CSA/ACVM Canadian Securities Administrators Autorités canadiennes en valeurs mobilières

CSA Staff Notice 33-316
Status Report on Consultation under CSA Consultation Paper 33-403: The Standard of Conduct for Advisers and Dealers: Exploring the Appropriateness of Introducing a Statutory Best Interest Duty When Advice is Provided to Retail Clients

December 17, 2013

Introduction

The purpose of this Notice is to:

- summarize the consultation work conducted to date in respect of the best interest consultation initiative, and
- identify the key themes that emerged from the best interest consultation process.

In October 2012, the Canadian Securities Administrators (**CSA** or **we**) published *CSA Consultation Paper 33-403: The Standard of Conduct for Advisers and Dealers: Exploring the Appropriateness of Introducing a Statutory Best Interest Duty When Advice is Provided to Retail Clients* (the **Consultation Paper**). We received numerous comment letters on the Consultation Paper and conducted three consultation sessions in June and July 2013.

Through this consultation process, we identified four key themes:

1) There was significant disagreement about (a) whether the current regulatory framework for advisors[1] adequately protects investors and (b) what regulatory response is required.
2) A best interest standard must be clear.
3) The potential negative impact on investors and capital markets must be carefully assessed.
4) More work is needed.

Background

Consultation Paper

On October 25, 2012, the CSA published the Consultation Paper.[2] The Consultation Paper:
summarized the background of the fiduciary duty debate,

- described what a fiduciary duty is and when it arises at common law,
- discussed the current standard of conduct for registrants in Canada (including both statutory and common law requirements),

[1] References to "advisor" in this Notice mean, unless otherwise specified, advisers and/or dealers (and their representatives) that provide securities advice to clients.

[2] Available online at http://www.lautorite.qc.ca/files/pdf/consultations/valeurs-mobilieres/2012oct25-33-403-consultation-en.pdf.

- reviewed what the United States, the United Kingdom, Australia and the European Union are doing in this area,
- identified the five key investor protection concerns with the current standard of conduct applicable to advisors in Canada,
- described one possible articulation of a statutory best interest standard for advisors, and
- reviewed the potential benefits and competing considerations of imposing a statutory best interest standard.

The Consultation Paper posed a variety of questions and requested comments from all interested stakeholders on the issues raised in the Consultation Paper. The CSA received 93 comment letters from a range of stakeholders, including investors, investor advocates, advisors, industry advocates, academics, law firms and professional associations. The list of commenters and copies of the comment letters are available online at http://www.osc.gov.on.ca/en/38075.htm.

Consultation Sessions

In addition, the CSA held three consultation sessions hosted by the Ontario Securities Commission (**OSC**) to further explore and discuss the issues identified in the Consultation Paper and the themes that emerged from the comment letters:

- The first consultation session was held on June 18, 2013 (**Investor Roundtable**). The Investor Roundtable was a three-hour discussion attended by approximately 30 stakeholders from the investor community.[3] The discussion at the Investor Roundtable was focused on several key issues:
    - what problem needs to be solved,
    - shifting the suitability standard to a best interest standard,
    - mitigating information and financial literacy asymmetry,
    - impact on legal certainty of relationship,
    - potential negative impact on advisory services for investors,
    - potential shift by investors and advisors to alternative investments,
    - role of recent reforms, and
    - other policy solutions that need to be considered.

- The second consultation session was held on June 25, 2013 (the **Industry Roundtable**). The Industry Roundtable was a three-hour discussion attended by approximately 55 stakeholders from the industry community.[4] The discussion at the Industry Roundtable was focused on several key issues:
    - whether the current standard of conduct offers the most principled foundation,
    - the effectiveness of disclosure for conflicts,
    - shifting the suitability standard to a best interest standard,
    - mitigating information and financial literacy asymmetry,
    - impact on legal certainty of relationship,
    - potential negative impact on advisory services for investors,

[3] The transcript of the Investor Roundtable is available online at http://www.osc.gov.on.ca/documents/en/Securities-Category3/oth_20130618_33-403_transcript-roundtable.pdf.
[4] The transcript of the Industry Roundtable is available online at http://www.osc.gov.on.ca/documents/en/Securities-Category3/oth_20130625_33-403_transcript-roundtable.pdf.

- costs of introducing a best interest standard, and
- the impact on capital raising.

- The third consultation session was a panel discussion held on July 23, 2013 (the **Panel Roundtable**). There were approximately 110 attendees at this two-hour session.[5] The panel was moderated by James E. A. Turner (Vice-Chair, OSC) and consisted of:
  - Connie Craddock (OSC Investor Advisory Panel),
  - Jim Kershaw (SVP and Regional Manager, TD Wealth Private Investment Advice),
  - Anita Anand (Professor and Academic Director, University of Toronto), and
  - John Fabello (Partner, Torys).

  The intent of the Panel Roundtable was to build on the progress made at the Investor Roundtable and the Industry Roundtable and to move the dialogue forward by focusing on two fundamental issues:
  - Should dealers (and their representatives) be subject to a best interest standard when providing advice to retail clients? What would the consequences be of introducing such a standard?
  - What other policy options could securities regulators consider in addition, or as alternatives, to a statutory best interest standard?

We also had informal meetings with a variety of stakeholders to both explain the Consultation Paper and solicit feedback on the issues raised in it.

We thank those who have contributed to our consultation process to date by responding to our request for comments and/or by participating in the consultation sessions. We have gathered a great deal of information from this process and will be using it to inform our approach going forward.

Themes from the Consultation

Based on our consultations to date, the following are the four key themes that have emerged:

- There was significant disagreement about (a) whether the current regulatory framework for advisors adequately protects investors and (b) what regulatory response is required.
  - Those stakeholders that support the introduction of a statutory best interest standard felt that the current regulatory framework for advisors does not adequately protect investors. Many also felt that targeted regulatory responses are also required in several specific areas, including titles, proficiency, suitability and conflicted compensation practices. Several took the view that recent international regulatory developments have left Canadian standards at a lower level than those in leading jurisdictions.
  - Those stakeholders that do not support the introduction of a best interest standard explained how the current regulatory framework, coupled with recent Canadian regulatory reforms, provided a robust, flexible and principled regulatory foundation that affords strong investor protection and that addresses the investor protection concerns identified in the Consultation Paper. Most of these commenters also suggested that although there was no evidence of actual harm to investors under the current framework, if there were such evidence, the appropriate regulatory response would be targeted

[5] The transcript of the Panel Roundtable is available online at http://www.osc.gov.on.ca/documents/en/Securities-Category3/oth_20130723_33-403_transcript-roundtable.pdf.

solutions to these problems, not a statutory best interest standard. Regarding the relevance of international regulatory developments, we heard that the regulatory context is different, that those jurisdictions had different experiences and regulatory starting points, and that it is too early to definitely determine their impact in any event.

- A best interest standard must be clear.
    - There was broad agreement that a best interest standard, if adopted, should be as clear as possible and include sufficient guidance to ensure all advisors understand how to comply with the standard. Many questioned whether certain restricted business models and certain compensation practices could continue under a statutory best interest standard.
- The potential negative impact on investors and capital markets must be carefully assessed.
    - Many commenters strongly believe that the potential for negative impact on investors and capital markets from unintended consequences of a statutory best interest standard is significant. The main concern was that a best interest standard could result in advice that is more expensive, less accessible and too conservative.
- More work is needed.
    - Many commenters suggested further work that should be completed before moving forward with a statutory best interest standard or other regulatory response.

Below, we discuss each of these key themes in detail. The themes underscore that the issues surrounding a best interest standard are complex, and some aspects of the issues are interrelated to the issues surrounding the separate CSA consultation on mutual fund fees initiated on December 13, 2012 (**Mutual Fund Fees Consultation**).

1. *There was significant disagreement about (a) whether the current regulatory framework for advisors adequately protects investors and (b) what regulatory response is required*

Summary

Those stakeholders that support the introduction of a statutory best interest standard felt that the current regulatory framework for advisors does not adequately protect investors. Many also felt that targeted regulatory responses are also required in several specific areas, including titles, proficiency, suitability and conflicted compensation practices. Several took the view that recent international regulatory developments have left Canadian standards at a lower level than those in leading jurisdictions.

Those stakeholders that do not support the introduction of a best interest standard explained how the current regulatory framework, coupled with recent Canadian regulatory reforms, provided a robust, flexible and principled regulatory foundation that affords strong investor protection and that addresses the investor protection concerns identified in the Consultation Paper. Most of these commenters also suggested that although there was no evidence of actual harm to investors under the current framework, if there were such evidence, the appropriate regulatory response would be targeted solutions to these problems, not a statutory best interest standard. Regarding the relevance of international regulatory developments, we heard that the regulatory context is different, that those jurisdictions had different experiences and regulatory starting points, and that it is too early to definitely determine their impact in any event.

The discussion below on this key theme is divided into the following areas:

- Supporters of a statutory best interest standard
- Opponents of a statutory best interest standard
- Appropriate influence of international developments

Supporters of a statutory best interest standard

Those commenters that support a best interest standard identified a variety of reasons why the current regulatory framework for advisors does not adequately protect Canadian investors, as follows:

- the existing regulatory requirements and industry practices are based on a regulatory foundation that cannot provide adequate protection for consumers of financial services in Canada. Fundamentally, they see the current regulatory foundation as inappropriate for the advisor-client relationship because it does not explicitly require that advisors put the interests of their clients ahead of their own and therefore does not align advisors' interests with those of their clients;
- due to continued low financial literacy among Canadian investors, coupled with the ever-increasing complexity of financial products, information and financial literacy asymmetry is becoming more pronounced. This leads to investors that place increasingly more reliance on their financial advisor;
- most investors receiving non-discretionary advice already assume that their advisor is required to act in their client's best interest when, at least in the common law jurisdictions, this is usually not the case for advisors that provide non-discretionary advice. We heard that part of this expectation gap may be driven by investor confusion caused by the lack of general understanding of various designations, titles and roles in the investment industry. We also heard that industry marketing and advertising (which often explicitly or implicitly states that clients receive ongoing, personalized financial advice) contribute to this expectation gap;
- the suitability standard is a low one that simply involves the advisor recommending products that match the general needs of the client, not necessarily the product that is in the client's best interest. We heard that in practice, this means that the suitability analysis is vague and complex, involving a multi-factor analysis conducted by the advisor that is tied to whether the product (which may be connected to the advisor) is suitable to the client, not necessarily whether it offers the fairest price/cost for the investor based upon the complexity of the product and/or service being offered. Specific concerns in this regard related to costs of the products (and disclosure of such costs) and compensation bias affecting the recommendation, with the advisor recommending the products with the highest advisor compensation instead of products that he or she felt were objectively superior. Further, some commenters felt that a flaw with the suitability standard is that it is based on a product-transaction model rather than an ongoing-advice model and allows advisors to recommend leverage (or borrowing to invest) in order to increase assets under management, which inappropriately increases risk for most investors. The ultimate impact of this regime on investors is poor investor outcomes, including sub-optimal returns and/or inappropriate risk exposure;
- in an environment where most investors lack even basic financial literacy, the effectiveness of disclosure (which is the common industry practice) as an antidote for conflicts of interest, confusion about advisor remuneration, and other similar issues, is ineffective and leads to increased agency (monitoring) costs for investors. In addition, without a thorough

understanding of such disclosure, these commenters argued, it is unlikely that truly informed consent can be granted by investors. Many commenters shared the view that some conflicts such as embedded compensation cannot be managed (they are inherently opaque, complex and difficult for consumers to understand) and should be avoided or prohibited and that this is critical for investor protection. Others proposed that all material conflicts of interest should be avoided altogether;

- advisor titles are confusing and even misleading (e.g., that inflate proficiency, scope of products reviewed and/or level of service provided), which results in investors being unable to differentiate between different financial service providers and the different advice options available to them;
- proficiency requirements for certain kinds of dealers are too low (e.g., brokers and bank staff are trained enough to know about in-house funds and products to sell them but not really whether they are beneficial for clients);
- in the absence of a statutory best interest duty, the current framework is uncertain and does not offer effective investor restitution in the event of investor harm caused by advisor misconduct;
- investors have a low level of trust and confidence in the financial services industry as a whole; and
- commenters from a variety of backgrounds touched on the importance of financial advice as part of a financial plan and expressed a concern that, because of the current regulatory framework, most Canadians are not receiving holistic advice but instead are receiving overly narrow, transaction-based advice on securities products.

These commenters felt that a statutory best interest standard is a highly desirable and feasible regulatory response to the concerns set out above and should be adopted promptly. In support of this view, they suggested that the introduction of a best interest standard would result in the following outcomes:

- it would require advisors to advance the best interests of their clients to the exclusion of all other competing interests that may exist;
- it would result in better financial outcomes for investors because it would (i) result in more objective recommendations, since a best interest duty, by addressing issues relating to conflicted remuneration, will reduce bias in recommendations, and (ii) explicitly require advisors to consider the investment costs in determining whether the investment is in the best interest of the client;
- it would ensure that conflicts are avoided and thereby eliminate much of the need for conflicts disclosure, which in their view is not effective for investors and which may cause unintended negative consequences (e.g., investors generally do not discount advice from biased advisors as much as they should; disclosure can increase the bias in advice);
- it would result in less investor confusion about the role of the advisor and ensure the most efficient allocation of responsibilities between the advisor and the client given the level of financial literacy of consumers, the degree of knowledge, specialized skills and abilities that the advisor needs to possess, and the complexity of financial products
- it would require regulators to consider whether embedded commissions (and other compensation practices) are compatible with a best interest standard. If embedded commissions were prohibited as a result of a best interest standard, investors would be encouraged to look more critically at what they are getting for what they pay. This would

improve competition and economic forces would spur innovation in the delivery of cost-effective advice that meets a best interest standard;

- it would help establish better means of restitution by removing the uncertainty about whether the standard applies and improving the chances of the client securing some restitution. The greater impact, however, may be that existence of the legislated duty and greater chance of success in court will influence the behaviour and standards of advisors and their firms, both reducing the losses and encouraging out of court settlements.
- it would support investor education initiatives which, although helpful, cannot be expected to address the significant power imbalance between advisor and client
- it would align the CSA's approach with the expectations of the International Organization of Securities Commission (IOSCO) and the G20 in how financial intermediaries should deal with their clients; and
- it would enhance the professionalism of the financial services industry and enhance public trust and confidence in the industry, thereby assisting the financial advice industry in its ambition to be recognized as a profession.

Although most of these commenters stated that a statutory best interest standard is necessary, most of them also took the view that it is not sufficient by itself. We heard that targeted reforms will likely also be necessary. Some of the key targeted reforms identified by commenters included (collectively, the **Other Policy Options**):

- Raising advisor proficiency and designations, especially for certain kinds of dealing representatives;
- Regulating advisor titles to ensure they are accurate and not misleading;
- Creating two categories of advisor similar to the U.K. model: one category ("adviser") would offer independent, holistic advice free of any conflicts and be subject to a best interest standard and another category ("salesperson") would offer restricted and/or conflicted advice that would be subject to the current regulatory requirement for advisors;
- Improving suitability (including allowing certain restricted dealers (e.g., mutual fund dealers) to offer a broader range of products);
- Improving the rules on conflicts of interest, including conflicted compensation models;
- Expanding financial literacy education programs to ensure investors understand, among other things, the standard of conduct owed to them by their advisor;
- Ensuring sound management control mechanisms at advisory firms to ensure regulatory requirements are met;
- Requiring investment policy statements in certain circumstances;
- Prohibiting or standardizing embedded commissions so that they are neutral to the type of product being distributed;
- Improving investor restitution by considering alternative (or additional) dispute resolution options;
- Examining the services provided by discount brokerages to determine if they could continue under a best interest standard and/or assessing whether certain services should be subject to a best interest standard; and

- Increasing enforcement, and compliance reviews, of the current regulatory framework.

Opponents of a best interest standard

Those commenters that do not support a best interest standard identified a variety of reasons why the current regulatory framework for advisors in fact does adequately protect Canadian investors, as follows:

- the current regulatory framework represents a robust, flexible and principled foundation that offers a high level of investor protection by:
  - addressing in what situations a fiduciary duty will appropriately be found to exist between an advisor and his or her client.
  - providing extensive investor protections through detailed rules and regulations of securities commissions and self-regulatory organizations (**SROs**), including:
    - a requirement to deal fairly, honestly and in good faith with clients;
    - suitability obligations (including recent SRO enhancements);
    - a requirement to observe high standards of ethics and conduct in the transaction of business with clients;
    - proper disclosure and handling of conflicts of interest (including recent SRO enhancements), including avoidance in certain circumstances;
    - prohibited sales practices;
    - dispute resolution requirements;
    - supervision of activity in client accounts;
    - background checks of advisors (such as police, credit, employment, education and proficiency course completion) before licensing;
    - industry-specific education requirements;
    - compensation disclosure;
    - cost disclosure and performance reporting (including the recent CRM2 reforms);
    - referral arrangement disclosure;
    - product disclosure (including management report on fund performance and Fund Facts reforms);
    - plain language requirements; and
    - insurance and bonding;

- existing comprehensive securities legislation and recent CSA and SRO initiatives, including the new SRO conflict of interest rules, the Client Relationship Model reforms to cost disclosure and performance reporting (i.e., CRM2), the management report of fund performance, the Fund Facts disclosure document, the relationship disclosure reforms, the SRO enhancements to suitability, and the CSA-sponsored investor education initiatives (collectively, the **Recent Canadian Reforms**) address the investor protection concerns (or will address these concerns, once fully implemented) expressed in the Consultation Paper;

- the Consultation Paper neither captured the perceived failure in the current regulatory regime nor presented any evidence demonstrating any actual investor harm with the current standard of conduct for advisors;
- financial literacy and information asymmetry will vary dramatically depending on the advisor and the client and is one of the reasons why clients engage advisors in the first place;

- an expectation gap does not exist in practice as most advisors already assume an obligation to provide advice in their clients' best interest;

- it is misleading to compare a best interest standard to the suitability standard in isolation from the related duty of care and duty to act fairly, honestly and in good faith. Moreover, many commenters pointed to the recent SRO enhancements to their suitability requirements, which include more frequent triggering events and reference to the client's portfolio in certain circumstances. Many were of the view that the duty to act fairly, honestly and in good faith would not allow an advisor to recommend a product that resulted in higher fees to the client. Some stated that a suitable product must, by definition, be a product in the client's best interest. Others stated that identifying the "best" or "better" products is subjective and contentious and would be difficult to enforce. Several commenters are of the view that cost is already a consideration, but that it is only one consideration as a high cost investment may also have a better long-term performance. Many commenters were also not convinced that a gap exists between suitable investments and investments in the client's best interest apart from the issue of cost and they believe that further study is required to determine what gap exists, if any; and

- since several of the Recent Canadian Reforms, including the SRO reforms relating to conflicts of interest (which now requires addressing conflicts of interest in a fair, equitable and transparent manner, and considering the best interests of the client), are not yet fully implemented, it is premature to conclude that the rules applicable to management of conflicts of interest are less effective than intended.

Finally, many industry commenters took the position that even if certain investor protection concerns remained (or emerged) after full implementation of the Recent Canadian Reforms, the appropriate regulatory response should be targeted in nature (some of the targeted reforms above were also suggested by certain industry commenters, such as improvements to title regulation, proficiency enhancements, and new investor education initiatives) rather than undertaking a foundational shift of the entire regime which may or may not address the concerns and may lead to negative unintended consequences for investors and capital markets (see discussion below under Key Theme #3). Their reasons against introducing a best interest standard as a solution to these concerns included the following:

- they did not see what investor protection issues a best interest standard would address that the current framework could not address, as the current regulatory framework either already imposes a best interest standard for advice to retail clients or imposes a standard that is functionally equivalent to a best interest standard. Certainty, advisors that provide discretionary advice to clients (or that have clients that are vulnerable and place significant trust and reliance on their advice) are subject to a best interest (or fiduciary) duty at common law. For all other advisors, the requirement to deal fairly, honestly and in good faith with investors along with rules around suitability, know your product, relationship disclosure, referral arrangement disclosure, continuous product disclosure, compliant handling, plain language requirements, conflict disclosure, compensation disclosure constitutes a standard that is functionally equivalent to a best interest standard;

- a best interest standard will exacerbate concerns around financial literacy and information asymmetry since investors will have less incentive to educate themselves on investments and place more reliance on their advisor. These commenters also feared that this will lead to

increased investor apathy, with investors waiving their own responsibilities in favour of any advice they are given, and will place all of the responsibility on their advisor, even in non-discretionary relationships;

- the Recent Canadian Reforms demonstrate that Canada's regulatory framework is successfully evolving further in the direction of achieving "best interest" requirements without the need to specifically impose a vague statutory best interest standard. Although concerns may remain or emerge, these commenters expressed the view that the current regime is robust enough to address any such concerns;

- among Québec's 11 commenters, several are of the view that investors are adequately protected by Québec's current requirements. They argue that Québec's courts must keep the flexibility that the current regime provides, which allows them to factor in the specific circumstances of each case. Commenters pointed out that amending the current regime could have the effect of lowering investors' sense of responsibility and could create an obligation focused on the ends (i.e., the returns of the investments) rather than on the means (i.e., the process used by the advisor to arrive at a recommendation) of advisory services. They are of the view that Québec's current regime is (or almost is) a functional equivalent of the common law fiduciary duty, though civil law and common law remain two different regimes. Nevertheless, one Québec commenter is of the view that a statutory, uniform and flexible best interest standard should be adopted by all CSA regulators and SROs; and

- in common law jurisdictions, a best interest standard will create legal uncertainty because courts will no longer be able to rely on existing jurisprudence relating to the content of the suitability obligation or fiduciary duty. They will have to develop new law on the meaning of "best interest" as defined by the CSA.

Appropriate influence of international developments

Many commenters felt that jurisdictions such as the United Kingdom and Australia have made important strides in investor protection and, in the case of Australia, in introducing a best interest standard. They claimed that the investor protection concerns identified by regulators in these jurisdictions mirror the investor protection concerns with the current regulatory framework in Canada. These commenters suggested that Canada is lagging behind in this area, leaving Canadian standards at a lower level than those in leading jurisdictions, and should adopt a best interest standard to afford investors with similar protection as is provided in those other jurisdictions.

Others questioned the comparison between Canada and other international jurisdictions in the standard of conduct context. They pointed out that:

- the policy responses in other jurisdictions were designed to deal with market failures and deficiencies that arose in those jurisdictions. Since Canada does not exhibit these same issues and has its own statutory framework that includes a duty to deal fairly, honestly and in good faith with clients that may not have existed in some of the other jurisdictions, any move toward adopting similar reforms in Canada would be unnecessary and misguided.
- when the implementation and contextual considerations are closely examined, it is difficult to conclude that international initiatives point to Canada lagging other jurisdictions in providing a robust framework for investor protection or falling down on considering the investor's best

interest. Some also said that the rationale for introducing tighter market regulation in some of the jurisdictions highlighted in the Consultation Paper is related to:

  - evidence of market failure or systemic mis-selling in these jurisdictions that does not exist in Canada, a further indication that the current rules are highly effective and appropriate to the Canadian market; and
  - at least in Australia, mandated employee savings programs that create a large pool of clients for advisors which does not exist in Canada (where the industry operates in a competitive environment); and

- the CSA should take advantage of the fact that the international reforms in the U.K. and Australia are now in force and that we should carefully review the impact on these reforms in those jurisdictions before deciding whether to pursue similar reforms in Canada. Some also suggested deferring any decision in Canada until the U.S. approach is finalized.

2. *A best interest standard must be clear*

Summary

There was broad agreement that a best interest standard, if adopted, should be as clear as possible and include sufficient guidance to ensure all advisors understand how to comply with the standard. Many questioned whether certain restricted business models and certain compensation practices could continue under a statutory best interest standard.

The discussion below on this key theme is divided into the following areas:

- Moving from 'suitable' investments to investments in the client's best interest
- Responding to potential conflicts of interest in the client's best interest

Moving from 'suitable' investments to investments in the client's best interest

We received significant feedback that introducing a requirement for advisors to recommend securities that are in the client's best interest (rather than investments that are suitable) is unclear and problematic. These commenters identified several areas of concern, including:

- it would be impossible to establish objective standards or guidance to determine whether one investment is "better" than another in every way. The review of trades against such a standard would not be practical and would depend on the extent of supervision expected by regulators.

- the risk that product cost would be a determinative factor in this best interest advice analysis. According to these commenters, cost is only one factor that advisors should consider when providing product-based advice (other factors include performance, reputation of fund manager, investment strategy, track record, product reputation and stability). Their concern is that cheaper investment options would be pursued by advisors purely because they are cheaper at the time of acquisition, rather than focusing on the likelihood of reaching higher risk-adjusted returns over the client's time horizon. The commenters believe this implication to be simplistic and lacking in context as the least expensive option is not necessarily the "best" option for a client.

- that this standard may be interpreted by investors as providing perfect advice or guaranteeing positive investment returns. We heard that if a best interest standard is implemented, it would need to be clear to investors, regulators and the courts that the duty to act in a client's best interest should not mean that advisors would have to give "perfect" advice, provide "perfect" service, or provide a guaranteed positive investment outcome.
- whether the know-your-product (**KYP**) obligation under a best interest standard would require firms to be knowledgeable about the entire universe of securities products and the feasibility of such an expectation.
- how this requirement would apply to those dealers (i.e., mutual fund dealers, exempt market dealers and scholarship plan dealers) that are restricted in what they can offer their clients or for those that focus on specific sector or product specialties as a business decision. Some also questioned whether these business models could continue to exist at all and suggested that the current proficiency requirements were not sufficient enough to expect these advisors to be proficient in other kinds of products. See additional discussion below under Key Theme #3.

Other commenters believed it should be fairly straightforward to determine when advice would be in the client's best interest. One commenter suggested that the criteria should include such factors as: (a) suitability (risk of loss, volatility, etc.); (b) diversification within current asset holdings; and (c) whether the client is able to hold the investment for any anticipated or requisite illiquid period. This commenter suggested that other important criteria would include the following: conflicts of interest must be eliminated or disclosed; decisions must be based on the whole portfolio rather than by security; and execution must always be in the client's best interest and not based on soft dollars or on a commission's basis.

Responding to potential conflicts of interest in the client's best interest

We also received significant feedback on the implications of a best interest standard for how conflicts of interest must be responded to. Commenters identified a number of areas where there was potentially a conflict of interest but where they felt it was unclear how a best interest standard would apply to certain common practices today, including whether:

- commission-based accounts would be banned (or restricted) in favour of fee-based accounts, which may not be accessible to low and medium-income investors and may not be the best option for clients that undertake frequent trading.
- advisors acting as principal (which currently allows for liquidity through market making, principal trading, and bond trading from inventory) would be banned or restricted.
- advisors selling proprietary products (which currently allows advisors to recommend underwritten offerings, proprietary products and affiliated issuer products) would be banned or restricted. This is particularly relevant for those dealers that focus on certain types of securities, such as mutual fund dealers, scholarship plan dealers and exempt market dealers as well as those advisors that are part of a large integrated distribution model.

In contrast, many commenters from the investor community felt strongly that conflicts of interest were often not addressed and that when they were, disclosure was industry's preferred response. They felt that a best interest standard should, in most cases, require avoidance of any conflicts of interest, especially conflicts of interest involving advisor compensation. They felt that this was the clearest way to address conflicts in the context of advisory services.

3. ***The potential negative impact on investors and capital markets must be carefully assessed***

Summary

Many commenters strongly believe that the potential for negative impact on investors and capital markets from unintended consequences of a statutory best interest standard is significant. The main concern was that a best interest standard could result in advice that is more expensive, less accessible and too conservative.

The discussion below on this key theme is divided into the following areas:

- Increase in costs
- Negative impact on choice, access and affordability
- Impact on different business models and registration categories
- Legal uncertainty
- Compensation model
- Potential for regulatory arbitrage with other non-securities products
- Application of duty on retail clients

Increase in costs

Many commenters believe that the introduction of the best interest standard will significantly increase costs for industry due to the increase in:

- litigation/complaints,
- compliance obligations,
- errors and omission insurance premiums,
- technology costs to build systems to comply with this standard,
- costs to educate individual representatives,
- costs to reassess products on firms' shelves, and
- supervision and back office procedures.

In contrast, other commenters stated that a best interest standard would not lead to increased industry costs by pointing to the following:

- if they already act in their client's best interest (as many advisory firms claim), then there should be minimal impact on cost of introducing this standard. So only advisors not acting in their client's best interest would incur material costs.
- when the interests of both the client and the advisor are aligned, this may result in fewer compliance and legal issues, thus reducing these costs and ensuring that retail clients do not need to resort to litigation, which is a path to redress that many clients cannot or will not pursue.

Negative impact on choice, access and affordability

Many commenters felt that the introduction of a best interest standard would have a negative impact on choice, access and affordability of advisory services for middle and low income Canadians for the following reasons:

- the increased costs for industry associated with implementing a best interest standard would be passed along to clients, making those services too expensive for many Canadians.

- it may cause a shift away from commission-based accounts, which for smaller investors, or those with more limited trading activity, are less expensive than fee-based accounts that often require minimum assets or a minimum fee.

- smaller profit margins for advisors may result in advisors increasing their minimum assets/account size (some suggested minimums of anywhere from $100,000 to $350,000), making advice less accessible.

- although large, integrated financial organizations will be better able to adjust to and/or absorb these costs, small and mid-market advisory firms will be less able to withstand these costs increases and will lead to their increased competitive disadvantage and their further decline.

- it may motivate firms to de-prioritize customers with small accounts.

- it may motivate firms to narrow the range of products available on their platform as the liability associated with choosing the “wrong” product for a client may drive firms to offer lower risk products that are viewed as having less liability risk. This would have the effect of lowering client returns since higher risk investments create the potential for higher returns.

- Canadians would receive less financial advice overall which would likely diminish Canadians’ overall personal saving and investing.

- there is some preliminary evidence that the U.K. may be experiencing an “advice gap” where, because of the increased costs of advice as a result of its recent reforms, low-income U.K. investors who, before the reforms, were receiving advice are no longer receiving advice after the reforms.

In contrast, other commenters disagreed that a statutory best interest standard would lead to a negative impact on choice, access and affordability of advisory services for the following reasons:

- the financial services industry is extremely entrepreneurial and innovative and has shown it will find profitable ways to deliver advisory services under any regulatory regime imposed by the CSA,
- although initially some clients may potentially lose access or experience increased costs from the advice channels they have previously utilized, they believe these would be a temporary effects,

- new business models will be encouraged, new choices will emerge, and innovation and competition will drive down consumer cost, and

- claims of increased costs to investors ignore the agency (monitoring) costs that clients are incurring today as a result of the suitability standard. In particular, a best interest standard will result in lower investor agency costs of monitoring the advisor since the new standard will require that the advisor put the client's interests first.

Impact on different business models and registration categories

Some commenters expressed concerns that a statutory best interest duty has the potential to be interpreted as requiring the dealer to offer all types of securities. For many, this would call into question how dealers that are only allowed to deal in one type of security (e.g., mutual fund dealers, exempt market dealers and scholarship plan dealers) can comply with this standard. As a result, commenters have questioned if the introduction of this standard will lead to an elimination of the traditional retail dealer, and if we will have a situation where the industry goes to two extremes: discount brokerages on one end of the scale (where a best interest standard may not apply) and portfolio managers on the other end (where a fiduciary duty already applies).

In this vein, some commenters pointed out that unless the best interest standard was "business model neutral" and carefully qualified to take into account all business models, these more narrow business models may not be feasible. These commenters point out that reforms in Australia and the U.K. allow restricted advice and scaled advice, respectively, to be provided. Some commenters preferred the Australian approach where even the so-called "scaled" advice has to consider the best interest of a client.

Some commenters did not support qualifying the best interest standard because they felt such qualification has the potential of causing more confusion as to the level of service and investment advice being received. These commenters felt that any standard short of a full fiduciary duty applied uniformly will continue to perpetuate unequal investor protection. Further, these commenters felt that if there were a lower tier of duty for certain dealers and therefore the duty would not be applied equally across the continuum for providing advice, the investor protection concerns outlined in the Consultation Paper would not be addressed. Other commenters took the view that instead of having different standards and rules for advisors depending upon the advisor's registration category and rather than drafting a standard with numerous carve outs (which adds complexity and dilutes its perceived benefits to investors), the CSA's investor protection goals can be more easily achieved through targeted policy initiatives.

Legal uncertainty

Several commenters felt that there is no uncertainty when a fiduciary duty is applied at common law to a given advisor-client relationship. In fact, most of these commenters felt that a statutory best interest standard would increase (not decrease) legal uncertainty because:

- the courts' appropriate discretion to apply its principled and fact-based analysis of whether or not a fiduciary relationship exists would be replaced with a "one-size-fits-all" duty that would apply to every retail client, regardless of their vulnerability or sophistication or whether they grant discretionary authority to the advisor;

- it may take several years for courts to conclusively define what a best interest standard means in respect of all aspects of the advisor-client relationship and along the way courts may interpret the standard differently;

- the CSA will not have control over how courts handle the application of a common law fiduciary duty or how it will impact the securities industry as a whole;

- unlike the common law, a statute does not have the flexibility to consider specific fact situations and that this will cause practical implementation problems;

- the equitable remedies available to the courts (such as those for a breach of fiduciary duty) would be inappropriate in circumstances where a fiduciary duty is imposed by regulation but would not have been imposed under common law. The application of equitable remedies could be misused by retail investors, especially sophisticated retail investors;

- the courts in Québec may be uncertain with how to interpret a statutory best interest standard in light of its current regulatory framework that already references a best interest duty and a duty of loyalty; and

- it would be impossible to ensure that a common principle would be adopted across all jurisdictions, and be applicable to all competing products in any particular jurisdiction. Creating a single compliance and supervisory oversight framework for those products with national distribution would be problematic, with the likely result that Canadians would find themselves being treated differently on a regional basis, with investors in smaller provinces at the greatest risk for reduced choice and access.

Other commenters disagreed. They felt that a statutory best interest standard would clarify that a fiduciary duty was always owed at common law and therefore clients in non-managed accounts would not need to be concerned whether the relationship with their advisor demonstrated the relevant interrelated factors sufficient to result in a fiduciary relationship. They believe that a statutory best interest standard would have a positive impact on advisor-client litigation because the parties would be clear at the outset that the advisor's fundamental duty is to put the client's interests ahead of their own.

Compensation model

Several commenters were concerned that if a best interest standard required the elimination of commission-based accounts and trailing commissions, for example, this would have a variety of negative impacts on Canadian investors. In particular, these commenters were concerned that:

- middle-class and less affluent investors would be most disadvantaged by a shift away from use of commission-based brokerage accounts, especially for those who trade infrequently and/or maintain small accounts;

- this will lead to a decreased choice in affordable investment products;

- investors in the US face higher costs and less transparency in the marketplace since embedded fee compensation model have disappeared from the United States mutual fund market and has been replaced primarily by a fee-for-service model;

- the embedded fee model represents the most popular, efficient and lowest-cost option for investors; and

- this may create an “advice gap” since investors may stop seeking advice as clients are generally unwilling to pay directly for advice, which preliminary evidence suggests may be happening in U.K. as a result of its recent reforms in this area.

Several commenters urged the CSA to consider alternatives to banning certain compensation arrangements so that advisors could receive compensation in respect of product sales but which would be neutral to the type of product being distributed. This would presumably eliminate the concern that products offering higher compensation would attract advisors to sell those products over other equivalent products with a lower compensation structure.

Some commenters submitted that permitted fee structures and compensation methods would need to be fully consistent with the duty of care established by a best interest standard. Most of these commenters stated that certain conflicts of interest, especially those related to embedded commissions, should be avoided altogether. These commenters expressed difficulty in understanding how advisors could meet a best interest duty to their clients while accepting payments from a third party.

Finally, there was broad acknowledgement that the issues around embedded compensation in the mutual fund context are explored in more detail in the Mutual Fund Fees Consultation and that CSA staff working on both projects should coordinate their analysis in this respect.

Potential for regulatory arbitrage with other non-securities products

Many commenters expressed the concern that a statutory best interest that applies only to securities products and related advice could create an opportunity for regulatory arbitrage for those advisors that are also licensed to offer non-securities products such as insurance products, which fall within a different regulatory framework. For example, these advisors would be subject to a best interest standard when selling mutual fund products but another standard when discussing segregated fund products. Commenters are concerned that this could potentially create product sales arbitrage opportunities. Some commenters felt that without a common standard of conduct that applied to all financial products, the CSA should not attempt to strengthen the standard only in the securities context. Others felt that despite the CSA’s ability to regulate only the securities context and the potential for regulatory arbitrage, such concerns should not discourage the CSA from introducing a best interest standard.

Application of duty on retail clients

The best interest standard described in the Consultation Paper only applies when advisors provide advice to retail clients. Some commenters felt that all clients should have the benefit of a statutory best interest standard. In addition, commenters stated that it would not be appropriate to try to define a retail client with metrics such as income or financial assets as these are not reliable indicators of investment knowledge. Other commenters expressed that the application of the standard ought to be based on the nature of the relationship and not the type of client as sophisticated clients and those not vulnerable or

dependent on advisors do not require this standard. In addition, it was pointed out that there are permitted clients that may not be sophisticated clients such as pension committees or charitable organizations that would benefit from a best interest standard.

Some commenters suggested that contractual adjustments could be allowed by some investors such as sophisticated institutional investors or certain sophisticated retail clients to opt out of a best interest standard. However, other commenters were critical of this approach and stated that if the registrant had an ability to modify the standard by contract, there would be the potential for abuse and misuse of the advisor's position, which negates a key rationale for the standard in the first place and that too often, such contractual variations would become the rule in the industry, rather than the exception.

4. More work is needed

Summary

Many commenters suggested further work that should be completed before moving forward with a statutory best interest standard or other regulatory response.

The discussion below on this key theme is divided into the following areas:

- Ensure the investor protection concerns are well defined
- Consider adopting the Québec model
- Conduct impact analysis
- Assess the international reforms
- Conduct further legal analysis
- Consider the Other Policy Options
- Coordinate with other financial-product regulators

The following sets out the main areas where further work was suggested by commenters. Several commenters from the investor community felt that the CSA should proceed as soon as possible rather than delay this initiative with further study or research.

Ensure the investor protection concerns are well defined.

As discussed above, many commenters not supportive of a best interest standard stated that there was not sufficient evidence of one or more problems or that a best interest standard would solve these problems. Many industry commenters suggested allowing the Recent Canadian Reforms to become fully implemented before evaluating whether any investor protection concerns with the regulatory framework remain. Many commenters from the investor community disagreed, arguing that the concerns are sufficiently defined and evidenced.

Consider adopting the Québec model.

Several commenters suggested conducting further research to compare the effect on investors and advisors of the standard of conduct for advisors in Québec versus the common law jurisdictions in Canada. Depending on the result of this comparison, the CSA should consider whether this model could be adopted by the common law jurisdictions in Canada.

Conduct impact analysis.

Many commenters stated that the CSA should conduct a robust Canadian cost-benefit analysis (CBA) before moving forward. Suggested areas of focus for the CBA should include the consideration of the transition from commission-based accounts to fee-based accounts, the effects of pricing low balance accounts out of the market and the resulting effects on middle class investors. Many commenters from the investor community disagreed, arguing that a best interest standard will not lend itself to traditional cost-benefit analysis.

Assess the international reforms.

Many commenters suggested that the CSA take the opportunity to allow the reforms in the U.K. and Australia to fully implement and analyze their regulatory impact before deciding whether to introduce similar reforms in Canada. Many also suggested conducting a detailed assessment of the initiatives within their jurisdictional context, including the current regulatory framework, retirement savings policy, and the market failures identified by those regulators.

Conduct further legal analysis.

Some suggested that the CSA conduct further legal analysis of what a fiduciary duty will mean for the sale of investment products. The analysis should include a survey of the principles from case law, the application to the investment industry of those principles, and a prospective understanding of the implications of a fiduciary duty. Consideration should also be given to the practical reality of how long it might take for case law to settle on an agreed understanding of the scope of a statutory best interest standard.

Consider the Other Policy Options.

As discussed above, commenters identified a variety of Other Policy Options in addition, or as an alternative, to a statutory best interest standard that the CSA should consider before deciding on its policy direction.

Coordinate with other financial-product regulators.

Many commenters highlighted the risk of regulatory arbitrage (i.e., the risk of advisors and/or clients seeking out non-securities products) with the introduction of a best interest standard or any other regulatory response that differs significantly in the regulatory approach of non-securities financial products. Commenters have requested that we make every effort to coordinate with other financial product regulators to ensure they is a consistent approach to the regulation of financial products for Canadian retail investors.

Conclusion

A number of the key messages from industry participants and investors set out above are similar to those that have emerged from the Mutual Fund Fees Consultation. We refer you to CSA Staff Notice 81-323 – *Status Report on Consultation under CSA Discussion Paper and Request for Comments 81-407 Mutual Fund Fees*, published concurrently with this Notice, for an overview of the key themes provided by stakeholders in response to that separate consultation.
The similarity of the feedback received from stakeholders demonstrates a connection between the two consultation initiatives and suggests a need for CSA staff to coordinate their policy considerations on these initiatives going forward.

Accordingly, in collaboration with the Mutual Fund Fees Consultation initiative, CSA staff continue to consider and discuss the information gathered through our consultation process with a view to determining next steps. We anticipate communicating in the coming months what, if any, regulatory actions and/or research we intend to pursue.

Questions

If you have any comments or questions, please contact any of the CSA staff listed below.

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