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Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission, New Brunswick
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon Territory
Superintendent of Securities, Nunavut

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Dear Sirs/Mesdames:

Re: CSA Notice and Request for Comment
Proposed Amendments to National Instrument 31-103 *Registrant 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) – published for comment June 21, 2018 (the Proposed Amendments)
Comments of the Investment Management and Securities Litigation Groups of Borden Ladner Gervais LLP

We are pleased to provide the members of the Canadian Securities Administrators (CSA) with comments on the above-noted Proposed Amendments. Our comments are those of the individual lawyers in the Investment Management and Securities Litigation practice groups of Borden Ladner Gervais LLP listed below, and do not necessarily represent the views of BLG, other BLG lawyers or our clients.

We continue to be motivated to comment on the Client Focused Reforms for the same reasons as we were to comment on the CSA Consultation Paper 33-404 *Proposals to Enhance the Obligations of Advisers, Dealers and Representatives Towards Their Clients* (published for comment April 28, 2016)[1] as well as the earlier Consultation Paper 33-403 (published for comment in late 2012)[2]. We are trusted legal advisers to many registered firms and individuals, ranging from MFDA and IIROC-member dealer firms and representatives, to portfolio managers (advisers), scholarship plan dealers, investment fund managers and exempt market dealers. In our role as securities lawyers and litigators, we see the interactions of the firms and representatives with their clients and with the various regulatory bodies and we work with many firms to enhance and strengthen their compliance systems and client disclosures and to help them navigate the implementation and enforcement of various regulations that apply to them. We have close interactions with regulatory bodies in reaching outcomes for our clients and the investors they service, with due regard to investor protection concerns. Our work with our clients has given us an informed view of the nature of the financial services industry in Canada today, as well as an unparalleled expertise in registrant regulation, compliance and enforcement that applies across multiple firms, registration categories and regulators. We are privileged to work with our clients and provide them with legal advice that allows them to comply with both the letter and the *spirit* of the regulations and to keep their clients' interests at the forefront of all they do.

We considered the Client Focused Reforms with interest. It is clear that much thought, analysis and discussion has gone into the Proposed Amendments, including consideration of the comments made on the 2016 Consultation Paper, which has resulted in positive changes to the Proposed Amendments from the 2016 Consultation Paper. For this reason we wish to clarify that, although we do not agree with certain of the CSA's proposals (for the reasons we outline below), we do recognize the CSA's efforts and the importance of the issues raised in the Client Focused Reforms for investors – and also for the financial services industry.

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[1] Our comment letter dated September 30, 2016 is available at this link http://www.osc.gov.on.ca/documents/en/Securities-Category3-Comments/com_20160930_33-404_borden-ladner-gervais.pdf.

[2] Our comment letter dated February 22, 2013 is available at this link http://www.osc.gov.on.ca/documents/en/Securities-Category3-Comments/com_20130222_33-403_cowderryr_gerhartm_dipaolod.pdf.

As the CSA review our comments, we would ask the CSA to keep in mind our central submissions, being that we agree with:

- The concept that all securities registrants (firms and individuals alike) should conduct themselves in a professional and proficient manner acting with integrity towards their clients and that any conflicts of interest between the firm, the representative and the client should be avoided or resolved in favour of the client to the greatest extent possible. Conflicts should be disclosed plainly and simply to the client so that informed decisions can be made.

- Plain and concise written explanations of material information being provided to clients to allow for informed investment decisions.

- Firms and representatives being provided (by the applicable regulatory regime and the internal compliance systems) with clear, consistent and commercially viable guideposts to follow to ensure that they understand what they must do to achieve the reasonable and proportionate investor protection goals of the CSA, but which are flexible enough to be adopted (or not) by the various categories of registrant and by registrants with varying business models and approaches and with due regard to the professional judgment that informs those models, approaches and services offered.

- Securities regulators enforcing the regulatory regime in a fair and balanced manner against any firm and representative who fails to follow the regulatory expectations that clearly apply to them.

- The very significant and pivotal role of the SROs (the MFDA and IIROC) in setting rules and expectations for the business and financial affairs of their members – and to ensure that there is appropriate investor protection of clients of their members. In our experience, the MFDA and IIROC perform their duties as vigilant regulators in every sense. We recognize that there is a role for the CSA in setting standards for that regulation, as they have with NI 31-103, but that detailed regulation and the administration of that regulation has been carried out by the SROs, whose rules, policies, procedures and enforcement activity provide a real contribution to this discussion.

All of our comments should be considered through the lens of our strong appreciation of the role of the securities regulators and the challenges they face in achieving balanced and proportionate investor protection while fostering, supporting and growing our Canadian capital markets.

We hope that our comments are considered to be constructive and helpful –we are not commenting on matters that are beyond our knowledge or experience nor are we advocating on behalf of any of our clients for any particular business model or relationship. Our comments come from our experiences as lawyers (and also as investors) and are coloured by our knowledge about what the vast majority of firms and representatives do to achieve the objectives long established by the CSA and the SROs, including their desire to be compliant and provide professional advisory services to their clients.

In some cases, in our view, there is simply no alternative other than to explain why we consider the CSA's proposals to be impractical or incapable of implementation, so in those areas, we suggest the CSA's proposals be dropped or pared back and the status quo retained. We hope that our comments are taken in the spirit as they are intended – namely to point out where some of the reforms need modification or reconsideration.

It is with this background that we provide the CSA with our collective comments and thoughts on the Proposed Amendments.

Overarching comments

The Proposed Amendments are said to be client-focused and designed to encourage firms and their representatives to put the interests of the retail client before any other consideration relevant to the client-registrant relationship. This is a very admirable principle and one with which we, and presumably all registrants, would agree. We do not, however, necessarily agree with how this principle has been proposed to be implemented, interpreted nor with the extent or manner in which it has been proposed that today's regulation be amended and supplemented through the CSA policies articulated in the proposed Companion Policy amendments.

Our comments that follow are not so much that we disagree with the underlying regulatory *principles* but that we disagree with some of the enhancements suggested by the CSA, particularly as we consider that they still will be enforced with a "one-size fits all" regulatory mindset that does not recognize – or even may no longer permit – the very different business models and client relationships that exist amongst the different categories of securities registrants and their clients. Although the CSA have explained that they intend for the proposals to be "scalable" to the size of the business of the particular firm, and not "one-size fits all"; this is not consistently applied nor is it at all clear from the Proposed Amendments. We remain concerned about this issue particularly since not all of the rules/guidance *should* apply to the business of all firms and it is this clear concept that is missing in the Proposed Amendments.

In many cases, the regulation and concepts have been so supersized that we have significant concerns about their practicality and commercial reasonableness for all registrants. We are concerned that some of the Proposed Amendments create nearly impossible standards of perfection for firms and their representatives. A number of proposals may lead to unintended consequences, including narrowing the choices of investment service providers available to investors and the reduction of the selection of and quality of investments and services offered by those providers.

Similarly we are concerned that the Proposed Amendments continue to lack enough (or really any) specific allowances for deference by the regulators and the regulation to the professional judgment of registrants. In our view, regulators should avoid substituting their own judgment for the professional judgment of registrants except in the most egregious of cases. As we will highlight below, the Companion Policy contains many examples of the CSA substituting their

own judgment on how client relationships should be managed, or on how clients should invest, over allowing the professional judgment of registrants determine what is appropriate for the firm and the clients of that firm, and for investors to select and be responsible for their investment choices, although they may differ from the investment choices of a member of the CSA.

We are also concerned that the reforms fail to reflect the diversity of investors. For example, the proposals assume that all mutual fund investors have the same (or very similar) investment goals, timelines, investment knowledge and understanding. The reforms fail to consider the many different reasons that individuals invest in mutual funds. Some investors choose mutual funds because doing so permits them to pool their smaller amounts of investable assets with others for the purposes of achieving a diverse portfolio. However, sometimes investors with sophisticated investment knowledge and large investable assets choose mutual funds because their employer or place of business does not permit them to invest other than through fully discretionary managed accounts or mutual funds. Mutual fund investors are diverse. The regulations should reflect that reality.

Much of the Proposed Amendments appear to be based on the premise that most investors are unsophisticated, vulnerable and inappropriately trusting of their financial services industry professional and/or should or must invest in a particular manner. Much of the discussion in the Companion Policy appears to have been written with the smallest, most vulnerable and least sophisticated investor in mind and with the assumption that the vast majority of investors are financially illiterate, incapable of understanding that they cannot achieve market returns without market risk and hence may expect market returns without market risk and/or should not take on risk or incur capital losses as a result of their investments. We believe these underlying assumptions, in part, have led to many of the Client-Focused Reforms, which are designed to "protect" these most vulnerable investors. We consider that this is problematic in that many of the suggested reforms and articulated best practices will no doubt result in increased regulatory burden, administration, disclosure, costs and business and regulatory risk. This will either result in increased costs for those very same small and vulnerable investors or in registrants rationalizing their clients to focus only on the most profitable investors and dropping the clients who do not have sufficient assets to cover these increased burdens. This will result in rules created to "protect" investors who do not want or need such protection, as they are well able to, and wish to, determine their own capacity for risk. We urge the CSA to consider the potential for these unintended consequences and to consider carefully the submissions of industry participants to this effect.

Flowing from the above concerns, we strongly urge the CSA to consider which portions of the Client Focused Reforms are inappropriate for more sophisticated, institutional and/or ultra-high net worth clients (referred to in NI 31-103 as "permitted clients"). In our view, much of the Client Focused Reforms would be a "sledgehammer" when considering the businesses of firms that predominately or in part deal with these clients, in addition to considering their clients. We consider that commercial realities are such that these clients are fully capable of negotiating a commercially reasonable

relationship with their chosen registrant service provider and the Client Focused Reforms would simply be overkill, unnecessary and completely disproportionate.

Additionally, in some cases, there is disconnect between the Proposed Amendments and the commercial realities of operating as a registered firm. Such disconnect will stifle competition in the investment industry and we anticipate that the unfortunate result will be reduced choice for investors, coupled with significant barriers to entry for potential new registrants. This narrowing of options available to investors will be caused not only by proposals that straightforwardly limit investor choice, such as removing the availability of securities purchased through a deferred sales charge option[3], but also by proposals that negatively impact investor choice in less direct, more subtle, but equally powerful ways. For example, the Proposed Amendments disadvantage dealers who sell non-proprietary funds such that they may be unable to effectively compete. Reduced competition will inevitably lead to consolidation of the dealer market. Reduced competition and increased consolidation in any industry is bad for consumers, as these industry characteristics incentivize suppliers, including dealers, to provide fewer, lower value and lower quality options to consumers.

We pointed out in our earlier comment letters that we fear that the blurring of the lines amongst registration categories that already exists today will become even more pronounced if the Proposed Amendments come into force in their current state. The Proposed Amendments continue to appear directed solely to distribution to retail investors acquiring securities from IIROC or MFDA dealers, as opposed to institutional investors or investors who have chosen a portfolio manager to manage their assets on a discretionary basis. We believe it important that the Proposed Amendments, in the proposed Companion Policy, should state this focus. Within retail distribution, the client relationships of mutual fund dealers with their clients is much different from the relationships of investment advisers and portfolio managers with their clients and also from EMDs with their investor-clients – and we believe that the "one-size fits all" approach or inclination suggested in the Proposed Amendments does not properly and clearly account for these differences, in that the stated aim of the CSA is to ensure that all registrants abide by the same or similar regulatory concepts, even when those concepts do not fit well with the specific relationship. We consider this to be very problematic.

As an overall theme, we urge the CSA to:

- Consider the implications of the proposals put forward in the Proposed Amendments on all facets of the industry;

- Consider carefully all comments received on the Proposed Amendments, notwithstanding those comments may not raise "new arguments" or may not be "fact" or may not be supported by evidence accepted by the CSA. The onus should not be on the industry to

[33] We recognize that this proposal is not reflected in the Client-Focused Reforms, but through the parallel Mutual Fund Fees project that resulted in the publication for comment of amendments to National Instrument 81-105.

refute CSA opinions and views with such evidence – the industry's views and opinions based on participants' own professional qualifications and extensive experience with the needs and preferences of investors, provided by way of commentary on the Proposed Amendments should be considered just as carefully as the CSA considers its own views and opinions;

- Carefully tie together all of the regulatory initiatives undertaken over the past 10 years into a holistic package – with a unifying message and clear, coherent regulatory goals and principles, along with a more creative, less prescriptive approach to regulating the industry, which includes supporting capital markets through commercially viable regulation. We provide more commentary on this below.

We were pleased to see the continued drawing back by the CSA from the concept of a "statutory best interest duty" or a "regulatory best interest standard"; however, as we comment on later in our response, we fear that this latter "standard" permeates the entire spectrum of the Proposed Amendments, albeit the CSA use different (in some cases looser) words. We consider this to be one of the most troubling aspects of the proposals, given the difficulties inherent for firms, and their executive, compliance officers and legal counsel, to explain what else these words mean and how they may be interpreted by the regulators, particularly when they are stated in different ways using different terminology. This leaves firms and representatives in the untenable situation of not knowing how they should conduct themselves so as to be compliant.

We continue to be troubled by the lack of any real articulation in the Proposed Amendments as to the "key investor protection concerns", which were listed in five bullet points on less than one page in the 2016 Consultation Paper and are again articulated in the Notice accompanying the Proposed Amendments. They are also analyzed briefly by the OSC in its regulatory impact statement contained in Annex E to the publication in Ontario of the Proposed Amendments. These concerns were cited as the rationale for the drastically supersized changes which would arise from the Proposed Amendments. We can only assume that somehow the CSA concluded that the existing regulatory regime does not deal adequately with these key concerns, but we remain unclear as to a solid and consistent basis for this conclusion. In our view, the concerns are listed as absolutes and as "givens", without any real explanations of evidence or substantiation. For example, the CSA explained that "clients are not getting outcomes that the regulatory regime is designed to give them". This statement was simply stated, but nothing is explained as to what this means (i.e. which "outcomes" and indeed what *are* "outcomes" and what is the regulatory regime [as opposed to the capital markets] actually designed to do?), and when coupled with the first concern enunciated as "clients are not getting the value or returns they could reasonably expect from investing" (which we find a very subjective, unexplained and loaded statement), leads us to question the extent of support for these sweeping statements. We also consider that the "problems" that were articulated by the CSA were described as being universal "problems" which apply to all categories of registrant, all business models, all client relationships and indeed all types of investors. We consider this to be a significant flaw in the Proposed Amendments. As we will build on in our comments that follow, we consider that a much more nuanced approach is

necessary and we urge the CSA to reconsider its articulation and assessment of concerns as they may arise for the different categories of registrants and client relationships.

We note that the above-noted Annex E expands on some of the earlier statements referred to above, but in ways that are very problematic. For example, the OSC, in expanding on the issues around an "expectations gap" speaks of misplaced trust or reliance on registrants, resulting in opportunities for some registrants to take advantage of their clients. These are very pejorative sweeping statements that are not backed by any evidence or facts, as well as being illustrative of a fundamental misconception of many (if not, most) client-registrant relationships.

We point out that the above-noted "key investor protection concerns" appear nowhere in the Proposed Amendments and we feel that the CSA should work to tie these concerns (articulated clearly and in an objective fashion) into the Companion Policy as justification for the various requirements of NI 31-103 and the CSA policies articulated in the Companion Policy. This will allow registrants to return to these principles when determining how best to comply with the various rules in light of the CSA policy articulated in the Companion Policy.

Specific Comments

We provide our comments on the Proposed Amendments, in the order that they appear in the proposed amendments to NI 31-103, including comments on the accompanying CSA policy articulated in the proposed Amendments to the Companion Policy. However, we would also like to provide an overarching comment on the CSA policy set out in the proposed amendments to the Companion Policy.

Comment on the Vagueness, yet Prescriptiveness, Inherent in the Companion Policy

Increasingly the CSA's policies articulated in the Companion Policies to the various instruments in force have become longer, more detailed and increasingly more prescriptive, yet still leaving many key concepts and difficult questions unstated and unexplained. The detail does not address the difficulties in implementation and interpretation. The proposed amendments to the Companion Policy are among the most detailed and difficult to sort through that we have seen in recent publications. In many cases, the policy so articulated is stated using rule-like wording, such as "should", "we expect", "must", which, in our view, means that the policy verges close to being of "legislative nature", contrary, at least in Ontario, to section 143.8(1) of the OSA. While in other cases, key concepts are more vague and far less precise. We have heard some seasoned industry participants aptly describe the concepts as "vaguely precise" and "gotcha" concepts which will allow the CSA to analyse registrant behaviour through a rear view mirror in compliance and/or enforcement actions. We urge the CSA to re-examine each of the articulated policies to see if a more creative, flexible approach can be developed so that registrants can understand that there is not only one way to comply with the rules articulated in NI 31-103. As the policies are written, there is only often one suggested way to comply with the rules, which we

do not consider appropriate. However, if the CSA do not wish to undertake a wholesale revision to each policy (although we strongly recommend a review for policies that are "rule-like"), we feel at a minimum that the statements made in the Notice as to the intent to create a "scalable" provisions that fit registrants' different operating models and to preserve "the technology-neutral" stance of the Rules must be consistently and repeatedly carried forward into the Companion Policy. It would be beneficial if these statements could be expanded upon to clearly illustrate that there is more than one way to achieve the objectives. Otherwise we fear registrants will be forced into adopting the provisions set out in the Companion Policy, even when those provisions and practices do not fit entirely their business model or their client relationships, and cannot be precisely implemented.

New training obligation for registrant firms – Section 3.4.1

While we do not disagree with the new rules requiring "training", the Companion Policy discussion on the need for an "ongoing" compliance training program and the need for testing of effectiveness at "regular intervals" is imprecise and therefore potentially onerous, and somewhat unrealistic and incapable of implementation in the ways indicated.

We consider that training should be clearly tailored to the nature of the securities and services offered by the firm, as well as the nature and size of the firm. The CSA give only the example of a one-registrant firm (describing this as a "small firm", which is problematic in itself), while there are obviously many different sizes and businesses of registrants. For some firms, an annual or semi-annual, firm-wide single comprehensive session for all staff, which covers all areas mandated under section 3.4.1 may be sufficient, given the need for a robust compliance regime (policies and procedures and a CCO). Other firms may wish to conduct a series of smaller sessions, webinars or online self-learning programs over the course of a year, each covering off a different aspect of the training and tailored to different staff members. It is common industry practice for analysts and sales representatives to have weekly or bi-weekly markets and product-focused meetings and for compliance to distribute notices and bulletins. We consider that these meetings, notices and bulletins should qualify as appropriate "training", including on KYP, and we urge the CSA to reflect this in the policy.

We point out below certain of the difficulties in the wording chosen by the CSA – and we wonder what kind of training would be considered sufficient, given the challenges we foresee in practically implementing these training programs.

- Training to provide examples of "how to identify existing and reasonably foreseeable" conflicts and how to address them in "the best interest of the client", and
- Training on how to "put the client's interest first" when making suitability determinations.

Similarly, although a firm may diligently develop, implement and provide the required training, no training, no matter how well designed and implemented, can possibly "<u>ensure</u> that <u>everyone</u> at

the firm … acts with integrity when dealing with clients" (as set out in the second sentence under the heading "compliance training"). We recommend softening of the words in this sentence to reflect reality that the best that training can do is to encourage or "seek to ensure".

Supersized Know-Your-Client (KYC) requirements – Section 13.2

We have no overall concerns with the amendments to section 13.2 of NI 31-103, although we foresee practical challenges in achieving the timing for updates for KYC indicated in new subsection 4.1, as well as explaining to clients why they must provide the mandated information to the firm (more than once) and somehow obtaining that information (or documenting why the client does not wish to provide it) where clients are unresponsive, unwilling or disinterested.

The concept that KYC information must be updated annually for all clients is problematic, particularly in circumstances where the client is making no new investments or has had no material changes in circumstances. As investors, we assume that we have a responsibility to monitor our accounts and to ensure that we are comfortable with the performance and level of risk we have taken on. Will all clients be responsive and have the patience or willingness to go over all of the same details with their advisor or representative on a yearly basis? We encourage recognition as to varying client relationships and expectations and the flexibility to meet them in a proportionate manner.

We agree with the concept that registrants should tailor their KYC processes to reflect the particular circumstances and the wishes of their clients, particularly sophisticated clients. In particular, we endorse the following statement, which is added to the Companion Policy:

> *A registrant should tailor its KYC process to reflect its business model and the nature of its relationships with clients. Paragraph 13.2(2)(c) outlines the information to be collected, although the depth of inquiry and what constitutes sufficient information required to support a suitability determination will vary according to the nature of the client's relationship with the registrant, the securities and services to be provided to the client, the client's personal and financial circumstances, the client's investment needs and objectives, and the registrant's business model. For example, extensive KYC information will be required if the registrant offers a fully-customized service or is a portfolio manager with discretionary authority for a client with relatively complex financial circumstances.*

Additionally, we agree that, due to the availability of technology, there should no longer be a requirement that registrants have face-to-face meetings with clients for the purposes of collecting and updating KYC information. However, we are concerned about the following statement which calls into question the above-noted flexibility: *[t]he process of collecting and updating the client's information requires a <u>meaningful interaction</u> with the client, even if that interaction does not take the form of a face-to-face conversation and regardless of the medium used.* It is entirely unclear how a meaningful interaction coincides with a tailored KYC process.

More clarity is required around the proposed requirement that an advisor must take "reasonable steps to obtain a client's confirmation of accuracy of information". The CSA should clarify whether the current industry practice of obtaining a client's signature on their KYC form is adequate and, if not, what else is required.

We note that the above-noted more flexible statements are countered by the very detailed suggestions (using the phrase "registrants should" or "registrants should consider") on exactly what information the CSA expect registrants to obtain and maintain up to date by way of KYC information from clients. In addition, some of what we commented on as unrealistic, paternalistic expectations of the CSA in the 2016 Consultation Paper have made their way into the Companion Policy, using different wording and phrasing, including:

- Desirability of setting a specific investment return that the client expects, which may lead to unintended liabilities for the firm and the advisor.
- Whether there are other "priorities" for the client, such as paying down debt or "directing cash into a savings account" that would be "better" suited for the client than investing through the firm. We strongly feel this concept should be simply dropped from the Companion Policy.

Supersized Know-Your-Product (KYP) requirements – Section 13.2.1

We completely agree with the concept that firms and representatives alike must understand what is being recommended to their clients. It is the supersizing of the existing requirements that we have questions about, as well as their application to all categories of registrant in the expected ways set out in the Companion Policy.

We question the practical implications of KYP requirements being imposed before securities are transferred in as set out in subsection (6) of section 13.2.1 and we urge the CSA to consult further with industry participants on the negative implications of this requirement. We consider, at least one unintended result may be additional restrictions on the ability of investors to move accounts (in specie) between registrants.

We agree with the concept that registrants should tailor their KYP process to suit the structure and features of diverse securities and that the procedures for such tailoring should be set out in registrants' policies and procedures. Specifically, we endorse the following statement which is added to the Companion Policy under the Proposed Amendments:

> *The extent of the KYP process required for a security will depend on the structure and features of that security, and a firm's policies and procedures should set out the different levels of review for different types of securities, as appropriate. For example, complex investment products, including those that are novel, not transparent in structure, or involve leverage, options or other derivatives, may require a more extensive review than more straightforward securities. Securities sold under a prospectus exemption may*

> *require a more extensive review because of the limited disclosure available about them and the less liquid nature of the securities.*

Though we agree with the above statement, we submit that further policy discussion is required. For example, due to the fact that mutual funds have a structure that is well understood, are publically traded and are highly regulated, in our view, a carve-out exempting mutual funds from extensive review may be appropriate. Further, guidance should be provided describing how the training requirements mandated under the proposed subsection 3.4.1(b) could be tailored to reflect the depth of knowledge that is reasonably necessary for securities with diverse characteristics.

Though we agree in principle that a representative should be knowledgeable about the products that he or she is recommending, we are concerned that the robust proposed KYP requirements will have unintended consequences. Since providing the requisite KYP process would be time consuming and costly for registrants, these commercial realities would incentivize firms to narrow their product shelf. This could have the industry-wide effect of reducing investor choice, which we understand not to be the objective of the CSA.

Clear guidance directing registrants for which securities a more streamlined KYP process is appropriate (including, perhaps, carve-outs for certain types of securities like conventional mutual funds), and how they might tailor that process, may help to lessen this narrowing of investor choice. However, even with expanded guidance, this still may lead to a disproportionate representation of tried-and-true, straightforward, prospectus-qualified securities being made available to investors and a stunted supply of novel or complex investment opportunities.

Further, the expanded KYP requirements may incentivize "monitoring" (or chasing) short-term performance of securities by a firm in their initial and ongoing review of a security's "competitiveness" and may block the approval of new, innovative products without a performance history (and with higher fees commensurate with a more complex product).

Supersized expectations for carrying out suitability determinations – Section 13.3

We agree with the CSA that, in most cases, it will be insufficient to conduct a suitability analysis by simply checking that the risk rating of the applicable securities is consistent with the client's risk profile. We also agree with the concept that firms and representatives may take a portfolio approach to suitability where doing so is in line with the client's preferences and instructions and that the risk rating of any specific security is only one input in the analysis of the overall risk of the portfolio held at the firm.

We also agree that in determining whether or not a particular security was suitable for the client (that is, after the fact), only the information relevant at the time of the suitability analysis should be taken into account. We agree that subsequent events, and in particular, poor performance, are not instructive or relevant to whether a suitability analysis at the given time met regulatory

requirements. We further agree that any review of a registrant's suitability determinations by a CSA member should be based on what a reasonable registrant would have done under the same circumstances.

However, we are concerned that the expanded rules around suitability set a "gotcha" standard that, as drafted, will be impossible for registrants to completely understand, implement and thus comply with. The Proposed Amendments require a registrant to determine that an "investment action" is suitable for the client based on a very extensive list of enumerated criteria. Pursuant to the proposed section 13.3(1), *the registrant must determine, on a reasonable basis, that the action satisfies the following criteria:*

(a) the action is suitable for the client, based on the following factors:

(i) the client's information collected in accordance with section 13.2 [know your client];

(ii) the registrant's understanding of the security required in accordance with section 13.2.1 [know your product];

(iii) the features and associated costs of the account type made available to the client;

(iv) the impact of the action on the client's account, including considering the account's concentration and liquidity;

(v) the overall concentration and liquidity across all of the client's accounts at the firm;

(vi) the potential and actual impact of costs on the client's returns;

(vii) a consideration of a reasonable range of alternative actions available to the registrant through the registered firm at the time the determination is made;

(viii) any other factor that is relevant under the circumstances, and

(b) the action puts the client's interests first.

This enhanced suitability determination includes the phrases "any other factor that is relevant to the circumstances" and "*puts the client's interests first*" as an undefined catch-all standard which we fear may render the "suitability" standard impossible understand and accordingly impossible to effectively comply with. In our view, this provision should be revised so that, after considering all the extensive criteria set out in the proposed subsection 13.3(1)(a) (i) through (vii) , and on that basis reasonably concluding that the investment action is suitable, this is sufficient to establish that the "action puts the client's interest first." In other words, we submit that the registrant ought to be able to take safe harbour in that the investment action puts the client's

interests first if it has considered all of the other enumerated criteria and reasonably concluded that the action is suitable for the client on that basis.

We strongly disagree with concept that "suitability is not enough" set out in subsection 13.3 of the proposed Companion Policy. Specifically, we reject the notion that *[t]he fact that a recommendation or decision is determined by the registrant, on a reasonable basis, to be suitable for a client, will not be considered enough to meet the [suitability] obligation. The registrant must also determine that the action puts the client's interest first.* The extensiveness of the enhanced suitability obligation and the vagueness of the concept of "putting the client's interest first" created by the lack of any clear definition or list of criteria or factors to assist registrants in making this determination renders this standard impossible to understand and highly vulnerable to misinterpretation and misapplication.

Further, we object to any removal of the following sections from the Companion Policy, which appear in the current version of the Companion Policy. These sections support the proposition that, like KYC obligations, suitability determinations should be tailored and scaled to be appropriate in the circumstances.

- *The extent of KYC information a registrant needs to determine suitability of a trade will depend on the:*
    - *client's circumstances*
    - *type of security*
    - *client's relationship to the registrant, and*
    - *registrant's business model*
- *In other cases, the registrant may need less KYC information, for example, if the registrant only occasionally deals with a client who makes small investments relative to their overall financial position.*

We are concerned that the proposed supersized KYC and suitability requirements take a one-size-fits-all approach that will not be appropriate for all investors. While the proposals may be beneficial to some vulnerable or unsophisticated investors who seek more fulsome financial planning, they inappropriately restrict the autonomy of other investors, who wish to retain privacy over the financial affairs (particularly wealthy investors may wish this) or wish to delegate some investment decisions to an adviser, while retaining control over other assets.

Supersized expectations for identifying and managing conflicts of interests – Section 13.4

We have no issue with the principle that all registrants should identify and then manage conflicts of interest by prioritizing client's interests and by explaining to clients what conflicts apply and

how they are managed to achieve this result. We propose, however, that these provisions should be revised to codify the established materiality standard for avoiding conflicts of interest.

There continues to be much use of vague and undefined language in the rules and the Companion Policy. The terms "existing conflict of interest", "conflicts of interest that are reasonably foreseeable", "addressing conflicts of interest in the best interest of the client", "avoiding conflicts", "addressing conflicts" are broad, vague and ill-defined concepts. In our experience as lawyers, it is very difficult to explain conflicts of interest in a conceptual theoretical way – much less identify circumstances when conflicts exist, except in the most obvious of circumstances. Given the challenges inherent in managing conflicts, we consider that a uniform and clear definition is in order for the concept of a conflict of interest. We fully appreciate that the CSA has attempted to provide guidance on a workable definition of conflicts of interest in *Division 2 – Conflicts of Interest in the Companion Policy*, and we consider that this guidance (particularly in the opening discussion under the heading "What is a conflict of interest?") will be of assistance. However, we are alarmed with the potential breadth of the concept set out in section 3 of this paragraph and in particular the addition of these words *potential detriments to which a registrant may be subject, may compromise the trust that a reasonable client has in their registrant.* The multiple potential meanings and interpretations that may be (mis)applied to "potential detriments" and/or how they may compromise the trust between registrant and client, is very troublesome.

Particularly when dealing with conflicts of interest, we consider it critical that the CSA allow registrants to determine their own approach to conflicts of interest, including a working definition of conflicts of interest, and unless that approach and definition is wildly off-base and deficient, the CSA must defer to the judgment of the registrant – particularly when the notions set out by the CSA are so broad and ill-defined, and likely not capable of additional precision by regulators. We strongly recommend that this concept be included in the Companion Policy, in an even more strong fashion than it is currently proposed.

Longstanding commercial realities that transcend the securities industry, including the necessary role of sales revenue and compensation reflective of such revenue, must be recognized in the Companion Policy discussion about conflicts of interest. For example, it is a commercial reality that registered firms charge fees for the services they provide. However, charging fees also creates a conflict of interest between the registered firm and a client of that firm. Arguably, under the proposed subsection 13.4.2(2), resolving the conflict in the client's best interest would require the firm to reduce its fee for services to zero. But, if the firm does not charge fees for the services it provides, it cannot, as a practical matter, remain in the business of providing services to clients. This is one of many examples where compliance with the proposed rule would require registrants to behave in a commercially untenable manner.

In our view, subsection 13.4.2(2) should be revised to better align with past consideration of registrants obligations with respect to conflicts of interest. In *Crown Hill Capital Corporation and Wayne Lawrence Pushka*, the OSC notes "… an IFM's fiduciary duty under section 116 of

the Act requires that the IFM….generally avoid material conflicts of interests and transactions that give rise to *material* conflicts of interest on the part of the IFM, including self-interest and related party transactions."[4] Codification of the requirement previously endorsed by the OSC, namely, that even registrants with fiduciary obligations need avoid material conflicts of interest, would permit more commercially tenable compliance with the rule and protect investors.

We submit that proposed section 13.4.3(3)(b) creates superfluous logistical issues and ought to be revised. Proposed section 13.4.3(2) requires that *a registered individual must not engage in any dealing or advising activity in connection with a conflict of interest identified by the registered individual unless…the registered individual's sponsoring firm has given the registered individual its consent to proceed with this activity.* Obtaining specific consent for each and every dealing or advising representative in connection with a conflict of interest would be logistically very challenging. However, the firm's policies and procedures must address conflicts of interests. Therefore, we recommend that clause 3(b) of this section be revised to read *the registered individual's activity is made in accordance with the policies and procedures of the individual's sponsoring firm with respect to such conflict of interest or the registered individual's sponsoring firm has given the registered individual its consent to proceed with the activity.*

We submit that the proposed subsection 13.4.5(5) flies in the face of long established common law principles and practice and should therefore be deleted. Under proposed subsection 13.4.5(5), *[a] registered firm must not rely solely on disclosure to address, in the best interests of the client, conflicts of interest….* It has long been established at common law and practice that, in some circumstances, disclosure is appropriate and sufficient to manage a conflict of interest. We note that this disclosure is anticipated in section 13.6, which raises significant questions as to meaning of this proposed rule. We also note that the Companion Policy discussion refers to the importance of disclosure to clients, which again raises significant questions as to when this subsection would ever be operative.

The compliance challenges related to conflicts of interest are amplified when reviewing the Companion Policy. Some examples of compliance challenges are set out below:

- The discussion on the record-keeping expected on conflicts provided for in section 11.5 of the Companion Policy. We agree with the notion of keeping records – but the level of detail expected in this discussion does not appear proportionate. In our view, the CSA should allow registrants to develop their own practices and conflicts mitigation strategies, which should be respected by the regulators on a compliance or enforcement action;

- The discussion around "avoiding" conflicts of interest provides little to no practical guidance on what it means to have *no controls available in the circumstances that would*

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[4] *Crown Hill Capital Corporation and Wayne Lawrence Pushka*, OSC, August 23, 2013 at para 112. http://www.osc.gov.on.ca/en/41599.htm

be sufficient to address the risks to the client's interest. These are strong words and CSA policy that are not backed up by any real concept of what this would be or mean.

- The discussion around "avoiding conflicts" in respect of "proprietary products" is inconsistent in various respects. What would it entail for a firm to be not *controlling this conflict in the best interests of clients*, such that it should be avoided (we recognize that the CSA has provided examples of controls)? What would happen if a firm decided not to put in place all of the controls listed – and in particular decides not to *obtain independent advice on, or an independent evaluation of, the effectiveness of the firm's policies, procedures and controls to address this conflict*? We consider the CSA's proposals here to be far too detailed and granular and are another example of the CSA substituting its judgment for that of registrants. Given the level of detail and granularity, we strongly recommend that the CSA explain they do not expect all registrants to adopt all concepts and will not take any action if they discover a firm has not done this.

- The discussion on "third party compensation" – comes with the unstated proposition that this would be the way that the CSA will address some of the concerns expressed over the past five-six years about trailing commissions. We fear that this Companion Policy discussion will be used to indirectly "ban" trailing commissions, which we understand not to be the case. A clear recognition from the CSA that trailing commissions remain an appropriate compensation practice would rectify the current impression.

New restrictions on referral arrangements – Sections 13.7 and 13.8.1

Under the Proposed Amendments, registrants will not be able to pay referral fees to a non-registrant, although referrals from non-registrants to registrants (so long as they are not compensated) will continue to be permitted. Where permitted, referral fees will not be able to be paid for more than 36 months and the referral fee cannot exceed 25 percent of the fees and commissions collected from the client by the party who received the referral. Clients must also not bear increased fees or commissions due to any referral fees being paid.

We note that the CSA did not fully explain the proposed blanket ban on referral arrangements, and the justification for such action is really only clearly explained in Annex E to the publication of the Proposed Amendments in Ontario. This is an Ontario-only "regulatory impact" study of the Proposed Amendments (although we feel it does not completely and fully achieve this status). We encourage the CSA to reconsider the elements of the proposed blanket ban – particularly in light of our comments and those of industry participants. We consider that some of the concerns raised in the Annex E particularly around incenting individuals to "give up" registration could be addressed in other ways that are less intrusive to existing industry practices and relationships.

We submit that the proposed blanket ban on referral arrangements paid to a non-registrant under the proposed section 13.7 is flawed and not in keeping with the 1999 Distribution Structures Committee Position Paper published by the CSA and the original reasons for implementing the current regime.

In the Distribution Structures Committee Position Paper, the committee found that (i) referrals between registrants and non-registrants carried potential risks, but these potential risks did not warrant banning such referral arrangements and (ii) referral arrangements between a registrant and a non-registrant that is nonetheless a regulated entity in the context of financial regulation (such as financial institutions, insurance agents, insurance brokers, mortgage brokers, real estate brokers and financial planners) cured most, if not all, of the concerns in (i) where specified conditions are satisfied.[5]

This finding was reflected in the originally proposed CP to NI 31-103 which noted:

Typically, a client will rely on a registrant to have the ability to invest their portfolio and to give appropriate investment advice… if a registrant does not have the expertise or appropriate registration to provide a service, it is expected that the registrant will refer their client to an appropriately qualified person.

Part 6, Division 2 of NI 31-103 applies to any referral to a registrant where the registrant is paying for the referral and to referrals from a registrant to a person or company that provides investment products or services including:

- *a mortgage broker or mortgagee*
- *a financial planner for financial planning services*
- *an exempt market dealer for trading in flow-through shares*
- *a portfolio manager for discretionary management services.*

Therefore, the previously-proposed referral regime was adequate for the purposes of guarding against the dangers associated with referrals. We continue to believe this is the case.

Moreover, the ban on referral arrangements between registrants and non-registrants negates the purpose of referrals. Non-securities related services providers, such as accountants, lawyers, financial planners and insurance agents, often refer their clients to registrants so that their clients (retail investors) can access services that the provider does not provide. A prohibition between referral arrangements between registrants and non-registrants defeats the purpose of having referral arrangements at all – which is to provide clients with access to services. We consider that the OSC’s suggestion in Annex E that portfolio managers who rely on referrals will *likely need to turn to alternatives such as traditional advertising to attract clients* is not commercially reasonable or balanced and fails to fully acknowledge the regulatory impact on these firms. This statement also fails to acknowledge that some investors may not fully appreciate their need for the services of a registrant (to which they would otherwise be referred).

[5] CSA Distribution Structures Committee Position Paper, August 27, 1999, http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_19990801_33-304_distributionstructures.jsp.

Further, these restrictions could have competition stifling effects since they could shut down very viable and proper sources of client business for smaller firms. This said, it will also stifle inter-group referrals among larger financial complexes since a referral arrangement between a non-registrant business that is related to a registrant business under the same corporate umbrella would also not be permitted. Similarly referrals amongst registrants are being subject to limitation, particularly with respect to length, which, we consider, prohibitive. The overall effect will be a less integrated and holistic experience for investors.

We submit that the Proposed Amendments should be revised to permit appropriate referral arrangements between registrants and among registrants and non-registrants that are nonetheless regulated entities in the context of financial regulation, as determined to be without risk in the Distribution Structures Committee Position Paper and as was reflected in the original proposed Companion Policy to NI 31-103.

We submit that many referral arrangements work and function in accordance with regulatory expectation and to the benefit of investors, who often receive a broader and more integrated financial experience from the parties involved as a result. Imposing the proposed restrictions on this otherwise workable rule to prevent a few "bad apples", whose behaviour could otherwise be addressed with existing enforcement tools and regulation, is not necessary.

Finally, we note the confusion that may be introduced into negotiated commercial transactions with the reference in the proposed revisions to section 13.7 of the Companion Policy regarding "bona fide sales of a business". What would be a non-bona fide sale of a business? This paragraph simply introduces a degree of confusion and unknowns that are unexplained (and are not referred to elsewhere) by the CSA and we recommend this paragraph be simply deleted.

Overall comment on the conflicting rules and policies with respect to registrants offering proprietary products

We assume that the concerns around "proprietary products" are primarily around investment funds and other manufactured investment vehicles (as opposed to public issuers of securities) that are managed and distributed by the same entity or related entities. We note that this term is defined in proposed subsection 14.2(0.1) of the proposed amendments to NI 31-103, using broader terms, but feel that, in light of the considerable commentary about "proprietary products" interspersed through the Companion Policy, the CSA are primarily focused on manufactured investment funds and other investment vehicles. Our first comment is that the CSA should say this clearly and explain what their concerns are – nowhere in the Notice or the Companion Policy are the CSA's concerns, if they have any, expressly discussed.

We are concerned that the current drafting of the Proposed Amendments is inconsistent and somewhat confusing around the distribution and use by registrants of "proprietary products". There are several references which could lead one to conclude that if a "proprietary products

only" registrant reviewed the other comparable securities, including funds, in the marketplace and determined that their proprietary funds were "less competitive" to other securities or funds in the asset classes appropriate for the client, then that registrant would have a duty not to make its funds available for sale and to instruct its representatives to advise clients not to buy their inferior funds. However, there are also several references which lead us to believe that the foregoing is not the position of the CSA or the intended outcome of the proposals. We submit that the CSA should revise the Proposed Amendments to correct these contradictions and clearly explain what principle they are attempting to achieve.

For example, section 13.2.1 of the Proposed Amendments provides that a registrant *must not make a security available to clients unless the firm takes reasonable steps to understand the security, including… how the security compares to* *__similar securities in the market__*. The registrant must then decide which securities to "approve" for its product shelf. These statements suggest that if the registrant concluded that a proprietary fund was inferior to other comparable funds on the market, it should not be approved for sale.

Further, under the proposed amended Companion Policy to 31-103, *it is a conflict of interest for a registered firm to trade in, or recommend, proprietary products. Such firms must be able to demonstrate that they are addressing this conflict in the best interest of its clients. If a registered firm is not controlling this conflict in the best interest of its clients, the firm must avoid this conflict.* Notwithstanding this statement, the proposed amended Companion Policy also states that a registered firm that only trades in or recommends proprietary products *__could__* *[not must] consider the following controls when determining how to address this conflict in the client's best interest*. The enumerated list of controls that follows includes *conducting periodic due diligence on comparable non-proprietary products available in the market and evaluating whether the proprietary products are competitive with the alternatives in the market.* It is unclear if this section of the Companion Policy means that, if periodic due diligence on comparable non-proprietary products available in the market leads a registrant to conclude that its proprietary products are inferior, then that the conflict cannot be addressed and must be avoided by ceasing to offer the product to clients.

We also highlight the reference to the requirement to disclose "any restrictions on products or services" registrants will offer clients contained in section 14.2 of NI 31-103. This provision goes on to require registrants to disclose in "relationship disclosure information" *the impact on a client's investment returns from each of the forgoing* – which includes the aforesaid restrictions. We ask the CSA to clarify what impacts are expected to be disclosed here regarding proprietary products.

The CSA also imply that a restricted shelf or the distribution of proprietary products involves a very material conflict in the discussion about the records a registrant must maintain in section 11.5 of the Companion Policy. We have no idea about what a "product-shelf development

conflict" would be (as referred to in this section). Because it is considered a material conflict, the CSA explain that the CSA would expect to see "more detailed documentation for conflicts".

However, there are other references in the Proposed Amendments that suggest that a registrant with a shelf of exclusively proprietary products may be able to continue to operate and offer products to its clients even if its products are "less competitive" to others available on the market. Pursuant to the proposed section 13.2.1(2) of NI 31-103, *a registered firm must maintain an offering of securities and service that is consistent with how it holds itself out.* Further, the Companion Policy states that *a firm's offering should meet the reasonable expectations of clients that result from how the firm holds itself out.* These sections suggest that, as long as the firm holds itself out as offering proprietary products, and as long as clients understand that they will only be proprietary products, the client's reasonable expectations will be met.

Further, proposed subsection 13.2.1(3)(a) of NI 31-103 further states that *a registered individual must not purchase or sell a security for, or recommend a security to, a client unless the registered individual takes reasonable steps to understand… the securities available through the registered firm.* This statement implies that, for a registered dealer of only proprietary products, the appropriate frame of reference against which to compare securities are the products available through the firm, and not the marketplace as a whole. The trade would only need to be declined, avoiding the conflict of interest, if there was no suitable product on the registrant's shelf, as stated in the proposed amended Companion Policy.

In addition, the proposed Companion Policy recommends that registrants offering only proprietary products to their clients consider making the following disclosure: *the suitability analysis … will not consider the larger market of non-proprietary products or whether those non-proprietary products would be better, worse, or equal in meeting the client's investment needs and objectives.* This again implies that it is not the position of the CSA that registrants offering only proprietary products must consider the broader marketplace of available securities and may not offer their products to clients if they determine that there is a non-proprietary product that is superior to their proprietary product.

However, in our view, somewhat unreasonably, the Companion Policy goes on to require that *the firm must also disclose how they are addressing this conflict in the best interests of their clients.* The registrant cannot address the conflict in the best interests of the client (as that phrase may be commonly understood) unless the registrant happens to consistently offer (objectively speaking) the *best* products on the market. Practically, such a requirement would make operating a firm offering exclusively proprietary products impossible in most cases. This added obligation, that the firm must also disclose *how they are addressing the conflict in the best interests of their clients*, should be deleted.

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We hope that our comments will be considered positively by the CSA and as helpful to advance the CSA's considerations of the important matters outlined in the Proposed Amendments. We would also be very pleased to organize a meeting with the lawyers who participated in the preparation of this comment letter to discuss our comments further with interested CSA staff if this would be considered useful.

The following lawyers (in alphabetical order) participated in the development of this comment letter:

Jason Brooks, Rebecca Cowdery, David Di Paolo, Maureen Doherty, Jessica Evans, John Hall, Lynn McGrade, Laura Paglia, Caitlin Sainsbury, Donna Spagnolo, Prema Thiele and Matthew Williams.

Please contact Rebecca Cowdery at rcowdery@blg.com and 416-367-6340 if you have any questions on our comments or wish to meet with us to discuss any or all of our comments.

Yours very truly,

Borden Ladner Gervais LLP

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