

CSA Staff Notice 33-319

Status Report on CSA Consultation Paper 33-404 Proposals to Enhance the Obligations of Advisers, Dealers, and Representatives Toward Their Clients

May 11, 2017

Introduction

On April 28, 2016, the Canadian Securities Administrators (the **CSA** or **we**) published CSA Consultation Paper 33-404 *Proposals to Enhance the Obligations of Advisers, Dealers, and Representatives Toward Their Clients* (the **Consultation Paper**). The Consultation Paper sought comment on proposed regulatory action aimed at strengthening the obligations that securities advisers, dealers and representatives (**registrants**) owe to their clients. The purpose of this Notice is to provide a high level summary of the consultation process to date, identify certain of the high level key themes that have emerged through this process and indicate the direction that the CSA will take in respect of the various proposals outlined in the Consultation Paper.

Background

The Consultation Paper sought comment on proposed regulatory action aimed at enhancing the obligations of registrants towards their clients. The Consultation Paper set out:

- a proposed set of regulatory amendments (the **targeted reforms**) to National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations (**NI 31-103**) and potential guidance, and
- a proposed regulatory best interest standard, accompanied by guidance.

The British Columbia Securities Commission did not consult on the proposed regulatory best interest standard.

Consultation Paper

(i) Key concerns

The Consultation Paper outlined five key concerns with the client registrant relationship that the CSA had identified, namely:

- clients are not getting the value or returns they could reasonably expect from investing
- the expectations gap created in some cases by misplaced trust or overreliance by clients on their registrants
- conflicts of interest
- information asymmetry between clients and registrants
- clients are not getting outcomes that the regulatory system is designed to give them

(ii) Targeted reforms

The CSA developed a set of targeted amendments to NI 31-103 that would work together to better align the interests of registrants with the interests of their clients and enhance various specific obligations that registrants owe their clients. The proposed targeted reforms covered the following areas:

- Conflicts of interest
- Know your client
- Know your product
- Suitability
- Relationship disclosure
- Proficiency
- Titles
- Designations
- Role of UDP and CCO
- Statutory fiduciary duty when client grants discretionary authority

(iii) Regulatory best interest standard

The Consultation Paper also sought comment on a proposed regulatory best interest standard that would serve as an overarching standard and governing principle that all other client-related obligations would be interpreted by. The proposed standard is not intended to be a fiduciary duty. The Consultation Paper set out the following principles that would guide the interpretation of the proposed best interest standard:

- act in the best interest of the client
- avoid or control conflicts of interest in a manner that prioritizes the client's best interests
- provide full, clear, meaningful and timely disclosure
- interpret law and agreements with clients in a manner favourable to the client's interest where reasonably conflicting interpretations arise
- act with care

Consultation Process

The comment period ended on September 30, 2016 and the CSA received over 120 comment letters. In this Notice, we provide a summary of the key themes and issues which were raised in the comments. More fulsome detail on the comments received during this comment period will be provided during the rule proposal process. Approximately 85% of the comment letters we received were from industry stakeholders (including registrants, industry associations and law firms), and approximately 15% of the comment letters were from non-industry stakeholders (including investors, investor advocates, academics and others).

The CSA also engaged in extensive in-person consultations following the publication of the Consultation Paper, including registrant outreach sessions, meetings with individuals as well as groups of stakeholders, speaking at conferences and meeting with members from self-regulatory organizations (SROs). The CSA also organized a series of roundtable sessions held across five jurisdictions in the following cities: Vancouver, Toronto, Halifax, Montreal and Calgary. The roundtable sessions were an opportunity to gather additional stakeholder feedback and explore key themes that emerged from the comment letters.

We thank those who have contributed to our consultation process to date by responding to our request for comments and/or by participating in one or more of the activities described above. We appreciate the time that stakeholders have taken to provide detailed, very extensive and thoughtful comments. We have gathered a great deal of information from this process, which we have carefully considered and will continue to use to inform our approach going forward.

The feedback from our consultation process was critical of a number of the proposals in the Consultation Paper. As noted below, we have carefully considered the feedback received from stakeholders and will be proceeding with proposed reforms in a manner that is responsive to the feedback received.

Themes from the Consultation

(i) Targeted Reforms

The comments from industry stakeholders reflected a very broad spectrum of views on the proposals. The following are some of the key themes from industry that emerged from the consultation on the proposed targeted reforms:

- the proposed targeted reforms are too prescriptive in nature
- depending on the registration category, some of the proposed reforms would be difficult for registered firms to implement
- the proposed targeted reforms are over-broad in their approach and application, with many commenters describing them as taking a one-size-fits-all approach that does not reflect the differences in registration categories, business models or range in the needs of clients for financial advice
- existing requirements, whether in securities legislation, including NI 31-103, SRO rules or professional codes of conduct, are sufficient to address the concerns identified in the Consultation Paper
- the reforms, as proposed, will have significant unintended consequences, including potentially reducing the number of products firms offer and the types of products registrants recommend to clients
- the CSA should wait to measure the impact of other regulatory initiatives, namely CRM2 and Point of Sale, before proceeding with further reforms

- the proposed targeted reforms do not consider the value of advice and advisors and the value they deliver to clients, and disregard the importance of representatives' judgement

The comments from non-industry stakeholders also reflected a full range of views on the proposals. The following are some of the key themes from investor advocates and non-industry stakeholders that emerged from the consultation on the proposed targeted reforms:

- the CSA should focus on compensation and incentives to move the industry towards a client-centered advice model rather than an incentives-driven model
- disclosure is not an effective means for addressing conflicts of interest
- support limiting the use of specific client-facing titles
- the proposed targeted reforms are not adequate to provide effective investor protection without an overarching best interest standard

(ii) Regulatory Best Interest Standard

The following are some of the key themes from industry that emerged from the consultation on the proposed regulatory best interest standard:

- concern that it will create legal and regulatory uncertainty with risk of significant unintended consequences
- concern over the potential lack of harmonization across jurisdictions
- concern over how to operationalize the standard, assess whether the standard is met, and supervise compliance
- not clear how the standard would apply across all registration categories and business models
- of the few in industry who supported the proposed regulatory best interest standard, some suggested that a regulatory best interest standard would be preferable to the proposed targeted reforms, and that if a principles-based standard is adopted, more prescriptive requirements in the targeted reforms would not be necessary

The following are some of the key themes from investor advocates and non-industry stakeholders that emerged from the consultation on the proposed regulatory best interest standard:

- a regulatory best interest standard is needed as a guiding principle
- the standard is needed because of the inequality in the relationship between investors and their registrant and that disclosure is not sufficient to address this inequality in the relationship

- investors already believe that their registrants are acting in their best interest and a regulatory best interest standard would close this expectations gap
- some commenters suggest moving beyond a best interest standard to a fiduciary standard for all registrants
- consideration is needed of how a regulatory best interest standard would apply in certain business models

Direction on Key Areas of Consultation

(i) Targeted Reforms

We have carefully considered the feedback received from stakeholders and have reviewed the targeted reforms outlined in the Consultation Paper in light of the issues raised in the comments.

The CSA remain committed to addressing the issues we have identified in the client-registrant relationship and raising the bar on what is required of registrants. This includes better aligning the interests of registrants with the interests of their clients, improving outcomes for clients and clarifying the nature of the client-registrant relationship. To achieve these outcomes, we will proceed with certain reforms in each of the targeted reform areas. We think these reforms will significantly enhance the standard of conduct required of registrants.

The CSA will reconsider some of the proposed targeted reforms, including:

- the mandatory collection of basic tax information that was proposed as part of the know your client reforms
- the element of the know your product proposal that would require the market investigation of a reasonable universe of products, and the differentiation of know your product requirements based on whether a firm is proprietary or mixed / non-proprietary in terms of its product offering
- considering adding an element of reasonableness or other modification to the requirement for representatives to understand and consider the structure, product strategy, features, costs and risks of each security on their firm's product list
- the default requirement to perform a suitability assessment at least once every 12 months absent a triggering event, and the requirement to perform a suitability assessment if there is a significant market event affecting capital markets to which the client is exposed

The CSA will also reconsider certain wording expressed in some of the proposed targeted reforms in light of comments received. For example, the wording of the proposal that a registrant must ensure a recommendation to a client is "most likely to achieve a client's investment needs and objectives, given the client's financial circumstances and risk profile, based on a review of the structure, features, product strategy, costs and risks of the products on the firm's product shelf" will be reconsidered.

As we consider the application of all the targeted reforms, we will look for ways to address concerns about a one-size-fits-all approach by incorporating the concept of scalability, where appropriate. For example, it may be appropriate for some of the proposals related to suitability or know your client to be scalable based on the nature of the relationship between the client and the registrant.

We will also consider changes to refine or eliminate a number of the prescriptive elements from the targeted reforms.

The above is not an exhaustive list of revisions or changes we may make to the targeted reforms as proposed in the Consultation Paper.

Detailed notices will be published by the CSA when rule proposals are published for comment, and stakeholders will have the opportunity to provide their comments on the proposed changes.

As next steps, we will prepare draft rule amendments to NI 31-103 as well as draft guidance. The CSA has identified certain reforms that should be given higher priority in the next phase of work. Proposed amendments in the following areas will be prioritized as they are fundamental to addressing the harms identified in the Consultation Paper:

- Conflicts of interest
- Suitability
- Know your client
- Know your product
- Relationship disclosure
- Titles and designations

The CSA will work with the SROs as we continue to refine these reforms. We are committed to working together, along with the SROs, to take compliance and enforcement action on existing rules and the targeted reforms, once implemented, in order to achieve the outcomes we seek.

In our analysis of the various reforms, it has become clear that the proficiency reforms may require a longer-term project in order to advance the work. The CSA plans to advance the proficiency reforms through a separate CSA project.

Additionally, the CSA intends to advance the proposed reforms to impose a statutory fiduciary duty when a client grants discretionary authority and to clarify the role of UDPs and CCOs, although the timing of this work has not yet been determined.

(ii) Regulatory Best Interest Standard

The CSA remain firmly committed to developing the targeted reforms. We are unanimous on implementing change and raising the bar in order to significantly strengthen the standard of conduct and make the client-registrant relationship more centered on the interests of the client.

The OSC and FCNB expressed their support for a regulatory best interest standard that would act as a guiding principle in the Consultation Paper, while the BCSC, AMF, ASC and MSC expressed strong concerns about the benefits of introducing a regulatory best interest standard over and above the targeted reforms.

The OSC and the FCNB are committed to further work to articulate a regulatory best interest standard and will carry out further consultation with stakeholders and SROs in order to be responsive to comments received on this proposal during the consultation process.

The AMF, ASC, MSC and BCSC will not be doing further work on the proposed regulatory best interest standard. In their view, in the current regulatory and business environment, implementing the targeted reforms to deal with specific harms identified will meaningfully and practically lead to better investor outcomes and advance the best interest of all investors. For example, the targeted reforms will require registrants to deal with conflicts in a manner that prioritizes the interests of the client ahead of the interests of the registrants. The BCSC and AMF are further of the view that introducing a regulatory best interest standard in the current regulatory environment, in which conflicts would still be permitted to exist between registrants and their clients, could exacerbate one of the harms the CSA identified, being misplaced trust and overreliance by clients on their registrants.

The NSSC and the FCAA are focused on finalizing the targeted reforms. Based on the comments received on the regulatory best interest standard proposal they have concerns about the standard as proposed. The NSSC and the FCAA may be open to further considering a regulatory best interest standard provided substantial revisions are made to add clarity and predictability. Towards this end they will consider the results of the OSC's and FCNB's further consultations with stakeholders and SROs.

Timing of Next Steps

Over the 2017-2018 fiscal year, the CSA will prioritize the work on many of the targeted reforms. This work will culminate in rule proposals that will be published for comment, providing further opportunity for meaningful input from stakeholders. For those jurisdictions undertaking further work on a regulatory best interest standard, this work will continue on a parallel path.

Other CSA Consultations

The CSA recognizes the interrelationship between the issues addressed in the Consultation Paper and CSA Consultation Paper 81-408 *Consultation on the Option of Discontinuing Embedded Commissions*, published January 10, 2017 and open for comment until June 9, 2017. Staff will continue to coordinate policy considerations on these initiatives going forward.

Questions

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