Canadian Independent
ASSET MANAGEMENT

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Delivered By Email:

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British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
The Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission (New Brunswick)
Nova Scotia Securities Commission

Attention:

Josée Turcotte
Secretary Ontario Securities Commission
20 Queen Street West, 22nd Floor
Toronto, ON M5H 3S8

Me Anne-Marie Beudoin
Corporate Secretary
Autorité des marchés financiers
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Montréal (Québec) H4Z 1G3

Dear Sirs and Mesdames:

CSA Consultation Paper 33-404: Proposals to Enhance the Obligations of Advisers, Dealers, and Representatives toward Their Clients

We welcome the opportunity to provide our comments with respect to the Canadian Securities Administrators' ("CSA") Consultation Paper 33-404 – *Proposals to Enhance the Obligations of Advisers, Dealers, and Representatives Toward Their Clients* (the "Consultation Paper"), published on April 28, 2016.

We fully support the introduction of a regulatory best interest standard as we believe it would help enhance the effectiveness of the proposed targeted reforms. In particular, we believe that the best interest standard would provide the CSA (and the MFDA and IIROC, the "SROs") with the additional ammunition they will need to address conduct which seeks to circumvent the goals of the targeted reforms or which falls between the specific rules of the targeted reforms.

As an independent Canadian asset management company, we partner with leading investment advisors at both IIROC and MFDA firms. These advisors continue to become more frustrated and challenged with avoiding conflict. We have recently grown increasingly concerned by the stories told to us by these advisors, of the pressure put on them by their dealers to sell proprietary products regardless of what is actually in the best interests of their clients.

As you know, from your own CSA sponsored research (Cummings and Brondesbury Reports), fund flows from affiliated dealers of the investment fund manager, show little or no sensitivity to past performance, and this lack of sensitivity is associated with reduced future outperformance (proprietary funds are recommended to Canadians, regardless of how poor their performance is).

As set out in the Consultation Paper, for firms that trade in or advise on proprietary products, the incentive to recommend the proprietary product results in a material conflict of interest to recommend a product that is not suitable for the client. A firm must either avoid this conflict and not recommend the proprietary product, or effectively control this conflict. We agree that, if the conflict is not avoided, that the onus properly lies on the registrant to demonstrate that procedures are in place to ensure that the conflict is effectively controlled.

One of our first reactions to the Consultation Paper was to wonder why, knowing the inherent conflict, the CSA does not just simply ban the distribution of proprietary products through related dealer channels? Indeed, it is our understanding that this is the position that has been taken by securities regulators in the United States. Having been educated by the stories from our investment advisor partners, we do not believe that dealers will have any serious intention of implementing effective controls on the sale of proprietary products, unless those controls are mandated and rigorously enforced by you and by IIROC and the MFDA (together, the "SROs").

Our second reaction to the Consultation Paper was to wonder why the CSA doesn't require the MFDA and IIROC to enforce the rules that already exist relating to the sale of proprietary products? The Consultation Paper discusses NI 81-105 - *Mutual Fund Sales Practices*, but IIROC and the MFDA continue to operate as if this law does not exist. Flagrant violations of these rules by Bank owned dealers continue to be completely ignored by the SROs.

Despite these initial reactions, we are encouraged that help may finally be on the way through the implementation of the Proposed Targeted Reforms which are clearly meant to target these exact conflicts. Regarding the Proposed Targeted Reforms, we wish to highlight the following with respect to the Know Your Product – Firm Proposal.

We believe that the 'most likely' test and associated due diligence work, should only be applied when firms and their advisors are recommending proprietary products. **Since the**

conflicts of interest are higher when dealing with proprietary products (and therefore the risk of an unsuitable recommendation is higher), the evidentiary bar should be set higher and firms should be required to prove that the related product is indeed the best choice. Since the conflict of interest in recommending third party funds is less/non existent, there is no need to apply a higher standard, and the current 'suitability' standard should continue to apply.

The main conflict to be addressed is with proprietary products and not unrelated investment products. The related party mutual fund through its parent has the ability to hire/fire advisors, to increase/decrease advisor compensation, and to build dealer systems specifically designed to drive clients to proprietary solutions. The 'organization of the mutual fund' (Bank parent and IIROC and MFDA subs) make more money selling their own products. The IIROC/MFDA CEOs, National Sales Managers, and Branch Managers all receive monetary incentives to grow related party businesses and receive bonuses based on their parent company shares.

There is little or no conflict in the case of a dealer representative selling a third party mutual fund. When investment advisors sell a third party mutual fund, they make less, their organization makes less, and their equity-based compensation is worth less. In addition, the people who determine the advisor's bonus and continued employment (the Branch Manager, the Head of National Sales, and the CEO of the IIROC/MFDA dealer) all make less. Why would the investment advisor sell any third party funds with all these strong incentives not to? The good advisor risks their very livelihood by selling third party funds, so likely will only do so if the third party fund is particularly compelling and in the best interest of their clients.

The main objections that will be voiced by the industry with respect to the Firm KYP 'most likely' proposal are that (i) it will be too burdensome on a dealer and their investment advisors to have to screen the thousands of investment products currently on their product shelves, and for the advisors to know not only the products they are recommending, but all the other products on their shelf; and (ii) that this burden will result in less choice for Canadian investors because the dealers will be 'forced' to shrink product shelves and limit product choice in order to practically comply with the new requirement.

Unfortunately, we do agree with the industry at large, that the unintended consequence of implementing the 'most likely' rule as currently proposed, will be for dealers to shrink product shelves to a small number of products 'recommended' by dealer head offices, and that this will exacerbate the already entrenched trend of dealers favouring their related investment products.

Our suggested solution is to still require the 'most likely' test, but have it only apply when the advisor or firm is recommending (or including in a fund on fund/ asset allocation program) a proprietary fund. Third party funds, where there is zero or much less risk of conflict, should stay with the current suitability test. This solves the 'burden' issue as the rep/firm only has to perform enhanced screening on the proprietary funds they recommend. They can still have thousands of third party funds on their shelves, as in order to recommend a third party fund, the firm/rep need only demonstrate that the fund choice was 'suitable' for the client (the current industry suitability standard). We also believe that this narrower application of the rule will also help to solve the problem of a shrinking shelf and a reduction of product choice for Canadian investors. Under this model, firms would only have to perform enhanced due diligence on their own products – not too much of a burden.

In closing, you need look no further than the United States, to see the damage caused when pressure is put on a salesforce to cross-sell proprietary products. The recent Wells Fargo case is one of many tragic examples of how trust can be broken in our industry. While we support your efforts to craft better rules to address conflicts of interest, you also need to ensure that the rules you already have are actually being enforced by IIROC and the MFDA. Rigorous enforcement of the current NI 81-105 rules on IIROC and MFDA members, would go a long way to help address the issues targeted by the Consultation Paper – and action here can be taken now.

We once again thank the CSA for the opportunity to comment upon and hopefully contribute to the improvement of Consultation Paper 33-404. We welcome all opportunities for further consultations, in writing or in person. We wish to keep our identity confidential and so have submitted our comment letter using the pseudonym "Canadian Independent Asset Management". Please feel free to contact us at independentassetmanager@gmail.com. We would be pleased to disclose our identity privately to CSA members.

Yours very truly,

Canadian Independent Asset Management

President & CEO
Canadian Independent Asset Management