

# Canadian Securities Law News

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## SIGNIFICANT NEW PROPOSALS FOR REGISTRANT OBLIGATIONS TOWARDS THEIR CLIENTS

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In 2012, the Canadian Securities Administrators (the "CSA") embarked on a consultation process as to the appropriateness of introducing a statutory best interest duty for registrants when advice is provided to retail investors. Since 2012, various members of the CSA have held town hall meetings, conducted various research projects and sought extensive stakeholder input to identify issues and possible enhancements to the regulations concerning how investment dealers, advisers and representatives deal with their clients.

On April 28, 2016, the CSA published Consultation Paper 33-404 (the "**Consultation Paper**") as a next step in the CSA's efforts to improve relationships between clients and their advisers, dealers and representatives. The Consultation Paper is significant. In it, the CSA is seeking input on regulatory reforms which create more detailed and explicit obligations for registrants towards investor clients. Such reforms would involve major amendments to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registration Obligations* ("**NI 31-103**"). In addition, certain members of the CSA, through the Consultation Paper, are seeking input on a proposal to implement a regulatory best interest standard (the "**BIS**").

### Current Regulatory Regime Requires Change

The CSA is concerned that as it stands, NI 31-103 does not explicitly set out certain specific obligations of registrants to their clients. For example, there are no specific requirements to: prioritize the interests of clients in conflicts of interest; collect information about and consider a client's investment needs and financial situation in a suitability review; and know the securities products sold.

Through research conducted, the CSA identified the following key investor protection concerns:

1. Clients are not receiving the returns expected as registrants are failing to consider all relevant factors in their investment recommendations;
2. Clients are over-relying on their registrants, creating a wide expectations gap;
3. Current conflicts of interest requirements are ineffective in actually mitigating conflicts;
4. Financial information asymmetry between registrants and non-institutional clients persists; and
5. Current requirements to analyze the suitability of a product for a client are unclear and not effectively enforceable.

## Proposed Changes — Targeted Reforms

To address these concerns, the main targeted reforms to NI 31-103 proposed for comment by the CSA include:

- **Enhanced Regulation of Conflicts of Interest:** Amendments would require registrants to prioritize the interests of a client in an identified material conflict of interest and to disclose conflicts. Disclosure must be specific, clear and sufficient to the extent that registrants can reasonably conclude that the client understands the conflict and its implications. Detailed guidance is provided on how to respond to specific conflict situations, such as when registrants are compensated from a source other than a client.
- **Enhanced Know Your Client (KYC) Requirements:** Currently, registrants are not required to collect information regarding the client's investment objectives, financial circumstances and risk profile, such as their loss aversion. The targeted reforms would mandate registrants to obtain such information for a thorough understanding of the client. Reasonable steps to annually update KYC information would also be compulsory.
- **Enhanced Know Your Product (KYP) Requirements:** Firms would be required to ensure that all representative registrants have the information and ability to comply with their obligation to know their investment products. In addition, firms must identify to clients whether they have a proprietary product list or a mixed/non-proprietary product list (products for which they are registered to advise on or trade in). Mixed/non-proprietary firms would have other requirements, such as selecting listed products based on a fair and unbiased market investigation.
- **Stricter Obligations in the Assessment of Client Suitability:** Before registrants make recommendations or accept instructions from clients to make a securities transaction, they will be explicitly required to ensure that such recommendations or instructed transactions are suitable from basic financial, investment strategy and product selection perspectives. Registrants would be required to identify any financial strategies, other than a securities transaction, that may achieve the client's investment objectives (for example, paying down high interest debt or directing cash into a savings account).
- **Requirement for Relationship Disclosure:** The amendments would require firms to explain the nature of the client-registrant relationship in plain terms and to disclose information regarding types of products offered, including which are proprietary products of the firm.
- **Prescribed Business Titles:** In a brand new regulation, registrants would be required to adopt client facing business titles from a prescribed list to address current confusion around a representative's roles and responsibilities.
- **Improved Registrant Proficiency:** The proposed amendments also intend to improve the proficiency standards of registrants to comply with the proposed reforms and to assess the impact of product costs and investment strategies on a client's investment objectives.
- **Clarification of the Role of the Ultimate Designated Person (UDP) and the Chief Compliance Officer (CCO):** Amendments would be introduced to clarify the role of the UDP and CCO, both in terms of compliance systems generally, but also ensuring compliance in specific areas such as conflicts of interest and suitability.
- **Statutory Fiduciary Duty when Discretionary Authority is Granted:** Securities legislation in BC, Saskatchewan, Ontario, Quebec, Nova Scotia, PEI and the three territories would be amended to introduce a statutory fiduciary duty for registrants who manage portfolios through discretionary authority granted by the client.

Some of these proposals would not apply for registrants who deal with institutional clients.

## Proposed Changes — Regulatory Best Interest Standard

Certain CSA members are seeking comment as to whether the CSA should codify a BIS for registrants, requiring those parties to deal fairly, honestly and in good faith with their clients, with the standard of care of a prudent and unbiased firm or representative, acting reasonably. They would be guided by the following principles:

1. Acting in the best interests of the client;
2. Avoiding or controlling conflicts of interests in a manner that prioritizes a client's best interests;

3. Providing full, clear and meaningful disclosure;
4. Interpreting laws and agreements with clients in a manner favourable to the client's interests if there is a conflict of interest; and
5. Acting with care.

The BIS is not a restatement of a fiduciary duty. The CSA explains that a regulatory standard is more comprehensive and is tailored to a client-registrant relationship. In addition, the common law fiduciary duty is unclear for registrants and remedies for a breach of fiduciary duty may be overly harsh for registrant misconduct. This standard is intended to: guide registrants in situations that fall outside of specific rules; clarify the standard of care clients expect to receive; establish a more objective standard of care; allow registrants to make personalized investment strategies for clients; and permit quicker regulatory action where registrants fail to meet the BIS.

Provinces are divided on this proposal. The Ontario and New Brunswick securities commissions believe that a BIS would materially enhance the client-registrant relationship, whereas the British Columbia Securities Commission ("**BCSC**") is not in favour of a codified BIS. The securities commissions of Quebec, Alberta, Manitoba and Nova Scotia share the concerns of the BCSC though they would like further input from stakeholders. Principally, the BCSC and other commissions are concerned that a vague, broad and unqualified standard may exacerbate current problems, such as widening the expectations gap, creating further legal uncertainty and diminishing existing fiduciary standards for some registrants (i.e. portfolio managers and investment fund managers). The expectations gap could be widened if clients believe that registrants have an unconditional duty to act in their best interests when, in reality, certain fundamental conflicts would continue to exist. For example, a registrant would be able to be compensated, owned or affiliated with businesses creating the investment products that they sell, despite being obligated to prioritizing a client's interests.

The proposed changes are substantial and this article only provides a brief overview. Market participants should pay attention to the status of these proposals as, if approved, the amendments, and particularly a new BIS for registrants, would affect day-to-day conduct of dealers and their advisers. Comments to the 68 questions posed by the CSA throughout the Consultation Paper are to be submitted by August 26, 2016.

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