CSA RELEASES CLIENT-FOCUSED REFORMS TO NI 31-103 IN RESPONSE TO CLIENT-REGISTRANT RELATIONSHIP CONCERNS

Posted on July 18, 2018

Categories: Insights, Publications

Overview of the Notice

On June 21, 2018 the Canadian Securities Administrators (the "**CSA**") released proposed amendments (the "**Proposed Amendments**") to National Instrument 31-103 *Registration Requirements,* Exemptions and Ongoing Registrant Obligations ("**NI 31-103**") and Companion Policy 31-103CP *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (the "**Companion Policy**"). The goals of the Proposed Amendments are to better align the interests of securities advisors, dealers, and representatives with the interests of their clients to improve outcomes for clients, and to help clients better understand the nature and the terms of their relationship with registrants. The Proposed Amendments are expected to impose additional compliance obligations on registrants.

Background

The Proposed Amendments were sparked by a number of the CSA's investor protection concerns relating to the client-registrant relationship including:

- clients not getting the value or returns they reasonably expect from investing;
- misplaced trust or overreliance on registrants;
- concerns over effective mitigation of conflicts of interest;
- information asymmetry between clients and registrants; and
- clients are not getting the proper outcomes in the regulatory system.

Summary of Amendments

The Proposed Amendments restructure registrant obligations relating to: (i) Know Your Client ("**KYC**"); (ii) Know Your Product ("**KYP**"); (iii) suitability determination; (iv) conflicts of interest; (v) disclosure requirements; and (vi) education and experience requirements for registered individuals.

KYC

The CSA has provided more clarity on what information it expects should be collected to "know a client" on a more tailored basis. The Proposed Amendments require:

- collection of explicit information by registrants in order to confirm their clients meet suitability requirements at the time of account opening;
- reasonable steps be taken to ensure client information is correct; and
- a combination of specified intervals and triggering events requiring when KYC information must be reviewed and updated including (i) every 12 months for managed accounts; (ii) within 12 months from executing a trade or making a recommendation to a client; and (iii) 36 months for other accounts. In addition, KYC information must be reviewed and updated at any time when the registrant knows or reasonably ought to know of a significant change to KYC.

Registrants may encounter difficulty fulfilling these obligations as they will require more participation from their clients including clients divulging more information about their financial situation than was previously required. In addition, registrant administrative efforts will need to be increased in order to comply with the increased expectations relating to monitoring and updating KYC.

KYP

Currently there is only limited principles based guidance concerning KYP in the Companion Policy. In contrast, the Proposed Amendments explicitly provide KYP obligations for both registered firms and registered individuals including:

- requiring registered firms to: (i) understand the securities it sells and how they compare to similar securities in the market; (ii) approve the securities it makes available; and (iii) monitor and reassess securities including for significant changes to the security; and
- requiring registered individuals to take reasonable steps to: (i) understand the securities available through their registered firm to purchase, sell, or recommend; (ii) understand each specific security they purchase, sell or recommend to a client as well as the impact of costs associated with acquiring and holding the security; and (iii) only purchase or recommend securities approved by their firm.

Registered firms must also ensure that their registered individuals have the necessary information about each approved security.

Codifying KYP obligations may require additional training for registrants as well as documenting that such training has occurred.

Suitability Determination

The changes to the suitability determination are extensive as the CSA notes that unsuitable recommendations generate the majority of complaints with the Ombudsman for Banking Services and Investments. The Proposed Amendments introduce a new core requirement that registrants must put their clients' interests first when making a suitability determination. Before a registrant opens an account, takes an investment action on behalf or, or makes a recommendation to a client, the registrant must determine that the action is suitable for the client based on a number of explicit factors including (i) specific KYC information; (ii) the registrant's understanding of the security; (iii) the features and associated costs of the account type made available to the client; (iv) the impact of the action on the client account; (v) portfolio-level concentration and liquidity; (vi) analysis of the actual and potential impact of costs on client return; (vii) available alternatives at the firm; and (viii) any other relevant factor in the circumstances.

The Proposed Amendments introduce triggering events, each of which requires a registrant to reassess suitability and take appropriate action in connection therewith. Triggering events include: (i) a new registered individual at the registrant being designated as responsible for the client account; (ii) a change in the KYC information of a client; (iii) a change in a security in the client's account that may result in the security or account not meeting previously established criteria; (iv) the registrant undertakes a requisite review of the client's information; or (v) the registrant becomes aware that a security in a client account or the account no longer meets prescribed suitability criteria.

Conflicts of Interest

The Proposed Amendments require that registered firms and registered individuals put the interests of clients ahead of their own interests. Additionally, the Proposed Amendments adopt a best interest standard relating to conflicts of interest that impact both registered firms and registered individuals, specifically:

- *all* conflicts of interest must be addressed, not only those that are material, although non-material conflicts of interest may be addressed proportionately to the risk posed. In addition, the Proposed Amendments to the Companion Policy provide potential conflicts of interest examples and controls that may be used to assist registrants to address conflicts of interest;
- conflict of interests obligations will apply to registered individuals as well as their sponsoring firms. In addition registered individuals must report identified conflicts of interest to their sponsoring firm;
- outlining conflicts of interest that must be avoided, including, subject to certain exceptions, borrowing money, arranging a guarantee in relation to money a registrant has borrowed, borrowing securities or any other assets from a client, extending credit, providing margin, or lending securities or any other asset to a client;
- broadened disclosure requirements relating to conflicts of interest requiring the identification of all

conflicts of interest that a reasonable client would want to know about. This disclosure must include an overview of the nature and extent of the conflict of interest as well as the potential impact and risk posed to the client as well as how it was or will be addressed;

- new prohibitions related to referral arrangements and limitations on referral fees including that a referral fee must not (i) continue for longer than 36 months; (ii) constitute a series of payments exceeding 25 percent of the fees or commissions collected from the client by the party who received the referral; and (iii) increasing the amount of fees or commission that would otherwise be paid by the client for the same product or service. In addition, referral fees: (i) are payable only to other registrants; (ii) must be reflected in a written agreement; and (iii) must be recorded by the registered firm. Finally, registered firms need to ensure that information required by NI 31-103 relating to referral fees is provided to clients in writing; and
- expanding registrant record keeping obligations, particularly in relation to sales practices, compensation arrangements and incentive practices.

Increased CSA expectations relating to identifying and responding to conflicts of interest will require registered firms and their registrants to be more proactive monitoring their activities in order to identify conflicts. This will require firms revamping existing conflict of interest policies, implementing new internal controls, and training not only their registered individuals, but all firm staff to enable them to effectively identify and respond to conflicts as they arise.

Disclosure Requirements

The Proposed Amendments introduce new disclosure obligations for registrants including:

- registered firms must make information that a reasonable investor would consider important in deciding whether to become a client of the firm, publicly available. The required information would include information relating to products and services offered, charges and other costs to clients, any third party compensation associated with the firm's products, services, and accounts; and
- updates to relationship disclosure information or "RDI" requiring enhanced disclosure about restrictions on the products or services a registrant makes available to clients, including whether the registrant uses "proprietary products", the impact on client investment returns resulting from such restrictions, as well as the potential impact of costs and charges.

Education and Experience Requirements for Registered Individuals

The Proposed Amendments require registered firms other than investment fund managers to provide training to certain employees on compliance with securities legislation including: (i) conflict of interest requirements; (ii) KYC and KYP obligations; and (iii) suitability determination. In addition, firms must provide training to their

registered individuals relating to the securities that the firm has approved for the registered individuals to purchase, sell, or recommend to clients.

Implementation

The CSA is considering the Proposed Amendments would come into effect for (i) KYC, KYP, suitability and conflict of interest, in two years; (ii) referral arrangements, immediately and three years for pre-existing arrangements; and (iii) RDI, in one year to provide publically available information and in two years for other requirements.

Conclusion

In addition to tabling the Proposed Amendments for consideration, the CSA has invited industry participants to respond to requests for comment relating to conflicts that must be avoided, referral fees and transactional relationships on a general basis. The deadline for submitting comments to the CSA regarding the Proposed Amendments is October 19, 2018. Please contact a member of McMillan's Investment Funds and Asset Management Group if you have any questions or seek assistance with the preparation of a comment letter.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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