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CSA announces harmonized approach toward client focused reforms and policy on embedded commissions

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The Canadian Securities Administrators (**CSA**) recently announced a comprehensive, harmonized approach for addressing investor protection concerns regarding the relationship between registered firms and individuals and their clients. Proposed amendments (the **Client Focused Reforms**) to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**NI 31-103**) will require registrants to put clients first when discharging their know-your-client (**KYC**), know-your-product (**KYP**) and suitability obligations, and to address all conflicts of interest in the best interest of clients. A separate but related Staff Notice announced the CSA's policy decision to prohibit almost all embedded commissions from investment fund sales (the **Embedded Commissions Policy**), other than trailing commissions where the dealer receiving the commission has made a suitability determination.

The Ontario Securities Commission (**OSC**) is satisfied that the client's best interest is infused into the Client Focused Reforms and is no longer pursuing the overarching statutory best interest standard for registrants proposed in the CSA's 2016 Consultation Paper 33-404 – Proposals to Enhance the Obligations of Advisers, Dealers and Representatives Toward Their Clients [PDF] (the Consultation Paper).

The Client Focused Reforms and Embedded Commissions Policy (together, the **Client-Registrant Relationship Reforms**) should significantly reduce opportunities for registered firms and individuals (**RIs**) to recommend investment products to clients when there are less expensive options available that satisfy their objectives. In addition, investors will be entitled to meaningful disclosure regarding registrant compensation practices and other conflicts of interest, which should improve transparency in the client-registrant relationship. These changes address longstanding investor protection concerns articulated in the OSC's 2004 concept paper – The Fair Dealing Model [PDF], which sought to bring the Canadian securities regulatory regime in line with the advice-driven business model of the financial services industry.

While the CSA has reached consensus to propose the Client Registrant Relationship Reforms after almost 15 years of public consultation, the highly prescriptive approach toward KYC, KYP and suitability is likely to frustrate clients, many of whom are already overwhelmed by the amount of personal information and time required to obtain financial advice. In addition, while the Client Focused Reforms should provide certainty for registrants and their compliance professionals, they may reduce flexibility for RIs to tailor solutions for individual investors outside the "client profiles," which are expected to frame KYP and suitability processes at most firms. Finally, the breadth of restrictions relating to conflicts of interest may stifle innovation and reduce the availability of specialized products to retail investors.

Anticipated consequences and potential challenges

Below, we highlight certain anticipated consequences and potential challenges posed by the main Client Focused Reforms. This section is not intended to be a comprehensive summary of the Proposed Client Reforms.

Enhanced KYC obligation

Anticipated consequences

- Requirement to gather KYC information regarding time horizon, risk tolerance and risk attitude should result in more accurate client risk profiles and education regarding the relationship between risk and return.

Potential challenges

- Six categories and at least 20 data points of KYC information must be collected and updated annually for most clients.
- Guidance discourages registrants from presenting "short, product-driven" categories of investment objectives from which clients may choose (e.g., growth, income or balanced), but expects RIs to assist clients to articulate their investment objectives and suggests categories of investment results (e.g., capital preservation, income, growth or speculation) and measurable financial goals (e.g., saving for retirement, saving for education, increasing wealth). For many clients (particularly those seeking discrete or transactional advice) this in-depth inquiry may be unnecessary and burdensome.
- Proposal to exempt registrants dealing with institutional clients (the **Institutional Client Carve-Out**) from enhanced KYC obligations included in the Consultation Paper has not been carried forward.

New KYP obligation

Anticipated consequences

- Express obligation for registered firms and RIs to understand essential elements of the securities they make available to clients, including how they compare with similar securities in the market, ensuring that practice aligns with client expectations when receiving investment advice.

Potential challenges

- Rigorous, prescriptive KYP approval and monitoring processes will likely be costly for many firms to implement and may reduce options available on product shelves.
- The Institutional Client Carve-Out from the new KYP obligation has not been carried forward, and no exceptions are made for portfolio managers (**PM**) exercising discretionary authority over managed accounts pursuant to a fulsome standard of care.

Suitability determination that puts the client's interests first

Anticipated consequences

- RIs will be required to inform clients when their return expectations are not achievable based on their risk profile and/or time horizon and offer practical solutions (i.e., retire later, save more, spend less, invest in cash deposits or guaranteed products).
- Clients will be more likely to receive least expensive investment option suitable for their objectives as RIs will be prohibited from considering their own compensation when providing advice.
- Likely to foster consistency, predictability and measurability of suitability determinations across firms.
- Improved carve-out for permitted clients that waive suitability for investments outside a managed account by clarifying that a registrant can rely on a suitability waiver for some services while providing discretionary investment management services to another account for the same client.

Potential challenges

- Eight categories of inputs, with an additional 35 recommended sub-categories (including KYC and KYP considerations), must be considered in respect of each proposed transaction for a client account; expected to necessitate semi-automation of most suitability determinations by RIs categorizing individual clients into pre-defined profiles developed by their firms.
- May be more difficult for RIs to fit alternative or niche products into recommendations.
- More generally, lack of flexibility may limit client investment opportunities.
- Imposition of suitability obligation on legacy securities may discourage clients from transferring in existing positions, negatively impacting overall portfolio visibility for the RI.
- The Institutional Client Carve-Out from the enhanced suitability obligation has not been carried forward, and no carve-out is available for portfolio managers (**PMs**) exercising discretionary authority pursuant to a fulsome standard of care.

Conflicts of interest must be resolved in the best interest of the client

Anticipated consequences

- Clarity regarding prohibited conflicts which must be avoided (e.g., types of borrowing, lending, guarantees and powers of attorney).

- Enumeration of specific conflicts arising from proprietary products, third-party compensation, internal compensation arrangements and incentive practices, supervisory conflicts and fee-based accounts (reverse churning).
- Prominent, specific written disclosure to clients proximate to the time of the conflicted activity, not just at account-opening, should improve clients' understanding of their relationships with registrants.

Potential challenges

- Guidance for registrants to attend to "any residual self-interest which may affect client outcomes...in a client-centric manner" is extremely broad.
- Materiality threshold for identifying conflicts is eliminated (although immaterial conflicts may be addressed through routine policies and procedures such as caps on gifts and entertainment).
- Prescriptive guidance regarding types of controls which must be used to address conflicts may steer firms toward client profiles and blanket rules and require costly updates to compliance processes.
- Guidance that disclosure may be a sufficient means for addressing conflicts of interest for registrants dealing with institutional clients has not been carried forward.

Relationship Disclosure Information (RDI)

Anticipated consequences

- New requirement for certain RDI to be publicly available should permit investors to research different types of firms prior to meeting an RI or taking steps to open an account online.
- Specific disclosure regarding proprietary firms and products, account restrictions and the potential impact of different account types (commission vs. fee-based) on client returns should provide clients with a deeper understanding of the scope of services available from a registrant and the range of alternatives.
- Ability to maintain related and connected issuer lists by category, rather than naming each specific fund or product, offers efficiency to firms and may be more easily understood by clients.

Potential challenges

- Overlapping requirements regarding conflicts of interest disclosure and cost impact disclosure (which should be reflected in annual reports of charges and compensation received by clients) may result in unduly voluminous RDI and discourage client review.

Training, education and experience

Anticipated consequences

- RIs will receive specific training on conflicts of interest, KYC, KYP and suitability, consistent with client expectations when receiving advice.

Potential challenges

- Training may become repetitive and costly.

Recordkeeping

Anticipated consequences

- Firm records demonstrating compliance with Client Focused Reforms will assist with complaint handling, self-evaluations and internal and external audits.

Potential challenges

- Highly prescriptive requirements will be costly to implement and may not sufficiently recognize the value of existing controls and recordkeeping procedures.

Titles and designations

Anticipated consequences

- Long-awaited prohibitions against misleading titles should provide additional protection to seniors and other vulnerable investors.

Referral arrangements

The Client Focused Reforms propose major changes to the referral arrangement provisions of NI 31-103, which were not contemplated in the Consultation Paper. While registrants will continue to be able to receive referrals from non-registrants, referral payments may only be made to registrants. In addition, referral arrangements may not exceed 36 months in length and the total amount of referral payments may not: (i) exceed 25% of the total compensation collected from the client by the party who received the referral; or (ii) increase the amount of fees or commissions that would otherwise be paid by a client to that registrant for the same product or service.

For new referral arrangements, the new requirements would take effect immediately upon the amendments coming into force, but there would be a three-year transition period to address compliance for existing referral arrangements.

Absence of Carve-out for portfolio managers with discretionary authority

Registrants that are concerned over the anticipated costs of building systems to ensure compliance with the Client Focused Reforms should be mindful that these prescriptive requirements are replacing the best interest standard initially proposed by some CSA members based on concerns raised by the financial services industry that an over-arching standard would create uncertainty and be difficult to enforce. The Client Focused Reforms are intended to be the CSA's compromise: specific, measurable requirements which practically implement the best interest standard.

Discretionary PMs that implement complex investment management strategies over large portfolios may oppose the client profiling, product approval process and other requirements

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of the Client Focused Reforms, which may reduce flexibility for addressing inter-generational considerations, tax issues and other unique factors.

PMs that have such concerns may consider proposing a carve-out from certain prescriptive elements of the Client Focused Reforms for PMs that agree to a fulsome duty and standard of care in their investment management agreements with discretionary clients, at a minimum for institutional accounts.

This suggestion is consistent with Institutional Client Carve-Outs included in the Consultation Paper which have not been carried forward in the Client Focused Reforms. The Consultation Paper had proposed to exempt registrants dealing with institutional clients from the enhanced KYC and suitability requirements, and also noted that disclosure by itself could be an acceptable response to a conflict of interest when dealing with institutional clients. The definition of "institutional client" in the Consultation Paper included: (i) Canadian financial institutions; (ii) registrants acting as principal; and (iii) various other categories of institutional investor that have waived the suitability requirement, including pension funds, government and government-related entities, accounts and investment funds managed or advised by registrants and other investors with net financial assets of $100 million.

The CSA provided no explanation for why the Institutional Client Carve-Outs were not preserved, with necessary modification, in the Client Focused Reforms.

Simplified process for transactional dealer relationships

The CSA acknowledges that exempt market dealers (**EMDs**) often have transactional or "episodic" relationships with their clients, in contrast to ongoing client relationships prevalent in other registration categories. The CSA has requested comments regarding implementation challenges and unintended consequences that the Client Focused Reforms may pose for EMDs.

Client Focused Reforms next steps

The Client Focused Reforms are subject to a 120-day comment period.

In addition to the specific input sought from sole EMDs describe above, the CSA has sought specific comment on:

- whether a nominal one-time referral fee payment to a non-registrant should be permitted in order to ensure investor access to securities-related services; and
- whether there are other specific conflicts of interest that cannot be addressed in the client's best interest and must be avoided.

Public comments are also welcome on all aspects of the Client Focused Reforms.

Upon implementation of the final Client Focused Reforms, the CSA has proposed a transition period of one year for the new public RDI requirement and two years for all other requirements, subject to the transition period for referral arrangements described above.

Embedded Commissions Policy

The CSA has announced its policy decision to prohibit all forms of deferred sales charge (DSC) compensation and the associated upfront commissions in respect of sales of public mutual funds, and to prohibit the payment of trailing commissions to, and the solicitation and acceptance of trailing commissions by, dealers who do not make a suitability determination in connection with the distribution of prospectus-qualified mutual fund securities. As a result, upon implementation of the Embedded Commissions Policy, classes or series of mutual fund securities which pay trailing commissions should no longer be available for purchase on order execution only (discount brokerage) platforms.

This decision is the result of a policy debate dating back to the CSA's 2012 discussion paper – Mutual Fund Fees [PDF], which led to a series of public consultations and empirical research studies culminating with the 2017 Consultation on the Option of Discontinuing Embedded Commissions [PDF].

By requiring RIs to put their client first in all suitability determinations, the CSA expects that the Client Focused Reforms should control conflicts of interest associated with those trailing commissions that remain permissible. This strategy acknowledges the connection between the CSA's two investor protection initiatives, and preserves a compensation structure which may be appropriate and preferable for some clients.

The CSA anticipates publishing a Notice and Request for Comment in September 2018 which will include proposed rules to implement this policy decision and include a regulatory impact statement (the Embedded Commissions Proposed Rules).

Unlike the Client Focused Reforms, the CSA does not seem to be inviting further comment or debate on its policy decisions regarding embedded commissions. That said, we expect that the Embedded Commissions Proposed Rules will raise many implementation issues which will need to be considered and addressed as part of the public comment process.

How we can help

Please contact Lori Stein or your primary legal contact at Osler if your firm would like assistance with the preparation of a comment letter regarding the Client Focused Reforms, or more generally to discuss the potential impact of the Client-Registrant Relationship Reforms on your business.

Our team will also be available to assist with the development of compliance policies and procedures and/or training programs for your firm in advance of the implementation of the Client Focused Reforms.