempt trade. Under the Proposed Amendments, it is now made clearer than at any previous time that the only *permissible* activities of an exempt market dealer are those which are expressly and positively stated in legislation – primarily, the various prospectus exemptions in securities legislation, such as the accredited investor, the minimum amount investment, and the offering memorandum exemption in National Instrument 45-106 *Prospectus Exemptions*.

Advocis' response:	With the Proposed Amendments, the CSA now explicitly states that the only permitted dealer registration category for a firm which wishes to participate in prospectus offerings or trade in listed securities, is the investment dealer category. Advocis is concerned about an effort to rigidly circumscribe from the outset the ability of exempt market dealers to flexibly respond to their client's investment needs. A rigid delineation of an exempt market dealer's activities does not sit well with the pace of development in the exempt market and a principles-based approach to regulation.

2. The CSA's proposed expanded exemption of the current dealer registration requirement

In addition, the Proposed Amendments also expand the exemption from the dealer registration requirement in section 8.6 of NI 31-103. The result is that a registrant may trade in the securities of investment funds – including those distributed under a prospectus – if the registrant or an affiliate of the registrant manages the investment fund and certain other conditions are met.

Advocis' response:	Advocis supports this proposal, since it will permit an exempt market dealer to use affiliated investment funds as a potentially effective, efficient investment option for a client's assets.

3. The CSA's proposals on permissible exempt market dealer transactions

The Proposed Amendments provide further clarification around permissible exempt market dealer activities, including trades of securities distributed under a prospectus exemption and certain resale trades.

Permitted exempt market dealer distributions and re-sale transactions

The CSA now clearly distinguishes between trades which are distributions and transactions which are secondary market trades and therefore not distributions. In regard to the secondary market, an exempt market dealer may trade in the secondary market securities that are subject to resale restrictions, or if a prospectus exemption would be available to the seller if the trade is a distribution and the class of securities is not listed, quoted or traded on a marketplace.

Advocis' response:	Advocis supports this proposal, since it is consistent with the general principle that an exempt market dealer may trade securities which are distributed under a prospectus exemption. However, as we argue below, we are concerned with the CSA's proposed "clarity" regarding the ability of an exempt market dealer to distribute the securities of a reporting issuer of prospectus-qualified securities.

Investment fund trades by adviser to managed account

Advocis' response:	Advocis supports the proposed changes to Section 8.6 of NI 31-103, as they will enable further efficiencies in the way an exempt market dealer can invest a client's assets.

4. The CSA's proposals regarding prohibited exempt market dealer transactions

The Proposed Amendments now explicitly state that an exempt market dealer may not establish an omnibus account with an investment dealer and trade listed securities through the investment dealer

on behalf of their clients. As well, the Proposed Amendments clearly state that an exempt market dealer cannot participate in a distribution of securities offered under a prospectus *in any capacity*. This prohibition applies to all securities whose classes are listed, quoted or traded on a marketplace, whether on-exchange or off-exchange.

Impact on current exempt market dealer practices

The CSA proposes that an exempt market dealer would be under a blanket prohibition from acting as a dealer, agent, finder, selling group member or underwriter, in two specific cases:

1. In the sale of a security for which a prospectus exemption is *otherwise* available – for example, on the sale to an accredited investor; and
2. In the sale of special warrants which are convertible into prospectus-qualified securities.

Advocis' analysis and response	At issue is the current practice of those exempt market dealers which sell prospectus-qualified funds in the exempt market. ***Is the CSA proposing a <u>new</u> prohibition on distributions of prospectus-qualified funds by exempt market dealers to their permitted clients?*** At the outset of its *Notice and Request for Comment*, the CSA states that its proposed changes to the regulation of exempt market dealers would "revise and clarify the activities that exempt market dealers may engage in with respect to the resale of securities" and "clarify the activities that may be conducted under the exempt market dealer category of registration in respect of trades in prospectus-qualified securities."[8] Despite the relatively circumscribed approach to regulation which this wording suggests, Advocis' review of the actual text which is proposed for section 7.1(2)(d) of NI 31-103 prompts us to ask if the CSA is proposing a *new* prohibition on distributions by exempt market dealers to their permitted clients of prospectus-qualified funds. ***What will be the impact on an investment fund/portfolio manager which is also an exempt market dealer?*** At present, portfolio managers and investment fund managers which are also exempt market dealers may distribute their own prospectus-qualified funds to permitted clients through their exempt market dealer channel. However, on our reading of the CSA's proposals, the amendments, if implemented, will prevent a portfolio manager/investment fund manager which is an exempt market dealer from distributing such prospectus-qualified funds beyond managed accounts.

[8] *Ibid.,* p. 4.

	Advocis believes that firms registered as both investment fund or portfolio managers and as exempt market dealers need certainty from the CSA on whether the Proposed Amendments would affect their ability to rely on their exempt market dealer registration when distributing to their clients' accounts the securities of reporting issuers. Advocis is concerned that this proposed change to the permitted activities of exempt market dealers is at odds with the CSA's goal, stated at the outset of the *Notice and Request for Comment*, that its wants to "expand the exemption from the dealer registration requirement in section 8.6 so that registered advisers may trade in the securities of investment funds (including, as is the case today, those distributed under a prospectus) if the adviser or an affiliate manages the investment fund and certain conditions are met."[9] This particular proposal is by any reasonable measure a *substantive* one, yet the *Notice and Request for Comment* does not offer a policy-based justification for it. With regard to what such a justification might be, we are not aware of investor protection concerns which would warrant the proposed change to the activities of an exempt market dealer *vis-à-vis* its permitted clients. Advocis would therefore ask if this proposed curtailing of the current ability of exempt market dealers to sell prospectus-qualified funds in the exempt market is the CSA's actual intention. If so, then that intention should be made clear in the actual text of NI 31-103, and not relegated to the guidance provided in section 7.1 of the instrument's *Companion Policy*.

Part III. Client Relationship Model Phase 2 Amendments

The CSA has proposed both minor and substantive amendments to the CRM2 requirements contained in NI 31-103 and its *Companion Policy*.

1. The CSA's Proposed Changes to Relationship Disclosure Information

The CSA proposes additional guidance on the requirement to disclose in the Relationship Disclosure Information (RDI) the nature of the charges a client might pay during the course of holding a particular security. The CSA proposal states that RDI is to include information about commissions paid by issuers, bonuses received from affiliated companies, and general information about those management fees that are associated with mutual funds.

[9] *Ibid*.

As well, the amended *Companion Policy* will state that if a registered firm exclusively or primarily invests its clients' money in securities issued by a related party, this information should also be disclosed in the RDI. Finally, the CSA would add a requirement to disclose custodial arrangements in the RDI, including the manner in which the client's assets are held and the relevant associated risks to and benefits for the client.

Advocis' response:	RDI is, among other purposes, intended to provide the client with "a general description of the products and services the registered firm offers."[10] Advocis therefore generally supports these proposed changes to CRM2's mandatory RDI, as they will better help clients understand compensation- and charge-related issues at the outset of the advisor-client relationship. However, there are a number of specific observations regarding the proposed changes to the RDI requirements which Advocis wishes to make. *What is meant by the term "related party"?* The *Companion Policy* calls for disclosure to be made in the RDI document about whether the firm "exclusively or primarily invests its clients' money in securities issued by a related party". It is not clear what is meant by the term "related party." Does the CSA mean to refer to the definition of related party provided in section 3840 of the *Canadian Institute of Chartered Accountants' Handbook*? This definition, which is referred to several times in NI 31-103, is one that is relied on for accounting purposes. It therefore seems more likely that the term "related party" is meant to have a meaning similar to the meaning of the terms "connected issuer" and "related issuer" – which are also used in NI 31-103, and have the same meaning as they have in section 1.1 of National Instrument 33-105 *Underwriting Conflicts.* Any clarity which the CSA can provide here would be welcome. *Does the CSA now intend to expand the purpose and ambit of RDI?* At present, RDI requirements are geared toward the disclosure of amounts which a client will pay for his or her investments. However, the Proposed Amendments would require new guidance on RDI regarding: • commissions paid by issuers, • bonuses from affiliated companies, and • amounts a client might pay when holding an investment including management fees associated with mutual funds.

[10] See Paragraph 14.2(2)(b) of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations.*

	It should be noted that bonuses from affiliated companies, commissions paid by issuers, and amounts a client *might* pay when holding an investment, including management fees on a mutual fund, are *not* charges *directly* paid by a client for the investment. Thus it seems that the CSA is now proposing to expand the scope of RDI. It seems to us that if this is the intent of the CSA, then it should state that intention expressly. In addition, the CSA should provide some justification for these late-stage expansion of the RDI. To expand the scope of RDI from *direct* charges to also include *possible* or *contingent* charges seems likely to unnecessarily complicate the initial, generalized disclosure to the client. Advocis believes that affiliated bonuses, commissions on new issues, and management fees on mutual funds should be *optional* RDI disclosure. Certainly all these charges *should* be disclosed, prior to investing, to any consumers who are going to have to pay them. But the RDI document is not of necessity the right time and place to disclose them. Moreover, the *Annual Report on Charges and Other Compensation* will capture for the client commissions paid by issuers, as it is a form of third-party compensation, along with *all* fees the firm received from third-parties. Finally, it seems awkward to mandate disclosure in the RDI of specific *transaction-based* charges, since the mandatory pre-trade disclosure of charges requires that a fee which affects the profitability of a client's investment must be disclosed before the dealer accepts the client's instruction to buy the security.

2. Tax information

The CSA proposes to amend *Companion Policy 31-103CP* so that it clearly states that position cost is not tax information and that a registered firm may not depart from the defined meaning of "original cost" or "book cost" in order to align position cost with tax cost for a security position. The amendment also provides guidance to the effect that if an important feature of the dealer's marketing to investors is the tax treatment of the security, then the dealer should provide both tax information and position cost information for that security to the investor.

Advocis' response:	Since it is in the interest of enhancing investors' understanding of their financial situation, and it is consistent with the duty to deal fairly, honestly and in good faith with clients, Advocis supports this proposal.

3. Pre-trade disclosure to clients

The CSA proposes to provide additional guidance on its expectations regarding clients who are frequent traders. For non-managed accounts, *Companion Policy 31-103CP* would be amended so that if a client

is a frequent trader, and if the firm has "good reason to believe applicable 'standard' charges are well understood," then a brief confirmation that the usual charges will apply would be an acceptable alternative to specifying the actual amount of the charges. Of course, the actual specific charges would, as always, have to be reported in writing on the trade confirmation.

Advocis' response:	Advocis supports this proposed amendment, given that it will better facilitate the wishes of clients who trade frequently.

4. Investor Protection Fund disclosure

The CSA proposes several amendments to NI 31-103 in order to clarify CRM's required investor protection fund disclosure. IIROC and MFDA rules require member firms to be participants in specified investor protection funds and prescribe disclosure to clients about the funds. The proposed changes seek to eliminate client confusion arising from the client being provided with inaccurate information about the applicable investor protection fund's coverage. To accomplish this, the CSA proposes to prohibit a registered firm that is not itself a member of the applicable investor protection fund from discussing its terms and conditions with clients.

Advocis' response:	Advocis supports this proposal, as it is obviously in the consumer interest and imposes virtually no costs on registrants.

5. Quarterly Account Statements

The CSA proposes to amend NI 31-103 to clarify that dividend and interest payments must be disclosed in account statements. This information is of considerable importance to consumers.

Advocis' response:	Advocis supports this amendment. However, it would be helpful to know what the CSA judges to be a sufficient transition period for dealers to comply with the production of amended account statements.

The CSA also proposes to amend *Companion Policy 31-103CP* to state that the required quarterly account statements must be provided to the clients for *each* account held by the client with the registrant. (These statements can be supplemented by consolidated statements if the client requests this).

Advocis' response:	Advocis supports this proposal, since it should provide additional clarity to investors. CRM2's reporting requirements mean that clients understand their overall position on an account-by-account basis, since they receive separate account statements for each of their various security positions, registered accounts, separately managed accounts, etc. Providing the dividend and interest payment information on individual account statement will further the objectives of CRM2.

6. The *Annual Report on Charges and Other Compensation*

Adding to the annual performance statement "other forms of compensation" and "specifically list[ing] all additional sales incentives"

At present, the *Annual Report on Charges and Other Compensation* only requires disclosure of the amounts paid to the registered dealer or to the registered adviser who provides the report to the investor. This disclosure is intended to assist the investor in understanding the costs and incentives related to his or her investment account. Now, the CSA is proposing a new requirement for CRM2's annual statement. When a firm or its representatives *have received* or *may receive* incentives not captured by the existing *Annual Report on Charges and Other Compensation*, then the annual report would have to specifically list *all* additional sales incentives. It would also have to contain prescribed text to the following effect:

> In addition to the payments specified in this report, [the firm] or its representatives may also receive other sales incentives related to the securities that you have purchased through us. These incentives can influence representatives to recommend one investment over another.

Advocis' analysis and response:	Advocis supports the additional clarity this proposal would provide to consumers. A simple statement in the client's annual statement that there *may* be other forms of compensation will help to further inform advisor-client discussions on annual fees and charges. Advocis believes that informing the investor of the potential existence of sales incentives is consistent with the duty to deal fairly, honestly and in good faith with clients. In regard to the portion of the proposed text which indicates that such incentives may influence the investment recommendations of dealing representatives, Advocis believes that additional wording to the following effect should be added: > Registered dealers and their authorized representatives are required by provincial securities law to deal fairly, honestly and in good faith with you as a client. Advocis believes that informing consumers of the legal obligations owed to them by registrants will help allay any *undue* fears on the part of consumers in regard to potential product bias on the part of their advisor. More importantly, the CSA's proposed text and our additional wording will set the stage for a more focused and informed discussion of what the client is paying for and how the advisor is compensated.

Proposed amendment of Companion Policy 31-103CP regarding disclosure of annual bonuses

In addition, the CSA proposes to amend section 14.17 of *Companion Policy 31-103CP* in the following manner:

> Disclosure of charges and other compensation
>
> Under paragraphs 14.2(2)(f), (g) and (h), registered firms must provide clients with information on the operating and transaction charges they might pay in making, holding and selling investments, and a general description of any compensation paid to the firm by any other party. This would include such things as commissions paid by issuers and bonuses from affiliated companies. We also expect this disclosure to include all amounts a client might pay during the course of holding a particular investment, including management fees associated with mutual funds.

Advocis' position and response:	Advocis, for its part, believes that fair and informed disclosure to consumers is a necessary part of any successful advisor-client relationship. If the practice of providing compensation based on sales bonuses – including such contingencies as bonus grids which can change throughout the year – can be captured and reproduced in the *Annual Report on Charges and Other Compensation* in a way that is intelligible and meaningful to consumers, then Advocis strongly supports the CSA's proposal. As a matter of fair dealing with clients, Advocis believes that such information should always be made available to investors at the appropriate time and in the appropriate format. However, Advocis would also suggest that the CSA should provide stakeholders with much greater detail forthwith on what the CSA's expectations are for the behaviour of advisors and dealers regarding its proposal that the *Annual Report on Charges and other Compensation* "specifically list all additional sales incentives" that are, or may be, received by a firm or its representatives. A template example of such a list which demonstrates how the various compensation practices would be captured on it on an itemized basis would be crucial here, if the CSA wants to avoid creating additional client confusion and negatively impacting the ongoing research on the effectiveness of CRM2 disclosure. Advocis therefore strongly encourages the CSA to amend the *Companion Policy* to include this guidance regarding the *Annual Report on Charges and Other Compensation*. The inclusion in the annual report of all "employee bonuses" linked to sales or other registrable services that are paid to dealing representatives is eminently justifiable as one of fairness to investors – and to other intermediaries. It will help address the current asymmetry in disclosure obligations between dealing representatives who are employed by financial

	institutions such as banks and financial advisors. The former are not remunerated by way of third party embedded compensation (such as a trailing commission) but instead work on a salary and bonus basis, whereas financial advisors working for smaller or independent registrants continue to be largely compensated by way of trailing commissions. Requiring mutual fund dealing representatives who are employed by banks to disclose their compensation will help "level the playing field" for all advisors. Such disclosure is also of fundamental importance to investors, as they need and deserve to know how intermediaries with whom they invest are compensated. And such disclosure is necessary to complete CRM2's project of mandating full and fair reporting obligations in the furtherance of the consumer interest. One final note: As a matter of practicality, it should be emphasized that identifying the actual amount of an "employee bonus" for any specific individual client may be difficult, depending on the nature of the registrant's bonus scheme(s). It may be that, in lieu of calculating a sum that is definitely linked to a specific client transaction, a reasonably accurate and representative number, such as may be derived from the total bonus divided by the number of client transactions, will have to suffice. Yet these difficulties should not dissuade the CSA from proceeding with this amendment; while bonus compensation may at present be disclosed by some parties in a client's RDI documentation because it is a potential conflict, the vast majority of consumers are oblivious to the existence of this incentive. For the reasons discussed above, the CSA's remedy for this situation should be implemented as soon as it is practical to do so.

7. The CSA's specific request for comment on prescribed text relating to non-cash incentives

At present, the *Annual Report on Charges and Other Compensation* does not extend to non-cash incentives that may be paid to the dealer or advisor and their representatives for sales of certain products, such as promotions or other employment benefits. The CSA now proposes (the text of which we reproduce for the reader's ease of reference) this prescribed text on non-cash incentives, which would be inserted into the *Annual Report on Charges and Other Compensation:*

> *4. Section 14.17 [report on charges and other compensation] The annual report on charges and other compensation requires disclosure of the amounts paid to the registered dealer or registered adviser that provides the report. This disclosure shows the client the costs and incentives related to their investment account.*
>
> *The report does not extend to non-cash incentives that may be paid to the dealer or adviser and its representatives, such as promotions or other employment benefits, for sales of certain*

products. We are considering ways of making clients aware of these kinds of incentives. We invite specific comments on the potential usefulness of adding a new requirement that, where a firm or its representatives received or may receive incentives not captured by the existing provisions, the annual report must specifically list all additional sales incentives and must include prescribed text to the following effect: "In addition to the payments specified in this report, [the firm] or its representatives may also receive other sales incentives related to the securities that you have purchased through us. These incentives can influence representatives to recommend one investment over another."

Advocis' position and response:	Advocis welcome's the CSA's proposal to review the treatment under CRM2 of non-cash incentives and to consider ways to make clients aware of these kinds of incentives. It is an initiative which will generate considerable commentary from industry stakeholders. We believe the CSA should anticipate a range of positions, ranging from strong support to committed opposition. The classic non-cash incentive is the case of the salaried advisor who works at the retail level and earns "rewards," such as sales conferences. Generally, these incentives have not been disclosed. Advocis believes that such non-cash incentives should be disclosed to consumers – especially in light of the fact that the fund manufacturer very often also owns or controls the distribution process. In order to properly assess the independence of the advice they receive, clients must be informed of these non-cash rewards. With regard to the CSA's proposed wording, Advocis believes the suggested language is sufficient to the task. Our only comment on the application of the wording is the suggestion that, in the event that the registrant does not apply any sales incentives or related fees and charges to the client's account, then the suggested language need not appear on that particular client's annual statement.

8. The CSA's specific request for comment on prescribed text relating to management fees

Finally, the CSA notes that the *Annual Report on Charges and Other Compensation* does not include the ongoing costs to the investor of owning securities which have embedded fees that are paid to issuers. Typically, these will be management fees associated with mutual funds. The CSA states that it wishes to make clients "more aware of such fees" and therefore raises the issue of adding a general notification in the *Annual Report on Charges and Other Compensation* which would "remind" clients who are invested in mutual funds or other securities with embedded fees of these management fees. We reproduce for the reader's ease of reference the CSA's proposed prescribed text on management fees for insertion into the *Annual Report on Charges and Other Compensation:*

5. The report does not extend to the ongoing costs of owning securities with embedded fees paid to issuers, such as mutual fund management fees. We are considering ways of making clients more aware of such fees. We invite specific comment on the potential usefulness of adding a general notification in the annual report that would remind clients invested in mutual funds, or other securities with embedded fees about the following:

- *management fees are paid to the issuer, whether or not the dealer or adviser receives any trailing commissions or other payments tied to those fees, and*
- *these fees may reduce the client's investment returns.*

Advocis' position and response	Advocis supports the principle behind the CSA's proposal to introduce additional disclosure about embedded fees – such as management fees on mutual funds – to the *Annual Report on Charges and Other Compensation*, and to require registrants to make clients aware of such fees. Advocis believes that the wording suggested by the CSA would be a helpful reminder to clients that there are charges implicit in most investment products. This reminder should also help prompt more informed advisor-client discussions regarding the *Annual Report on Charges and Other Compensation.* Clearly, the general goal of improving investor knowledge is a desirable one. However, the roll-out of CRM2's annual statements is already poised to overwhelm many retail clients with a surfeit of information related to fees, charges and other compensation. Advocis therefore questions the prudence of including yet more information to clients who will already be struggling to understand the various itemized fees and costs tied to their mutual fund investments. Advocis would therefore suggest that the proposal, if implemented, be characterized as a form of suggested guidance during the first year or two of the new annual statement, and not become a mandatory requirement of NI 31-103 until the dealers, advisors and clients have had time to acclimate themselves to the already extensive disclosure required under CRM2. In addition, we would like clarification from the CSA on whether the proposed text is to be required in its current or modified form for F-class mutual funds held in fee-based accounts.

9. The *Annual Investment Performance Report*

The CSA has proposed several amendments to the *Annual Investment Performance Report* which may necessitate changes to the report templates of issuers or dealers, as well as to registrants' compliance systems. If implemented, registered firms would have to provide clients with information on the operating and transaction charges they might pay in making, holding and selling investments, and a

general description of any compensation paid to the firm by any other party, including commissions paid by issuers and bonuses from affiliated companies.

Advocis' general response	While Advocis supports many of these proposals, we wonder whether the CSA has duly considered the additional costs to be incurred by registrants in the event these proposals are implemented. We further wonder if these changes might be better introduced in the second or third iteration of the *Annual Investment Performance Report*, so that investors have had some time to acclimate to the tremendous amount of new information contained in the statement, much of which they will only being seeing for the first time in the first iteration of the report.

Determining market value

A dealer is expected by the CSA to use its professional judgment regarding the reliability of that information provided by an issuer which is to be used in the firm's determination of the market value of the security. The CSA now proposes to refine the CRM2-mandated procedure which is to be followed if a security's market value cannot be determined by the prescribed methodology. The CSA wants to amend *Companion Policy 31-103CP* to state that if the dealer reasonably believes it cannot determine the market value of a security, the firm must then report its value as "not determinable" and exclude it from the calculations in client statements. The CSA also states that while the dealer is not required to deliver a nil report in circumstances where it has concluded that none of a client's securities have a determinable value, it does expect the firm to tell the client that it will not be delivering an investment performance report for the period and to provide the client with an explanation.

Advocis' analysis and response on market value determination	The CSA's *expectation* is that the dealer should explain to the client why it concluded that client's securities did not have a determinable value. We would like to see the CSA's expectation become an absolute requirement. There will be cases where it falls to a client's financial advisor to explain *why* the dealer valued the security the way it did. It would be helpful to advisors if in such cases the *Companion Policy* indicated that the dealer *should* provide to the client a document explaining the determination of market value. Otherwise, the advisor may be left with a vague explanation for the client, such as "there was no issuer-related financial data available, so the valuation methodology prescribed for CRM2 couldn't be completed." Although the conclusion by the dealer that the value of the security is *not determinable* is not the same as determining that the market value of a security is *zero*, the very real probability is that a client's reactions will include disappointment, confusion, or anger. Thus we would suggest that providing some form of additional documentary support to assist the advisor in these cases would be in the consumer interest.

Ensuring that CRM2's first annual statements contain sufficient information for investors

The CSA's Proposed Amendments to section 14.19 of the *Companion Policy* relate to an account's opening market value, deposits and withdrawals. Revisions to these items will in turn impact the client's *Annual Investment Performance Report.*

The proposed new guidance relates to the "inception" date that the dealer firm may choose to use for reporting purposes in the client's *Annual Investment Performance Report* if that inception date is earlier than July 15, 2015 or January 1, 2016. The date has to be "reasonable" based on the availability and accuracy of recorded historical market value information. The dealer's choice of date will be considered "reasonable" in the event it uses the same earlier date for either (1) all client accounts or security positions that were transferred to the firm at the same time; or (2) all client accounts or positions which are on the same reporting system of the registered firm, provided that the firm has more than one reporting system.

Now to ensure that the first annual statements provided to clients under CRM2 provide investors with sufficiently complete investment information, the CSA proposes the following for accounts opened before July 15, 2015:

> Annual statement for a client account with a reporting period covering the calendar year
>
> For these accounts, the dealer can now meet its CRM2 annual reporting requirement to deliver an *Annual Investment Performance Report* covering the period from January 1 to December 31, 2016, by including market value information either (1) as at and since January 1, 2016, or (2) from a date earlier than January 1, 2016, if this earlier date is reasonable based on certain requirements.[11]
>
> Annual statement for a client account with a non-calendar year reporting period
>
> For these accounts, the first CRM2 reports will cover the period from July 15, 2016 to July 14, 2017. The CSA proposes to permit the report to include market value information as at and since July 15, 2015, or a date earlier than July 15, 2015, if that earlier date is reasonable based on certain requirements.[12]

Advocis' response	Advocis supports these proposals, as they should further the aim of providing clients with an understanding of the value and performance of their investments that is as accurate as is practicable. Given that these proposals are being made at a very late stage in the process of CRM2's roll-out of the annual statements, Advocis believes the CSA should provide notification to industry stakeholders of whether dealer firms will be subject to regulatory review of their decision to use a common inception date for transfers-in, and

[11] The main criteria are that the dealer's decision take into account the availability and the accuracy of recorded historical market value information, and that all clients in the reporting situation be on the same reporting system of the dealer (if the dealer has more than one reporting system).

[12] *CSA Notice and Request for Comment, supra* note 1.

	for the decision to use of the same reporting system for all of a dealer's securities, Finally, we would suggest that fairness to registrants limit such review to a criterion of reasonableness based only on the availability and accuracy of the relied-upon data.

Annualized total percentage return information

The *Annual Investment Performance Report* must include annualized total percentage return information, either for the period since inception or for the period since July 15, 2015. The CSA now proposes, for accounts opened before July 15, 2015, that the dealer may meet its reporting obligation on annualized total percentage return in the same manner as the calculation of market value discussed immediately above. This means that accounts with calendar-year-based reporting may use either information for the period since January 1, 2016, or information from an earlier date, provided that the use of the earlier date is reasonable based on certain requirements.[13] Similarly, accounts with non-calendar-year-based reporting may use either information for the period since July 15, 2015, or information from a date earlier than July 15, 2015, provided that the use of the earlier date is reasonable based on the same criteria.[14]

Advocis' response	Again, Advocis supports these proposals, as they further the goal of providing clients with a fuller understanding of the value and performance of their investments, one that is as accurate as is practicable in the circumstances.

The CSA's proposal to add a comparative target rate of return

The CSA also suggests that amending the guidance regarding the Percentage Return Calculation Method in section 14.19 of the *Companion Policy* so that firms are advised to compare the client's actual rate of return with his or her targeted rate of return.

Advocis' response	The CSA's proposal to "customize" annual performance reporting for investors by introducing a targeted rate of return is an admirable one. Advocis believes that the concept behind this proposal is crucial to investors. Comparing the client's actual rate of return with an objective measurement which has been agreed-on by the advisor and client would be yet another means of ensuring that clients "don't lose sight of their goals" and assist them in judging their progress toward their goals. The suggested changes to *the Companion Policy* would require that a client's actual personal rate of return be compared on the annual statement to his or her "target rate of return." Several problems with the implementation of this proposal immediately spring to mind, including the following:

[13] *Ibid.*

[14] *Ibid.*

	• the existing regulatory regime may not be equipped to administer the proposal: since current regulatory requirements do not mandate the retail investor receive a comparative target rate of return in an annual investment statement, the industry will have to develop a set of common proficiency standards which fit with the current IIROC and MFDA standards for persons who participate in the distribution of mutual funds and other securities; • the proposal may not easily fit with existing suitability requirements: it is easy to foresee that a plethora of situations in which an advisor will be placed in a position where, in trying to fulfill mandatory suitability requirements, he or she is soon at odds with the client, as in the case of an older client who is adamant on setting a relatively high target rate of return, even though the advisor is obligated by regulation to recommend a mix of lower-risk investment options by virtue of the client's age; • cost concerns and client expectations: it will be no simple task to provide a client with a comparative target rate of return which is realistic in light of the client's own unique circumstances. It seems to Advocis that the CSA is almost certainly expecting the creation of a risk-adjusted rate of return which takes into account the client's income sources and cash flow needs. This in turn means that the registrant responsible for preparing the annual statement will have to calculate the comparative target rate of return in reference to a set of criteria which amount to a financial plan. If the CSA requires that the client receive a comparative target rate of return for each single investment account, then the advisor will have a significant amount of work to do. The client will likely be expected to share with the advisor any existing financial plan (a plan which may have been prepared by another financial advisor, and may very well be several years old), or to compensate the advisor for the preparation of a new financial plan. It is certain that the proposal will increase the average client's costs; moreover, these will be costs which some clients will not want to incur, and which other clients will simply not be able to afford; • CRM2's roll-out of annual statements is not the time to add yet another source of client confusion: requiring an advisor to explain a comparative rate to return which appears on every single investment account for which the client receives an *Annual Investment Performance Report* seems to us a recipe for "information overload."

	In addition, further client confusion will certainly result for clients who assumed that a pre-selected target rate of return is one that is easily achievable; and • an increase in client complaints: in light of the other regulatory reforms currently under review across Canada, it seems almost reckless to create another category of client information that, if introduced for the first iteration of the *Annual Investment Performance Report,* will surely function as another source of client complaints. It is almost a certainty that many of these complaints will be rooted more in client frustration than in advisor incompetence or malfeasance. Again, the CSA should delay this proposal until advisors have had sufficient "lead time" to educate clients about target rates of return. In sum, Advocis' position is that this sort of evaluative exercise is best left – especially at the present time – to the preferences of the client and the advisor. It is a certainty that CRM2's annual performance report will lead to an abundance of client confusion arising from their efforts to get to grips with such nuances as the differences between time-weighted versus money-weighted rates of return. While progress towards client goals should always be assessed, now is not the time to formalize the introduction of the concept of a targeted rate of return. It is simply too ambitious a proposal to layer on to the CRM2 annual statement at this time. We would therefore ask the CSA to forestall adding either an express requirement to the National Instrument or suggested guidance to its *Companion Policy* until it appears that a sizable cohort of investors are sufficiently adept at interpreting their existing CRM2 statements. For the time being, it should be recalled that a primary goal of CRM2 was to help foster the advisor-client relationship. At the appropriate time, an industry consultation should consider the issue of whether the CSA should introduce a requirement for a target rate of return. A full canvassing by stakeholders of the necessary issues and concerns could then be undertaken. A list of such issues and concerns should include: • whether it is advisable or even possible to mandate a target rate of return measurement into an annual client statement without also requiring the creation of a full-blown financial plan for the client;

	• the creation of a comprehensive document on what constitutes a realistic target rate of return and how intermediaries should create and manage client expectations in relation to it; and • a review of the impact of CRM2 on the financial literacy of retail investors, in order to help the CSA better judge when a target rate of return requirement could be introduced with a minimum of client confusion, etc.

10. CRM2 Implementation Concerns

Advocis' position	Advocis' believes that stakeholders need, as soon as possible, an indication of the regulatory expectations relating to the implementation of a number of the proposed CRM2 amendments. Dealers have already begun – if not completed – the final implementation of CRM2 on their systems in accordance with IIROC or MFDA rules. In the event the proposed changes to CRM2's annual statements are implemented, it is not clear from the CSA's *Notice and Request for Comment* when the amendments would impact dealers and members. The CSA should move to address its silence on this issue as soon as possible.

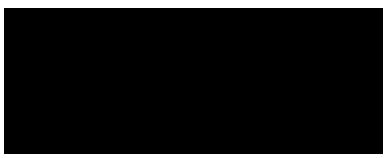
Concluding Comments and Next Steps

Advocis believes that the advisor-client relationship plays a critical role in helping Canadians realize their financial and life goals. It is a relationship which, when regulated properly, contributes in no small measure to the efficiency and integrity of Canada's capital markets. Advocis shares the CSA's view of the importance of addressing both potential and emerging investor protection issues before they can cause substantial consumer harm. Advocis is therefore grateful to the CSA for the opportunity to respond to the various custodial, exempt market and CRM2 issues raised by its recent *Notice and Request for Comment*.

Members of the CSA who have any questions regarding our response, or wish to meet with us to discuss these issues in greater detail, should contact either the undersigned or Ed Skwarek, B.A., LL.B., LL.M., Vice President, Regulatory and Public Affairs, at 416-342-9837 or at eskwarek@advocis.ca.

Sincerely,

Greg Pollock, M.Ed., LL.M., C.Dir., CFP
President and CEO



Mr. Wade A. Baldwin, CFP
Chair, National Board of Directors