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October 18, 2018

VIA E-MAIL

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

Attention:

The Secretary
Ontario Securities Commission
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22nd Floor, Box 55
Toronto, Ontario M5H 3S8
Fax: 416-593-2318
comments@osc.gov.on.ca

Me Anne-Marie Beaudoin
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Dear Sirs/Mesdames:

Re: Proposed Amendments to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* and to *Companion Policy 31-103CP Registration Requirements, Exemptions and Ongoing Registrant Obligations*

We are writing in response to the CSA Notice and Request for Comment dated June 21, 2018 outlining proposed amendments to NI 31-103 and its companion policy. We welcome the opportunity to comment on these important matters.

Nest Wealth Asset Management Inc. (Nest Wealth) is an independently owned and operated firm committed to bringing Canadians sophisticated and transparent wealth management. By offering some of the lowest portfolio management fees in the country, Nest Wealth helps thousands of Canadians save money on fees and achieve personal goals.

Nest Wealth is registered as a Portfolio Manager (PM) across the ten provinces in Canada and also as an Investment Fund Manager (IFM) and Exempt Market Dealer (EMD) in Ontario. Under its PM registration, Nest Wealth constructs and manages sophisticated low-cost portfolios for clients onboarded through its digital advice platform. Through a separate platform called Nest Wealth Plus, independent professionals can also refer clients to Nest Wealth in exchange for a referral fee subject to existing NI 31-103 requirements.

We are very interested in the CSA's referral arrangement proposals and have focused our response on this topic. While valid concerns about referrals have been raised, we believe the current proposals are too wide in scope and will lead to negative investor and industry outcomes that should be avoided. As such, we believe investors would ultimately benefit from the referral proposals undergoing additional consultation and being pursued through a separate stream focused on compensation incentives identified in CSA Staff Notice 33-318. Notwithstanding the foregoing, we believe the main regulatory issues and concerns raised by the CSA about referrals can be addressed by amending NI 31-103 to:

1) Cap referral payments to registrants and non-registrants at 1% of referred assets;
2) Prohibit registrants from paying referral fees to a non-registrant that has surrendered registration until, in most cases, 365 days pass from the NRD termination date;
3) Prohibit referral payments to non-registrants with a history of regulatory misconduct in the securities industry and other financial industries;
4) Require registrants to disclose referral fees clearly and separately from other fees to investors on client reporting; and,
5) Require registrants to conduct and document ongoing referral arrangement due diligence and include these results in the firm's annual Chief Compliance Officer (CCO) report.

As a firm committed to innovation, **we believe better investor outcomes will be achieved if more investors are aware of and can access solutions that serve their needs and protect their interests.** Accordingly, we believe that any changes to the referral proposals should allow for a level playing field between traditional and emerging advice channels and make certain that investors aren't limited in their likelihood of finding out about solutions in the market that can ultimately better serve their needs and improve their retirement security.

The first section of our response addresses the CSA's two questions around referral arrangements that commenters were asked to opine on. This is followed by a discussion around the other concerns and comments raised by the CSA around referral arrangements in the proposal paper in the context of investor/industry issues that we believe are imperative to the discussion. Lastly, the final part of our letter outlines our rationale and advocacy for the aforementioned recommendations in greater detail.

CSA Proposal Paper Question #1 - Does prohibiting a registrant from paying a referral fee to a non-registrant limit investors' access to securities related services?

In our view, prohibiting a registrant from paying a referral fee to a non-registrant will limit investors' ability to access securities related services—specifically wealth management solutions being offered at a lower cost than average and obliged to put their best interests first.

Although self-directed channels will remain available to investors irrespective of referral reform, studies undertaken by the CSA indicate that this channel may be unsuitable to a large segment of the population lacking the proficiency needed to self-manage investments.[1] Accordingly, we deemed it appropriate to assess how the prohibition will impact investor access to portfolio advice needed by the general population to achieve financial goals at a lower cost.

Investor Access to Professional Portfolio Management and Advice

Before online advisers (or "robo-advisers") were introduced in the Canadian market, securities advice was available to investors either through private wealth services or through the traditional advisor (dealing reps) channels. Due to private wealth generally being restricted only to high net worth (HNW) investors with at least $250,000 or more to invest, most Canadians have historically accessed professional portfolio management through mutual funds.

To date, Canadians have invested $1.53 trillion (CAD) into mutual funds which as of July 2018 accounted for roughly 31% of Canadians' financial wealth.[2] With an asset-weighted median expense ratio of 2.23% for an equity fund, Canada also continues to charge amongst the highest mutual fund fees in the world.[3] This means that Canadians are currently paying approximately $28 billion per year in mutual fund fees.[4]

As a solution, digital advice platforms gave all Canadians access to professional portfolio management that historically was only available to HNW investors. This service was also introduced to

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[1] CSA 2017 Investor Index Report - According to the report, 51% of Canadians failed the general investment knowledge test, answering fewer than four out of seven general investment proficiency questions incorrectly.
[2] https://www.ific.ca/en/info/stats-and-facts/
[3] Morningstar Global Fund Investor Experience Survey (2017), October 3, 2017
[4] Using the IFIC Monthly Statistics - August 2018 report and Morningstar Global Fund Investor Experience Study, we have assumed a 2.23% MER on the $516B invested in equities, 1.15% MER on the $188.3B invested in bond funds, and a 1.80% MER on the $788.2B in balanced funds and $17.2B in Specialty funds. The 1.80% MER assumed on balanced funds and specialty funds represents a 60/40 split using the aforementioned equity and bond MERs.

Canadians at a fraction of the cost of traditional advice channels with greater obligations of care than most traditional advice channels.

Registrants Lack Incentives to Refer to Better Solutions

On a fundamental level, referral fee payments incentivize an individual to refer to a certain solution or product whether they are registrant or non-registrant. However, there are clear differences in the compensation incentives that drive registrants and non-registrants to refer.

For large institutions with vertically integrated operations, it is not unusual to see lengthy client disclosures about referral arrangements and payments of several pages.[5] While it is probable that this motivates registrants to favor referrals to some products over others, the issue of registrant compensation incentives goes well beyond referrals.

In CSA Staff Notice 33-318, over 20 other types of compensation incentives that firms use to compensate and provide incentives to representatives and registrants were identified. Thus, in asking ourselves about the likelihood of receiving referrals to our low-cost solution from another registrant if non-registrants lose the incentive to refer, the excerpt below from the staff notice summarizes our limited hopes in that regard:

"In the case of related party referral arrangements, it may encourage representatives to send their clients to another arm of their firm, even when third party product and/or service options may be more suitable. It may also encourage representatives to shift clients to more profitable business lines within the firm with little or no benefit to the client.[6]

In our view, there are clear investor protection concerns that exist outside of referrals in the registrant channel that lead to negative investor outcomes. In recent months, we saw one of the largest institutions in the industry fined for contravention of NI 81-105 and receive a fine of over $1,000,000 for incentivizing in-house fund sales.[7] Beyond this isolated case, similar news articles paint a picture of a culture of sales that appears to be misaligned with investors' needs of objective advice.[8] So long as this continues to be a problem in the industry, we believe investor protection would benefit from the CSA looking to encourage more referrals to smaller independent fiduciaries from individuals that are not driven by these types of conflicts. Instead, the CSA's suggested course of action would do the exact opposite.

Non-registrants are crucial in bringing to Canadians information about fee transparency and alternative advice channels that most would otherwise be unaware of. According to studies conducted by the CFA institute, the prospects of working with a fiduciary and recommendations from trusted people are the most important attributes that over 50% of investors assign to their decision to work with a financial advisor/asset manager.[9] The reality of prohibiting referral payments to non-registrants is therefore quite clear. If the vast majority of the population loses its incentive to learn about and refer others to lower-cost solutions, potential referrers will simply stop referring people to lower cost solutions. At the same time,

[5] https://www.bmo.com/img/smartfolio/pdf/en/Terms_En.pdf
[6] CSA Staff Notice 33-318 Review of Practices Firms Use to Compensate and Provide Incentives to their Representatives (December 15, 2016)
[7] Royal Mutual Funds Inc. (Re), 2018 ONSEC 32 - Oral Reasons for Approval of a Settlement (June 13, 2018)
[8] Erica Johnson, "'We are all doing it': Employees at Canada's 5 big banks speak out about pressure to dupe customers," CBC.ca. CBC News, May 15, 2017
[9] The Next Generation of Trust: A Global Survey on the State of Investor Trust. CFA Institute, 2018

more investors will remain invested in higher fee products that are severely impacting their ability to reach their financial goals.

Referral Arrangements Bring Greater Value and Transparency to Investors

When a client is referred to Nest Wealth for online discretionary portfolio management, clients pay a portfolio management fee of 30 basis points of assets under management (AUM) which are capped at $960 annually.[10] The fee set by the referrers on our platform ranges between 0% and 1% of AUM. This means that even when an investor pays the maximum of 1.3% under the referral arrangement, he/she still pays almost 50% less than the 2.23% alternative and receives sophisticated portfolio management from a fiduciary.[11]

From a disclosure standpoint, clients referred to Nest Wealth Plus receive a referral arrangement disclosure document which outlines all material terms required under NI 31-103. This includes information about the fees payable to Nest Wealth and to the referrer and is also clear about the fact that all registrable activity is exclusively done by Nest Wealth. More importantly, no referral payments are paid out to referrers until clients sign the document which is a control meant to prevent the scenario of investors paying for something that they are unaware of.

After account opening, clients continue to have ongoing visibility into the fees that they pay to Nest Wealth and that Nest Wealth pays to the referrer through account statements and their online transaction portal. The statements and the portal both clearly disclose referral fees paid to referrers separate from the other fees paid by the client. As such, there is no embedded compensation payments that clients would be unaware of. We believe this level of transparency is the proper way of going about disclosing referral payments and also exceeds the level of transparency that embedded compensation fund investors receive.

Under the traditional advice channel, an investor would pay around 2.23% for the likely recommendation to invest in an active mutual fund. Despite lower cost alternatives available in the market, there are still ten times as many client assets invested in actively managed products than in passively managed products which suggests active products are still the default alternative for traditional advice channels.[12] After years of industry debate and consultation, these products will also continue to be allowed to pay embedded compensation to the advisors that sell the products in the industry despite the controversial fee transparency this brings. The irony of allowing embedded opaque compensation to continue with mutual funds but at the same time arguing for the elimination of transparent referral fees on lower cost products is not lost on anyone.

Transparency aside, there are other important investor issues to consider with implementing rules that would keep most active fund investors less informed about lower cost investment solutions. According to research undertaken by S&P Dow Jones Indices LLC, the majority of Canadian active funds have underperformed the index across the most recent one-year, three-year, five-year, and ten-year periods.[13] While past performance is not indicative of future results and an active strategy may make

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[10] Other fees include trading fees (capped at $100/year per account) and custodian fees ($75/year per non-registered account and $100/year per registered account not including a client's first account which is free). The average MER of the ETFs we use is 0.13% for a balanced portfolio.
[11] In many cases, we have also seen referral arrangements lead to clients receiving specialized advice in other areas of financial planning. These examples are discussed on the second section of our letter in greater detail.
[12] John De Goey, "Advisors don't want to talk about cheaper alternatives," Moneysense.ca. October 16, 2017
[13] Aye M. Soe & Ryan Poirier, SPIVA® Canada Scorecard. S&P Dow Jones Indices, 2017.

sense for some types of investors, one of the bigger issue that has gone unaddressed in the fund industry is that of closet index funds leading to consistent underperformance of investor's assets.[14]

Recent work done by academics and industry participants on the problem of closet indexing in Canada point to 37% to 50% of equity funds in this country being closet index fund.[15] This means that even in the best case scenario, at least one third of Canadian investors that think they are paying for active management are overpaying billions of dollars every year for market exposure that lower cost solutions could give. This is a serious issue of investor deception and we believe there is no question that the closet index fund investors in this country (at minimum) would be better served by a lower cost solution and fiduciary relationship. The most likely way for this outcome to be achieved is by expanding, not limiting, the number of people incentivized to refer investors to better solutions.

Why Limiting Referral Arrangements will Lead to a Lower Standard of Care for Investors

Rather than having a fiduciary obligation to act in a client's best interest, most registrants in traditional advice channels are only obliged to recommend products that are suitable to a client. The comparison drawn by the ASC to the suitability standard is that "it's not unlike purchasing a car from a dealership" as there is no requirement to know about, or recommend other alternatives that may better meet someone's needs.[16] The client issues that can result from this as seen in the SRO enforcement reports includes cases of mis-selling of higher cost products, poor portfolio construction, leveraged products, account churning and the like. It is therefore imperative that in the absence of a fiduciary standard amongst all registrants, that non-registrants be able to also refer to registrants that are fiduciaries.

We have no doubts that most advisors probably have the best of intentions - however, proficiency concerns in the traditional advice channel clearly still exist and need to be addressed before the best interest guidance introduced by the CSA achieves its desired outcomes. A recent paper from authors who had access to "comprehensive" trading and portfolio information from more than 4,000 advisors and more than 500,000 clients from 1999 to 2013 painted this proficiency issue as follows:

"[M]ost advisors invest their personal portfolios just like they advise their clients. They trade frequently, prefer expensive, actively managed funds, chase returns, and under-diversify. Differences in advisors' beliefs affect not only their own investment choices, but also cause substantial variation in the quality and cost of their advice. Advisors do not hold expensive portfolios only to convince clients to do the same – their own performance would actually improve if they held exact copies of their clients' portfolios, and they trade similarly even after they leave the industry."[17]

Although proficiency reforms are a potential solution to this issue of investor protection, it is possible that better investor protection and outcomes can also be achieved when the client is referred to a fiduciary portfolio manager. In and of itself, the fiduciary relationship can go a long way in helping to avoid the sorts of aforementioned complaints. At the same time, the client receives access to professionals

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[14] Closet indexing is a strategy used to describe funds that claim to actively purchase investments but, in reality, have a portfolio that looks very similar to the benchmark index.
[15] Clare O'Hara, "Regulators launch probe into the 'closet indexers' of the mutual fund industry," The Globe and Mail, March 2, 2016
[16] Alberta Securites Commission, "What's in a name? Does the title of your investment professional matter?" July 7, 2016
[17] Linnainmaa, Juhani T. and Melzer, Brian and Previtero, Alessandro, The Misguided Beliefs of Financial Advisors (May 16, 2018). Kelley School of Business Research Paper No. 18-9. Available at https://brianmelzer.com

registered as Associate Representatives (ARs) and/or Associate Advising Representative (AARs) which undergo highly stringent proficiency requirements that can ensure investors' portfolio advice needs are more adequately met.

It cannot be overstated that the goal of regulators must be to increase the likelihood of people discovering or being referred to relationships that protect the investor better and not limit the amount of people that are motivated to inform and refer to better suited solutions.

Limiting Referrals Means More of the Status Quo

The cumulative effect of prohibiting non-registrant referral payments are clear—fewer investors will learn about and access sophisticated portfolio management through fiduciary relationships obliged to serve their best interests at lower costs. At the same time, more investors will remain in traditional advice channels that have historically been misaligned with investors' best interests and for years have charged investors more for less.

In addition, any regulation which prohibits referral payments to non-registrants while continuing to allow them for registrants will immediately shift the playing field in favour of fund distributors and traditional advice channels. It follows that many investors will remain invested in high-fee products predicated on advice and recommendations that were never required to take their best interests into account. Over time, small registrants and low-cost solution providers will struggle to compete with the traditional advice channels in this environment. Many smaller firms and Fintech innovators will have no choice but to leave the industry altogether which will lead to a reduction of investor choices. Before long, we would see that the only companies receiving referrals would be those that were doing so via a conflicted relationship.

To avoid these negative outcomes, we believe it is important that CSA members eliminate or significantly narrow the prohibitions against non-registrants.

CSA Question #2 - 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?

Narrowing Section 13.8.1 while leaving Section 13.8(1)(a) intact still results in the non-registrant payment prohibition that we believe will lead to less clients assessing lower-cost advice solutions that can better serve their interests.

We therefore think that investor protection would only be enhanced if Section 13.8(1)(a) is also narrowed to allow certain types of non-registrants to continue referring to low-cost solutions for a fee. Assuming that 13.8(1)(a) is meaningfully amended in this regard, we agree that setting a cap on referral fees would help enhance investor protection. However, we advise against doing so through a nominal one-time payment cap.

A nominal one-time payment cap, if set too low, would likely incentivize greater usage of embedded compensation products. Given embedded compensation products (i.e. trailer fees) grow as a percentage of AUM and continue to be paid in perpetuity, one-time referral payments for referring into a low-fee product would clearly become a more unattractive option for a referrer to refer to compared to the less investor friendly product that pays them more. At the same time, setting the one-time referral fee cap too high may encourage referral churn which is also not an ideal outcome for investors.

As such, we recommend setting a cap of 1% of AUM on referral fees for registrants and non-registrants. We believe this will continue to incentivize referrals to low-cost solutions as it keeps a level playing field with traditional compensation incentives that have been allowed to remain in the industry.

Beyond a 1% cap as suggested above, we believe the other provisions in 13.8.1 are unnecessary and could actually work against investors. We therefore suggest these provisions be removed per the rationale below.

13.8.1(a) - the referral fee constitutes a series of payments that continue longer than 36 months from the date of the referral

Setting a time limit (whether 36 months or longer) will incentivize churning behaviour and lead referrers to refer clients to other providers at the end of the 36-month period (or whichever period is set) so that their revenue stream is not disrupted.

In addition, this would also make referrals to lower-fee solutions less desirable than higher-fee products paying embedded compensations in perpetuity. Given these are clearly negative client outcomes that do not enhance investor protection, we advise against setting a time limit on the referral so long as higher fee alternatives like mutual funds with embedded compensation continue to exist in the marketplace.

13.8.1(b) The referral fee constitutes a series of payments that together exceed 25% of the fees or commissions collected from the client by the party who received the referral

Capping the referral fee payments at 25%, absent any cap on the referral fee permissible, would encourage referrals into high-fee products that will allow a referrer to earn more revenue relative to a referral to a lower-cost solution. For this reason, we would strongly caution against using a percentage of total fees collected cap at any level.

To illustrate how this scenario would play out, imagine an advisor had the option to refer to two different products (one product had a fee of 30 basis points, or 0.30% while the other had a fee of 4%). The firm offering Product A could only pay 7.5 basis points to the advisor for the referral to avoid breaching 13.8.1(b). On the other hand, the firm offering product B could pay the advisor as much as 1% and, despite subjecting the investor to a significantly higher cost, keep the firm onside with 13.8.1(b). There is no way this outcome is desired or intended.

Other unintended consequence that could come from leaving 13.8.1(b) would be the inadvertent incentivizing of firm A to increase the price of its low-cost solution so that they are able to incentivize others to refer to their solutions.

Both outcomes are negative to the end investors so we would advise against proceeding with implementation of this section.

13.8.1(c) The referral fee results in an increase in the amount of fees or commissions that would otherwise be paid by a client to the party who received the referral for the same product or service

This provision will work against investors not acquired through referral channels as it will lead firms to increase their entire fee schedule to put them on par with what clients pay under the referral arrangement relationships.

In the alternative, firms may simply marginally enhance the product or service offering received by the clients referred so that it is able to justify that investors acquired through referrals are not receiving the identical service as other clients of the firm and therefore can be charged a different fee.

Due to this provision likely raising all fees and also being difficult if not impossible to properly monitor and enforce, we believe a simple limitation on 13.8.1 to focus on a referral fee cap of 1% combined with strict guideline on transparency of referral fees to investors would be a far more practical way to set a meaningful limit on referral payments that protects investors.

CSA Concerns & Comments About Referrals

In this section of our response, we have addressed the specific concerns and comments raised by the CSA in the proposal paper about referral arrangements. Throughout, we have tied the discussion in this section to broader impacts that we foresee as ultimately being negative to investors, the industry and Canadians' retirement security. This is followed by our recommendations at the end of this paper.

CSA Concern #1: There is a concern that referral fee payments provide an incentive for registered individuals to give up their registration. There is a potential regulatory arbitrage concern created when registered individuals can generate similar levels of income without incurring the added oversight and cost of being registered. Remaining players in the system all pay higher costs as more registrants give up their registration and investor protection suffers as more of the advice and relationship chain is held outside the purview of regulators and compliance officers

Like the CSA, we believe regulatory oversight is an important pillar of investor protection and that referrals should not be used as a way to circumvent securities regulation. However, it seems that important issues around market realities, client expectations and investor protection are oversimplified or ignored altogether in this particular argument.

Presently in the securities industry, there are about 83,000 individuals registered to sell mutual funds and another 29,284 registered to sale other types of securities.[18] In recent years, we have also seen lower-cost solutions including online advisors and low-cost ETFs gain popularity despite mutual funds still being where the majority of assets are held. By contrast, there are only about 17,000 licensed Certified Financial Planners (CFPs) in Canada.

A continued emphasis on fee transparency makes it conceivable that this development will erode the value proposition for advisors selling high-fee products to clients who have modest assets and/or straightforward advice needs. Given lower-cost alternatives in the market that can fill these needs at a fraction of the cost, it is clear that purely selling mutual funds is becoming riskier as a career choice and that financial professionals may be positioning themselves to offer specialized services, like tax planning via investments, while outsourcing securities advice. We must therefore respectfully disagree with the notion that non-registrants that surrender registration are doing so for regulatory arbitrage reasons.

[18] Number of approved persons according to the 2017-2018 IIROC Annual Report and 2017 MFDA Annual Report (most recent).

In our view, there is also a disconnect between what the proposals seem set on imposing (more advice within the securities advice channel) relative to what investors need (advice beyond securities). According to research undertaken by Accenture in 2017, roughly 4 in 10 investors do not feel that they are getting what they pay for under traditional advice which is leading investors to seek out other alternatives.[19] Separate research undertaken on the topic also suggests that 68% of emerging wealthy and HNW investors already prefer hybrid models to traditional advice models.[20] These numbers should not come as a surprise considering investors need objective advice to achieve financial goals that goes beyond picking “winning” investments.

Investors need individuals specialized in savings, debt management, budgeting, tax, estate, and other areas of financial planning that SROs have publicly stated go beyond what they require.[21] It is therefore unclear how more non-securities advice being delivered to investors by non-experts under traditional securities advice channels better protects investors relative to referral arrangements where fiduciary PMs handle securities advice and a financial professional handles specialized non-securities advice outside the scope of securities regulation.

In our case, most of the non-registrants that are currently incentivized to refer to our platform are under the purview of other regulatory bodies such as the provincial insurance regulators. The vast majority of other independent professionals have industry accreditations (i.e. CFP, CFA, CPA). In all cases where a referral arrangement leads to a PM or other registrant servicing a client, there is some level of oversight by a securities regulator. In other cases, a referral arrangement also results with a client working with registrants in two different regulatory regimes. As such, labelling registrants in other sectors as non-registrants and taking away their incentive to refer clients to securities registrants brings no apparent regulatory oversight benefits to investors as the CSA suggests. It does, however, risk that today’s insurance professionals and tomorrow’s financial professionals that would be referring to low cost portfolio management solutions will simply sell the investor a higher cost segregated fund or cause the investor to overpay for market exposure.

There are also investor issues and risks that are introduced if financial planning and specialized areas of non-securities advice are left to the devices of the securities regime and registrants. As the Financial Planning Standards Council (FPSC) has warned in the past, key investor protection concerns exist regarding the “information asymmetry” between registrants and clients as well as the “expectations gap” created by use of titles that do not accurately reflect registrant proficiency which puts consumers at risk.[22] In their recommendations to the CSA, the FPSC also clearly warned that inherent risk to consumers can be presented if investors are left to receive financial planning from registrants lacking the appropriate proficiency and educational foundations. When we consider that all it takes to become a registrant in some regimes is completion of the Canadian Investment Funds Course Exam, the Canadian Securities Course Exam or the Investment Funds in Canada Course Exam, we would agree that these registrants are not the best suited to handle more specialized financial planning needs of clients.

In sum, it may seem logical that investor protection would benefit from more registrants and advice relationships being subject to oversight by the securities regulatory regime. However, this expectation ignores that misleading titles continue to be an issue in the industry and that investors need

[19] Accenture Consulting, "Powering Hybrid Advice in Canada," 2017.
[20] Accenture Consulting, "The New Face of Wealth Management in the Era of Hybrid Advice," 2017.
[21] Michelle Schriver, "What happens when advice breaks up with investments," Advisor's Edge, January 25, 2018
[22] Financial Planning Standards Council Response to CSA Consultation Paper 33-404 – Proposals to Enhance the Obligations of Advisers, Dealers, and Representatives Toward Their Clients. September 30, 2016

financial advice beyond securities selection - something today's registrants in the securities regime lack the necessary proficiency to provide. As such, we must warn that acting on these misconceptions could have catastrophic consequences for the retirement security of Canadians and that we should encourage arrangements where investors can benefit from specialized advice being provided from specialists, not generalists.

CSA Concern #2: We have noted several instances where non-registrants are receiving the bulk of the revenue generated through registerable activity. In some cases, registrants are reporting that greater than 80% of the revenue generated through registerable activities such as portfolio management is being handed over to non-registrants as referral fee payments. As a principle, there is a belief that if an individual is receiving the bulk of revenues from the registerable activity then that individual should be registered.

Many of today's mutual fund investors are paying 1% of their assets every year through a trailing commission predicated on "ongoing advice" that, in some cases, means an investor simpy attends a one-hour annual meeting with their dealing representative. The 1% trailer commission deemed appropriate by the regulators does not amount to 80% of fees paid by the investor but ultimately still leaves him/her paying over 2% in annual fees with almost half of those fees going to a dealing rep that may not be doing very much for a client. Therefore, we maintain that it is more appropriate to focus on the situation that investors are ultimately placed in than the percentage of fees being paid to non-registrants.

Technological developments have allowed firms to offer certain services such as portfolio management at a significantly lower cost than traditional alternatives. While we believe that whether or not the client is better served as a result of the referral arrangement and that there is transparency with respect to what he/she has agreed to pay is paramount, there are also cases where a client may be using the "referral" as a way to subsidize the payments for other services rendered by the professional they work with from the assets held in custody by the registrant. In many ways, this is like the fee-based model that most advisors and registrants have been moving to in recent years but instead of all the services being provided by one advisor, they are parsed out to a series of specialists.

Per NI 31-103, referral agreements must be clear as to who is conducting the investment and registrable activity. Provided the client receives and agrees to the material terms and there is no other embedded compensation paid by the client that he/she is not aware of, then it is unclear how this type of arrangement compromises investor protection. It is also not clear how the alternative being suggested by the proposal is better for the end investor given they would almost certainly pay more in fees and receive less sophisticated portfolio advice.

CSA Concern #3 - There are market power concerns regarding the ability of referring agents to extract referral fees from registrants. Certain registrants may not want to pay the referral fee or current referral fee levels but are being forced to under the current system.

As earlier suggested, we believe setting a cap of 1% would prevent agents from being able to extract unreasonably high referral fees from registrants while creating a level playing field with other embedded compensation incentives that exist in the industry.

While we are confident that controls within NI 31-103 reasonably mitigate the bigger risk of clients entering into relationships that are clearly not in their favor, it may be helpful to also codify the requirement that referral arrangements expressly stipulate that the registrant or the client reserve the right to discontinue a referral arrangement at anytime and without the express permission of the referring agent.

Other Important Investor and Industry Considerations

Despite comments from the industry and the CSA to date, there is clearly a lot of uncertainty surrounding the investor outcomes that the CSA's referral proposals will actually achieve. If the CSA is wrong about its anticipated outcomes, we believe the consequences could be devastating not just to investors but to the entire financial technology (Fintech) sector that is actively delivering solutions to improve, amongst other things, the retirement security of Canadians. Considering what is at stake, we believe it is important to undertake a more cautious approach to policy formulation and avoid advocacy of policy directions based on speculation as the CSA seems to suggest in some instances:

> *"For PMs that service retail clients to some degree (60% of PM firms and 9% of PM assets), a large share of their referral arrangements are with non-registered entities such as financial planners.* ***These firms will likely need to turn to alternatives such as traditional advertising to attract clients. However, it is not clear where the clients being referred to PMs by financial planners today would go in the future. Some referring agents may decide to become registered and bring over their clients in order to keep existing relationships and revenue lines intact. Others may decide to refer clients to alternative financial service providers instead.****"*

As we have previously argued, incentivizing non-registrants to refer to PMs like those in the Fintech space leads to investors' best interests being served by fiduciaries at a fraction of the cost of traditional alternatives. So long as referring agents (including financial planners and professionals / non-registrants specialized in other areas of financial advice) do not engage in securities advice, they are unlikely to pursue registration. At the same time, there is also a risk that more clients will simply end up in higher cost products outside of the securities regime such as segregated funds. Thus, it seems counterintuitive and risky both for investors and the industry to advocate referrals going to "alternative financial providers" with uncertainty as to the standard of care and value that investors would receive. Given these uncertainties, the CSA owes it to registrants to better understand the business impacts of its proposals and why traditional advertising alone is not a realistic substitute to referral arrangements.

Negative Impacts on Fintechs & Why Governments Would Care about Referrals

Study after study show that the majority of people (at least 84% by some accounts) rely on referrals and recommendations from trusted individuals as the most trustworthy source of information.[23] Also considering earlier statistics that at least 50% of individuals would base their decision to work with an asset manager/adviser merely on the prospect of working with a fiduciary or from a trusted person's recommendation, referrals are strategically important to keeping the securities industry competitive with other segments of the financial industry that will still be able to refer. More importantly, referrals are a powerful tool that can help address the problems of low fee awareness and transparency limiting the retirement potential of Canadians.

Despite it being almost two years since the Client Relationship Model Phase 2 (CRM2) requirement to provide annual charges, compensation and performance reports came into effect, 79% of

[23] The Nielsen Company (US), LLC. "Global Trust in Advertising and Brand Messages," September 17, 2013

Canadians are still unaware of CRM2 according to some studies.[24] This suggests roughly 4 out of 5 investors could still be in the dark about advice fees and/or fund management fees never explicitly required under CRM2 statements.[25] When we consider the average Canadian household that is unaware about fees can pay hundreds of thousands of dollars over their lifetime on fund investment fees (and lose around 50% of investment gains to fees in the process), we believe that the issue of fee transparency is really an issue about retirement security for Canadians.[26] We need to be doing more to inform Canadians that there are alternatives that can help them save more for retirement by reducing their fees. Unfortunately, the lack of awareness surrounding fees and digital solutions are limiting greater adoption of these alternative channels.

As of 2017, only 10% of Canadians had used an automated online investing service and only 16% were even familiar with the service. Many investors (44%) indicated they did not know whether there were fewer rules for robo-advisers or whether they charged lower fees (49%) despite the fact that robo-advisers are fiduciaries that charge significantly lower fees than traditional advice channels. Of those that used low cost advice channels, almost half of investors (44%) with higher investment knowledge did so due to lower fees.[27] It is clear to us from these statistics that if more investors had true fee transparency and awareness, that more investors would willingly adopt alternatives that can help them better prepare for retirement.

Despite the clear benefits that low cost advice brings to investors, it costs an American robo-advisor, on average, $389 USD (or about $500 CAD) to acquire a new customer.[28] Similar numbers have been found in the United Kingdom, albeit slightly higher at a range of roughly £200 to £500 (which translates to a median of about $595 CAD).[29] In the Canadian market, the issues of low investor awareness around fees and alternative low-cost solutions do not paint a prettier picture. As such, referrals from financial planners and other professionals have permitted portfolio managers to continue servicing lower value accounts at 0.5% management fees. If non-registrants lose their incentive to refer to low-cost solutions, it would cost the PM servicing lower value accounts roughly $500 CAD to acquire the account and over five years to cover the cost of acquiring that account. Shutting off referrals therefore risks a discontinuation of firms being able to, or willing to, service these account types in the future which could again paint a big question mark around how lower-income Canadians would get access to advice. On the other hand, if regulations allow Fintechs to continue acquiring these accounts through lower cost referral channels, this could ultimately translate into hundreds of thousands of dollars in additional savings for Canadians entering retirement.

In our view, Portfolio Managers in the Fintech space offer clear benefits to improving the retirement security of Canadians. For these reasons, we believe the CSA should be exploring policy alternatives that will lead to more investors being referred to lower cost solutions that better serve their needs. This requires expanding the number of people incentivized to refer to alternative solutions, not limiting it. With that in mind, we propose the following recommendations for referral arrangement reform in the industry.

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[24] "Has CRM2 Missed the Mark? Most Investors in Canada Unaware of or Unfamiliar with New Fee and Performance Disclosures, J.D. Power Finds," Business Wire, August 16, 2018

[25] Tim Shufelt, "New investment statement still won't expose billions of dollars in fees", The Globe and Mail, January 18, 2017 (Updated May 17, 2018)

[26] Bates, Larry. "T-Rex Score." www.larrybates.ca/t-rex-score/ (accessed October 17, 2018)

[27] 2017 CSA Investor Index. Innovative Research Group, Inc., November 23, 2017

[28] Business Insider Intelligence, "The US still has the robo-advisor lead," Business Insider, April 26, 2017.

[29] FT Adviser, "Robo-advisers pay £500 for each client," September 13, 2017

Recommendations

1. *Cap referral payments to registrants and non-registrants at 1% of referred assets*

We believe that setting a cap of 1% of AUM on referral fees for registrants and non-registrants will continue to incentivize referrals to the best solutions including low-cost solutions. This will avoid referral payments that are excessive while keeping the playing field level with traditional embedded compensation incentives that have been allowed to remain in the industry.

2. *365-day Restriction on Non-Registrants that Surrender Registration*

To address concerns with individuals giving up registration to immediately pursue income through referral payments, we recommend that the CSA implement a time restriction that prohibits a registered firm from paying a referral payment to a non-registrant until 365 days have passed from the time the individual was deregistered on the National Registration Database (NRD) system.

We would suggest carving out an exception to the above year long non-referral period if the registrant could demonstrate that by undertaking the resignation and referral process 1) their clients are better off and 2) they wouldn't have been able to refer their clients to the better situation unless they had resigned.

While we believe it is important for the CSA to recognize that there are important market realities actively eroding the value proposals of registrants in some regimes, we believe this restriction would introduce a new opportunity cost for registrants and help with CSA member concerns about registrants surrendering registration while also making sure any new rules do not get in the way of investors having their interests put first.

3. *Prohibit Referral Payments to Non-Registrants with History of Conduct Problems*

Registrants should be prohibited from being able to pay referral payments to non-registrants who have had registration penalties or suspensions in the securities industry (or similar regulatory misconduct under other jurisdictions) or have otherwise been deemed unfit to be registered by regulatory bodies.

To help registrants in this area, we recommend that the CSA work with other financial regulators in Canada (i.e. FSCO and related provincial regulators) and local/global professional accreditation organizations (i.e. CFA, CSI, etc.) to implement a database that builds on the CSA disciplined list. We note a similar approach was undertaken by U.S. regulators and can significantly enhance the quality of referrers that can refer to securities registrants in exchange for referral fees.[30] To do this, the CSA could establish Memorandums of Understanding (MOUs) with these organizations modeled on the MOU that the Ontario Minister of Finance approved between FPSC and the OSC.[31]

Through these MOUs, cooperation can be sought towards the sharing of information regarding registration/certification and compliance and enforcement activities where appropriate and in the public interest. In our view, establishing a greater level of transparency between different industry regulatory and

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30 James Langton, "SEC launches additional investor protection search tool," Investment Executive, May 2, 2018

31 2017 Enforcement and Disciplinary Review Report. Financial Planning Standards Council, April 19, 2018 - see page 17.

professional bodies can lead to the financial services industry better adapting to evolving investor needs and strengthen consumer protection. At the same time, these initiatives can prevent bad actors from utilizing referral arrangements as a way to circumvent regulation and enhance investor protection arising from referral arrangements.

4. *Require registrants to disclose referral fees clearly and separately from other fees to investors on client reporting*

To improve fee transparency for investors in referral arrangements, we recommend that NI 31-103 be modified to codify the requirement that referral fees must continue to be disclosed to clients on an ongoing basis in client account reporting. Rather than doing this through an annual report, we believe this should be provided to clients through quarterly or monthly account statements. Referral fees paid to referring agents should be clearly disclosed separately from other fees that the client has paid to ensure that there is no embedded compensation that the client is unaware of.

5. *Require registrants to conduct and document ongoing referral arrangement due diligence and include these results in the firm's annual Chief Compliance Officer (CCO) report.*

Firms should undertake and document initial due diligence on new referral agents to ensure compliance with existing NI 31-103 requirements and our aforementioned referral arrangement control enhancements proposals.

On an annual basis, firms should also receive signed attestations from referring agents confirming that the agent continues to comply with the terms of the referral arrangement including the requirement to not engage in any registrable activity.

To aid CSA members in assessing registrants' compliance with referral arrangement requirements, we recommend that registrants be required to document the results of its referral agent due diligence in the firm's annual CCO report. Where deficiencies or issues are identified, these should be noted in the CCO report along with an explanation of the steps taken by the firm to resolve the issue(s) identified.

Closing Comments

Overall, we believe better investor outcomes will be achieved if regulations create a level playing field that provide investors with better information and give investors greater choice and access to wealth solutions that can best serve their needs.

While we acknowledge that reforms could be made around referral arrangements to enhance investor protection, it is clear to us that de-incentivizing the majority of the population from referring to low-cost, fiduciary type relationships is not the best way to protect Canadian investors.

Beyond giving clients better securities related outcomes, referral arrangements have the potential to lead to partnerships between low-cost portfolio managers and independent financial professionals not compensated for product sales. This gives investors low-cost advice that takes their best interests into account and specialized advice on more complex subjects.

So long as the objectivity of financial advice that registrants in our industry provide is compromised by sales incentives while proficiency issues exist, unacceptable risks to investor protection will remain a clear and present danger in our industry. We must also recognize that investor expectations are evolving and that a one-size fits all model is clearly not only bad for the competitiveness in the industry, but also for the end consumers.

For these reasons, it is critical we find ways to get the greatest number of investors into the best possible solution for them. To do this, regulators must expand the number of professionals that can refer to better independent solutions, not limit it.

We hope you will consider our recommendations on the proposed referral reforms and look forward to your final decision on the matter.

Sincerely,

Nest Wealth Asset Management Inc.

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