



INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

LETTER FROM THE PRESIDENT Vol. 120

Transforming Practices in the Wealth Business: A preliminary assessment of the June 2018 CSA reforms to the client-advisor relationship



HIGHLIGHTS:

The CSA has done a commendable job in reaching consensus on a package of harmonized rules and guidelines to achieve best interest/client-first conduct between registrants and their clients, and in promoting a regulatory level playing field across all securities registrants.

The proposed rules leverage the existing SRO rules framework and add additional requirements in core aspects of the retail business, including Know Your Client, Suitability, Know Your Product, and conflicts of interest. Developing clearly articulated and practical guidelines for advisors and providing an effective safe harbour will be important.

The proposed rules will promote changes in business practice: intense scrutiny of mutual funds with high MERs and complex structures; increased availability and access to lower paying fee-based accounts; shift to hybrid robo-investing platforms; and further cost-cutting and structural adjustments across the industry to manage higher fixed and variable costs.

On June 21, the Canadian Securities Administrators (CSA) released its long-awaited proposed reforms related to the client-registrant relationship. From an industry perspective, one of the key benefits for all market participants is the success of the CSA securities jurisdictions in achieving a harmonized approach to the reforms. The CSA jurisdictions agreed on a model that embeds a detailed and obligatory best interest and client-first conduct within the specific reforms to reach consensus, rather than the alternative of an overarching best interest standard. The CSA deserves much credit for bridging the differences in regulatory approach to achieve a uniform set of regulations across securities jurisdictions in the country.

The reforms set out in National Instrument 31-103 are detailed and sweeping, covering all major aspects of the wealth business. The proposed rules are intended to leverage the existing self-regulatory organization (SRO) rule framework and impose additional requirements related to advisor conduct to achieve a best interest/client-first standard. The development of clear guidelines to meet the best interest/client-first conduct rules will be critical to provide a bright line test for market participants, and for regulators responsible for monitoring compliance with the rules. This will be particularly important because the new rules depart significantly from the existing stringent SRO rules and because the rules will apply to other registrants without similar experience of rigorous conduct compliance. The regulators deserve acknowledgment for the deliberate and positive effort to establish a level playing field in the wealth business. This approach needs to extend to the insurance industry, with the proposed CSA reforms embraced by insurance regulators, notably the anticipated rule-making effort of the Financial Services Regulatory Authority (FSRA) in Ontario.

These rules and guidelines will result in changes

to existing business practice to meet the targeted outcomes of best interest and client-first conduct. Over time, these reforms could have a transformative impact on the retail business in the investment industry, particularly driving further structural change and forcing greater reliance on financial technology.

It is reassuring the regulators have telegraphed a willingness to listen carefully to public comment and be open to constructive suggestions to achieve the best possible rule framework. Interested parties have until October 19, 2018 to comment on the proposed rules and guidelines.

The regulators and the investing public should be aware that individual IIROC-registered firms have invested substantial effort to comply fully with the SRO rule framework and professional standards to meet the securities regulatory principle of duty of care, and dealing fairly, honestly and in good faith—a standard considered by firms as operating in a manner consistent with best interest and client-first. The proposed rules and guidelines will be judged in terms of material improvement to best interest conduct and practicality. In certain cases, the industry will put forward reasonable alternatives.

It will also be important that the ultimate reforms (once modified after public comment) are put to a cost-benefit test to mitigate unnecessary costs and avoid unintended consequences for investors and intermediaries in the marketplace, given the wide-ranging impact of these reforms. In this regard, in November 2016, the IIAC commissioned Deloitte Canada to undertake a study on the costs of compliance with the provisions in CSA Consultation Paper 33-404. We suggest the regulators build on this quantitative analysis to estimate the industry cost of implementing the new proposals to juxtapose against the incremental improvement in the standard of advisor and firm conduct.

HIGHLIGHTS FROM THE CSA PROPOSALS

Know Your Client (KYC) requirement

The recently proposed reforms have been modified in places from the original version released in the spring of 2016, but retain a comprehensive rule framework that builds significantly on existing SRO regulations governing advisor market conduct. The KYC obligations for advisor and firms in the latest June CSA notice require registrants to take reasonable steps to obtain sufficient client information about personal and financial circumstances, investment needs and objectives, investment knowledge, risk profile and investment time horizon. While advisors and firms already generally meet this requirement, the proposed rules and guidelines will require changes to existing business practices and supervision and compliance procedures. For example, the guidance goes into great detail outlining the determination of a client's risk profile. The proposed KYC requirements no longer prescribe elements of financial planning and tax planning, nor do the requirements contain the previous prescriptive requirements regarding client signatures, or the frequency of updates. In a similar vein, the client due diligence exercise, or KYC requirement, can be tailored for different categories of client, dependent in different portfolio size, income and investment need. A "one size fits all" approach to the due diligence process is no longer required, but client due diligence undertaken to reasonably achieve desired outcomes is.

Know Your Product (KYP) requirement

Under the KYP obligation, the advisor is expected to take reasonable steps to understand the securities made available to the client and the costs of these securities, and the impact of costs on the client. The advisor is expected to have a high level of understanding of the firm's product shelf to compare and select appropriate securities. The firm must undertake reasonable steps to ensure the firm's product shelf is consistent with how the firm holds itself out in the marketplace; examine how a particular security generally compares to similar securities available in the market; have procedures to monitor and assess approved securities on the shelf; ensure sufficient information is available to registrants to meet their KYP obligations; and provide training programs for advisors on approved products.

Suitability

The new reforms propose a more comprehensive suitability obligation, "suitability plus", that includes an explicit consideration of investment fees/costs and the impact on potential returns, and consideration of a reasonable range of alternative investments available at the time. While the SRO rules generally interpret suitability on a trade-by-trade approach, the proposed rules now require a portfolio approach to suitability, taking into consideration all accounts of the client. The SRO list of conditions that trigger a suitability review remain in place. However, if a suitability review is not triggered by the designated conditions, a suitability review must be carried out at a minimum of every 36 months. The

registrant must put the client's interest first in carrying out the suitability determination. The industry will have many technical issues on compliance with the expanded suitability requirements.

Conflicts of interest

The new proposals require registrants and firms to take reasonable steps to identify all conflicts of interest and address these conflicts in the best interests of the client. The specific conflicts, and the impact of these conflicts on the client, must be disclosed in a timely fashion.

The conflicts of interest require that firms have a framework to identify and respond to conflicts of interest. The proposed guidelines focus on what is expected to address conflicts in the best interests of the client, with reference to an extensive list including internal compensation arrangements, the sale of proprietary and non-proprietary products, client referral arrangements, and fee-based accounts. The requirements for referral arrangements that prohibit the payment to non-registrants and place limitations on the term and amount of the referral fee paid could be unduly restrictive on member firms, particularly dealers within corporate financial groups. Firms will have to undertake new policies and procedures requirements for such areas as documenting training for advisors; how conflicts of interest are addressed in the best interests of clients; sales practices, compensation arrangements and incentive practices; and compliance with the new "misleading communications" prohibitions.

Under the proposed reforms, embedded commissions or trailer fees are not prohibited for registrants that make a suitability determination, unlike DSC (deferred sales charge) mutual funds that will be prohibited. However, the advisor and firm will be required to disclose and address the inherent conflict in the embedded commission in the best interests of the client. It will be difficult to justify recommending a mutual fund with an embedded fee or trailer if alternative up-front low cost alternative investments exist in the marketplace.

In this regard, we are pleased the regulators have turned to market practitioners for further comment and input on the proposed rules and guidelines. The investment industry and its phalanx of working groups on the various proposed rules and guidelines will scrutinize the material to weigh the effectiveness and costs of the proposals and the need for clarity—for example, what does "reasonable" mean in different business contexts. The industry groups will propose practical and constructive alternatives to achieve the intended outcomes. Practical and clear rules and guidelines across all the proposed reforms are also important to provide a clear safe harbour to protect advisors and firms from unfair allegations of failure to meet a best interest/client-first standard of conduct.

It will be important to conduct these consultations expeditiously because considerable systems work will be required. As compliance systems are often interdependent across different firm functions and operations, the underlying

technology can only be built effectively once the overall rule framework is in place.

SOME MEASURE OF BUSINESS IMPACT FROM THE RECENT REFORMS

Tighter operating margins

The new proposed rules and guidelines differ and exceed the existing SRO rule framework. Once the consultation process has ended, firms will build out the compliance systems, including adjustments in business practice, new policies and procedures for operations, new supervisory and oversight systems and new technology systems. One-time fixed costs will be significant and ongoing variable costs will increase, placing a proportionately heavier burden on small retail firms. Many small firms will rely on their carrier firms to put in place the new compliance requirements of the proposed reforms, although significant in-house costs will occur.

Further, advisor fees and charges will be under pressure from the ongoing transparency requirements under CRM 2 and the increased availability of lower commission paying products. The mutual fund distributors more reliant on embedded fee mutual funds will be forced through the more stringent suitability and conflict requirements, into alternative lower fee-paying products.

The higher costs paid directly by self-clearing firms and higher fees to the carrying broker, coupled with the squeeze on revenues, will cut into operating margins, already under competitive pressure. It will push more firms into amalgamation and merger, or in certain cases, a decision to close operations.

Lower priced mutual fund product

Firms in the industry have already taken steps to remove mutual funds with high gross Management Expense Ratios (MERs), and complex-structured mutual funds, from their product shelf. This pruning process will probably accelerate under the new proposals. The emphasis on investment costs in the proposed suitability requirement will sharpen assessment of mutual funds with high MERs. That said, firms would take into account the offsetting benefits of complex active management and the potential for relative higher return.

Series A mutual funds with embedded trailer fees will be under particular scrutiny, given the related conflict of interest concerns. The lower fee-paying Vanguard mutual funds, launched several weeks ago, offer an attractive option for fee-based accounts. These funds, with a solid performance track record, give the opportunity to structure a low charging fee-based account as a competitive alternative to most embedded fee mutual fund products. Similarly, ETF portfolios provide a cost-effective alternative to embedded fee mutual funds. The rapidly growing ETF market will likely accelerate under the new proposals.

The recent effort to consider expanding the CRM 2 requirements to include investment product cost, as a complement to advisory fees and charges, will put the spotlight on high-priced mutual funds, particularly in relation to their performance, putting further downward pressure on mutual fund fees. This exercise to enhance disclosure has just begun. It is already apparent, however, that the break-out of MER fees and determination of ETF charges is a complicated and costly process. This work should await the CSA post-implementation review of CRM 2, and a proper cost-benefit assessment on the merits of expanding the CRM 2 requirements.

Extensive documentation

The expanded KYC and KYP requirements, expanded suitability and detailed conflict of interest rules will require more documentation from advisors to explain actions and recommendations in the context of the detailed requirements. The greater focus on documentation will interfere with increased efforts at client relationship-building and meeting the demands for financial services, such as financial and tax planning. Demand will grow for more desk-top technology to improve advisory productivity. The larger firms and many nimble mid-tier firms will have an edge, providing administrative resources and out-sourcing planning, and providing technology. Firms will also be putting pressure on advisor pay-outs to cover the increased operating costs of the advisory business.

Robo-investing

The new proposals will accelerate the shift to white-labelled advisor hybrid robo-investing platforms. The client shift to these platforms reduces compliance costs and risks. This may be the most economic option for affluent mass market clients with assets below the \$250,000 threshold.

CONCLUSION

The proposed new rules and guidelines released in the June CSA notice leverage the existing SRO rule framework, as well as impose additional requirements on advisors and firms across all registrant categories, to meet a best interest/client-first conduct. Existing business practices in the advisory business will change, and new supervisory and compliance procedures, as well as accompanying technology, will have to be put in place. Clear and well-defined guidelines will be important to direct advisors and firms on required conduct. Industry engagement will be critical to ensure the proposed rules and guidelines have clear purpose and are practical and cost-efficient, as well as have sufficient clarity. The guidelines will function as a needed safe harbour for the industry.

The evidence already suggests the IIAC's industry working groups will be large and interactive, as firms recognize these proposals are sweeping in nature. Individual firms will need detailed understanding of the rules and guidelines, and the opportunity to share perspectives with their peers, to build the policies, procedures and related technology for compliance purposes.

The reforms are far-reaching, covering all aspects of the retail business, and will be costly to implement. Over time, they will have significant impact on the conduct of the advisory business, on offered products and services, and on the application of financial technology. The increased costs and reduced operating margins that will result from implementing the new rule framework will lead to further consolidation of the domestic wealth industry as small firms amalgamate, merge and terminate operations.

Yours sincerely,

A handwritten signature in black ink, appearing to read "I. Russell", with a long horizontal flourish extending to the right.

Ian C. W. Russell, FCSI
President & CEO, IIAC
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