Eric Adelson
Senior Vice President
Head of Legal – Canada
Tel: 416-228.3670
Fax: 416-590.1621

Invesco
5140 Yonge Street, Suite 800
Toronto, Ontario M2N 6X7

Telephone +1 800 874 6275
Facsimile +1 800 631 7008
invesco.ca
institutional.invesco.ca

VIA 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 Commissions of New Brunswick
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Island
Registrar of Securities, Northwest Territories
Registrar of Securities, Yukon
Superintendent of Securities, Nunavut

October 19, 2018

Dear Sirs/Mesdames,

Re: CSA Notice and Request for Comments
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*
Reforms to Enhance the Client-Registrant Relationship (Client Focused Reforms)

We are writing in respect of CSA Notice and Request for Comments (the "**Release**") on Proposed Amendments to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (the "**Proposed NI**") and to Companion Policy 31-103CP *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (the "**Proposed CP**") - Reforms to Enhance the Client-Registrant Relationship (Client Focused Reforms)[1]. Thank you for the opportunity to submit comments.

Invesco Canada Ltd. is a wholly-owned subsidiary of Invesco, Ltd. Invesco is a leading independent global investment management company, dedicated to helping people worldwide get the most out of life. As of September 30, 2018, Invesco and its operating subsidiaries had assets under management of approximately USD 981 billion. Invesco operates in more than 20 countries in North America, Europe and Asia.

[1] (2018), 41 O.S.C.B. (Supp-1) (collectively referred to as the "**Client Focused Reforms**")

The client-registrant relationship is the cornerstone of the retail wealth management market and any reforms in this area affect all Canadians in significant ways. As an investment fund manager and portfolio manager (primarily), the Client Focused Reforms will impact Invesco directly in some ways but indirectly in many more. For this reason, on September 30, 2016, we submitted comments on Canadian Securities Administrators Consultation Paper 33-404: *Proposals to Enhance the Obligations of Advisers, Dealers, and Representatives Toward Their Clients*[2] and have eagerly awaited the Client Focused Reforms. We believe that the Client Focused Reforms are a clear improvement over the proposals contained in the 2016 Consultation Paper and address some long-simmering issues in retail wealth management. Similar to the 2016 Consultation Paper, however, we believe the Client Focused Reforms go too far in some respects and we will highlight those in our comments herein.

We commend the Canadian Securities Administrators (the "**CSA**") on the consultation initiated by Consultation Paper 33-403 in 2013 which consisted of the 2016 Consultation Paper as well as numerous in person consultations and discussions. It appears to us that, while the CSA has not accepted all of our comments or those of our colleagues, the CSA has made a genuine effort to listen to industry concerns with the proposals and to address those concerns in the Client Focused Reforms. It is clearly time for change in the conduct of registrants and the Client Focused Reforms are consistent with what the CSA has been saying for at least five years. We do not share the criticism from some quarters that this process has taken too long. There is too much at stake, both for registrants and their employees as well as clients, for the CSA and the industry to not get this right. The time taken has clearly been time well spent.

We have tried to organize our comments as follows:

(1) First, we make general comments on the Client Focused Reforms and potential consequences of this initiative;

(2) Next, we review specific provisions in the Proposed NI and Proposed CP, raise issues with these provisions, and propose solutions to those issues; and

(3) Last, we respond to the three specific consultation questions in the Release.[3]

Please note that Invesco Canada is a member of the Portfolio Management Association of Canada ("**PMAC**"). We have participated in PMAC's process to draft its comment letter and are in substantial agreement with the views expressed therein.

General Comments and Consequences

The goal of the Client Focused Reforms is to improve and enhance the client experience when interacting with Canada's capital markets. Canadian securities regulators have a mandate to do this through provincial securities legislation and have been working toward improved client experiences for many years. We applaud the CSA and individual securities regulatory efforts in this regard. It is in everyone's interest, including industry participants, that clients have confidence that they will be treated fairly and appropriately when interacting with our capital markets and we all must work hard to ensure client trust in us is not misplaced. The Client Focused Reforms should help tremendously in that regard.

In the following pages we express our concerns with specific provisions in both the Proposed NI and the Proposed CP. However, there are overriding concerns and consequences that we wish to highlight first. While we have self-interest at heart, our comments here are based on how we perceive the investor experience will change as a result of the Client Focused Reforms.

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[2] (2016), 39 O.S.C.B. 3947 (the "**2016 Consultation Paper**").
[3] *Ibid.* at 13.

The importance of enforcement

As readers of our prior comment letters know, we cannot help but be dubious about the effectiveness of regulatory reform in light of the enforcement approach of Canadian securities regulators. Most rules are not subject to enforcement. Many registrants, once they figure out that a particular rule is not enforced, tend to ignore the rule. That is not to say that the rules are not good, but human nature sometimes requires there to be a consequence in order for a particular activity to be deterred and such deterrence is elusive in Canadian securities law. In the Client Focused Reforms, the conflict of interest provisions are very strong, but if enforcement of these provisions is not assured then the effectiveness of those amendments will die within a few years of enactment.

Proprietary products

One of the biggest conflicts that we face as an independent manager (and, by definition, not owning distribution) is competition from proprietary products. We do not denigrate the quality of the category as a whole, but note that conflicts of interest are pervasive in that space. In our comments later in this letter, we argue that too many elements for addressing this conflict are contained in the Proposed CP and not the Proposed NI, which creates a legal legitimacy concern per the *Ainsley*[4] case, and the effectiveness of these provisions depends on enforcement. Make no mistake, we believe the proposed provisions regarding conflicts of interest and proprietary products should be effective and are well considered; however, absent effective enforcement they will simply die on the vine.

We have raised this issue not to further our own business – although that certainly helps – but because we do not believe that investors are well served by a system that allows pervasive conflicts inherent in proprietary product distribution to persist. The greater the separation between manufacturing and distribution, the less pervasive the inherent conflicts, and that benefits the investor. We do not advocate banning proprietary products as we do not wish to limit investor choice. Many proprietary products are good products and investors should be able to access them. However, proprietary products should be recommended to investors based on their merits rather than on other incentives which may be contrary to an investor's interests due to a conflict of interest. Our specific comments below will reflect this view and we will provide our thoughts on how to practically mitigate these issues. We note that our concern with proprietary products resides not with portfolio managers who place clients in their pooled funds but with distributors who sell both proprietary and non-proprietary products. We have no conflict of interest concerns regarding portfolio managers selling their own pooled funds.

Investor choice

One of our overriding concerns is that the KYP requirements in the Proposed NI will lead to significant product shelf consolidation, which ultimately leads to less choice for investors. Since the release of the 2016 Consultation Paper we, and other manufacturers, have had extensive discussions with dealers about the impact of the Client Focused Reforms on the product shelf offered by dealers. There can be no doubt that the onerous (albeit perhaps necessary) KYP requirements will lead to each dealer offering fewer products and dealing with fewer manufacturers, due to the cost of compliance. The CSA must carefully consider the long-term impact of this likely outcome. We suspect there are those who believe there are too many products available and, thus, they are not concerned with this. However, this limits investor choice among both products and manufacturers when the perceived problems in the industry have nothing to do with a plethora of choice.

We have argued, and will continue to argue, that investor choice is paramount to a vibrant and competitive industry. It is important to understand that different manufacturers have different investment styles, and there are benefits to letting the market determine which of these styles is best. For example, we are currently in a 10-year bull market, so the perception has been created that actively-managed

[4] *Ainsley Financial Corp. v Ontario (Securities Commission)* (1993), 14 O.R. (3d) 280 (Ont. Gen. Div.), affirmed by (1994), 21 O.R. (3d) 104 (Ont. CA) (hereinafter "**Ainsley**").

products are inferior to passively-managed products. However, this is a fallacy because it is based purely on where we are in the market cycle, and does not account for the potential systemic risk associated with passive products. Importantly, numerous academic studies have been made showing that active management adds value.[5] One study cited by Prof. Cremers and colleagues finds that "the average active fund outperforms an equivalent index fund by 36 basis points a year."[6] This study is important as it compares an active fund's performance net of fees with that of an index fund, which is also net of fees, and differs from the more popular studies that simply compare an active fund to a benchmark which itself has no fees included and, thus, cannot be obtained by an investor. We urge the CSA to review this paper and consider the important findings therein. If the dealer shelf is limited to passive products, for example, investors will lose in the end. If the dealer shelf is limited to a small number of actively managed products, investors will have few choices when the market conditions dictate that they invest in that manner and investors will be worse off. For this reason, it is vital that the CSA avoid regulation that may produce a specific investment outcome, despite the personal views of some regulators, and our comments will reflect this view.

Distinction between advisers and dealers

Another of our overriding concerns is the lack of distinction in the Client Focused Reforms between advisers and dealers. Repeatedly the industry has complained that a "one size fits all" approach to the Client Focused Reforms will not work and CSA members have expressed agreement with this view[7]; however, such is not reflected in the Client Focused Reforms. Advisers are almost always subject to fiduciary duties by law, meaning they are subject to a higher standard than that underlying the Client Focused Reforms. The specific provisions in the Client Focused Reforms often make sense for dealers but not for advisers. We strongly support and endorse the views expressed by PMAC on this topic.

Jurisdiction

Finally, we comment on jurisdictional issues. Through the present debate, the CSA has emphasized that the regulatory system is not producing the outcomes for investors that it is designed to produce.[8] We are not aware of how this concept arose but it is a fallacy, pure and simple. The securities regulatory system is not designed to produce any specific outcomes. It is geared toward ensuring fairness in the capital markets so that all participants maintain confidence in those markets and assets are allocated efficiently in our economy. Retail participation in capital markets comes from buying and selling securities. By definition, some will make money and some will lose. The CSA cannot regulate to ensure that all retail investors are winners. That is an impossibility. The CSA does not have expertise in investing per se and should not try to engineer outcomes. It should try to ensure there is general fairness, there is no abuse, and that individual retail investors and institutional investors can deal in the capital markets with the full confidence of a robust regulatory system to ensure they are not mistreated. To the extent the Client Focused Reforms achieve that goal, we are strong supporters of them. Where the Client Focused Reforms go too far and seek to generate an investment outcome, we are adamantly opposed.

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[5] Cremers, Martin K.J., Jon A. Fulkerson and Timothy B. Riley, (2018), "Challenging the Conventional Wisdom on Active Management: A Review of the Past 20 Years of Academic Literature on Actively Managed Mutual Funds," https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3247356.
[6] *Ibid.* at ii.
[7] CSA Staff Notice 33-319 *Status Report on CSA Consultation Paper 33-404 Proposals to Enhance the Obligations of Advisers, Dealers, and Representatives Toward Their Clients,* (2017), 40 O.S.C.B. 4778 at 4781 (hereinafter, the "**2017 Staff Notice**").
[8] *Ibid.* at 4778; 2016 Consultation Paper, *supra*, note 2 at 3956.

<u>Issues that Require Further Guidance</u>

<u>Know Your Client</u>

(1) Gaining a Thorough Understanding of the Client Through the KYC Process

The Proposed CP emphasizes the need for the dealing or advising representative to gain a thorough understanding of the client through the KYC process.[9] The Proposed CP provisions relating to KYC are quite extensive and provide registrants with a helpful list of things they should know about the client at the end of the KYC process in order to make a suitability determination where required. Where the Proposed CP can be improved is the application of these requirements to different business models and to different uses of technology.

In our comments on the 2016 Consultation Paper[10], we expressed concern that the implied message from the CSA was that all dealings with clients are the same and that clients have a choice between full financial planning or do-it-yourself investing, with no options in between.[11] In the Proposed CP, the guidance provided for the KYC requirements is confusing because the guidance is written as if the two options cited are the only ones permitted but there are a few extra sentences which suggest that the KYC obligation may be different depending on the business model, without further elaboration. We believe this attempt at clarification is weak and unhelpful. Further, at the Ontario Securities Commission ("**OSC**") Roundtable[12], Chair Jensen stated that the regulators realize the one-size fits all approach will not work and this was further echoed in the 2017 Staff Notice.[13] That comment does not appear to be reflected in the Client Focused Reforms.

The guidance does not fully recognize the evolution of robo-technology in the wealth management distribution industry. Specifically, the OSC has, to date, authorized two forms of robo-advice: the "call" model, where, after the client fills in an online questionnaire, a registered adviser must speak with the client to review the KYC; and the "no call" model, which is just as the name implies. The OSC has permitted the "no call" model on the basis that the KYC process follows the accepted dealer model questionnaires, including the questionnaire mandated by the MFDA, the algorithms that underlie the KYC process are designed to alert the client to and require the client to resolve conflicting responses, and the end result is a discretionary portfolio. However, the guidance states that the interaction with the client must be "meaningful", although it does not have to be face to face.[14] As there is no difference in the KYC obligation for KYC collected using technology, it is not clear how the "no call" model would continue under the Proposed NI when considering the guidance relating to the client's investment needs and objectives. We believe the CSA should address this point specifically.

Proposed Solution:

With respect to our concern regarding a "one size fits all" approach, we note that this is somewhat addressed in the Proposed CP; however, in our view such guidance is lacking in several respects. Accordingly, we suggest that language substantially similar to the following be included in the Proposed CP to replace the paragraph currently under the heading "Tailoring the KYC process" in paragraph 13.2 of the CP:

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[9] Client Focused Reforms, *supra*, note 1 at 179.
[10] http://www.osc.gov.on.ca/documents/en/Securities-Category3-Comments/com_20160930_33-404_adelsone.pdf
[11] *Ibid.* at 12.
[12] Transcript, *Roundtable Discussion Re CSA Consultation Paper and Request for Comment 33-404, December 6, 2016 at the Ontario Securities Commission*, at 7.
[13] 2017 Staff Notice, *supra,* note 7.
[14] Client Focused Reforms, *supra*, note 1 at 179.

"**Tailoring the KYC process**

The expectations set out herein represent the highest level of KYC that a registrant is expected to obtain on behalf of each client. However, the amount of information and the level of detail required for collection will vary depending on the nature of the relationship between the client and the registrant. We would expect the registrant collect the highest level of KYC for a true bespoke discretionary relationship, where the registrant selects individual securities for the client's portfolio based on the client's situation and not on pre-determined model portfolios. Next along the spectrum would be discretionary relationships where the registrant selects one of a number of model portfolios for the client. As the discretion decreases, the requisite level of KYC should decrease as well. For a more traditional transactional relationship, where the registrant recommends individual securities to the client and the client truly makes the investment decisions, a low level of KYC may be appropriate. In these cases, less emphasis on the client's financial circumstances and investing objectives is acceptable, although the registrant must still take these factors into account when making recommendations to the client. In contrast, for relationships at this lower end of the spectrum, greater emphasis should be placed on the client's investment knowledge, as that is more relevant when the client is making investment decisions and less relevant when the client is placing complete reliance on the registrant. We note that in discretionary relationships, the client is further protected by the common law fiduciary duty."

To address the issues raised by technological innovation, we suggest that the following paragraph be added to the Proposed CP at the end of the section entitled "Interaction with the client":

"In certain online models, the meaningful interaction will occur by the client completing the questionnaire and receiving a recommended portfolio. Often referred to as the "no call" model, further interaction is not required, as distribution models that rely on technology and have been permitted to operate on a "no call" basis must have algorithms that resolve conflicting responses in a meaningful manner, i.e. the client is not simply put into a money market portfolio or a 50/50 balanced portfolio by default in the face of conflicting responses."

(2) Client's Financial Circumstances

Under subparagraph 13.2(2)(c)(ii) of the Proposed NI, the registrant must take reasonable steps to ensure it has sufficient information about the client's financial circumstances in order to make a suitability determination. While the wording in the Proposed NI is vague, the guidance contained in the Proposed CP puts much needed meaning to this requirement. Similar to our point above, the amount of information that is necessary to be collected under this item will depend on the nature of the registrant-client relationship. In this regard, we note the Open Banking initiative[15] in the U.K. and E.U. which requires financial institutions to make customer data available (with the customer's consent) to other financial and non-financial institutions and firms in order to provide products and services beneficial to the client, such as finding the best possible loan terms or savings accounts (among many examples). This is not presently available in Canada and we urge the Canadian regulatory community, including the CSA and the Office of Superintendent of Financial Institutions, to work together and study the U.K. Open Banking initiative as inspiration. Such is necessary for any advisor to get a full financial picture of the individual and meet the requirement of subparagraph 13.2(2)(c)(ii). Absent "Open Banking", it will be extremely difficult to fully comply with this requirement.

That said, we are concerned that threats to a client's privacy would be greatly enhanced if this provision were to be adopted. It is well known that privacy and identity theft are major concerns today. The CSA has issued several notices relating to cybersecurity, most recently CSA Staff Notice 33-321 *Cyber Security and Social Media*[16] in which the CSA states that "Cyber threats and social media pose

[15] *Background to Open Banking*, https://www.openbanking.org.uk/wp-content/uploads/What-Is-Open-Banking-Guide.pdf, and *Open Banking*, https://www.investopedia.com/terms/o/open-banking.asp.
[16] (2017), 40 O.S.C.B. 8483 (the "**Cyber Security Notice**")

growing risks for registered firms. These risks are complex, constantly evolving and widespread."[17] The CSA has made cyber security a priority,[18] implying there is much work to be done. The CSA acknowledges the risks of cyber-attacks elsewhere: "The impact of a cyber attack can spread quickly, potentially affecting the integrity and efficiency of markets globally as well as trust and confidence in the financial system… The number of entities experiencing financial losses, intellectual property theft, reputational damage, fraud, and legal exposure is rising."[19] Six months after the publication of CSA Staff Notice 11-332, the CSA said "cyber security incidents can potentially have far-reaching implication beyond the immediate organizations that are affected."[20] The vulnerability of registrant systems is worsened by the number of firms who do not even use encryption to safeguard information.[21] What is missing from these CSA publications is that while nefarious actors are interested in corporate data, they are also interested in client data for identity theft and related purposes. The hackers are known to strike at vulnerable systems for this purpose. Lowering the risk of inadvertent disclosure of personal information is the current underlying federal and provincial privacy laws that seek to limit the disclosure of personal information to where it is necessary. The CSA has not made the case that the disclosures in the Client Focused Reforms are entirely necessary and we refer you to the comments of PMAC for an excellent discussion on this topic.

The bottom line is that most registrants do not have best-in-class cyber security and even those who do remain vulnerable. This is vital to considering how much information about a client must reside on dealer or adviser systems. While it may be possible for the registrant to provide better advice with more information, we strongly encourage the CSA to weigh the value of that potential against the significantly higher possibility of identity theft where so much of a client's information is located on the registrant's systems. In our view, the case has not been made that the incremental risk of identity theft is worth it, especially in light of the CSA's clearly articulated concerns regarding this matter.

Proposed Solution:

We recommend that the CSA remand this matter for further thought and establish guidance that makes it clear that only KYC which is necessary for the business model should be collected due to the privacy risks inherent in holding this information and the CSA should clearly delineate the appropriate level of KYC on a business model basis.

(3) Client's Investment Objectives

Under subparagraph 13.2(2)(c)(iii) of the Proposed NI, the registrant must take reasonable steps to ensure it has sufficient information about the client's investment needs and objectives in order to make a suitability determination. The Proposed CP elaborates on this by advising registrants to take into account whether the client has other priorities, such as paying down debt or directing money into a savings account. With respect, this is simply outside the scope of securities regulation. This is financial planning, which is entirely different. The government of Ontario is currently working on regulating financial planning, which strongly implies that it does not believe securities regulators have this jurisdiction. The CSA should not be guiding toward outcomes. It is not an expert in how to achieve investor outcomes. It should regulate and guide on behavior and conduct by market participants, registered or not. The guidance in this case does not do that and is not consistent with the purposes of the Securities Act.

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[17] *Ibid.*

[18] Canadian Securities Administrators, *CSA Business Plan 2016-2019*, https://www.securities-administrators.ca/uploadedFiles/General/pdfs/CSA_Business_Plan_2016-2019.pdf, at 5.

[19] CSA Staff Notice 11-332 *Cyber Security,* http://www.osc.gov.on.ca/documents/en/Securities-Category1/sn_20160927_11-332-cyber-security.pdf at 2.

[20] CSA Staff Notice 11-336, *Summary of CSA Roundtable on Response to Cyber Security Incidents,* http://www.osc.gov.on.ca/documents/en/Securities-Category1/csa_20170406_11-336_roundtable-response.pdf*,* at 1.

[21] Cyber Security Notice, *supra* note 16 at 8488.

We remind the CSA that the purpose of the *Securities Act* (Ontario) (the "Act") (and other provinces' securities legislation has similar, although not identical, purposes) is:[22]

(a) To provide protection to investors from unfair, improper or fraudulent practices;

(b) To foster fair and efficient capital markets and confidence in capital markets; and

(c) To contribute to the stability of the financial system and the reduction of systemic risk.

The foregoing is qualified in relation to capital markets. One might argue that mandating that registrants advise clients to put money into a savings account is an investor protection issue and therefore falls within (a) above, but such is definitively not a capital markets activity and the failure of a representative to suggest that course of action to a client is neither unfair, improper nor fraudulent in the context of the capital markets.

Proposed Solution:

We recommend that the CSA delete the following paragraph from the Proposed CP under the heading "Client's investment objectives":

"**Client's investment objectives**

Subparagraph 13.2(2)(c)(iii) requires the registrant to ensure that it has sufficient information on the client's investment needs and objectives. A client's investment objectives are the results they want to achieve when investing, such as capital preservation, income generated by invested capital, capital growth or speculation. A client's investment objectives help establish what particular type of investments are needed to fulfill the purpose of the account or portfolio. Investment needs and objectives are determined based on the client's financial goals, financial needs, and any applicable investment constraints and preferences.

Financial goals can be monetary targets driven by specific future liquidity needs. A client's financial goals can be set for short or long term, but should be specific and measurable. The registrant's approach in ascertaining their clients' investment objectives should include an opportunity for clients to express their financial goals in meaningful terms, such as saving for retirement to maintain a certain lifestyle, increasing wealth by a certain percentage in a specific number of years, investing for purchase of a home, or investing for the post-secondary education of the investor's children.

When establishing a client's investment objectives, a registrant should consider setting out the investment return that would be required to meet the client's financial goals, taking into account the client's risk profile. A registrant should also provide explanations to the client as to whether the outcome of their account or portfolio is on track to achieve their financial goals.

"~~Depending on the nature of the relationship with the client, and the securities and services offered by the registrant, registrants should take into account whether there are any other priorities, such as paying down high interest debt or directing cash into a savings account, that are more likely to achieve the client's investment objectives and financial goals than a transaction in securities.~~"

(4) Requirement to update KYC

The Proposed NI is very clear on the requirement to update KYC, including timelines and triggering events. We agree with this guidance and believe it is helpful. However, one triggering event for updating KYC is when the registrant knows or **reasonably ought to know** of a significant change in the client's information. We do not understand what is meant by the bolded words and urge the CSA to

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[22] *Securities Act* (Ontario), R.S.O. 1990, c.S.5, as amended by, among others, S.O. 1994, c.33, s.2; S.O. 2017, c.34, Sched. 37, s.2; s.1.1.

remove them as it is not clear how the registrant would have this knowledge absent (a) client disclosure or (b) the client being in the news. We suspect the CSA means something different than that, but what the CSA means remains elusive and the guidance on this point is ineffective.

Proposed Solution:

We respectfully request that the bolded language be removed from proposed subparagraph 13.2(4.1)(a)(i) of NI 31-103.

Know Your Product

(5) Information on Returns for KYP

Under subparagraph 13.2.1(1)(a)(i) of the Proposed NI a registrant is required to take reasonable steps to understand a security prior to offering it to its clients and, among the items caught by this provision is the returns of the security. The guidance on KYP is generally satisfactory, however, there is no guidance on what the CSA is seeking on this specific point. For an existing product, presumably the registrant is required to understand the return history of the product. However, it would be helpful if the CSA discussed this in the Proposed CP. We would not expect the CSA to interpret this as simply examining the standard performance data of an investment product or other security but rather understanding where those returns came from and why they fell short or exceeded benchmark performance in various instances. If this is what the CSA intends, it is vital that is so states. More difficult is the applicability of this requirement to new products or securities that do not have a return history or have an insufficient return history to draw any meaningful conclusions. We note that the CSA has expressed discomfort with the use of hypothetical performance in a number of instances[23] but it is hard to imagine anything other than hypothetical performance (whether devised by the manager of the product or by use of a reference index) would be available.

Proposed Solution:

The following should be added to the Proposed CP, immediately following the bulleted list under the heading "Understanding the securities made available to clients":

> "In addition to understanding the basis of a security's return as set forth above, the registrant should also understand the return history of the security and what factors have affected that return history. For a new security without a return history, the registrant should undertake this analysis based on a reference index recommended or a hypothetical performance profile constructed by the product sponsor."

(6) Applicability of KYP to Portfolio Managers

The proposed KYP obligations are proposed to be added to Part 13 of NI 31-103. Part 13 itself is separated into divisions with the KYC, KYP and suitability determination contained in Division 1 which is stated not to apply to investment fund managers. The structure of Part 13 (and NI 31-103 generally) is that the provisions apply to all registrants unless specifically excluded. Therefore, the KYP obligations apply to portfolio managers.

In the 2016 Consultation Paper, the KYP obligations were stated to apply to investment products and there were numerous comments on this as it was unclear what was contemplated. As a result, these provisions in the Proposed NI apply to "securities". From a portfolio manager's perspective, this is problematic. A portfolio manager is typically responsible for investing on behalf of a client, whether that

[23] OSC Staff Notice 33-729 *Marketing Practices of Investment Counsel/Portfolio Managers*, (2007), 30 O.S.C.B. 9213 at 9214-9216; and CSA Staff Notice 31-325 *Marketing Practices of Portfolio Managers*, (2011), 34 O.S.C.B. 7436 at 7439-7440.

client be a direct investor, or a mutual fund or other investment product. In those cases, the portfolio manager selects individual securities, such as stocks and bonds, to invest in a portfolio. Under proficiency requirements contained in s.3.11 of NI 31-103, a portfolio manager is required to have a certain level of proficiency and most individual portfolio managers are CFA Charterholders. Importantly, by common law (and codified law in the Province of Quebec), all portfolio managers are subject to a fiduciary duty. As such, they are well trained in how to select securities and are subject to an elevated duty of care to their clients in making those decisions. Therefore, it is not necessary for the CSA to mandate a KYP process around those individual securities that a portfolio manager must follow and we suspect that is not what the CSA intended in this case. Rather, we suspect that the CSA intended this provision to apply to portfolio managers who deal directly with clients and are, effectively, asset allocators; that is, these portfolio managers select investment products to include in a client's investment portfolio, in which case imposing a KYP obligation is at least defensible. However, to apply the KYP provisions to a portfolio manager in deciding whether or not to buy Loblaws stock in a client portfolio simply does not make sense.

Proposed Solution:

The KYP obligation should be re-written to either exclude portfolio managers from its application or to apply only when the portfolio manager is selecting among investment products for the client.

(7) Offering Securities and Services Consistent with How the Registrant Holds Itself Out

Subsection 13.2.1(2) of the Proposed NI requires a registered firm to offer securities and services consistent with how it holds itself out. In the Proposed CP, this requirement is essentially repeated without elaboration. In principle, we agree with the provision but believe it is lacking in certain respects and seek clarification from the CSA on this point.

Is it the intention of the CSA that every possible product mix is acceptable? In other words, is it consistent with the principles underlying the Client Focused Reforms that a firm can hold itself out as offering a mixed product shelf, and yet only allow, say, 10% of all products offered to be non-proprietary products. It is unclear from the language in the Proposed NI or Proposed CP that this would not be acceptable, and therefore this must be clarified. We note that the CSA has sought to define "proprietary products" and we agree with the proposed definition. However, the concept of "open architecture" must also be addressed. We believe that the following are the prevailing business models:

(a) Full captive distribution: A dealer firm sells only proprietary products, as such term is defined in the Proposed NI

(b) Open Architecture: A dealer firm does not offer proprietary products and sells only direct securities or investment products managed by third party manufacturers

(c) Mixed: A dealer firm that is open architecture but also sells proprietary products.

As the Proposed NI are written, it is clear that the third category, "mixed", is prone to abuse. There are many reasons a firm may want to claim "open architecture" yet tilt its product shelf to proprietary products (which are more profitable for the dealer). It is not unforeseeable that a dealer might offer 1 third party product for every 10 proprietary products and claim open architecture. In our view, this would be misleading. While the Proposed NI address misleading claims, these provisions are, by necessity, vague. We note also that the firm KYP obligations are intended to ensure that in a mixed shelf situation, the scenario described does not occur, but there is nothing that actually prevents it.

Additionally, a dealer might be truly independent (in the sense that it is not affiliated with a product manufacturer) but have assets concentrated with one fund manager such as to call into question their independence from that manager. This is problematic as the client of such a dealer may believe that their representative will select products from the universe of available product but the reality is that the selection will be made from a much more limited universe. This also raises competitive market issues and risks oligopolistic tendencies.

Proposed Solution:

In our view, the best way to address this gap is to define “open architecture” and “mixed” and allow a firm to hold itself out as captive, open architecture, or mixed. Accordingly, we recommend moving the definition of “proprietary product” from subsection 14.2(0.1) to the definitions in section 1.1 of the Proposed NI and we recommend adding the following definitions to section 1.1:

“<u>“open architecture dealer” means a dealer that offers only third-party products and no proprietary products and not more than 50% of whose client assets are invested in the products of any single product manufacturer, including affiliates of that manufacturer;” and</u>

“<u>“mixed dealer” means a dealer whose product shelf consists of at least 50%, by number, of products that are not proprietary products and who derives at least 40% of its revenue from products that are not proprietary products, and not more than 50% of whose client assets are invested in the products of any single product manufacturer, including affiliates of that manufacturer.”</u>

In our opinion, if the revenue is above 60% proprietary, that indicates that the firm has selected third party products intended to fill regulatory requirements but that it has concluded that these products are likely to be less competitive against its proprietary products, which would be doing indirectly what the rule seeks to prevent indirectly.

Furthermore, we propose to amend paragraph 14.2(2)(b) as follows:

“(b) a general description of the products and services the registered firm offers to the client, including

(i) whether the firm will primarily or exclusively provide proprietary products to the client, <u>whether the firm is an open architecture dealer or whether the firm is a mixed dealer</u>;”.

(8) Transfers-In

Under subsection 13.2.1(6) of the Proposed NI, before a registrant can accept a transfer-in from another registrant, the receiving dealer must meet the KYP standard for the transferred investment as if it were offering such investment product on its own product shelf. We believe the proposed rule, as written, is impractical and unworkable. If the product is not already on the dealer’s shelf, then it may not be possible to do KYP on the product in the same timeframe as a transfer request is or ought to be honored.

Transfer requests are typically handled by dealers through ATON, which requires both dealers to acknowledge the transfer as a necessary first step. Under the current process, the receiving dealer either approves all securities to be transferred, or it rejects all, without regard to whether the receiving dealer itself offers the security or investment product. As an example, Invesco issues Series PTF securities but only to select dealers that have entered into a Series PTF agreement with us. None of the investment dealers owned by the major Canadian Banks have done so yet they all have accounts that hold Series PTF, which they acquired on transfers-in. Approving transfers on a per security basis would be disruptive as a significant change in process with no clear commensurate benefit. It should be noted that the security was initially acquired on the advice of a registrant under securities laws so the client knows or should know the pertinent details about the security.

More importantly, however, is what occurs if the receiving dealer rejects one security from the account while accepting others? The possible options are (1) the client rescinds the transfer of the account, (2) the client rescinds the transfer of just that security and continues to hold it at the old dealer, (3) the client liquidates the investment prior to transfer. The first option is impractical because the transfer situation arises only after the client has decided to terminate all or part of a relationship with the transferring dealer. Continuing with the previous dealer is certainly not consistent with acting in the client's best interest. This reasoning applies equally to the second scenario above. The third scenario, liquidation, is also impractical as there could be immediate tax consequences to the disposition or the client may wish to continue to hold the security.

Proposed Solution:

It would be preferable to allow the transfer to proceed as is the case today. The KYP concern is valid, as it is difficult if not impossible for a registrant to advise on a security about which it knows little. Therefore, we propose amending subsection 13.2.1(6) and adding a subsection 13.2.1(6.1) as follows:

> (6) In the case of a security transferred by a client from another registered firm that is accepted by the registered firm or of a client-directed trade of a security, the requirements of subsections (1) and (3) apply to a registered firm or registered individual, as the case may be, only insofar as, under those requirements,
>
> (a) <u>subject to subsection (6.1),</u> the firm must not permit the security to be transferred into the client's account or the trade in the security to be made unless the firm
>
> (i) takes reasonable steps to understand the structure, features, returns and risks of the security,
>
> (ii) takes reasonable steps to understand the initial and ongoing costs of the security and the impact of those costs, and
>
> (iii) monitors and reassesses the security, including monitoring for significant changes to the security; and
>
> (b) the individual must not permit the security to be transferred into the client's account or the trade in the security to be made unless the individual takes reasonable steps to understand
>
> (i) the structure, features, returns and risks of the security; and
>
> (ii) the initial and ongoing costs of the security and the impact of those costs.
>
> <u>(6.1) Notwithstanding paragraph (6)(a), the registrant may proceed with the transfer as requested although the receiving dealer must meet the requirements of subsection (1) to (3) within 3 months following the date of the transfer unless the client disposes of any securities during that 3 month period for which those requirements have not been met.</u>

<u>Suitability</u>

(9) Companion Policy Relating to Suitability

Under subparagraph 13.3(1)(a)(vi) of the Proposed NI, one of the factors that a registrant must consider in determining if an action is suitable for the client is "the potential and actual impact of costs on the client's returns".[24] We agree that the potential and actual costs of the investment should be determined in any suitability determination. However, this provision is "explained" in the proposed Companion Policy: "Unless a registrant has a reasonable basis for determining that a higher cost security will be better for a client, we expect the registrant to trade, or recommend, the lowest cost security available to the client in the circumstances that meets the requirements of subsection 13.1(1)."[25] This "explanation" serves to create a presumption in favor of the lowest cost product and requires any higher cost product, even if higher by 0.01%, to be justified. This raises several problems.

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[24]Client Focused Reforms, *supra*, note 1 at 80.
[25] *Ibid.* at 191

First, by biasing regulation toward the lowest cost products, the CSA is seeking to engineer an outcome and this is simply inappropriate. While it may be true that a regulatory body is an expert in the laws and regulations of the area regulated, this does not mean they are expertised in the business being regulated. Further, as mentioned above, the CSA does not have the jurisdiction under securities legislation to provide guidance or promulgate rules with such effect.

Second, we note that the current rulemaking exercise is occurring during a 10-year bull market. In such markets, passive products tend to outperform actively-managed products. But the current market environment is not perfect and some prominent investors are even predicting a market downturn will occur during the time the CSA is considering comments on the Client Focused Reforms.[26] During such downturn, the client may benefit from an actively-managed investment product as noted in the Cremers paper in relation to active management generally.[27] Passive products will decline in line with the market. Viewed from a different lens, passive investing is simply an investment style and, like other investment styles, there are market conditions where it is expected to outperform versus other styles and market conditions where it is expected to underperform.

Third, in most cases, the suitability determination where this will be impacted will be by dealer registrants and the individual dealing representatives (as opposed to advisers). The dealing representative and the dealer, faced with potential regulatory problems and client litigation exposure, will often choose the path of least resistance, regardless of whether that is actually the best decision for the client. We believe this will undoubtedly lead to negative client outcomes. We are aware that some members of the OSC defend this provision as saying it applies only when all other factors and elements are equal but, in reality, such equality does not exist. As such, it is highly likely that s.13.3(1)(a)(vi) will be applied to nearly equal or almost equal or close enough to equal investment possibilities. Even if those other possibilities are better, the registrant knows they will not have to defend the suitability determination when the lowest cost product is chosen. The regulators will surely point to s.13.3(1)(b) which requires that the "action puts the client's interest first" but this is illusory as the regulator is extremely unlikely to question whether the client's interest is put first when the client is placed in the lowest cost product.

Proposed Solution:

The only solution is to leave s.13.3(1)(a)(vi) intact but remove the relevant sentences in the Proposed CP as follows:

"**Potential and actual impact of costs**

Cost as referred to in subparagraph 13.3(1)(a)(vi) is interpreted broadly and can include all direct and indirect costs, fees, commissions and charges, including trailing commissions and any other kind of direct and indirect registrant compensation Annex C: Blackline Showing Changes to Companion Policy 31-103CP Supplement to the OSC Bulletin June 21, 2018 191 (2018), 41 OSCB (Supp-1) which may be associated with a client purchasing, selling, holding or exchanging a security, or a registrant making a decision for a client's managed account.

Costs can have a significant impact on a client's return over time. Registrants must assess the relative costs of various options available to clients at the firm when making a suitability determination, as well as the impact of those costs. This includes assessing the impact on the client's overall return of any compensation paid, directly or indirectly, to the registrant, whether by the client, a registered individual's sponsoring firm, or a third party.

Different options available to clients at the firm may have different costs associated with them. For example, even after registrants have addressed conflicts of interest in the client's best

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[26] Town, Phil, "Are We Headed for a Stock Market Crash in 2018", https://seekingalpha.com/article/4184509-headed-stock-market-crash-2018, June 28, 2018 and Derousseau, Ryan, "'Just Around the Bend': This is When the Stock Market Will Crash, According to 5 Famous Investors", http://time.com/money/5235032/just-around-the-bend-this-is-when-the-stock-market-will-crash-according-to-5-famous-investors/, April 24, 2018.

[27] Cremers et al., *supra,* note 5.

interest as required by Part 13, Division 2 [conflicts of interest], it may be the case that certain options available at the firm compensate registered individuals better than others. For example, recommending certain securities or account types to clients may compensate registered individuals better than other securities or account types available at the firm. Such higher payouts may come at the price of higher costs to the client, directly or indirectly. Registered individuals must put their client's interest first when selecting between multiple suitable options available to the client.

~~Unless a registrant has a reasonable basis for determining that a higher cost security will be better for a client, we expect the registrant to trade, or recommend, the lowest cost security available to the client in the circumstances that meets the requirements of subsection 13.3(1). However, we recognize that there may be reasons why a specific higher cost security available at the firm may be better for a client than other suitable securities available at the firm.~~ We expect registrants to include an assessment of the relative costs of, including the relative compensation associated with, various options available when documenting the reasonable basis for their suitability determinations."

(10) Reasonable Range of Alternatives

Subparagraph 13.3(1)(a)(vii) of the Proposed NI requires the individual registrant, in making a suitability determination, to consider a reasonable range of alternative actions. In the Proposed CP, the "reasonable range of alternative actions" is qualified by the degree of skill and proficiency of the registrant.[28] It is not clear to us what this means.

Proposed Solution:

Elaborate upon this point in the Proposed CP. At a minimum, please explain the baseline for skill and proficiency and what reasonable range of alternatives would be appropriate for such a registrant. Additionally, it would be helpful if the CSA could give examples of a heightened level of skill and proficiency and what this would mean for the reasonable range of alternatives. While providing an exhaustive list is impossible and far beyond the scope of this request, a few additional examples would assist a firm and individual registrant in applying the CSA's reasoning on this point to situations not specifically addressed in the Proposed CP.

(11) Putting Client's Interests First

Clause 13.3(1)(b) of the Proposed NI requires the registrant to put the client's interests first in making a recommendation or decision. The Proposed CP provisions on this point are also, for the most part, helpful: "They must put the client's interests first, whether in terms of remuneration, financial gains or other incentives, and exercise their professional judgment in a client-centric manner when opting for one decision or recommendation among other suitable possibilities, if any."[29] We agree with this statement as an excellent articulation of what it means to put the client's interests first in the context of a suitability determination. Unfortunately, the paragraph continues with an example that, in our view, further muddies the waters as the example talks about not leaving cash uninvested for "unduly long periods of time". While we believe the wording of the Proposed CP is intended to account for portfolio reasons for maintaining cash, the wording used is somewhat indelicate and less helpful than it otherwise could be. For example, it is unclear how one determines if the cash holdings are inappropriate and how long is "unduly long". We believe we understand why the CSA would not be more specific on this point but that makes the guidance less helpful than it would be without that example.

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[28] Client Focused Reforms, *supra*, note 1 at 191.
[29] *Ibid.* at 189.

Proposed Solution:

To remedy the foregoing, we propose to revise the guidance by deleting the offending the sentence in the penultimate paragraph under the heading "Interests of the client are paramount":

"**Interests of the client are paramount**

The client's interests, as distinguished from those of the registrant, are at the core of the obligations under section 13.3. The fact that a recommendation or decision is determined by the registrant, on a reasonable basis, to be suitable for a client pursuant to paragraph 13.3(1)(a) will therefore not be considered to be enough to meet this obligation; the registrant must also determine that the action puts the client's interests first pursuant to paragraph 13.3(1)(b).

A suitability determination comprises both the suitability and the client interest components, in all cases, including:

• upon the occurrence of certain events in accordance with subsection 13.3(2), and

• upon receiving a client instruction.

We expect registrants to act with integrity towards their clients, and pay particular attention to any residual self-interest which may affect client outcomes. They must put the client's interests first, whether in terms of remuneration, financial gains or other incentives, and exercise their professional judgement in a client-centric manner when opting for one decision or recommendation among other suitable possibilities, if any. ~~For example, maintaining inappropriate amounts of cash in the client's account, or leaving cash in the account uninvested for unduly long periods of time would not meet the requirement of putting the client's interest first.~~

If the registrant cannot recommend a suitable type of account or security to the client because these are not available at the firm, we expect the registrant to decline to provide the securities or the services to the client."

As we noted earlier in this letter, we do not believe it is appropriate for regulators to engineer investment outcomes as regulators do not have the expertise to do so. What to do with cash is engineering an investment outcome.

(12) Trade by Trade Analysis

The opening words of subsection 13.3(1) of the Proposed NI set out when the suitability determination must be made, which is before opening an account or taking any action on an account. The Proposed CP discusses the portfolio approach to suitability[30] and we commend the CSA for including this in the guidance as we believe suitability analysis must always be based on the portfolio rather than individual securities. In this regard, however, we find the wording confusing as it states, "Suitability must not be determined only on a trade by trade basis, but rather on the basis of the client's overall situation." The inclusion of the word "only" may lead to registrant processes different from that which is intended. Our interpretation of this guidance is that while every trade triggers a suitability determination, that determination must be conducted at the portfolio level. The word "only" however may imply that the trade must be suitable both with regard and without regard to the portfolio and if that is the intended interpretation, we respectfully disagree.

The CSA has heard repeatedly from registrants about the merits of conducting a suitability determination at the portfolio level only. The reason for this is that a highly risky security placed in a portfolio may lower the risk of that portfolio.[31] A client whose risk tolerance is anything but high may

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[30] *Ibid.* at 189

[31] We believe this is now "received wisdom" from the CSA and, therefore, have not elaborated but we would be pleased to follow up with an elaboration should that be desired.

benefit from including a high-risk investment (such as, for example, gold) in their portfolio which would have the effect of lowering overall portfolio risk.

Proposed Solution:

There are two possible solutions to this. First, remove the word "only" from the guidance quoted above. Second, re-word the guidance as follows:

"Suitability must not be determined only on a trade by trade basis, but rather on the basis of the client's overall situation. By this we mean that while each trade should trigger a fresh suitability determination, such determination must be made at the portfolio level and not the individual security level so that a "low" risk client might still have a "high" risk security in a portfolio if such is justified on a portfolio risk/reward basis."

(13) When Suitability Factors Are Not Met

Subsection 13.3(2.1) of the Proposed NI sets out a regime for accepting an unsuitable trade. We applaud the CSA for including this and we are pleased to see it in the Proposed NI, rather than in the Proposed CP. We believe that it is important for the registrant to explain to the client why the client's instruction is not suitable and for the client to authorize the instruction in writing following receipt of that explanation. Where we differ from the CSA is that we do not agree that a duty to recommend alternatives should be imposed. This is overly burdensome yet vague as the section does not elaborate on what would be acceptable in the way of alternatives. Further, we believe that the suggestion of an alternative will become a meaningless check-the-box exercise to meet the requirement but without any real benefit to the client. Generally, an alternative will not be relevant in the sense that if the client is inclined to proceed, there is no sense wasting time on alternatives and, if the client is convinced of the suitability explanation, only then would it be appropriate to discuss alternatives.

Proposed Solution:

There are two possible solutions to this. First, simply delete s.13.3(2.1)(b) of the Proposed NI. Alternatively, or in addition, revise the guidance in the Proposed CP[32] as follows:

> " A registrant has no obligation to accept a client order or instruction which it considers to be unsuitable. In our view, marking the order as unsolicited is not sufficient. The registrant must take the measures set out in subsection 13.3(2.1) to deal with the order and advise the client in a timely manner against proceeding.
>
> After the registrant explains to the client why the proposed action is unsuitable, if the client accepts this advice then the registrant should propose an alternative course of action, which could include taking no further action.
>
> Should the client choose to keep an unsuitable investment, the registrant does not need to suggest any alternatives. The registrant is reminded that it still must undertake a suitability determination at the portfolio level and, following that, it may be appropriate to recommend changes to other investments held by the client at the firm in order to maintain the suitability of the overall account. Any advice given should be documented if the client declines to follow the registrant's recommendation."

(14) Review of Suitability After the Fact

In the Proposed CP, the CSA states that it

[32] Client Focused Reforms, *supra,* note 1 at 192.

> "will not review whether the suitability determination has been met based on events subsequent to the determination by the registrant, nor do we expect that there is only one best decision, recommendation or course of action: there could be several decisions or recommendations that the registrant has a reasonable basis for concluding are equally suitable and that puts the interests of the client first. Our review will be based on what a reasonable registrant would have done under the same circumstances."[33]

This statement strikes us as problematic for several reasons. First, what is the standard of review? It is easy to say that hindsight will not be applied but it is harder to not apply hindsight in a review such as that contemplated by this guidance. In our opinion, the standard of review should be one of reasonableness, the same standard to which securities regulators are held by the courts.

Second, it is not clear to us what constitutes a "reasonable registrant", given the many different business models and complexity of the industry. The intent behind the drafting is clearly to create an objective standard, however, standards as to acceptable practice in this regard vary among business models. In our opinion, the reasonable registrant should be the registrant with a similar business model and a similar client base and which uses a similar investment approach, so that there is not a 'one size fits all' approach to finding reasonableness. This should be stated clearly.

Third, this provision has no corresponding section in NI 31-103 so it is purely a statement of intent, subject to change at any time. As such, this statement does not provide the comfort intended.

Proposed Solution:

To achieve the intent of this provision, we recommend adding to the Proposed NI a subsection to s.13.3 as follows:

> <u>"(5) The regulator may review any registrant's compliance with subsection (1) solely with regard to the facts and circumstances that the registrant knew or reasonably ought to have known at the time of the determination and shall take no further action with regard to that suitability determination unless the regulator has determined that the suitability determination was unreasonable."</u>

Furthermore, we recommend revising the last paragraph in the Proposed CP under the heading "Review by the regulator of the suitability determination" as follows: "Our review will be based on what a reasonable registrant<u>, having regard to the registrant's business model and investment approach,</u> would have done under the same circumstances."

<u>Conflicts of Interest</u>

(15) Third Party Compensation

While not addressed directly in the Proposed NI, the Proposed CP addresses third party compensation conflicts. We agree that the language in the Proposed NI is broad enough to cover this topic but are concerned with the discussion in the Proposed CP and the interplay with trailing commissions.

The relevant section in the Proposed CP[34] bluntly states that it is a conflict of interest to receive third party compensation. Insofar as the conflict is defined by quantum of compensation, we disagree with this view because in a situation where a mutual fund charges a management fee of 2% and pays a trailing commission of 1%, the client is or ought to be indifferent between that and a mutual fund that

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[33] *Ibid.* at 192.
[34] *Ibid.* at 195

charges a management fee of 1% and the client directly pays compensation to the dealer of 1%. These are, by definition, economically neutral transactions. This should be stated in the Proposed CP.

Insofar as the third-party compensation conflict impacts whether to recommend a product that pays compensation (as opposed to one that does not), we agree that this is a conflict but, again, it must be measured against the direct cost to the client. It has been discussed in comment letters on the embedded commissions consultation[35] that it is rare for a fee-based client to pay 1% to the dealer; rather they typically pay more than 1%. In that case, if the choice for the client is to buy a mutual fund that pays a 1% trailing commission or one that pays nothing but the client has to pay more than 1% to the dealer, then the conflict clearly lies in the decision to recommend the latter product. This duality is often ignored by regulators and now is the time to remedy that situation.

Proposed Solution:

To remedy the foregoing, we propose the following changes to the Proposed CP:

"Conflicts arising from third-party compensation

It is a conflict of interest for a registrant to receive third-party compensation<u>, although there are situations where choosing a non-compensation-paying product over a compensation-paying product will itself be a conflict of interest. Registrants should be mindful of these possibilities when considering account structures for clients. That is, clients who trade infrequently or clients who pay an asset-based fee above a standard trailing commission of 1% may be better off in a compensation-paying product that they can exit at any time and without penalty.</u> We also consider circumstances where registrants receive greater third-party compensation for the sale or recommendation of certain securities relative to others to be a conflict of interest. If a registrant is not controlling these conflicts in the best interest of its clients, the registrant must avoid these conflicts."

(16) Supervisors

The Proposed CP has a section on conflicts of interest at the supervisory level.[36] The discussion in the Proposed CP focuses on compensation related conflicts for the supervisor by framing the conflict as arising when compensation is tied to sales or revenue generation. In contrast, when discussing conflicts relating to the sale of proprietary products generally, the Proposed CP addresses non-monetary conflicts as well.[37] It does not make sense that the CSA would express concern about monetary and non-monetary conflicts at the individual representative level but only monetary conflicts at the supervisory level as it is foreseeable that supervisors might see this as license to act in a non-monetary conflict. We do not believe this is what the CSA intended.

Proposed Solution:

To address this problem, we propose the following modification to the Proposed CP:

"Conflicts of interests at supervisory level

If compliance or supervisory staff's compensation is tied to the sales or revenue generation of the registered individuals that they supervise, this creates a conflict of interest that may cause compliance or supervisory staff to put their interests ahead of the clients' interests. Compliance and supervisory staff may not be able to properly oversee these registered individuals when

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[35] See Invesco Canada's letter, for example, http://www.osc.gov.on.ca/documents/en/Securities-Category8-Comments/com_20170609_81-408_adelsone.pdf at 6.
[36] Client Focused Reforms, *supra*, note 1 at 197.
[37] *Ibid.*, at 194.

compensated in this manner. This is not intended to suggest that monetary or compensation conflicts are the only conflicts present at the supervisory level. Rather, the same conflicts that apply to the individual registrants being supervised apply to the supervisors, including non-monetary conflicts."

(17)Avoiding Conflicts – Loans

Under subsection 13.4.4(2) of the Proposed NI a registrant is not permitted to lend money to a client. An investment fund is typically viewed as a client of the investment fund manager. Under s.2.6(a)(i) of NI 81-102, a mutual fund is permitted to borrow money in two circumstances: (1) as a temporary measure to settle portfolio transactions, and (2) as a temporary measure to fund redemptions. Typically, the investment fund manager lends money directly to the funds in these circumstances, arranges for the fund's custodian to lend money, or employs a credit facility with a lending institution to fund these situations. Under s.13.4.4(2)(b) of the Proposed NI, a registrant that is an IFM is also allowed to lend money to a mutual fund under two circumstances. Only one circumstance is common to both provisions: lending money temporarily to fund redemptions. S.13.4.4(2)(b) appears deficient to us in that it does not allow the investment fund manager to lend money to the fund as a temporary measure to settle portfolio transactions. Therefore, the fund would be obliged, under the Proposed NI to seek a third-party loan in one situation permitted by s.2.6(a)(i) of NI 81-102 but not the other. It is not clear what rationale there would be for this difference and therefore we assume this is a drafting error. Furthermore, the ability under s.13.4.4(2)(b) of the Proposed NI for the investment fund manager to lend money to meet expenses incurred by the investment fund has no foundation in NI 81-102 and, therefore, is not permitted for investment funds subject to that instrument. We agree that an investment fund should be permitted to borrow for that purpose but that would require an amendment to NI 81-102 which is beyond the scope of the Client Focused Reforms.

As drafted, therefore, the following would be the law:

- An NI 81-102 mutual fund can borrow from its manager or a third party to fund redemptions.
- An NI 81-102 mutual fund can only borrow from a third party to settle portfolio transactions.
- An NI 81-102 mutual fund CANNOT borrow from anyone to settle expenses.
- A non-NI 81-102 mutual fund can borrow from its manager or a third party to fund expenses.

This is a less than desirable outcome.

Proposed Solution:

We propose to revise s.13.4.4(2)(b) of the Proposed NI as follows:

"the registrant is an investment fund manager lending money on a short term basis to an investment fund that it manages, if the loan is for the purpose of funding redemptions of its securities, settling portfolio transactions, or meeting expenses incurred by the investment fund in the normal course of its business;".

We propose to revise s.13.4.6 of the Proposed NI as follows:

"Section 13.4 to 13.4.5, except for s.13.4.4(2)(b), do not apply to an investment fund manager in respect of an investment fund that is subject to National Instrument 81-107 Independent Review Committee for Investment Funds.

We propose to add the following to the Proposed CP, immediately prior to "Addressing conflicts between clients" the following:

"***Investment fund manager conflicts***

Clause 13.4.4(2)(b) of NI 31-103 permits the investment fund manager to lend money to an investment fund it manages in certain circumstances. For mutual funds that are subject to NI 81-102, this provision should be read in conjunction with s.2.6(a)(i) of NI 81-102 which does not permit the mutual fund to borrow money to settle expenses. Therefore, investment fund managers of mutual funds subject to NI 81-102 cannot take advantage of paragraph 13.4.4(2)(b) of NI 31-103 and lend or cause to be loaned to the mutual fund monies to settle expenses."

(18)Proprietary Products

The sale of proprietary products alongside third-party products by many dealers is a conflict of interest and the Proposed CP is clear about this.[38] The Proposed CP lists numerous possible controls that dealers can implement in order to act in the face of this conflict. While this guidance is helpful, we are concerned that it does not go far enough, that it is easy to circumvent, and that none of this is contained in the Proposed NI. We believe the Conflict of Interest section of the Proposed NI should include a complete code for the handling of proprietary products. Without the force or law[39], those who face the proprietary product conflict have an incentive to ignore the Proposed CP or to work around it. One such way is with regard to structured products created by the dealer's capital markets desk. These products may have third party representation but often are created for the dealer's own clients as a revenue enhancer for the firm. Given the lack of comparability for these products, it is within contemplation that a dealer would approve the product as unique in its category and thus avoid the suggestions for controlling the conflict in the Proposed CP.

We note that the Proposed CP seeks to address monetary and non-monetary conflicts relating to proprietary products. One such non-monetary conflict is a requirement by some dealers that certain individual representatives have a book of business consisting of 90% proprietary product. We seek confirmation that this practice would not be permitted under the Proposed NI and we ask how the CSA intends to enforce this. Many of the incentive practices put in place by proprietary product dealers are not apparent, and require intensive investigation and consideration. Is the CSA prepared to devote resources to this endeavour?

We also note that the Proposed CP suggests that firms monitor "the use and level of proprietary products in client portfolios to assist in evaluating whether the conflict is being addressed in the best interests of clients." This is an excellent suggestion but, again, it comes back to the enforcement question. Will the CSA members seek information on a regular basis from dealers who distribute both proprietary and third-party products to ensure these statistics are "normal"? Does the CSA have a position on what use and level of proprietary products is indicative of an uncontrolled conflict?

Proposed Solution:

To remedy the foregoing, the CSA should state clearly in the Proposed CP what is a use and level of proprietary products in client portfolios that is indicative of poor controls over the conflict of interest. In our proposed solution in the subsection "Offering Securities and Services Consistent with How the Registrant Holds Itself Out" earlier in this letter, we set forth our views on appropriate thresholds. It is our belief that most dealers would manage to a level set by the CSA and ensure it is not surpassed. Such

[38] *Ibid.*

[39] The statements in the Companion Policy are simply Staff's view of how they will interpret certain provisions. The Companion Policy, therefore, has a legal status similar to that of a Staff Notice, which is something short of the force of law. See *Ainsley, supra,* note 4, and *Pezim v. British Columbia (Superintendent of Brokers)* at [1994] 2 S.C.R. 557 at 596.

an outcome would represent a vast improvement for clients and for competition generally compared to the status quo. The CSA should also direct, or should require the self-regulatory organizations to direct, dedicated resources to patrolling conflicts at dealers who distribute both proprietary and third-party products, at least in the first several years following implementation of these provisions.

In addition, to signal the importance of this particular conflict, the following section should be added to the Proposed NI:

"13.4.X **Proprietary Product Conflicts**

(1) It is a conflict of interest for a registered firm to trade in, or recommend, proprietary products.

(2) Registered firms who offer proprietary products alongside non-proprietary products shall submit to the securities regulatory authority or securities regulator in the jurisdiction, a detailed plan for mitigation of the conflict and may only act in the face of the conflict with the approval of the securities regulatory authority or securities regulator.

(3) Registered firms referred to in subsection (2) shall submit a report, annually, to the securities regulatory authority or securities regulator in their principal jurisdiction setting out a comprehensive list of proprietary products and non-proprietary products offered, categorizing such products based on similarity, and showing the amount of assets and sales in each category."

Referral Arrangements

(19) Payments to Non-Registrants

Under paragraph 13.8(1)(a) of the Proposed NI, referral fees can only be paid to a registrant. Reviewing Division 3 of the Proposed NI in its entirety, it seems clear that the CSA has identified abuses in this area. It would be helpful for the CSA to elaborate on the abuses it has seen.

Of concern to us is the prohibition on referral fees in the context of the institutional market. These are investors that are generally more sophisticated than retail investors and they seek expertise from a variety of sources, most notably pension consultants. There is effectively no difference between a consultant for a pension plan and a financial advisor for an individual yet the latter is regulated and the former is not and under the Proposed NI the latter can accept the equivalent of a referral fee (or an actual referral fee) and the former cannot. Unfortunately, this is not explained very well in the Release and we cannot ascertain the reason for this distinction.

Proposed Solution:

We propose to revise section 13.8(1)(a) of the Proposed NI as follows:

"the person or company receiving the referral fee is a registered individual or a registered firm unless the client on whose behalf the referral fee is paid is a permitted client;".

(20) Quantum of Fee

In the institutional market, referral fees are negotiated between two sophisticated entities. The quantum and duration of the fee is subject to that negotiation. There is no indication of an imbalance of bargaining power in those negotiations and, therefore, it is unclear why the quantum or the duration of the fee should be regulated in those cases.

Proposed Solution:

We are reluctant to suggest deletion of s.13.8.1 of the Proposed NI without hearing from the CSA as to the rationale for the provision. However, consistent with our comments on payments to non-registrants, we do not believe these limits should apply to institutional clients and, therefore, propose the following revisions to s.13.8.1:

"13.8.1 Limitation on referral fees

(1) A registrant must not provide or receive a referral fee if one or more of the following applies:

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

(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;

(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.

(2) Subsection (1) shall not apply to a referral arrangement on behalf of a permitted client,".

Misleading Communications

(21) Titles

Under paragraph 13.18(2)(b) of the Proposed NI, a registered individual may not use a corporate officer title unless they are duly appointed under corporate law. We understand the rationale for this in that a corporate title may convey a level of expertise and status on a registered individual that is not warranted and this may mislead a client or potential client. It is not clear, however, why this type of restriction would be necessary for registrants who are not client-facing. For example, at Invesco, we manage investment funds and most of our portfolio managers have the title "Vice President" even though they are not appointed corporate officers. We are unaware of any harm this has caused and, therefore, question the necessity of this restriction in our own situation.

Proposed Solution:

We propose to revise s.13.18(2)(b) as follows:

"a corporate officer title unless their sponsoring firm has appointed that registered individual to that corporate office pursuant to applicable corporate law, unless the registered individual does not deal directly with the retail public;".

Specific Consultation Questions

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?

The same issues arise in this context as we raised on page 5 of this letter in the discussion on “Gaining a Thorough Understanding of the Client Through the KYC Process”. Traditional broker-client relationships are indeed transactional, CSA members have stated that the Client Focused Reforms are not intended to disrupt or alter those relationships, and the same ought to apply to EMD-client relationships. We note that the complicating factor in this question is that CSA members have accepted an offering memorandum exemption from prospectus requirements in recent years and this has the effect of opening the EMD products to retail investors, who may lack the sophistication or financial resources to invest in these products. However, imposing the Client Focused Reforms on that market would be unduly disruptive to new and emerging businesses seeking public capital and, perhaps, the better approach would be to rescind the offering memorandum exemption.

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?

We have addressed this issue elsewhere in this letter.

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?

It is not entirely clear what the CSA’s goal is with these proposed restrictions. Many clients seek financial advice following a referral from an accounting or legal professional with whom they deal. Those professionals may have less incentive to provide referrals absent compensation, especially when they are providing ongoing service on behalf of the referred client and work on that client’s behalf with the registrant to whom the referral was made and, therefore, this restriction could have the effect of limiting investors’ access to securities related services. If the concern relates to the quantum and frequency of payment, it is not clear why the proposed restrictions would resolve any issues regarding payments among registrants but not payments to a non-registrant.

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Conclusion

Invesco is generally supportive of the Client Focused Reforms. We urge the CSA to carefully consider all comments received in formulating a final rule and hope that our proposed solutions are helpful. We would be pleased to discuss our proposals in greater detail with any CSA member at such CSA member’s convenience.

Thank you for the opportunity to comment on this important matter.

Yours truly,

Invesco Canada Ltd.

Eric Adelson
Senior Vice President
Head of Legal – Canada

cc. Peter Intraligi, President, Invesco Canada Ltd.
Jasmin Jabri, Chief Compliance Officer, Invesco Canada Ltd.