The Canadian Advocacy Council for Canadian CFA Institute Societies
ADVOCATING THE CFA INSTITUTE'S CODE OF ETHICS AND STANDARDS

October 17, 2018

BY EMAIL

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

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Dear Sirs/Mesdames:

Re: CSA Staff Notice 31-303 and Request for Comment – Proposed Amendments to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* and Companion Policy 31-103CP (collectively, the "Proposed Amendments") – Reforms to Enhance the Client-Registrant Relationship (Client Focused Reforms)

The Canadian Advocacy Council[1] for Canadian CFA Institute[2] Societies (the CAC) appreciates the opportunity to provide both general comments on the Proposed Amendments and respond to the specific questions posed in the Request for Comment.

[1] The CAC represents more than 15,000 Canadian members of CFA Institute and its 12 Member Societies across Canada. The CAC membership includes portfolio managers, analysts and other investment professionals in Canada who review regulatory, legislative, and standard setting developments affecting investors, investment professionals, and the capital markets in Canada. See the CAC's website at http://www.cfasociety.org/cac. Our Code of Ethics and Standards of Professional Conduct can be found at http://www.cfainstitute.org/ethics/codes/ethics/Pages/index.aspx.

[2] CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion of ethical behavior in investment markets and a respected source of knowledge in the global financial community. Our aim is to create an environment where investors' interests come first, markets function at their best, and economies grow. There are more than 154,000 CFA charterholders worldwide in 165+ countries and regions. CFA Institute has eight offices worldwide and there are 151 local member societies. For more information, visit www.cfainstitute.org or follow us on Twitter at @CFAInstitute and on Facebook.com/CFA Institute.

Overarching Regulatory Best Interest Standard

As respondents to your April 28, 2016 consultation paper, we voiced support for the principles set out as an understandable and reasonable means of elevating client-related obligations. In particular, we strongly supported the core changes requiring registrants to act in the best interests of the client and avoid or control conflicts of interest in a manner that prioritizes the client's best interests. As CFA charterholders, we have agreed to uphold a Code of Ethics and Standards of Professional Conduct[3] that we believe is aligned with this principles-based approach.

We are disappointed that regulators are abandoning the best interest standard and are implementing a rules-based approach. The proposed registrant obligations may be targeted to portfolio managers already operating at a best interest standard. A number of external sources suggest that portfolio managers have the least number of disputes and the highest legal standards of care. As a result, we would have favoured an approach with targeted guidance where the firm obligations and client expectation gaps may be wider. However, given the absence of an explicit best interest standard, in the alternative, we generally support the harmonized approach built into the Proposed Amendments. It is important however during this process to acknowledge that simply adding more rules and requirements risks distracting clients and advisers in well-functioning relationships from the objective of striving to achieve client financial objectives.

General Comments on Specific Proposals

1. **Know your client (KYC) Amendments**

The stated purpose of the KYC obligation is to establish the client's identity, the suitability of the proposed transaction, and if applicable, to determine whether the prospectus exemption relied upon is available in the circumstances.

According to the CSA, a proper assessment of a client's risk profile is often lacking owing to insufficient KYC. The OSC's *Annual Summary Report for Dealers, Advisers and Investment Fund Managers* published on August 23, 2018 stated that approximately 57% of the firms reviewed in a senior suitability sweep did not collect and document sufficient KYC information, including information relating to risk tolerance, time horizon and investment knowledge for some clients. The majority of complaints to the Ombudsman for Banking Services and Investments stem from insufficient KYC information that often results in unsuitable client recommendations[4]. The Proposed Amendments seek to remedy issues, and prevent such complaints from arising from the KYC process, by clarifying the content and scope of what is required.

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[3] Our Code of Ethics and Standards of Professional Conduct can be found at http://www.cfainstitute.org/ethics/codes/ethics/Pages/index.aspx.

[4] Approved Changes to OBSI's Suitability and Loss Assessment Process, and Summary of Public Comments", Ombudsman for Banking Services and Investments (November 2, 2012), online: https://www.obsi.ca/en/for-firms/resources/Documents/Approved-Changed-to-OBSIs-Suitability-and-Loss-Assessment-Process-and-Summary-of-Public-Comments.pdf; please also see: "Consultation Paper: Suitability and Loss Assessment Process" Ombudsman for Banking Services and Investments (May 26, 2011), online: https://www.obsi.ca/en/for-firms/resources/Documents/2011-Consultation-paper-on-Loss-Assessment-Process.pdf.

We are therefore generally supportive of the changes made. However, we respectfully disagree with the view taken by the CSA and other commenters who have previously stated that collecting tax information when the representatives do not have any tax expertise does not serve the interest of investors. Registrants dealing with taxable investors should understand their client's general tax position and the impact of taxes on a recommended investment strategy or a product's expected rate of return. Registrants must take the scale, nature and complexity of the portfolio of investments into account.

We note that an understanding of tax concepts would not require collection of detailed tax information in all cases, but the information they collect should be appropriate to the client, the recommended product or strategy, and considered at a sufficient depth to determine whether tax implications would represent a consideration in terms of a suitability determination. For example, in some instances, the tax consequences of an investment decision may significantly change the desirability of a proposed investment strategy or transaction. Registrants should be required to identify to what extent, if any, tax considerations will affect investment decision making. This would apply where products or strategies are substantially affected by tax considerations, such as flow through shares and strategies incorporating leverage.

Currently, we understand that in order to obtain certain designations, including becoming a CFA charterholder, the proficiency requirements for those designations include a reference to tax considerations in making suitability determinations. For example, one course for the Chartered Investment Manager (CIM®) Designation also indicates that "taxation effects must play a role in an investor's choice of investment universe."[5]

We encourage the CSA to consider adding guidance to the Companion Policy with respect to the level of tax knowledge that a registrant should reasonably be expected to have. In all other circumstances where the tax matter is complex or goes beyond the knowledge of the registrant, then the registrant should direct the client to obtain advice from a tax professional.

The administrative cost of compliance is also an important consideration as subsection 13.2(3.1) of the Proposed Amendments set out a requirement for registrants to take reasonable steps to obtain clients' confirmation of the accuracy of their KYC information collected at account opening and when any significant change occurs. This requirement could be clearer, and as written requires judgment on the meaning of "significant changes", both on the part of the registrant and the client, who will require an understanding of its meaning so as to ensure their advisor is made aware of said changes. It would otherwise be impossible for registrants to become aware of "significant changes" on a sufficiently timely basis, as they cannot reasonably be expected to be aware of all changes beyond an appropriately scheduled update, at which point the requisite questions can be posed of the clients.

2. Know your product (KYP) Amendments

We support the CSA's decision to create an explicit KYP requirement, as well as the more detailed guidance in the Companion Policy, to codify KYP expectations of firms and registrants.

[5] CSI Global Education, *Portfolio Management Techniques* (Toronto: Canadian Securities Institute, 2014) at 6-35.

However, we outline below some of the hurdles that codified rules may present to registrants in practice. While we note the potential difficulties, overall we are of the view that the explicit KYP requirement is necessary and that the benefits outweigh the costs.

Knowledge of comparable products for firms

As part of the KYP process, subsection 13.2.1(1) of the Proposed Amendments imposes an obligation on a registered firm to take reasonable steps to understand the essential elements of the securities it makes available to clients, including how they compare with similar securities available in the market, approve the securities it will make available, and monitor and reassess its approved securities.

We believe that registrants of all categories need to understand the essential elements of securities made available to clients, but that this cannot be achieved unless education standards are raised. An identified issue during the best interest standard consultations was that certain registrants lacked the knowledge or skill to provide effective advice. Clients must be able to access a person who is sufficiently credentialed to provide the kind of useful advice that would require a comparative understanding of similar securities.

As we have stated in previous letters, when considering the overall competitiveness of the security, as compared to a reasonable range of similar investment opportunities, we are concerned about the pragmatism of the requirement for any firm to engage in a widespread market investigation and product comparison. KYP investigations and decision-making could be based on a set of pre-determined criteria by which products can be evaluated, rather than relying on the product universe itself to establish the basis for product comparison and assessment.

With respect to the suitability analysis, firms that only offer proprietary products are permitted to make conflicts of interest disclosure to the effect that the analysis will not consider the larger market of non-proprietary products. There does not appear to be a similar allowance for the KYP requirement, which could be more consistent.

Knowledge of comparable products for registered individuals

Similar to the obligation on registered firms, subsection 13.2.1(3)(a) of the Proposed Amendments imposes an obligation on registered individuals to take reasonable steps to understand at a general level the securities that are available for them to purchase, sell or recommend through their firm, and how those securities compare to others.

Subsection 13.2.1(5) of the Proposed Amendments states that registered firms must ensure that their registered individuals have the necessary information about each approved security. To meet this obligation, firms will need to maintain information systems that are available to representatives, in addition to providing training.

KYP, suitability and enhancing the continuing education requirements of registrants are all linked. If investors are purchasing financial advice from a registrant rather than merely an investment product, it is reasonable to expect a thorough KYP and suitability analysis done at the time of sale. KYP is necessary to know how the product being sold alters the risks and return expectations of the investors' portfolio (portfolio level suitability).

At the portfolio level a subjective analysis that documents the investors' willingness and ability to take risk, financial goals, basic tax position and any other relevant factors or constraints should be documented. Documenting the relevant facts at the point of sale would facilitate a more meaningful comparison of investor outcomes vs. expectations and may help more investors achieve their financial goals.

We query however how the requirement in subsection 13.2.1(6) can be reconciled for those positions that are transferred to an adviser (because, for example, they are illiquid private securities that cannot be easily sold) but the adviser is not expected contractually by their client to provide advice with respect to those specific securities (i.e. client-directed trades). While an adviser would normally consider the general implications of these securities in the client's investment policy statement, they would not customarily conduct a deep KYP assessment. If the security cannot be sold, the adviser should only be held to the account reporting standards under the current requirements of subsection 14.14.1 and section 14.17 of NI 31-103 (i.e. additional statement and annual cost/compensation reporting if trailer fees are paid).

Knowledge of costs associated with acquiring and holding a security

We support the specific aspect of subsection 13.2.1(3)(b) of the Proposed Amendments that imposes an obligation on registered individuals to understand, for each specific security they purchase, sell or recommend to a client, the impact of all of the costs associated with acquiring and holding the security. This obligation ensures that advisers are aware of the differing cost structures of the products they offer and the impact of such costs on the investor. If costs are duly considered in each recommendation and KYP analysis, we expect that this would result in an improvement in investor outcomes.

3. Suitability Requirements

Registrants must put their clients' interests first when making a suitability determination

As set out above, the proposed enhanced suitability obligations would introduce a new core requirement that registrants must put their clients' interests first when making a suitability determination. This requirement will help to enforce a regulatory standard with regards to the quality of advice provided to clients. We believe that a stable and harmonized regulatory regime with clear obligations for registrants will allow new advice delivery models and compliance solutions to proliferate.

However, we would like to highlight, despite the measures implemented by the Proposed Amendments, there are certain conflicts that remain inherent within the system, particular in compensation models for advisers. Particularly, how would a registrant meet the test of "putting a client's interest first", in an embedded commission regime? The concept of an embedded commission, arguably, stands in opposition to a suitability assessment that is made in the best interest of the client.

It would be helpful for the CSA to provide an additional framework with respect to the factors that should be applied to a suitability determination. For example, one research report suggests that the analytic hierarchy process can be used to characterize investors with respect to suitability, and makes the process of choosing securities less subjective while producing more consistent results[6]. Another study indicated that if a complicated product is not understood by investors, they will not be able to make informed decisions, and thus certain advisers have tried to standardize product complexity. The authors of the study proposed a framework for classifying product risk and complexity, as well as compile factors that contribute to the classifications. [7]

Enhancing education standards with respect to the KYP obligation will also benefit suitability decision-making. The suitability determination should consider a holistic series of factors including costs, historical performance, comparable products, and a reconciliation of the product's anticipated risks to the client's tolerance for risk.

Requirement to consider costs and their impact in making suitability determinations

While we are glad to see that product and account costs will now be integral to making a suitability recommendation, it is one thing to take cost into account but quite another to enable investors to understand those costs. We strongly recommend enhanced cost reporting so that all costs incurred by an investor are visible on client statements. This level of transparency may help improve the client-registrant relationship and may improve overall investor protection.

As a result of the Proposed Amendments, there may be some narrowing of the product selection that advisers are willing to recommend to clients based on the best interest standard. In recommending mutual fund products with varying costs, registrants should be able to articulate the merit in more expensive products before recommending them in order to meet their suitability obligations. Advisers may also be motivated to recommend less risky products that will be not be challenged. Firms will need to implement policies and procedures to counteract both these possibilities.

The move away from trade-based suitability to an overall portfolio-level suitability analysis

The CSA states that enhanced suitability obligations include moving away from trade-based suitability to an overall portfolio-level suitability analysis. We believe this would be beneficial for investors as it would result in a more holistic and appropriate approach to product recommendations and portfolio construction. The CAC believes that a registrant should be required to disclose how specifically the portfolio will meet the client's risk and return objectives.

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6 Paul J. Bolster, Vahan Janjigian & Emery A. Trahan, "Determining Investor Suitability Using the Analytic Hierarchy Process" (July-August 1995) 51:4 Financial Analysts Journal 63.

7 Benedict S.K. Koh et al, "A Risk-and Complexity-Rating Framework for Investment Products" (2015) 71:6 Financial Analysts Journal 10.

Without the additional layer of disclosure, clients will not be able to understand the methodology or framework used to construct the portfolio.

In order to properly execute adequate portfolio-level analysis, however, higher proficiency standards may be needed. For example, dealers may need improved analytical tools. This should be addressed in the CSA's continued work on proficiency requirements, and should be considered as part of the necessary training for registered individuals.

Triggering events that will require a registrant to reassess suitability

For the most part, we agree with the enumerated list of triggering events. However, we would like further guidance on the triggering event where "there is a change in a security in the account". It might only be practical to complete a full suitability assessment if the change is material. For example, we would expect a material change to include if an issuer is facing a regulatory proceeding, including with respect to fraud, or is filing for bankruptcy or is otherwise in financial distress.

Compliance reviews

The CSA state that "in order to ensure that the suitability obligation has been met, our review will be undertaken on the basis of what a reasonable registrant would have done under the same circumstances." We would like further clarification on this point, particularly with respect to the degree of flexibility that might be afforded when there are often a number of reasonable outcomes for a client.

Various CSA members over time have provided very helpful guidance during registrant outreach sessions, email blasts, and staff notices which go over in great detail compliance deficiencies discovered in reviews and staff's suggested improvements. Registrants across the country could benefit if NI 31-103 contained an annex of such published guidance (recognizing the need for updates) which would then have consistent application.

4. Conflicts of Interest

Firms must resolve conflicts in the best interest of the client

Section 13.4.2 of the Proposed Amendments requires that registered firms address all conflicts of interest between the firm (including each individual acting on its behalf), and the firm's client, in the best interest of the client. If a conflict is not, or cannot, be addressed in the best interest of the client, then the registered firm must avoid that conflict.

In financial markets, incentives drive behavior. The financial industry would benefit from a structure of economic incentives that promotes transparent, simple fee structures, full attribution of all costs to the end investor related to their financial advice, and a structure that promotes competition in the distribution of investment fund products to investors. We think that better alignment of interests of the adviser and the client would facilitate more optimal outcomes for everyone in the industry. A regulatory regime that relies excessively on disclosures to mitigate conflicts of interest is a departure from the principles of the best interest standard and benefits the suppliers of advice at the expense of the consumers of advice.

The best practice is to avoid actual conflicts and the appearance of conflicts of interest, whenever possible.

We also believe that an effective regulatory approach to disclosure must be careful not to provide too much information which could overwhelm or confuse a client. Instead, sufficient information should be provided that is clear and that succinctly outlines the nature and source of the disclosed conflict. Such disclosure should be material to the client, the document(s) should be concise, in plain language, and not difficult to review.

Expanded scope of conflict of interest reporting

The Proposed Amendments extend the obligation on registrants to take reasonable steps to address all existing conflicts of interest (including those that are reasonably foreseeable) beyond those that are material and state that disclosure must include the nature and extent of the conflict of interest.

Situations involving potential conflicts of interest with respect to responsibilities to clients may be extremely complex. We support the flexibility for firms to engage in thorough, independent, and unbiased analysis of conflicts of interest matters and address them in a risk proportional manner.

We further support the requirement to disclose potential conflicts of interest, including the nature of those conflicts when a client would reasonably expect to be informed of such. When conflicts cannot be reasonably avoided, clear and complete disclosure of their existence is necessary. To be effective, disclosures must be prominent and must be made in plain language and in a manner designed to effectively communicate the information.

We believe the added guidance on compensation related conflicts of interest will be helpful. Firms must ensure then that they do not remunerate or evaluate their staff in a way that conflicts with their duties to act in the best interest of their clients. Additionally, investment firms with proprietary products that manufacture securities for sale to clients should ensure those instruments are designed to meet the needs of the relevant clients.

5. Misleading Communications

Through the Proposed Amendments, the CSA clarify the meaning of a misleading communication and state that registrants must not hold their services out in any manner that could reasonably be expected to deceive or mislead any person.

In particular, we support a stricter approach to regulating titles that could assist investors in understanding the roles and responsibilities of the registrants with whom they deal. We are of the view that if an individual who provides advice is client-facing, their title should clearly inform clients about their registration status.

We agree with the CSA in that registered individuals should not use a title, designation, award, or recognition that is based partly or entirely on that registrant's sales activity or revenue generation, registered individuals must not use a corporate officer title unless their sponsoring firm has appointed that registrant to that corporate office pursuant to applicable corporate law, and registered individuals must only use a title or designation with the approval of their sponsoring firm. We would argue that representative titles and their proficiency standards should be congruent and that their titles must be substantiated by the requisite degree of knowledge.

6. Relationship Disclosure Information

The requirement for all registered firms to disclose the costs and impact of their professional services on their website requires further consideration and should be dependent on the delivery channel. We query whether this requirement is an absolute necessity or a "nice-to-have". When considering the registrant landscape, it is clear that while some registrants (i.e. robo advisers and discount brokerage firms) can post their prices and standardized levels of service on their websites, other registrants function in a less standardized manner. For example, a discretionary wealth manager may provide a much more comprehensive range of services, including financial planning and customized withdrawal plans, which will often be negotiated based on discussions with clients. The applicable fees for these services will not be known without a shared understanding of the scope of service being provided.

In addition, to the extent a client meets face-to-face with a registrant, the utility of information provided on-line may be lessened. Conversely, electronic disclosure takes on more importance for on line delivery channels.

Disclosure should be concise

It is very possible that prohibiting registrants from transacting on behalf of clients until any material change in the information is disclosed would be potentially harmful in circumstances where trades need to be carried out quickly to avoid significant losses.

In addition, for disclosure to be effective it must focus on key information and be as concise as possible to help encourage more clients to read the material.

Enhanced disclosure on the use of proprietary products

The CSA intends to enhance disclosure on the use of proprietary products, limitations on the products and services made available to clients and the impact of these limitations on investment returns. For instance, it is proposed that a registrant would disclose if they only offer proprietary products or whether they offer a mix of proprietary products and non-proprietary products on their shelf and recommended product list. Moreover, registered firms would also be required to make public information that includes the newly defined terms "third-party compensation" and "proprietary product."

We agree with the proposed additional disclosure. The disclosure should also specifically include information for a situation where the principals of a registrant have dual roles with the registrant and the issuer (currently imposed as terms and conditions on certain captive dealers), as well as the degree of compensation they receive for distribution of the product.

We recommend that the CSA also supplement this disclosure with additional obligations on dealers, such as plain-language disclosure requirements, to help investors understand this information. Any additional guidance the CSA can provide with respect to the type of disclosure that would be adequate to meet these enhanced requirements would be helpful to registrants.

7. Education and experience requirements

While the current educational framework may be adequate for the current registrant obligations, the heightened KYP and other requirements may create challenging circumstances for the less comprehensive educational requirements. Enhancing registrant proficiency, particularly with respect to registered dealers, needs to be a priority if the anticipated objectives of the Client Focused Reforms are to be achieved.

8. Additional Regulatory Requirements

The proposed amendments are being imposed in lieu of an overall best interest standard. Consideration could be given to any current requirement in NI 31-103 (or otherwise in securities legislation) that imposes a potentially different standard (for example, anything that specifically already suggests a fiduciary standard of care) to avoid unnecessary duplication or confusion.

Specific Questions

We wish to provide the following comments to the specific questions raised with respect to the Proposed Amendments:

1. Transactional relationships

Exempt market dealers often have transactional or "episodic" relationships with their clients, in contrast to the ongoing character of client relationships in other categories. Would the Proposed Amendments pose implementation challenges unique to transactional relationships, or would they have other unintended consequences related to them?

We are aware of registrants operating in the MFDA and IIROC channels who function in a similar transactional or "episodic" manner to those in the exempt market segment who are registered with the CSA. We believe the degree of contact with a client and the fluidity and frequency of the relationship cannot reduce the rigour required to understand the client and the respective investments being recommended. Clients in channels where relationship are episodic may, indeed, find greatest improvements in their advisory relationships.

2. Conflicts that must be avoided

Are there other specific conflicts of interest that cannot be addressed in the client's best interest and must be avoided?

The proposed reforms will not adequately address asymmetrical fee structures, such as embedded commissions. High commission products create a conflict between the adviser and the client and would be hard to justify in the context of a statutory best interest. This would likely motivate manufacturers of investment products to find other ways to compensate advisers.

3. Referral fees

Does prohibiting a registrant from paying a referral fee to a non-registrant limit investors' access to securities related services? Would narrowing section 13.8.1 [Limitation on referral fees] to permit only the payment of a nominal one-time referral fee enhance investor protection?

The CAC was surprised to see this area targeted specifically, given a lack of data provided to evidence the referral arrangements with non-registrants were problematic.

CFA Institute requires Members and Candidates to disclose to their employer, clients and prospective clients, as appropriate, any compensation, consideration or benefit received from, or paid to, others for the recommendation of products or services. In this light, the CAC believes the disclosure of any referral fee or benefit to all parties involved sufficiently captures a principle behind investor protection.

In fact, prohibiting referral fees or limiting fees to one-time charges risks reducing investor protection as non-registrants may seek to shuffle clients through different firms to maximize fees.

We believe that it would be helpful for the CSA to provide additional guidance on unacceptable practices to be addressed in connection with referral arrangements, including but not limited to compensation matters.

Concluding Remarks

We thank you for the opportunity to provide these comments. We would be happy to address any questions you may have and appreciate the time you are taking to consider our points of view. Please feel free to contact us at cac@cfacanada.org on this or any other issue in future.

(Signed) *The Canadian Advocacy Council for*
Canadian CFA Institute Societies

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