Now the Work Begins — “Client Focused” Registrant Reform Rules Published by Canadian Securities Regulators

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On October 3, 2019, the Canadian Securities Administrators (CSA) released final rule amendments intended to better align the interests of registrants, including individual registrants, with the interests of their clients. The CSA emphasize that their aim is to create a “new, higher standard of conduct” across all categories of registrants, which will result in registrants putting the interests of their clients first, particularly (but not solely) when managing conflicts of interest and making suitability determinations. Thus, the CSA describe the rule amendments as “client focused reforms” (CFRs).

The amendments to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* and the associated Companion Policy will come into force on December 31, 2019 (subject to government approvals), but will become effective over phased-in transition periods of two years ending December 31, 2021. The CSA also expect that the Investment Industry Regulatory Organization of Canada (IIROC) and the Mutual Fund Dealers Association of Canada (MFDA) will amend their rules within that time-frame, so that members of those self-regulatory organizations (SROs) – investment dealers and mutual fund dealers, respectively, and their representatives – will be subject to the same rules as other registrants.

It is clear that the CSA intend for the rule amendments to be transformational and give rise to real change in how registrants approach their interactions with clients, as well as compliance with existing principles of registrant regulation. While certain of the proposals published for comment in April 2016 and in June 2018 have been dropped pending further consideration by the CSA, much of the June 2018 proposals were adopted in final form. Consistent with the CSA’s recent approach to registrant regulation, the CSA provide extensive and detailed guidance in the Companion Policy to NI 31-103, on the regulatory principles behind the rule amendments, as well as the regulatory expectations for compliance with the rules. It is vital that registrants work to implement the rule changes with a clear understanding and consideration of the CSA’s regulatory expectations.

Although some firms will have less to do to implement the changes (depending on such factors as the size of their operation and business model), we believe that all registrants will need to proceed promptly to develop a project plan to identify and implement

changes to client documentation, internal controls, training programs, compliance policies and procedures, compensation models and client services and product line-up, among other things. Significant work is required within the applicable transition periods and we anticipate that there will be much to discuss, both internally and with external advisers, including BLG. The CSA are organizing an implementation committee to provide guidance and answer questions on the client focused reforms; we have asked to be represented on this committee.

The CSA are also continuing to work on the next stages of reforms. Each of the following topics is described as a separate and longer-term project:

- Considering proficiency requirements for registrants and their representatives;
- Reviewing titles and designations, in addition to what is provided for in the rule amendments;
- Imposing a "statutory" fiduciary duty for discretionary asset/portfolio managers in those provinces where one does not already exist;
- Reviewing referral arrangements, given that the restrictive June 2018 proposals were dropped, pending this further study. With the rule amendments, referral arrangements must be considered in the context of considering material conflicts of interest;
- Clarifying the role of Ultimate Designated Persons and Chief Compliance Officers;
- Revisiting the June 2018 proposals regarding publicly available information, which have been dropped pending this further study.

NI 31-103 Amendments: Supersizing Existing Regulation and Regulatory Guidance

The NI 31-103 rule and policy amendments generally incorporate and expand upon SRO regulation and regulatory concepts and apply them to all registrants, as well as articulate CSA policy in relation to them. The CSA emphasize that a registrant may implement the new rules and guidance in ways that make sense for the particular firm – that is, the rules and guidance are not intended to be "one-size-fits-all", but rather are "scalable" in light of different business models. This concept is not specifically provided for in the rule amendments nor as a general overall statement in the Companion Policy. Rather, at various points in the Companion Policy, the CSA address this concept in general terms stating that firms may tailor their processes for compliance with the new requirements to the firm's "business model". Firms are expected to use their "professional judgement" in determining how best to implement the specific rule amendments and stated regulatory expectations. This should give some comfort to registrants in deciding to what extent they are obliged to implement the full panoply of rules and guidance, although the CSA staff will be the ultimate arbiters of whether firms have done enough.

The most significant NI 31-103 amendments are summarized below, along with some of our broader thoughts on their implications. As noted previously, in most cases, the new rules are concise; it is the guidance forming the CSA policy provided in the Companion Policy that is often lengthy and detailed and can be expected to give rise to the most significant implementation and compliance issues.

Our summary below highlights the rule amendments in the order that they appear in NI 31-103. Together with our clients, we will continue to consider the reforms over the coming weeks. We plan to host a focused seminar on the implementation issues associated with the rule amendments at our Toronto office on January 16, 2020, where we will address questions from our clients and other industry participants.

The new rules and guidance relating to conflicts of interest and the mandated changes to "relationship disclosure information" will come into effect on December 31, 2020, with the balance of the rule changes and guidance becoming effective on December 31, 2021.

New Training Obligation for Registrant Firms: Firms must provide training to representatives (which can be provided by external providers) on the firm's compliance with securities regulation, with particular focus on the new "know your client" obligations, suitability assessments, "know your product" obligations and conflicts of interest. Training of representatives is described as a fundamental obligation of firms. Specific training is expected on how to identify conflicts of interest and how to put clients' interests first when making suitability determinations. Training is an example of an area where the CSA acknowledge that "formal" training programs may not be "necessary or practical" for "small" firms, and that the scope of a firm's compliance training will depend on the "nature, size and complexity" of its business. Registered representatives are expected to "update their knowledge and training" to keep pace with new developments in their industry relevant to their business.

New and Supersized Books and Records, Policies and Procedures and Internal Controls Requirements and Expectations: Among other matters, firms must document how they provide training to their representatives, how they address various identified conflicts of interest in the "best interests of clients", their sales practices, compensation arrangements and incentive practices, their internal compensation and incentive practices and how they comply with the new "misleading communications" prohibitions. All of the new enhanced requirements must be reflected in revised and updated policies and procedures. Internal controls must be specifically designed to assist firms in monitoring compliance with the KYC, KYP and suitability determination obligations. Internal controls must also be in place to manage the risks associated with "referral arrangements" and "the use of titles and designations" by representatives of the firm. Specific attention must be provided to documenting and supervising how representatives and firms "address conflicts of interest in the best interest of their clients" and "put the client's interest first when making suitability determinations".

Supersized Know Your Client Requirements: In addition to taking reasonable steps to establish the identity of clients and ensuring that it has sufficient information about a client's investment needs and objectives, a registrant will be required to ensure it has sufficient information about a client's personal circumstances, financial circumstances, investment knowledge, risk profile and investment time horizon. The accuracy of all KYC information must be "confirmed" by a client within a reasonable period of time and must be kept current, particularly when the firm becomes aware of a significant change in the client's KYC information. KYC information must be reviewed (i) for managed accounts, every 12 months, (ii) by EMDs, within the previous 12 months before making a trade or recommendation to the client, and (iii) for all other accounts, by the registrant no less than once every 36 months.

There is significant guidance provided on the various elements of KYC in the Companion Policy, including discussions of the importance of obtaining and using this information to support the requirement to make suitability determinations in ways that "put the client's interest first". In particular, the CSA explain that they will expect firms to develop a process for collecting and updating KYC in ways that result in a "meaningful interaction" between the firm and the client. Although standardized questionnaires and other "tools" may be used to facilitate the collection of KYC information, firms will be expected to provide assistance to clients in understanding the various questions asked and concepts used, and to follow up with the client if there are inconsistent answers. The CSA provide specific guidance around the need for processes to assess the client's risk profile (risk tolerance and risk capacity), as well as how firms should resolve "conflicts" between the client's expectations and their risk profile. The CSA acknowledge that the nature of the KYC information requested for any client will depend on the nature of the services provided by the registrant, with the most extensive requirements being suggested for discretionary managed accounts. Registrants should not simply rely on the client's word for certain of the information – there are expectations that registrants will ask probing questions and request further information as follow-up. Client confirmations of the KYC information provided must be documented – either by way of client signature (including a digital signature) or as notes to the client file.

Supersized Know Your Product Requirements: The components of new KYP obligations include a requirement that a firm only make a security available to its clients once it has taken reasonable steps to assess the security – including its "initial and ongoing costs and the impact of those costs", to approve the security and to monitor and assess the security on an ongoing basis for significant changes. Representatives have their own KYP obligations, so that they can be certain they have met the requirements for a suitability assessment. Representatives must not buy, sell or recommend a security unless they take "reasonable steps" to understand "at a general level" the securities that are available at the firm and may only recommend a security that has been approved by the firm. The firm must ensure that representatives have the necessary information about each security approved by the firm to meet their obligations. Firms must develop an approval process for securities recommended by the firm – and here the CSA note that the process may vary based on the "complexity and risks" of the securities. The CSA provide guidance on what matters a firm must consider when developing an approval process, which must include a process to monitor significant changes in each approved security. KYP requirements will apply to securities transferred in to the firm by the client from another firm or that are acquired for the client in response to a client directed trade. KYP expectations regarding proprietary products ("related and connected issuers") offered by the firm are the same for any other type of security – although the CSA tie together the KYP requirements with the conflicts of interest discussion about proprietary products. Training programs and recordkeeping requirements are also closely tied to the KYP expectations.

Supersized Expectations for Carrying Out Suitability Determinations: The expanded rules around suitability require a registrant to determine, on a reasonable basis, that a specified investment action taken or recommended on behalf of a client, including the opening of an account or a recommendation to continue to hold a security, is suitable for the client. Suitability must take into account the client's KYC information, the registrant's KYP assessment, the impact of the action on the client's account (including concentration and liquidity considerations), potential and actual impact of costs on the client's return on investment and a consideration of a reasonable range of alternatives.

In addition to the above noted points, any specific action must also "put the client's interest first". In this way, "suitability" (as we have always interpreted this word) is not enough – the registrant must be able to demonstrate how the action puts the client's interest first. There are new rules as to when suitability assessments must be carried out on an ongoing basis, including when the registrant becomes aware that a security or the account may no longer be suitable for the client.

There is much guidance provided in the Companion Policy on CSA expectations for registrants meeting the expanded suitability expectations. The bottom line is that the CSA will expect registrants to be able to demonstrate that a particular action for a client was made in a way that put the client's interest first. The CSA explain, however, that registrants must make these assessments "based on the information reasonably available to them at the time" of the assessment. The CSA will monitor how registrants carry out suitability by looking at what a "reasonable registrant" with a similar business model would have done under the same circumstances. This is intended as comfort to registrants that the CSA staff will not necessarily "second guess" registrants on suitability assessments.

A welcome change is that institutional permitted clients may now waive the suitability assessments even when they have established a managed account with the registrant, although it is not clear if this permission can be adopted prior to December 31, 2021, when the new suitability rules become effective. Permitted clients who are individuals can still only waive the suitability assessments if they do not have a managed account with the registrant, as NI 31-103 currently permits.

Supersized Expectations for Identifying and Managing Conflicts of Interest: The new supersized rules will continue to require firms to take reasonable steps to identify existing material conflicts of interest, and also those material conflicts of interest that are "reasonably foreseeable", between the firm and the client and each of its representatives and its clients. The CSA have reverted back to a "materiality" threshold for conflicts of interest, but have retained the fundamental concept that all material conflicts must be addressed in "the best interest of the client". If the conflict cannot be managed in the best interest of the client, it must be "avoided" (prohibited). Conflicts must be disclosed to clients, but registrants may not rely solely on disclosure to address conflicts in the best interests of the client. Representatives have specific responsibilities regarding conflicts, including identifying and reporting conflicts to their firm, addressing conflicts in the best interest of the client and waiting until the firm "approves" the representative's proposed actions in connection with a material conflict of interest. The guidance provided on identifying and addressing conflicts of interest is very detailed and extensive, but generally will require firms to establish well-defined processes for identifying and managing material conflicts of interest, and understand for each material conflict, how it can be managed "in the best interest of the client". Documentation and analysis will be critical.

The CSA provide specific guidance about the "inherent" material conflicts of interest which they consider are raised in the following circumstances:

- a firm and its representatives trade or recommend "proprietary products" (a newly defined term);
- a firm and its representatives receive "third-party" compensation;

- a firm creates internal incentives to sell or recommend certain products over others or for representatives to receive compensation from their firm which varies according to specific products or securities recommended/traded for a client;
- a firm manages a client's assets in a "fee-based account" where that account holds securities with embedded compensation or where the firm does not provide services to the client consistent with the terms of the account or agreement with their client;
- a firm is involved in paid referral arrangements – we note that the existing referral arrangement provisions have been modified in ways that will require attention from firms that engage in these practices;
- a firm acquires assets from a client "outside the normal course of a registrant's business";
- a registrant has full control or authority over the financial affairs of an individual client;
- a registrant acts as a director, officer, shareholder, owner or partner of an issuer whose securities the registrant also recommends to clients.

Disclosure as a way to mitigate conflicts of interest receives extensive attention in the Companion Policy – and while disclosure is required, it is also stated to be insufficient on its own to illustrate that the conflict was addressed "in the best interest of the client".

Note that investment fund managers are exempt from these requirements in connection with their management of public investment funds, given the conflicts regime inherent in National Instrument 81-107 *Independent Review Committee for Investment Funds.*

As noted above, these rule and policy amendments come into force on December 31, 2020 and therefore must be addressed first; in our view, the work to do what is expected by the CSA in the area of conflicts of interest should not be underestimated.

New Rules and Supersized Expectations for Disclosure and Holding Out: Notwithstanding that the CSA indicate that they will continue to work on a project around "titles and designations", new anti-"misleading communication" rules will serve to moderate titles of individual representatives. All titles must be approved by the firm, and "titles, designations, awards or recognitions" that are based partly or entirely on a registered individual's sales activity or revenue generation are prohibited. Registrants must not hold their services out in any manner that could reasonably be misleading in respect of qualifications and products and services provided. Any title that is a "corporate officer" title, such as President or Vice-President, cannot be used unless the individual has been appointed as a corporate officer under applicable corporate law. Other guidance on misleading communication is given, including when a firm exaggerates the products or services made available to clients.

Expansions to the requirements to provide clients with relationship disclosure information (RDI) are also mandated. These changes will be effective on December 31, 2020. We expect further clarity will be required on the CSA's expectations about immediately revising RDI documents and making the updated information available to clients.

BLG Analysis and Focused Seminar on Implementation: The NI 31-103 rule and policy changes are the outcomes of among the most time-consuming and detailed review of existing regulation and industry practices we have ever seen (dating back to

pre-2012). In addition to understanding the impact of the amendments on your business, including your representatives, it will be important to consider how you may need to change your business models and practices in order to comply with the new requirements.

We have closely followed the path of the various reforms of registrant regulation for many years, as well as being in the heart of the discussions about conflicts of interest, sales practices and incentives, investment fund fees and disclosure. We would be pleased to discuss with you how you can learn about the rule amendments and analyze them to determine the impact on your business.

We intend to speak with our clients to seek to help ease the burdens associated with the impact of the amendments and discuss what will need to change with business models and operations, compliance systems, internal controls, compensation practices, disclosure, training programs, client documentation and the like. We will collect questions asked of us, along with our suggested answers, and will seek feedback from the regulators as necessary. Please watch for your invitation to our focused seminar on the NI 31-103 amendments and their implementation, scheduled for *Thursday, January 16, 2020* at our Toronto office (we will offer Webex participation) where we will provide more in-depth analysis.

Please contact any of the authors of this Bulletin, as well as your usual lawyer in BLG's Investment Management or Securities Litigation and Regulatory practice group for further information or should you like our assistance to understand how the reforms will apply to you.

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