Stikeman Elliott

Stikeman Elliott LLP
Barristers & Solicitors
5300 Commerce Court West
199 Bay Street
Toronto, ON Canada M5L 1B9

Main: 416 869 5500
Fax: 416 947 0866
www.stikeman.com

October 19, 2018 **By Email**

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

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

M[e] Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, Square Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal, Québec H4Z 1G3
Fax: 514-864-6381
Email: consultation-en-cours@lautorite.qc.ca

Dear Sirs/Mesdames:

Re: CSA Notice and Request for Comment – Proposed Amendments to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* and to Companion Policy 31-103CP *Registration Requirements, Exemptions and Ongoing Registrant Obligations* – Reforms to Enhance the Client-Registrant Relationship (Client Focused Reforms)

We refer to the CSA Notice and Request for Comment published by the Canadian Securities Administrators (the "**CSA**") on June 21, 2018 with respect to proposed amendments to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* ("**NI 31-103**") and to Companion Policy 31-103CP *Registration Requirements, Exemption and Ongoing Registrant Obligations* ("**CP 31-103**") described as "Reforms to Enhance the Client-Registrant Relationship (Client Focused Reforms)" (the "**CSA Proposals**").[1]

We act as counsel to Newport Private Wealth Inc. ("**Newport**") and this letter is submitted by the undersigned on its behalf. Our comments are limited to the proposed restrictions on referral arrangements, as our client has contributed, as appropriate, to submissions made by industry associations on the other matters in the CSA Proposals.

[1] *Client Focused Reforms: Proposed Amendments to National Instrument 31-103 and Companion Policy 31-103CP*, (2018) 41 OSCB (Supp-1) [CSA Proposals].

As discussed in further detail below, our response to the CSA Proposals is: (i) that the development and articulation of the proposed restrictions on referral arrangements falls far short of accepted norms concerning the use of regulators' rule-making authority, and (ii) that these proposed restrictions will not advance the stated purposes of the proposed reforms, instead having material negative consequences for investors, the financial services industry and the Canadian economy.

The remainder of this letter is divided into two sections. The first section provides background information about Newport, its approach to referral arrangements and the benefits its clients obtain as a result of referrals. The second section provides specific comments on the CSA Proposals, identifying items where inadequate rationale was provided, unintended consequences of the proposed restrictions on referral arrangements and alternative approaches for consideration by the CSA.

1. About Newport

Newport was founded in 2001 and is registered as a Portfolio Manager, Exempt Market Dealer and Investment Fund Manager in all jurisdictions in Canada. The firm employs 48 people and is entrusted with managing over $2.8 billion of the wealth of hundreds of clients.

In 2012, Newport determined that there was an opportunity to expand the reach of its service offering to include mass affluent clients and began creating a network of referral arrangements (the "**Referral Network**"). The Referral Network was purpose-built to achieve three main objectives: (i) provide more clients with access to a professionally managed portfolio and investment solutions, (ii) create opportunities for younger investment professionals, and (iii) build awareness of the firm with a stronger presence across Canada. As further described in Appendix A, the pursuit of these objectives through the Referral Network has allowed Newport to bring enhanced investment options subject to a higher standard of care to hundreds of clients since 2012 while contributing to both the development of investment professionals and the availability of portfolio-management services across Canada.

Based on its involvement in and observation of the market for financial services, Newport shares many of the concerns raised by the CSA in the CSA Proposals, specifically those regarding exclusive arrangements, fee parity, full disclosure, reporting requirements and clear guidelines for the activities of referral sources, as further detailed in Appendix B. While Newport agrees that these issues must be addressed, its experience also leads it to believe that the CSA's objectives would be best achieved by other means and that the CSA Proposals would likely have unintended, negative consequences.

2. Comments on the CSA Proposals regarding Referral Arrangements

The CSA cites four primary concerns as motivating the CSA Proposals, summarized as: (i) a perception that clients are receiving poor value or returns from investing; (ii) agency conflicts that may result in sub-optimal decisions being made for clients; (iii) the existence of a loose or poorly understood framework for managing conflicts of interest between clients and financial professionals; and (iv) information asymmetries between clients and registrants.

In response to these concerns, the stated purposes of the CSA Proposals are to better align the interests of registrants and their clients, improve outcomes for clients and clarify the nature and the terms of their relationship with registrants. These proposed reforms include: (i) new requirements to put clients' interests first when making suitability determinations; (ii) enhancing the existing know-your-client requirement and introducing a new know-your-product requirement; (iii) addressing conflicts of interest; (iv) imposing additional disclosure, training, record-keeping and monitoring requirements; and (v) imposing significant new restrictions on referral arrangements.

For Newport, referral arrangements allow financial advisors to introduce clients to its registered portfolio managers, who manage clients' investments under a strict best-interests standard. Currently, any firm that pays referral fees must provide comprehensive details on all such arrangements to its regulator (the frequency and content of which are prescribed by the regulators) and the introducing financial advisor must refrain from further advising the client on investment decisions. Generally speaking, the compensation paid to an introducer is less than what a financial advisor would earn selling a client a segregated fund or mutual fund.

Newport agrees with the CSA's overarching goal, which is to have more clients be served according to a best-interests standard. Newport believes that promoting the broad availability of referrals to Portfolio Managers represents the single fastest method of effectively achieving that goal. By contrast, the CSA Proposals regarding referral arrangements would likely decrease the number of clients managed according to a best-interests standard. The driver of this unintended consequence is the proposed implementation of arbitrary limits to referral compensation:

- the requirement that the person referring a client (and receiving a referral fee) be a registrant; and
- the restriction of referral fees to (i) not more than 25% of fees/commissions paid by a client, and (ii) not more than 36 months in duration.

The above terms would represent an unprecedented imposition of compensation limits in the financial services sector. While most of the proposed reforms in the CSA Proposals were expected, have been the subject of extensive discussion and debate within the industry and are consistent with the overall focus of the CSA on improving client relationships, the restrictions on referral fees (the "**proposed restrictions**") were a surprise. In discussions over the past four months with dozens of industry participants (firms and associations) that would be most affected by the proposed restrictions, neither we nor Newport could find a group that was consulted on them.

As discussed in section 2(a) below, the development and articulation of the proposed restrictions on referral arrangements falls far short of accepted norms concerning the use of the regulators' rule-making authority (and regulatory reform generally). More importantly, as discussed in section 2(b) below, it is clear that the proposed restrictions will not advance the stated purpose of the proposed reforms and will have material negative consequences for investors, the financial services industry and the Canadian economy.

We embrace the CSA's stated regulatory objectives, but are concerned that the application of certain of the proposed reforms concerning referral arrangements will cause regressive outcomes – clients will be subjected to information asymmetry as financial advisors remain constrained to the largest financial service firms in Canada.

We believe that the securities industry and investors will be better served by enhanced transparency and oversight. While we are also sympathetic to the OSC's stated concern that existing referral arrangements can lead to "leakage" of regulatory jurisdiction (and fees) – i.e., dealing representatives giving up their registrations and working on a referral basis – the proposed restrictions leave a major gap because they do not capture a range of financial advisors and products not regulated under securities laws (including high-cost segregated funds offered by the insurance industry). As outlined in section 2(c) below, we believe there are more effective (and less intrusive) regulatory instruments to address the OSC's stated concern.

a. The CSA (and OSC Staff in Our Discussion with Them) Provide Weak Rationale and Virtually No Analysis to Support Restrictions on Referral Arrangements

Notwithstanding the CSA's full access to data on referral arrangements, the proposed restrictions are not supported by any published empirical evidence, cost/benefit analysis or regulatory-impact analysis.

Subsection 143.2(2) of the *Securities Act* (Ontario) specifies that, when publishing proposed rules for public comment, the notice must contain a discussion of all alternatives to the proposed rule that were considered by the OSC and the reasons for not proposing the adoption of alternatives considered. The notice must also contain a description of the anticipated costs and benefits of the proposed rule. Both are absent from the CSA Proposals.

The proposed restrictions do not reflect any consideration of alternative regulatory approaches. This is particularly surprising as, in 2015, an Expert Committee mandated by the Minister of Finance consulted broadly on the issue of referral arrangements and, in 2016, published its recommendation to extend the existing framework applicable to those in the securities industry (transparency to clients and assumption of training and oversight responsibility by the registrant) to those within the insurance and mortgage brokering sectors. The Expert Committee noted that referral arrangements can help consumers access financial services and products that meet their needs and enhance the ability of registrants to act in the best interests of clients.[2] Its recommendations were supported by investor advocacy groups and industry participants alike.

Alternative referral structures that have been successfully implemented in other jurisdictions were not examined. The CSA did not review or consider the approaches taken regarding referral arrangements by the U.S. Securities and Exchange Commission, the U.K. Financial Conduct Authority or the Australian Securities and Investment Commission. While each has taken a slightly different approach, none have adopted hard limits or caps on referral fees.[3] Further, each has provided explicit guidelines for registrants and non-registrants who wish to conduct referral activity in a compliant manner. This approach has undoubtedly expanded the number of clients who have been able to access a licensed fiduciary to manage their investment assets.

The OSC has made bald assertions about those accepting referral fees engaging in "registrable activity" without providing any supporting legal analysis.[4] Nor have the CSA proposals considered the likelihood that imposing restrictions will result in "arbitrage" (the shifting of clients into unregulated referral arrangements or high-cost proprietary products). This concern and other unintended consequences are considered in greater detail in section 2(b) below.

Questionable authority for rate regulation. The proposed restrictions would implement, on a highly selective basis, "rate regulation" with respect to the marketing of investment products and services without regard for other equivalent or less favourable (from a client-interest perspective) forms of sales costs and incentives. Many securities dealers and mutual funds pay financial advisors between 50% and 60% of client revenues. The only relevant limitation on referral fees consistent with a best-interests standard might be to ensure that a client is not paying more because of the referral. Even this would be more restrictive than the regulatory frameworks imposed elsewhere in the investment industry.

Evidence provided in earlier industry studies was ignored. The CSA cited industry-based evidence in Staff Notice 81-330 that a majority of investors prefer an ongoing bundled payment option and, if financial

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[2] "Financial Advisory and Financial Planning Regulatory Policy Alternatives: Final Report of the Expert Committee to Consider Financial Advisory and Financial Planning Policy Alternatives" (November 1, 2016) [Expert Committee] at 60-62.

[3] See Appendix C.

[4] See Appendix D.

advisors were required to charge their clients directly, almost a quarter of investors would be less likely to seek out advice.[5] These possible consequences of the proposed restrictions have not been sufficiently addressed by the CSA. Such analysis is required by law and logically necessary, as it would appear that the possible detrimental effects of the proposed restrictions could outstrip their purported benefits.

Concerns exist regarding the definition of conflicts of interest. The CSA simply states that "paid referral arrangements are conflicts of interest"[6] even though there is not necessarily such a conflict where, as discussed above, a client is not paying more to access a Portfolio Manager because of the referral. The CSA has framed its analysis of conflicts of interest from the perspective of a referral source without consideration of the existing checks on conflicts of interest resulting from the obligations of the registrant to whom a client is referred. Moreover, concerns regarding potential conflicts due to exclusive arrangements have not been considered in light of industry practices. Newport itself does not promote a model in which a referral source relies exclusively on one Portfolio Manager and Newport has not encountered any requests for exclusivity from its referral sources.

A clear framework for managing conflicts already exists. Where there is the potential for a referrer and/or a registrant to be conflicted as a result of a referral arrangement, we believe that such conflicts are capable of being addressed through a combination of disclosure to the client and the obligations of the registrant to whom such a client has been referred to act in that client's best interests. Again, rigorous analysis of why existing measures are lacking is absent from the CSA Proposals. In fact, the limited analysis provided by the CSA suggests that the non-compliance of a small subset of registrants and non-registrants has been mistaken for the ineffectiveness of certain rules. As discussed in section 2(c) below, this matter may be more appropriately addressed through enforcement action and, if necessary, more targeted reforms.

b. The Proposed Restrictions Would Have Material (Presumably Unintended) Consequences for Clients and the Financial Sector that Were Not Considered

If implemented, the proposed restrictions would have adverse effects on the availability of financial services for retail investors and the synergies between providers of such financial services, resulting in deleterious consequences for investors. The CSA Proposals do not consider these concerns, which militate against the imposition of the proposed restrictions. Nor do the CSA Proposals provide a viable solution for the billions of dollars of client investment assets and thousands of Canadian families that will likely lose access to fiduciary portfolio-management services as a result of the proposed restrictions.

The proposed restrictions would negatively affect the availability of financial services for a significant number of Canadian investors. According to the CSA Proposals, retail client referral activity is conducted by 60% of portfolio managers and represents 9% of their assets,[7] representing thousands of Canadian families. The CSA Proposals go on to state that "it is not clear where [these] clients […] would go in the future"[8] – a reasonable admission as to the lack of analysis and the likelihood of unintended adverse investor outcomes. The proposed restrictions would reduce client service options (as acknowledged recently by the Expert Committee in Ontario[9]) and increase concentration and homogeneity in the market for such services. Without referral activity, retail investors will have access to fewer services as readily as under the current regulatory framework. This concern is particularly acute in remote communities and with

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[5] CSA Staff Notice 81-330 *Status Report on Consultations on Embedded Commissions and Next Steps*, (2018) 41 OSCB 5041 at 5045 fn 16.

[6] CSA Proposals, *supra* note 1, at 199.

[7] *Ibid* at 259.

[8] *Ibid*.

[9] Expert Committee, *supra* note 2, at 60-62.

respect to less regulated financial products and services (i.e., insurance), where retail investors may be reliant on referrals to access services only available in distant capital-market hubs.

The proposed restrictions would disrupt synergies among providers of financial services and encourage avoidance through investor-unfriendly behaviour. Currently, Portfolio Managers, Mutual Fund Sales Representatives, IIROC-regulated advisors and Dealing Representatives of Exempt Market Dealers provide ongoing compensation to financial advisors. The proposed restrictions would significantly reduce the desirability of pursuing a fiduciary offering for a client through a referral to a third-party Portfolio Manager. This compensatory element has also not been adequately considered by the CSA.

Concerns regarding client abandonment and three-year churn. The introduction of an arbitrary misalignment between the referral payment term and the duration of a client relationship will have negative consequences for investors. For example, currently, ongoing referral payments ensure that financial planning services continue to be provided to clients by certain referral sources and complement the activities of Portfolio Managers, which either may not offer such financial planning services on an ongoing basis or would be less effective at doing so given their lack of proximity to many clients. Under the proposed restrictions, independent financial planners may be disincentivized to continue providing such services beyond the initial 36-month period. Moreover, some planners and financial advisers may be incentivized to churn their clients through Portfolio Managers on three-year cycles in order to maximize their referral payments. While each new Portfolio Manager may be equally suitable for such clients, these activities would defeat any advantages gained through long-term registrant-client relationships, such as a more precise understanding of each client's financial needs and circumstances and the minimization of friction costs. Aligning the terms of referrals and financial services creates synergies for clients, which have not been adequately considered by the CSA. To achieve these benefits, compensation must be aligned as well, both with respect to referrals and services and across providers of those services.

The reforms could cause a switch to investment options provided by non-registrants. The proposed restrictions will likely result in greater investor-unfriendly behaviour, including the switching of clients to higher-cost products and the imposition of new commissions. Some financial advisers and planners will be provided with a financial incentive to switch their clients to higher-cost products that are not subject to the proposed restrictions. In addition to being more costly to clients, such products may not provide the fiduciary offering of Portfolio Managers. For those financial advisors and planners that do continue to provide referrals, some may begin to require their clients to pay additional commissions or fees directly to them for the referral. There is no evidence to suggest that financial advisors and planners will undertake referrals to Portfolio Managers for free. Commissions and fees paid directly by clients would be the only forms of compensation available to referrers in a market constrained by the proposed restrictions. Such commissions would not only increase the amount ultimately paid by clients for financial services and products but also represent a new inefficiency and inconvenience for them.

Stranded business investments for industry participants. A further consequence remains unanswered by the CSA, which is what firms with referral activities should do with existing business lines. A somewhat glib comment regarding a return to "traditional advertising"[10] is a further signal of regulatory insensitivity to the livelihood of hundreds of individuals and families across the country who have engaged in a referral business model in a compliant manner and in the interest of serving clients under a model endorsed internationally and, indeed, by the Government of Ontario's own Expert Committee.[11]

[10] CSA Proposals, *supra* note 1, at 259.

[11] Expert Committee, *supra* note 2, at 60-62.

c. The Stated Objectives of the CSA Can Be Better Achieved by More Targeted Reforms and Regulatory Initiatives

Any perceived abuses of referral arrangements should first be addressed by concerted enforcement initiatives. The OSC and other regulators already possess a number of enforcement options for tackling inadequate referral arrangements that provide considerable flexibility.[12] The success of past enforcement measures in identifying and correcting non-compliant referral activity suggests that targeted initiatives can be effective. In any event, the CSA did not provide an explanation as to why the existing approach is no longer sufficient.

Newport is supportive of the CSA providing guidance in instances where Portfolio Managers have been required to implement enhanced business model requirements due to managing referral arrangements improperly (e.g., inappropriately delegating know-your-client and suitability obligations). These enhanced requirements have generally resulted in improved business practices to the benefit all stakeholders. While there have been troubling categories of referrals outside of the system maintained by the CSA (e.g., referrals from non-registrants to brokers licensed by the Financial Services Commission of Ontario ("**FSCO**") selling syndicated mortgage products as investments), within the CSA's purview, there have been many more cases of successful referrals benefiting clients and promoting more efficient capital markets. Examples include allowing registrants and life-insurance-licensed financial planners to refer clients to Portfolio Managers for investment-management services while maintaining essential client relationships. In the context of these successes, the proposed restrictions appear heavy-handed and unnecessary. Fine-tuning the regulation of referral arrangements for financial services in Canada requires targeted reforms rather than a drastic overhaul.

We offer the following suggestions for consideration:

Require comprehensive transparency on referral activity and enhanced proficiency requirements for firms accepting referrals. The CSA should focus on comprehensive transparency and monitoring requirements. Portfolio Managers who accept referrals should undertake responsibility for vetting, qualifying, training (on an ongoing basis), monitoring, auditing and reporting on referral activity. This will facilitate compliance with their fiduciary obligations to their clients and provide data for future regulatory reform, if needed. Each of the U.S. and U.K. regulatory frameworks addresses these concerns. In fact, the U.K. model establishes a separate category of registration for introducer authorized representatives ("**IARs**").[13] Each of these approaches (both focused on imposing a best-interests standard on those engaged in referral arrangements) would achieve better client outcomes than the proposed restrictions. The U.K. approach with a distinct category for IARs also has the added benefit of addressing regulators' concerns about regulatory "leakage".

Introduce a formal regulatory standard for referrals. An alternative approach would be a prescriptive business model designed to ensure that portfolio managers and non-registrants act consistently in a manner that protects the best interests of clients. The framework set out below centres on proficiency testing, referral disclosure, on-going training and distinguishing between active and passive referral businesses:

- First, a requirement for registrants to undertake comprehensive proficiency testing of all referrers in the areas of education, integrity and solvency would address many of the policy considerations identified in the proposed amendments to CP 31-103 without arbitrarily constraining referral compensation.

[12] See Appendix E.

[13] See Appendix C.

- Second, disclosure of referral arrangements in a manner consistent with the CSA Proposals would be beneficial for investors and the industry.

- Third, portfolio managers should provide ongoing training to all referral partners regardless of registration status. Such training would be consistent with the proposed section 3.4.1 of NI 31-103 but be applied beyond only registered individuals.[14]

- Fourth, this framework would distinguish between active and passive referral businesses to prevent unintended consequences. Individuals with active accounting, legal, financial-planning, wealth-management and life-insurance activities that incidentally provide referrals in the ordinary course of such businesses ought not be subject to any caps on referral compensation subject to registrants complying with the other elements of this framework. Preventing non-registrants such as life-insurance advisors and qualified financial planners from engaging in referrals would lead to unintended consequences as described in section 2(b) above. Moreover, it is unclear if the proposed restrictions would be effective at achieving the desired outcomes in the absence of regulatory alignment with FSCO rules. With respect to active referral businesses, such businesses may warrant targeted regulatory oversight or even a distinct category of registration, as discussed in the preceding paragraph. The distinction between active and passive referral businesses may be necessary to address concerns regarding some non-registrants while not penalizing all non-registrants, particularly those that provide referrals incidentally to professional and financial services.

These frameworks (coupled with targeted enforcement initiatives) provide two possible approaches to reforming the regulation of referral arrangements. They are intended to highlight how targeted reforms might ensure that investors are better protected while still enjoying the benefits of referral arrangements. They should be considered before moving ahead with the proposed restrictions on referral arrangements contained in the CSA Proposals.

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[14] CSA Proposals, *supra* note 1, at 17.

Thank you for the opportunity to comment on one element of the CSA Proposals. Should you have any questions or wish to discuss the comments provided in this letter, please do not hesitate to contact the undersigned.

Yours truly,

Edward J. Waitzer

Darin R. Renton

John C. P. Henderson

c.c.: Douglas C. Brown, *Newport Private Wealth Inc.*
Novlette Simpson, *Newport Private Wealth Inc.*
Kelly A. Baird, *Newport Private Wealth Inc.*
Matthew Reynolds, *Newport Private Wealth Inc.*

Appendix A

The Objectives of Newport's Referral Network

Access and benefits for Canadians: Through its Referral Network, Newport now serves hundreds of clients and is entrusted with prudently managing over $1 billion of their aggregate wealth. Newport provides investment management services to a range of clients across the country through discretionary managed accounts and portfolios that are diversified across 13 asset classes, many of which are not otherwise available to most investors. Without an introduction through the Referral Network, these clients would not be aware of or have access to this investment option that provides reduced cost, enhanced diversification and an enhanced standard of care from a discretionary managed portfolio. Additionally, many clients have access to Qualified Disability Trusts and Individual Pension Plans for the first time as a result of referrals through the Referral Network. Such solutions are typically not offered by the branches of larger financial institutions in these clients' smaller communities. Over 65% of the assets under management by Newport through its Referral Network are in registered products and managed to a medium-risk mandate with monthly contributions being made by younger clients and withdrawals by older Canadians to help with the funding of their retirements while still preserving capital, which is a paramount tenet of how Newport manages investments.

Development of investment professionals: Newport's Referral Network has created opportunities to add to its professional client service ranks. Clients of the Referral Network are serviced by eight portfolio managers (Advising Representatives), three associate portfolio managers (Associate Advising Representatives) and a dedicated support and operational team. Since 2012, Newport has seen three professionals move through its mentorship and training program and qualify as Advising Representatives, has added three more Associate Advising Representatives and plans to add further depth to its client service team. These young professionals have been given the opportunity to hone their investment and client service skills by working side by side with more seasoned portfolio managers, providing them with a unique career path as an alternative to those provided by large institutions. Opportunities to work with small and mid-sized clients would not have been available to Newport or many small to mid-sized independent firms had they been forced to rely on traditional marketing efforts, given the barriers to entry and documented ineffectiveness of such efforts.

Building a national profile: Newport has arrangements with referral sources across Canada. The overwhelming majority of client assets have been referred either through registrants or entities regulated by provincial insurance authorities. Its Referral Network has allowed Newport to build awareness and the profile of its service offering in a strategic and focused way. Newport committed significant resources, both financial and human capital, in the development of its Referral Network and it has evolved over time in response to consultations with legal counsel, consultants and clients as well as the results of regulatory field reviews. The operation of the Referral Network has been informed by the existing principle-based regulations and CSA publications in addition to industry best practises and Newport's own governance model that has been in place since the firm was founded in 2001.

Appendix B

Newport Shares Many of the CSA's Concerns

Newport is aware that there are some referral arrangements in the marketplace that present regulatory concerns and do not operate in the best interests of clients. Newport fully supports the need to address these arrangements in a targeted and focused manner. Newport's arrangements do not fall into this category. Specifically, Newport agrees with the CSA's concerns on several matters:

- **Exclusive Arrangements:** Newport believes that a conflict of interest could exist if a referral source only has access to one Portfolio Manager. Such an arrangement is analogous to the "captive dealing representative model" in the mutual fund industry in which financial advisors may only access one family of funds. For this reason, Newport does not require or recommend exclusive arrangements with its referral sources;

- **Fee Parity:** Newport believes that a common fee structure must be provided to clients or a conflict could exist. For this reason, Newport charges the same fee to clients regardless of how those clients come to Newport. It does not negotiate its fee, nor is there a fee difference to the client who arrives through the Referral Network or comes to Newport directly;

- **Full Disclosure:** Newport agrees that the terms of referral arrangements should be disclosed to clients. Newport provides fulsome disclosure to clients at the time of client engagement, following the precise language prescribed by securities law. Newport also engages and communicates with each client in the same way regardless of how the client comes to Newport;

- **Reporting to the CSA:** Newport believes that referral activity should be tracked and reported on an ongoing basis to provide transparency and prevent abuses. Newport has developed robust systems to track and report on its Referral Network business; and

- **Clear Guidelines on Activity by Referral Sources:** Newport believes that the CSA should develop clear guidelines for the effective operation of referral activity. Newport has developed a comprehensive acceptance, vetting, training and ongoing monitoring program for participants in the Referral Network to ensure that clients and referral sources clearly recognize the roles and responsibilities of the parties involved. Newport has negotiated fair and clear contracts with referral sources and the relevant terms of these contracts are disclosed to clients, including the fee that Newport – not the client – pays to the referral source.

Appendix C

United States

In the United States, Rule 206(4)-3 under the *Investment Advisers Act of 1940* prohibits an investment adviser registered with the Securities Exchange Commission (the "**SEC**") from paying a referral fee to a third party (a "**solicitor**") who solicits clients for that investment adviser unless certain conditions are met, including that:

1. the agreement between the adviser and solicitor be set out in writing, with a copy retained by the adviser;

2. the solicitor is in good standing (i.e., not subject to SEC disciplinary penalty or criminal conviction);

3. at the time of solicitation, the solicitor provides the client with:

    a. a copy of the adviser's brochure; and

    b. a separate written document disclosing, among other things, that:

        i. the solicitor is being compensated for referring the client to the adviser; and

        ii. the terms of that compensation, including any additional amounts that the client will be charged by the adviser as a result of the referral agreement; and

4. prior to or at the time of entering into any investment advisory agreement with the client, the adviser receives a signed and dated acknowledgement from the client that the client received:

    a. the adviser's brochure; and

    b. the solicitor's written disclosure document.[15]

Generally, solicitors may be unregistered persons so long as they comply with the above rule, though the SEC notes that failure to do so may result in both the solicitor being deemed an unregistered investment adviser and the adviser being liable pursuant to the anti-fraud provisions of the *Investment Advisers Act of 1940*.[16]

The adviser must conduct due diligence as to the solicitor's compliance with the above-noted requirements and maintain records of written disclosure documents and client acknowledgements.[17]

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[15] 17 CFR § 275.206(4)-3 2010; see also: SEC, "General Information on the Regulation of Investment Advisers" (March 11, 2011) online: <https://www.sec.gov/divisions/investment/iaregulation/memoia.htm>.

[16] SEC, *supra* note 15.

[17] 17 CFR § 275.204-2(a)(10) and (15).

While the requirements of Rule 206(4)-3 seem comparable to those of the existing rule in NI 31-103, Part 13, Division 3,[18] the SEC rule exists in a regulatory scheme that imposes a higher standard of conduct on advisers. The SEC regards investment advisers as fiduciaries to their clients,[19] requiring them to place the best interests of their clients above personal financial gain or risk being offside the anti-fraud provisions of the *Investment Advisers Act of 1940*.[20]

Under the SEC Rule a solicitor does not need to be registered so long as their activities are limited to making the referral. It should be noted that certain states require solicitors to be registered as investment advisor representatives. While this may be a limited registration (i.e., no examinations are required), filing may be necessary even when the solicitor is involved only in providing impersonal advice.[21]

United Kingdom

In the United Kingdom, an authorised firm may pay a referral fee to a third party (an "**introducer**"), so long as the authorised firm meets its regulatory requirements and the introducer does not engage in any regulated activities.[22] The Financial Conduct Authority (the "**FCA**") has voiced concern regarding the activities undertaken by introducers, such as influencing the advice being provided by authorised firms, and recently began enforcement proceedings against introducers engaging in regulated activities or misleading consumers about their unauthorised status.[23] The FCA recommends that an authorised firm accepting referrals from introducers take certain actions to ensure compliance with its own regulatory obligations, including:

1. carry out robust due diligence on introducers;
2. institute robust vetting procedures to ensure introducers have been sourced legitimately;
3. ensure the authorised firm has full and complete ownership of the advice being provided;
4. only recommend products understood by the authorised firm; and
5. only delegate the performance of regulated activities to other authorised firms or appointed representatives, with appropriate monitoring.[24]

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[18] The existing rule in NI 31-103 requires that the referral arrangement be set out in writing, the payment of fees be recorded and the arrangement be disclosed to the client in the form set out in section 13.10 before services are provided.

[19] Gretchen Passe Roin, "Understanding the Investment Adviser Regulatory Scheme" (July 31, 2014) Law360, online: <https://www.law360.com/articles/562680/understanding-the-investment-adviser-regulatory-scheme>.

[20] SEC, "Information for Newly-Registered Investment Advisers" (November 23, 2010) online: <https://www.sec.gov/divisions/investment/advoverview.htm>.

[21] See, for e.g., requirements of California Department of Business Oversight-Securities Regulation Division and of the Texas State Securities Board.

[22] Nabarro LLP, "The Regulation of Introducers: Article 25 of the Regulated Activities Order" (April 30, 2010) Lexology, online: <https://www.lexology.com/library/detail.aspx?g=69eed2ca-2c9f-4729-a0ce-1ee6d584b0d1>.

[23] FCA, "Investment Advisers' and Authorised Firms' Responsibilities when Accepting Business from Unauthorised Introducers or Lead Generators" (August 2, 2016) online: <https://www.fca.org.uk/news/news-stories/investment-advisers-responsibilities-accepting-business-unauthorised-introducers-lead-generators>.

[24] *Ibid*.

When an introducer does more than merely introduce a prospective client to an authorised firm, such as providing advice or assisting in the structuring of a transaction, that introducer is engaging in regulated activities and so is offside the *Financial Services and Markets Act 2000*. However, it is possible for an introducer to engage in certain regulated activities if it is properly registered as the representative of a principal authorised firm. An authorised firm may register an introducer as:

1. an authorised representative ("**AR**"), who may engage in certain regulated activities for which its principal has authorisation and accepts responsibility for the AR;[25] or

2. an introducer authorised representative ("**IAR**"), who may:

    a. effect introductions to the principal firm, and

    b. distribute non-real time financial promotions which relate to products or services available from or through the authorised firm.[26]

Registration as an IAR does not subject a referrer to regulatory obligations beyond being included on the register of the FCA as being associated with any principal firms for which it is an IAR.[27]

Australia

Under the *Australian Corporations Act 2001* it is possible for a financial services licensee to pay a referral fee to a non-registered person subject to transparency requirements and restrictions on the advice a referrer can provide.

The Australian Securities and Investment Commission recently banned conflicted remuneration paid to licensees however referrers are specifically exempted from licensing requirements. Rather, the *Corporations Act 2001* requires that providers of financial advice must do so in the best interests of their client.[28] This elevated standard of conduct imposes a discipline on the ability of licensees to accept referrals.

[25] FCA Supervision Handbook, online: <https://www.handbook.fca.org.uk/handbook/SUP> [FCA SUP], s 12.2.7G; Nabarro LLP, *supra* note 22.

[26] FCA SUP, *supra* note 25, s 12.2.8G.

[27] Nabarro LLP, *supra* note 22.

[28] *Corporations Act 2001* (Australia), s 961B(2).

Appendix D

The OSC has made bald assertions about those accepting referral fees engaging in "registerable activities" without providing supporting legal analysis.

The term "registerable activities" is not defined under Canadian securities laws. Individuals and companies are required to be registered pursuant to section 25 of the *Securities Act* (Ontario) (the "**Act**") if they "engage in or hold [themselves] out as engaging in the business of trading in securities".[29] Pursuant to section 1(1) of the Act, the term "trading" encompasses acts in furtherance of trading in securities.[30] While such acts can include providing advice, the OSC clarified in *Re Costello* that the mere provision of financial information regarding securities does not constitute the giving of advice.[31] Advice may have been given where an opinion is provided regarding the wisdom or value of investing in a specific security.[32]

The CSA employ a "business trigger" test to determine whether an individual or company is trading or advising in securities for a business purpose. If so, such persons must be registered.[33] This determination is fact-dependent and based on a variety of factors, including: soliciting for securities transactions or with offers of advice, regularly engaging in trading or advising for a business purpose, being or expecting to be compensated for such activities and otherwise engaging in activities similar to registrants.[34]

In OSC Staff Notice 33-746 *Annual Summary Report for Dealers, Investment Advisers and Investment Fund Managers* ("**Staff Notice 33-746**"), the OSC noted in the context of referral arrangements that registerable activities could include "meeting with investors to ascertain their investment needs and objectives, risk tolerance and financial circumstances, discussing and recommending investment opportunities and performing ongoing portfolio reviews".[35] It is inconsistent for the CSA Proposals to suggest that financial planning professionals should not undertake or understand the investment needs, objectives or financial circumstances of clients. In acting for their clients, it is essential that they have access to such information and may even conduct their own distinct client reviews independent of a Portfolio Manager. What is relevant is whether the Portfolio Manager is delegating responsibility for any of its fiduciary responsibilities or promoting an unregistered financial advisor to conduct or control any form of portfolio-management activity. Activities such as introducing clients to registrants and accepting referral fees from registrants are not captured by the business trigger factors set out in CP 31-103. Notably, the OSC excluded these activities from its list of examples of registerable activities provided in Staff Notice 33-746. The fact that some registrants improperly offload their responsibilities regarding certain

[29] *Securities Act*, RSO 1990, c S.5, s 25(1).

[30] *Ibid*, s 1(1) "trade".

[31] *Re Costello*, 26 OSCB 1617 at para 28.

[32] *Ibid*.

[33] CP 31-103, s 1.3.

[34] *Ibid*.

[35] OSC Staff Notice 33-746 *Annual Summary Report for Dealers, Investment Advisers and Investment Fund Managers* (September 21, 2015) [Staff Notice 33-746], s 4.1(b)(i).

registerable activities (and, *vice versa*, that some referrers may engage in registerable activities) reflects on those particular registrants and referrers rather than on the nature of referral arrangements generally.

Traditional referral arrangements are distinguishable from the actions of finders, which have attracted regulatory scrutiny for constituting registerable activities in certain circumstances. Finders, who may receive finders' fees or other compensation from issuers in connection with offerings of securities, solicit prospective investors with information regarding specific securities transaction. An individual or company in the business of making such solicitations would be caught by the business trigger test. Referrers offer to introduce clients to registrants who provide services that the referrer is not able to provide itself. Such introductions do not entail advising on particular securities or facilitating trades in those securities. As such, referral fees are incidental to a referrer's business and satisfying a single factor of the business trigger test is insufficient to constitute "registrable activity".

Appendix E

The OSC is capable of – and already engages in – effective regulatory action and enforcement proceedings against inadequate referral arrangements.

In Staff Notice 33-746, the OSC noted a variety of issues that it had identified while conducting compliance reviews of referral arrangements that it perceived as having a high risk of non-compliance with securities laws, including the fact that some registrants were delegating their know-your-client and suitability obligations to non-registered referral agents.[36] The OSC went on to note that "in the instances where these issues were identified, [it] responded by taking further regulatory action, including the imposition of terms and conditions on registration" and that it was "considering additional regulatory action, including recommending a suspension of registration".[37] The OSC has no shortage of enforcement options for ensuring that registrants and referral sources are held responsible for any registerable activities performed (or which ought to be performed) for their clients. Indeed, the OSC has employed a range of measures in recent years to address inadequate referral arrangements, including imposing terms and conditions on registrants, ordering non-compliant referral sources to cease trading in securities, ordering fines and penalties against both registrants and referral sources and, in one egregious case, suspending a registrant's registration permanently.

[36] Staff Notice 33-746, *supra* note 35, s 4.1(b)(i).

[37] *Ibid*.