October 19, 2018

Delivered by e-mail to comments@osc.gov.on.ca and consultation-en-cours@lautorite.qc.ca

Attention:

The Secretary
Ontario Securities Commission

Me Anne-Marie Beaudoin
Corporate Secretary
Authorite des marches financiers

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorite des marches financiers
Financial and Consumer Services Commission of New Brunswick
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Registrar of Securities, Yukon Territory
Superintendent of Securities, Nunavut

Re: Client Focused Reforms (Proposed Amendments to National Instrument 31-103 and Companion Policy 31-103CP)

Sterling Mutuals Inc. is writing to provide comment on the *Reforms to Enhance the Client-Registrant Relationship*. As a firm we share the desire of the Canadian Securities Administrators (the CSA) "to better align the interests of registrants with the interests of their clients, to improve outcomes for clients and to make clearer to clients the nature and the terms of their relationship with registrants".

We also believe that the fundamental theme of "putting clients' interests first", which is at the heart of the *Client Focused Reforms (CFRs),* is a noble one which should not be altered. Where we may disagree with the CSA is in the recognition that the reforms, if implemented quickly and all together in a big bang approach, may actually run counter to the interests of clients. Our response attempts to highlight some

of the areas where the CFRs may unintentionally serve to undermine the aim of promoting the best interest of clients.

Scope and Timing of CFRs Implementation may Limit Competition

The *Client Focused Reforms* (CFRs) as proposed in their totality are very significant in both scope and the degree of change which firms and their approved persons must undergo to successfully implement. Meaningful recognition of this fact seems to be missing from the CSA's proposals. Thankfully, mention is made by the Ontario Securities Commission (OSC) that "We anticipate that the proposed amendments will impose significant one-time, transition costs as registrants evaluate, adapt and implement new compliance processes and controls for their particular business model." However, the fact that this statement is made in Annex E on page 252 of a 259 page document mutes the impact of concerns around the transitional costs and impacts of the CFRs.

It is a fact that increased regulation, regardless of the industry, favours incumbents with large market share. Because of their scale, incumbents are more able to absorb the tax of higher regulatory burden. The Canadian securities industry is not immune from this reality and it should be expected that due to the scope of the CFRs, business models of independent dealers may be negatively impacted, potentially removing competition and reducing the opportunity for Canadians to receive financial advice. As the number of independent dealers shrinks, so will the number of independent fund companies, resulting in an asset management space within Canada which is even more concentrated.

One way that we believe the CSA could aid in fostering a competitive securities industry in the best interest of clients is to provide for a longer transitional period and to stagger the implementation of the CFRs. Such an approach then allows for the proposed reforms to be more easily digested by firms with greater resource constraints. The contemplated 2 year transitional period is quite daunting when faced with changes to KYC, KYP, suitability and conflicts of interest all at once. The industry has never gone through such fundamental changes in as short a period. A more measured approach would be to begin with RDI after a 1 year transition, conflicts of interest after a 2 year period, followed by KYP after 3 years and then KYC and suitability at the 4 year mark.

In the end, the CSA's goal of "putting clients' interests first" is better achieved through an industry that has healthy competition. To go too quickly on the implementation of the CFRs puts this at risk.

Aspects of Rule 3.4.1 may shrink fund shelves at Dealers

This new rule obliges firms to provide training to its registered individuals on compliance matters - 3.4.1 (1) (a) and also in the area of in-depth know your product training - 3.4.1 (1) (b). Dealer firms today spend significant time and resources on training advisors on the matters of compliance. Codifying this into 3.4.1 (1) (a) as a rule is not objectionable.

However, dealer firms today, generally speaking, do not spend the same amount of time and resources on training advisors in the areas of:

" (b) the structure, features, returns and risk, and the initial and ongoing costs and the impact of those costs, of the securities available through the registered firm for the registered individuals to purchase or sell for, or recommend to, clients."

We recognize this may be a surprise to some CSA members. We find nothing objectionable with respect to the above requirement being placed on dealers. However, current economic business models for product training have already been established and we ask for the CSA to give consideration to this fact. The economics of the industry are such that fund companies have historically provided in depth product training to advisors and they have been paid to provide this through the pricing of their fund offerings. To now require a dealer to be the primary means of training of advisors will necessitate a significant new expense for all dealers. What will occur as dealers take on this new responsibility is that fund shelves will quickly shrink to manage this sizable new education requirement. This will of course limit new fund mandates and also lessen the likelihood of new firms coming to market neither of which fit the CFRs goal of “putting clients’ interests first”.

The Companion Policy to 3.4.1 is quite scanty as it speaks to the product training or part (b) of the rule. There is great uncertainty and angst among dealer firms around how to satisfy this requirement in an efficient way. Most dealer firms largely employ staff with compliance focused skill sets. They do not currently employ many individuals with strengths or experience in the product training arena.

As a way forward, we recommend that for dealer firms not distributing proprietary products, these firms should be able to direct advisors to the publicly available disclosure documents provided by the fund companies eg: simplified prospectus, Fund Facts or ETF facts to fulfill training requirements. As these documents are all approved by the respective provincial securities commissions they provide for a high degree of reliability, consistency and comparability. This approach could then be enhanced with supplemental in-depth product training from the fund companies in a manner consistent with National Instrument 81-105.

Because of the conflict inherent with a dealer selling proprietary products, the above approach would need to be supplemented with specific dealer product training for advisors around understanding the proprietary product offerings in light of competing products on the shelf and in the best interest of clients. We recommend this additional training requirement for advisors also be mandatory for dealers selling exempt market products or other less transparent products not covered under National Instrument 81-102.

13.2.1 Know Your Product Reforms for Firms and Individuals

The proposed Reforms to Know Your Product have far reaching consequences to the shelves at many dealers. The Canadian marketplace is unique in that many dealers employ an open shelf concept for conventional National Instrument 81-102 mutual funds. Due diligence is performed on the fund company and if the fund company is deemed appropriate for sale then the mutual fund products of that firm are approved without significant or in-depth security by security review. This results in a marketplace where many dealers have a very wide approved list without any specific recommended list. What this allows for is for new fund companies and new product ideas to come to the marketplace in a very open and non-restricted manner. This encourages competition among fund companies and enables advisors to choose from a very wide opportunity set of investment options. Investment theory tells us that outcomes are enhanced when the investment universe is unconstrained.

We do see problems with 13.2.1 as it is currently written as Canadian client returns will be lessened. The Know Your Product Reforms will force firms to narrow their investment shelves and to come up with a very finite list of recommended securities. Pressure will arise between fund companies to obtain dealer

shelf space. The issue that comes to the fore quickly is one of "pay for play" access as we have seen in the United States. There will be the temptation for firms to construct hidden revenue sharing deals to secure preferred access to dealer fund shelves. As securities regulators it is very difficult to monitor and detect "pay for play" type arrangements as they often involve soft dollar, "quid pro quo" arrangements and legal entities outside of a securities regulator's jurisdiction.

We see clear benefits to consumers of a dealer with a very neutral open shelf policy, but see new conflicts arising from implicitly forcing all dealers into a narrowly recommended list approach. Currently, some firms within Canada do employ the latter approach and so in fairness we ask for modifications to 13.2.1 to allow clients the continued option of working with a firm who employs a neutral open shelf policy.

The current wording of the National Instrument 13.2.1(3)(a) reads as *"… the registered individual must take reasonable steps to understand at a general level, the securities available through the registered firm for the registered individual to purchase or sell, or to recommend to clients, and how these securities compare."*

The difficulty arises in the interpretation of the words *"understand at general level".* The Companion Policy interprets this as "*This involves a high level understanding of the structure, features, returns, risks and costs of each security that a firm makes available to clients that the registered individual is able to purchase and sell for, or recommend to, a client. Registered individuals must have a high level understanding of each such security in order to be able to compare them, and to be able to select a smaller universe to focus on should they choose to do so.*"

For registered individuals at dealer firms with open shelves and thousands of funds options, it would be impossible to satisfy the obligation of *"understand at a general level"* as interpreted by the Companion Policy. We believe the understanding of the structure, features, returns, risks and costs of each and every security that a firm makes available to clients is quite a detailed and extensive undertaking and as such is inconsistent with the wording within the proposed National Instrument which is only to *"understand at a general level"*.

We encourage the CSA to consider amending the wording within the proposed CFRs to clarify that registered individuals are only to have a general understanding of the different product types sold within the firm while having a "*high level understanding"* (as defined by the Companion Policy see above) of each security recommended by that individual. Such clarification would go along way to ensuring that the current open shelf dealer model which many Canadians desire and receive value from remains a viable option.

Suitability and What Clients Care About

The proposed CFRs will significantly overhaul both Know Your Client and Know Your Product requirements leading into a greatly enhanced suitability framework. Although not explicitly stated, the CFRs set an expectation that firms and advisors need to provide the best investment recommendations to clients. Such a goal would appear to be the logical natural extension of "putting clients' interests first". To suggest any less would seem to be inconsistent with acting in the interest of the client.

However, we know that there isn't a best investment recommendation or set of alternative recommendations *ex ante*. This can only be determined *ex post*. *Ex Ante* all investment

recommendations are subjective. Very few consumers desire to purchase the best of any product or service. What Canadians really value in any product or service purchase is that the product or service deliver what was promised. Investment advisors are never promising that an investment recommendation is the best. If you really simplify it down, what is promised by advisors as they make recommendations to Canadians is access to investment markets at specific costs through plan types providing differing tax benefits and providing aspects of diversification and professional investment management. It really is that simple. Most Canadians feel that advisors are fulfilling what has been promised. Those that don't find another advisor or manage their own investments.

We fear the CFRs take the focus away from what is most important to Canadians and replaces it with an elusive and theoretical aim for a best investment recommendation and alternative recommendations. It would be better to reframe more clearly within the CFRs that the desired goal is to have investment recommendations which deliver what they promise. This is what Canadians care about the most and hence is the real essence of "putting clients' interests first".

Conflicts of Interest Related to Proprietary Products

Sterling Mutuals is an independent mutual fund dealer with no related investment fund managers. We do support the leveling of the playing field between proprietary products and non-proprietary products by firms providing both as this clearly puts the interests of clients first. As we are not directly impacted by the proposed requirements affecting firms distributing proprietary products we provide only two comments on this area of the Client Focused Reforms.

We recommend that the Reforms be strengthened to ensure that dealers who distribute both proprietary products and non-proprietary products allow for any proprietary products to be transferable outside of the related dealer. This is consistent with the guidance in the Companion Policy which encourages *"making non-proprietary products offered by the firm as easy to access for its registered individuals and its clients as proprietary products offered by the firm."* Such an approach should extend not only to the access of the product offering at the beginning of a client relationship, but also equally at the end of a client relationship. Clients desiring to change their advisor or dealer after purchasing a proprietary product which is exclusively available at the related dealer are disadvantaged compared to if they had purchased a non-proprietary product. This conflict must be resolved in the best interest of the client. A client should not be forced to retain their proprietary product position with the related dealer. The best way to resolve this is to ensure that clients be allowed to transfer proprietary products outside of the dealer in the same way they are allowed to transfer non-proprietary products through an in-kind transfer to another dealer. This issue is especially acute on open or nonregistered accounts when a disposition of the proprietary product forces a premature capital gain or loss which in many situations is not in the best interest of clients.

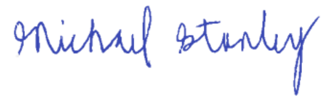
We encourage the CSA to clarify the intent of the wording in the Companion Policy to paragraph 11.5.2 which highlights the firm's obligations to document sales practices set by the firm including *"sales targets and revenues quotas for the sale of proprietary products."* Such wording is acceptable for proprietary only firms, however, using sales targets and quotas on proprietary products is clearly inappropriate for firms providing both proprietary and non-proprietary products. To avoid any misunderstanding arising from the Companion Policy we request the CSA to clarify that this wording is guidance for proprietary only firms.

Comments on CSA's Referral Fee Questions

Sterling Mutuals is a mutual fund dealer which is licensed in all provinces. Referral business is not core to our business model. Our firm does conduct a small amount of referral business through unaffiliated investment counselling/portfolio manager (ICPM) firms. We disclose this as the CSA's request for comments specifically asks the question *Does prohibiting a registrant from paying a referral fee to a non-registrant limit investors' access to securities related services?* This is a sensitive question to many ICPMs and so we encourage the CSA consult directly with them. Our view is that although such a prohibition will necessitate changes to certain portfolio manager business models in the short term, over the long term it will not result in reduced access to securities related services by Canadians. That is because the proposed 3-year transition period for grandfathering pre-existing arrangements provides affected portfolio manager firms with sufficient time to restructure their business models. We do believe that allowing non-licensed individuals to receive ongoing referral compensation is not in the best interest of Canadians as it provides the impression to clients that they are in the securities business when in fact they have no oversight from a securities regulator. That is a problem and we encourage the CSA to continue forward in closing this gap after close consultation with affected ICPMs.

Although we support the prohibition of referral fees to non-registrants, we do not support the limitations on referral fees as outlined in 13.8.1. We do feel that the competitive marketplace should determine the length of continuity of payments along with the level of those payments. The CSA's decisions around 36 months and a maximum of 25% seem arbitrary with no supporting rationale. Our recommendation would be to provide clients the option of continuing compensation from their portfolio manager to a licensed registrant beyond a 36-month period. However, this desire must be formally provided by the client to the portfolio manager every 36 months for the compensation to continue. We also recommend an increase in the maximum level from 25% to 50%. We feel that as currently written the proposed limitations in 13.8.1 would severely hamper portfolio manager business models resulting in a limitation of access by Canadians to portfolio manager services. We feel even more strongly this is the case in relation to the CSA's question of *Would narrowing 13.8.1 to permit only the payment of a nominal one-time referral fee enhance investor protection?* Limiting payment to a nominal one-time referral fee may marginally increase investor protection in that it would take away any uncertainty on who the primary securities registrant is in the relationship. However, the cost to Canadians of such a change would far outweigh the benefits and so we encourage the CSA to not move in the direction of a nominal one-time referral fee and to consider modifying the proposed 13.8.1 to allow more latitude by clients and the marketplace in determining the length and level of referral compensation. Such changes to the CSA's proposed 13.8.1 would better enable ICPM's adjust to the prohibition of referral payments to non-licenced individuals thereby ensuring continued access by clients to securities related services.

In closing, given sufficient time, we look forward to the implementation of the Client Focused Reforms in a balanced manner that ensures better outcomes for clients and a strong and vibrant securities industry. We thank the CSA for the opportunity to provide comment on this very important next phase of change within Canada.



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