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A Workable Compromise: "Client Focused" Reforms Finalized

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By Susan Han

The prolonged effort on the part of Canadian regulators to elevate the statutory standard of conduct required of financial advisors and other registrants and the equally sustained campaign by industry to resist the bulk of such reforms has ended, for now, with an uneasy truce. Earlier this month, on the 3 rd of October, the Canadian Securities Administrators released amendments (the "**2019 Amendments**") to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* ("**NI 31-103**") and its companion policy (the "**CP**"). These amendments come into force December 31, 2019, with a two-year transition period during which various provisions will take effect.

Industry and investor protection advocates had sharply differing views on the reforms which were originally proposed in 2016, with a second round in 2018. There were long and, at time, heated discussions on the meaning of "fiduciary" and "best interest", and claims and counterclaims about what it is that "average" investors understand they are getting, in terms of disinterested advice, from their financial advisors. It would be fair to say that neither industry or consumer groups are completely pleased with the outcome of these discussions as expressed in the 2019 Amendments. In other words, a classic Canadian compromise.

We can score one for the entirely sensible idea that regulation should tread lightly on, and ought not to unduly intervene in, commercial bargains made by market participants in good faith. Many observers were alarmed by proposals which purported to remake certain referral arrangements. Under the proposals, the payment of referral fees to non-registrants (such as to "finders", but also to lawyers, accountants and estate officers at trust companies) would have been prohibited, and permitted referral fees were to be capped at 36 months and to no more than 25% of the fees charged to the client. That bit of regulatory overreach appears to have been reconsidered, and is not included in the 2019 Amendments. In the interest of completeness, however, we are obliged to note that the CSA includes, in the list of items designated for "separate, longer-term projects" in respect of which further development is intended, a review of referral arrangements.

Referral Arrangements (Section 13.7 of NI 31-103)

Although the 2019 Amendments did not carry forward certain restrictions on referral arrangements , the definitions of "referral arrangement" and "referral fee" have been revised to capture arrangements that were not caught under the previous definitions. The current CP expressly notes that the definition of "referral fee": (i) captures sharing or splitting commissions from the purchase or sale of a security; and (ii) does not capture any unexpected gifts of appreciation. With the 2019 Amendments, the commentary on gifts has been removed from the CP, and it is possible that gifts (and perhaps other forms of non-monetary benefits, or any monetary arrangements that do not fall neatly into the category of commissions) may need to be disclosed to clients as per revised Section 3.10 of NI 31-103.

Conflicts of Interest (Sections 13.4 and 13.4.1 of NI 3-1013)

The 2019 Amendments have enhanced the conflicts of interest sections of NI 31-103, to reflect that a registrant is obligated to identify *material* conflicts of interest (including those that are reasonably foreseeable), and to resolve them in the *best interest* of the client (the "**Best Interest Standard**"). In discharging the Best Interest Standard, a registrant must ensure that the "interests of the client are paramount", and place the interests of clients ahead of its own and any other competing considerations. The CSA is at pains to note that the Best Interest Standard is *not* a fiduciary duty, although it continues to be the prerogative of the courts to determine if a common law fiduciary duty applies in the context of a claim.

In addition, the 2019 Amendments include a materiality threshold, such that registrants would be responsible for identifying and addressing only material conflicts. The CP offers guidance on the materiality threshold. In determining if it has crossed the materiality threshold, a registrant should consider whether the conflict may be reasonably expected to affect the decisions of the client in the circumstances, or the recommendations or decisions of the registrant in the circumstances.

Suitability (Sections 13.3 and 13.3.1 of NI 31-103)

The 2019 Amendments include the requirement that registrants conduct a suitability analysis for its client, prior to taking certain actions for the client. Some factors for determining suitability are listed in Section 13.3 of NI 31-103, including taking into account: (i) "know-your-client" ("**KYC**") information collected from the client; (ii) the assessment of the applicable product consistent with the registrant's "know-your-product" ("**KYP**") obligations; (iii) the impact of the action on the client's account, including concentration of securities within the account and the liquidity of those securities; (iv) the potential and actual impact of costs on the client's return on investment; and (v) a reasonable range of alternative actions available to the registrant through the registered firm, at the time the determination is made. The CSA has made available certain other suitability factors, which are listed in the CP.

The point of having the suitability factors listed separately in NI 31-103 and CP, respectively, is to provide registrants with a level of flexibility, so that they may tailor their suitability assessment process to their business needs and objectives.

Note that "permitted clients" as defined in Section 1.1 of NI 31-103 may waive suitability; in addition, non-individual permitted clients may waive suitability in respect of a managed account.

KYC Obligations (Section 13.2 of NI 31-103)

Enhanced KYC requirements require registrants to inquire about (among other items currently enumerated in NI 31-103) a client's: (i) personal circumstances; (ii) investment knowledge; (iii) risk profile; and (iv) investment time horizon. Additionally, registrants are required to update KYC information when they are aware of a significant change. At a minimum, a client's KYC information must be reviewed every: (i) twelve (12) months for managed accounts; (ii) twelve (12) months before making a trade or recommendation for exempt market dealers; and (iii) thirty-six (36) months for other cases. Guidance in the CP includes the ways a registrant may tailor its KYC process to reflect its business model and the nature of its relationship with clients.

KYP Obligations (Section 13.2.1 of NI 31-103)

The 2019 Amendments introduce an express KYP rule in new Section 13.2.1 of NI 31-103, which requires registrants to take reasonable steps to assess the relevant aspects of the applicable securities, including the securities' structure, features, risks, initial and ongoing costs and the impact of those costs. Further guidance for how registrants may properly discharge their KYC obligations may be found in the CP.

Relationship Disclosure Information (Section 14.2 of NI 31-103)

The 2019 Amendments include additional obligations on a registered firm to disclose to a client about its use of proprietary products,

as well as limitations on the products and services that they will make available to the client. A registered firm will also be required to provide a general description of the products and services it will offer to the client, including: (i) a description of the restrictions on the client's ability to liquidate or resell a security; and (ii) a statement of the investment fund management expense fees or other ongoing fees the client may incur in connection with a security or services the registered firm provides.

Moving Ahead

Registrants will want to review their policies and operations to determine the impacts of the 2019 Amendments on their businesses. The 2019 Amendments are not revolutionary; they represent a continuation of the well-established movement toward more concrete investor protection measures and greater transparency. Two years may seem like a generous amount of time to phase in. Nevertheless, ensuring that the new standards are thoroughly understood and internalized by everyone in the organization, from senior management to all client-facing staff, may take some doing. It's not too early to start.

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