CSA PROPOSE REFORMS TO THE CLIENT-REGISTRANT RELATIONSHIP MODEL AND A REGULATORY BEST INTEREST STANDARD

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The Canadian Securities Administrators (the "**CSA"**) released CSA Consultation Paper 33-404[1] (the "**CP 33-404**") on April 28, 2016 seeking comments on potential amendments to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* ("**NI 31-103**"). The proposals, which are aimed at enhancing the obligations of advisers, dealers, and representatives (collectively, "**registrants**") towards their clients target specific reforms to registrant conduct and compliance requirements under NI 31-103 and further advance the discussion of the regulatory best interest standard first introduced back in 2012.[2] The comment period expires on August 26, 2016.

Targeted Client Relationship Reforms

The CSA propose to implement targeted amendments to NI 31-103 (the "**Targeted Reforms**") in order to enhance the obligations of registrants regarding conflicts of interest, know-your-client ("**KYC**") requirements, know-your-product ("**KYP**") requirements, suitability requirements, relationship disclosure, proficiency requirements, titles and designations used by representatives and the roles of the ultimate designated person ("UDP") and chief compliance officer ("**CCO**").

Regulatory Best Interest Standard

The CSA is considering a regulatory standard mandating that registrants act in their clients' best interest (the "**Best Interest Standard**"), against which all client related obligations would be measured.

All of the CSA jurisdictions are supportive of the Targeted Reforms, but there is mixed support for the Best Interest Standard,[3] with British Columbia indicating that they are not supportive of this approach.

Background to Proposal

Over the past few years, the CSA and other third parties have engaged in research initiatives canvassing different aspects of the client-registrant relationship in Canada. In CP 33-404, the CSA concluded that this body of research identifies the following key investor protection concerns:

- *Inadequate Value or Returns*. Clients are not receiving the value or returns they could reasonably expect from investing. This partly stems from the failure of registrants' suitability analysis to consider all relevant factors, including product costs and alternative investment strategies.
- *Expectations Gap*. Most investors incorrectly assume that their brokers or advisers must always provide advice that is in their best interest. This creates misplaced reliance or trust on registrants, resulting in opportunities for some registrants to take advantage of their clients and creating an expectations gap between clients and registrants. The problem of misplaced reliance is exacerbated when registrants (i) use titles or designations that exaggerate their proficiency or the services they actually provide, and (ii) sell a limited or proprietary shelf of products.
- *Conflicts of Interest*. The current conflicts of interest rules are often less effective than intended. In some cases, disclosure may even have a counter-intuitive effect of increasing reliance on advice where the client is told such advice is, or potentially is, conflicted.
- *Information Asymmetry*. With the limited financial literacy of most investors, the increasing complexity of securities products, and the limited effectiveness of initiatives to improve financial literacy, there is not enough responsibility placed on registrants to prioritize the client's interest and ensure that clients understand the information and advice they receive.
- *Regulatory System Falling Short*. Clients are not getting the outcomes that the regulatory system is designed to give them. The potential causes of this include: insufficiently clear registrant requirements, a suitability assessment process that is not transparent, barriers to obtaining redress for registrant breaches, and lack of effective compliance and enforcement in certain cases.

In an effort to address these concerns, the CSA has put forward a wide-ranging and ambitious set of amendments that take two forms. The Targeted Reforms attempt to address specific weaknesses identified in the current regulatory framework, while the Best Interest Standard aims to create an over-arching principle that can be applied to any situation by both registrants and regulators. These two proposals are described in more detail below.

Targeted Reforms

The Targeted Reforms propose to add the following explicit obligations to NI 31-103.

Conflicts of Interest

In contrast to the current regime,[4] firms and representatives would have to prioritize client interests over those of the firm when responding to every material conflict of interest identified. Any disclosure given to a client about a conflict must be meaningful such that the client fully understands the conflict, including its implications and consequences for the client. Firms and representatives must have a reasonable basis for concluding that a client fully understands the implications and consequences of the conflict.

CP 33-404 introduces "**institutional clients**" as a new category of potential clients, which includes, among others, Canadian financial institutions, registered firms, pension funds, governments and trust companies, registered advisors acting on behalf of fully managed accounts, investment funds and other entities (other than individuals) having net financial assets of $100 million.

When dealing with institutional clients, disclosure by itself may be an acceptable response to a conflict of interest as long as the conflict is not obviously contrary to the interests of the institutional client, based on the information the firm and representative have about the institutional client.

Know Your Client

Registrants would be required to gather more client-centred information in respect of the following three key elements of the KYC obligation:

a. *Investment needs and objectives* – registrants must understand the client's investment time horizon, liquidity needs, and applicable investment constraints.
b. *Financial circumstances* – registrants must inquire about the amount and nature of all assets and debts, employment status, basic tax position, and the needs of spouses and dependents.
c. *Risk profiles* – the registrant must create a risk profile based on concepts including risk attitude, risk capacity and loss aversion, which terms are to be defined for the client.

In addition, the KYC forms and a record of the risk profile would have to be dated and signed by both the client and representative at account opening and upon any material changes to the KYC or risk profile information. A copy of these signed documents would have to be provided to the client. A specific requirement would be added that KYC information is updated at least every 12 months or more frequently if there are material changes in the circumstances affecting the client or the client's portfolio.

These reforms would not apply to registrants dealing with institutional clients or in respect of discount brokerage clients.

Know Your Product

Adding to the current regime,[5] representatives of registrants would need to understand and consider the following:

a. *Product Characteristics* – the structure, product strategy, features, costs and risks of each security on mcmillan

their firm's product list.

b. *How a product compares* – how a recommended product compares to other products on the firm's product list.
c. *Costs of product* – the impact on the performance of the product of all fees, costs and charges connected to the product, the client's account, and the product and account investment strategy.

In turn, firms would need to ensure that their representatives have the information and ability to comply with their KYP obligations by having in place policies and procedures, training tools, guides, and other processes.

Firms would also need to identify whether the investment products they offer are classified as "proprietary" or "mixed/non-proprietary". A firm that carries mixed/non-proprietary products must select investment products that it offers in accordance with policies and procedures that include: (i) investigation of a reasonable universe of potential products that the firm can advise on or trade in, (ii) comparison of products from this universe, and (iii) optimization of the range of products ultimately offered in order to meet its clients' investment needs and objectives.

Suitability

Currently, the suitability analysis obligation is primarily "trade"-based, meaning it is generally triggered by a product order or a recommendation to buy or sell. The Targeted Reforms expand the situations when a suitability analysis would apply to include recommendations or decisions to *hold* or *exchange* securities and also recommendations or decisions *not to* purchase, sell, hold, or exchange securities. Under the Targeted Reforms, the suitability analysis would have to satisfy the following three enhanced elements, as applicable:

a. *Basic financial suitability* – by identifying whether any other basic financial strategies, such as paying down high-interest debt, are more likely to achieve the client's needs and objectives.
b. *Investment strategy suitability* – by identifying a basic asset allocation strategy that is most likely to achieve the client's needs and objectives, taking into account the target rate of return, the risk required to achieve that return, and whether that risk is within the client's risk profile.
c. *Product selection suitability* – by ensuring that the purchase, sale, holding, or exchange of a security is both (i) *suitable* for the client and (ii) *most likely* to achieve the client's needs and objectives given the client's financial circumstances and risk profile based on a review of the structure, features, strategy, costs and risks of the products on the firm's product list.

Registrants would perform the suitability analysis when accepting instructions from the client, when recommending to the client, or within a reasonable time after any of the following: (i) receiving securities into the client's account; (ii) a change in the representative or firm for the client's account; (iii) a material change in the client's KYC information that the registrant knew or reasonably should have known had occurred; (iv) a significant market event affecting capital markets to which the client is exposed; or (v) a material change in the risk profile of an issuer of securities held in the client's account. At a minimum, the suitability analysis would have to occur every 12 months.

These reforms would not apply to registrants dealing with institutional clients or in respect of discount brokerage clients.

Relationship Disclosure

Firms would need to clearly disclose the nature of the client-registrant relationship in terms the client can understand. Other than when dealing with institutional clients, firms would have to disclose whether they offer proprietary products only or a mixed/non-proprietary product list. In the case of a proprietary product list, the firm must inform its clients that their product list is restricted to their own products and, therefore, the suitability analysis conducted will not consider the larger market of non-proprietary products or whether such non-proprietary products are better or worse at meeting the client's investment needs and objectives.

Other than when dealing with institutional clients, a firm operating under a restricted registration category, such as a mutual fund dealer or an exempt market dealer, would have to clearly disclose to the client that it only offers a limited range of products. The client must also be informed that, as a result, the suitability analysis conducted will not consider a full range of securities products or whether other types of products are better or worse at meeting the client's investment needs and objectives.

Proficiency

Representatives would have to meet increased proficiency requirements that explicitly incorporate certain knowledge elements. In particular, this aspect of the Targeted Reforms focuses on proficiency regarding how product costs and investment strategies (e.g. active vs. passive) can impact investment outcomes for clients. Additionally, all representatives would be subject to certain continuing education requirements.[6]

Titles

CP 33-404 contains three alternatives for prescribing the client-facing business titles that may be used by representatives:

a. *Alternative 1* – There are four possible titles[7] based on whether the representative's firm is a portfolio manager or investment dealer, whether the firm carries a mixed/non-proprietary product list, and whether the representative manages a client's discretionary account.
b. *Alternative 2* – The title "advisor" is used for representatives of firms registered as portfolio managers or

investment dealers that are IIROC members and who manage clients with discretionary accounts. For representatives of any other firm, the title "salesperson" is used.

c. *Alternative 3* – Representatives can only use their individual category of registration as a title (e.g. dealing representatives and/or advising representative).

These reforms would not apply to representatives when they are dealing with institutional clients.

Designations

Designations are credentials signifying that a representative has attained specialized knowledge or expertise in a certain area through education and/or experience. Although no specific rules have been proposed yet, NI 31-103 would be amended to include specific provisions concerning the designations that each category and type of representative may use when dealing with clients. The sample guidance published so far states that no representative should use designations in a way that deceives or misleads[8] a client or other person about the representative's proficiency, qualifications, or scope of product/service offering. In addition, firms would be expected to have clearly communicated and enforced policies and procedures that promote transparency of designations used by their representatives.

Role of UDP and CCO

CP 33-404 attempts to clarify the roles of the UDP and CCO. The UDP would have to:

- ensure the firm has policies and procedures to identify and manage conflicts of interest;
- ensure that material conflicts are avoided if they cannot be managed;
- promote consideration and management of conflicts of interest in a manner that prioritizes the interest of the client; and
- promote compliance with the suitability analysis and, in particular, the assessment of how product costs impact the client's investment needs and objectives.

The CCO would have to establish and maintain policies and procedures and monitor resulting compliance with:

- the obligation to respond to material conflicts of interest in a manner that prioritizes the interests of the client; and
- the suitability obligation and, in particular, the assessment of how product costs impact the client's investment needs and objectives.

Statutory Fiduciary Duty for Discretionary Accounts

In the provinces of British Columbia, Saskatchewan, Ontario, Quebec, Nova Scotia, Prince Edward Island, Nunavut, Yukon, and the Northwest Territories, a statutory fiduciary duty is proposed only for those registrants managing a client's investment portfolio through discretionary authority granted by the client. Such a fiduciary duty would have a narrower application than the proposed Best Interest Standard, which would apply to *all* registrants.

Regulatory Best Interest Standard

The proposed Best Interest Standard would require a registrant to deal fairly, honestly, and in good faith with its clients and to act in its clients' best interests. In order to meet this standard of care towards the client, five guiding principles are set out:

1. act in the best interest of the client;
2. avoid or control conflicts of interest in a manner that prioritizes the client's best interests;
3. provide full, clear, meaningful and timely disclosure;
4. interpret law and agreements with clients in a manner favourable to the client's interest where reasonably conflicting interpretations arise; and
5. act with care.

CP 33-404 makes it clear that the Best Interest Standard is not intended to be a common law fiduciary duty. Instead, it is a regulatory standard of conduct, which would be more comprehensive than a fiduciary duty, but also appropriately tailored to the client-registrant relationship. However, the Best Interest Standard is not intended to interfere with the ability of courts to apply common law doctrines such as fiduciary duty, negligence or contract law principles to the client-registrant relationship.

Support for the Best Interest Standard

There is mixed support across Canada for the Best Interest Standard. Securities regulators in Ontario and New Brunswick believe that it would bring several benefits, such as assisting in the interpretation of more specific requirements (including the Targeted Reforms) and providing guidance for registrants to address novel situations or those that fall between specific rules.

Other jurisdictions[9]are uncertain whether the Best Interest Standard would be beneficial and are concerned about unintended consequences. They await the feedback from CP 33-404 before taking a position.

The British Columbia Securities Commission rejects the Best Interest Standard, as it believes the adoption of what it views as a broad, sweeping and vague standard (i) will create uncertainty for registrants, and (ii) may be unworkable in the current regulatory and business environment. On this last point, for example, registrants who are permitted under the current regulatory regime to sell only a limited range of products would be at risk of contravening the Best Interest Standard as there may be nothing in their range of products that is actually in a particular investor's best interest. Other registrants are owned by or affiliated with businesses that create the investment products they sell, creating a conflict that is difficult to reconcile with the Best Interest Standard.

Conclusion

The CSA have posed a comprehensive set of consultation questions in CP 33-404 and are seeking feedback on both the Targeted Reforms and the Best Interest Standard. The deadline for submitting comments to the CSA is August 26, 2016. 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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1 CSA Consultation Paper 33-404 *Proposals to Enhance the Obligations of Advisers, Dealers and Representatives Toward Their Clients*.

2 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* (October 25, 2012) and 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).

3 See the section titled "Support for the Best Interest Standard" below.

4 Currently, there is no explicit requirement to prioritize the interests of the client when responding to conflicts. There is also no explicit requirement that conflicts of interest disclosure must be fully understood by clients or that registrants must have a reasonable basis for concluding clients have understood.

5 Although KYP is currently a key element of the suitability analysis, it is not an explicit, standalone requirement. There is also no explicit requirement for representatives to know about all the products on their firm's product list, how each product compares to the others, and all the related fees, costs and charges related to a product that may be incurred by a client.

6 Currently, there are no specific continuing education requirements.

7 "Securities advisor – portfolio management" is used for a representative whose firm is registered as a portfolio manager or investment dealer that has a mixed/non-proprietary product list and who manages a client's discretionary account. "Securities advisor" is used for a representative whose firm is registered as a portfolio manager or investment dealer that has a mixed/non-proprietary product list and who advises on a client's non-

discretionary account. "Restricted securities advisors" is used for a representative of any other firm that is not a portfolio manager or an investment dealer but that has a mixed/non-proprietary products list. "Securities salesperson" is used for a representative of any form that a proprietary product list.

8 Or could reasonably be expected to deceive or mislead.

9 Alberta, Saskatchewan, Manitoba, Quebec, and Nova Scotia.

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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