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**Client Focused Reforms – Proposed Rule Amendments for Public Comment 20-0238 November 19, 2020** https://www.iiroc.ca/Documents/2020/0212672e-b195-40d7-a9a9-e1c045b7b223_en.pdf

We regret that we do not have the resources to provide a more fulsome input. This would involve us reviewing the CSA requirements, cross correlating them to the IIROC rules, considering various exemptions and assessing the language used to enable the changes.

Kenmar Associates is an Ontario-based privately-funded organization focused on investor education via on-line research papers hosted at www.canadianfundwatch.com. Kenmar also publishes *the Fund OBSERVER* on a monthly basis discussing investor protection issues primarily for investment fund investors. An affiliate, Kenmar Portfolio Analytics, assists, on a no-charge basis, harmed investors and/or their counsel in filing investor complaints and restitution claims.

Over the past two decades the financial services industry has rebranded itself from a transaction business to an advice business and more recently to a Wealth management business but have remained anchored in a transaction-based regulatory environment. Firms now promote holistic advice including financial planning, tax optimization, charitable giving and estate planning. In other words, a lot more than trading and advice on securities. As such, we do not believe CFR captures the range of services being provided by IIROC Member Firms . It remains to be seen how this disconnect develops and the impact on clients.

Kenmar appreciate the challenge of accurately and completely reflecting CFR requirements/intent into operational rules. Presumably, it involves a lot more than cutting and pasting CSA CFR requirements into existing rules. That being said, Kenmar understand that comment is only being sought on the drafting of the proposed conforming amendments in specific areas and is not inviting comments

that seek to revisit the regulatory policy rationale behind the new requirements adopted under the CFRs. We do however feel that CFR directly and indirectly impacts other rules that need redrafting as a result. A "systems" approach is needed for holistic rule amendment. After all, these rules will be the rules that govern the life savings of millions of Canadians saving for retirement and other life goals.

The implementation of the CFR plays a key role in clarifying Firm requirements, not only in terms of policies and procedures aimed directly at addressing compensation-related conflicts, but also in related touchpoint areas such as relationship disclosure, KYC/ suitability ,product due diligence and complaint handling. The devil is in the details of CFR implementation and it is those details that will make or break the success of CFR. In this short note we provide some of our experiences highlighting some of the key failure mechanisms of current KYC, risk profiling and suitability determinations.

The CFR reforms are based on the fundamental principle that clients' interests come first in their dealings with Firms and individuals that are registered to give investment advice .Per CFR, Registrants are required to address material conflicts-of-interest in the best interest of their clients and put clients' interests first when determining the suitability of investments. The CFR reforms introduce new obligations on registrants or codify best practices, not only with registrants' obligations to "know your product," "know your client," specific suitability factors, and disclosure of important information to clients but more generally with the client -Firm relationship.

The CSA has publicly stated that the reforms are expected to increase investor confidence in the industry by better aligning industry conduct with investors' expectations. Given the emphasis on conduct and confidence building , we are of the view that the entire IIROC rule book should be reviewed for congruence with the intent and spirit of CFR .An example would be IIROC rule 2500B , Client complaint handling. A complaint, by its very nature, creates a conflict-of-interest between the Firm and client. This review is necessary so that all components of the rule book "system" are synchronized and work in harmony with CFR. Specifically, complaints must be resolved in the best interests of clients.

We expect that where an existing rule is more demanding than CFR, that IIROC will retain the existing rule. In some cases it is not clear this has occurred. For example at 3102 the words *due diligence* have been replaced with *reasonable .*Para 3103 has been deleted but we thought it was robust and clearer.

Kenmar also expect that IIROC has worked closely with its sister SRO, the MFDA, to harmonize comparable rules as much as possible.

Although we are unable to fully respond to the consultation as we would prefer, we would however at least like to provide IIROC with some food for thought that might be helpful.

- Are IIROC complaint handling rules impacted by CFR? Complaint handling is an important client-Firm touchpoint ripe with conflicts-of-interests. Kenmar believe that all rules linked to complaint handling should therefore be reviewed for congruence with CFR in words and spirit. Re 3804 (2) (xiii) provides the linkage.
- Will CFR provisions impact IIROC's principles- based sanction guidelines? Here, we raise the question if CFR impacts the wording in the sanction guidelines. It is certainly not obvious that moving to a higher conduct standard would not suggest changes to sanction guideline language.
- Does the introduction of CFR impact any protocols with OBSI? What rule changes, if any, are required to deal with Firms making lowball offers and settlements against OBSI recommendations? Kenmar believe that low-ball settlements are inherently not resolutions in the best interest of complainants and need IIROC CFR rule coverage.
- For some types of conflicts (e.g. personal financial dealings) IIROC have prescriptive rules in addition to their Conflicts Rule but do not have rules specifically on compensation- related conflicts. Does CFR necessitate prescriptive rules to address for example commission grids, reversion to a fee-based account and choice of mutual fund series.
- Will Discount brokers holding or selling A series funds be in breach of the CFR conflict-of-interest provisions on June 30, 2021?
- Will the definition of "recommendation "be harmonized across all Member platforms? ( we are thinking here of the unique definition of recommendation used in OEO guidance) We recommend the term "time horizon" be defined in plain language and that that standardized definition be incorporated into Firm KYC / account forms, policies, rules and processes.
- What is the accepted definition of "trailing commission" for the purpose of IIROC rule interpretation and application? Should there be a specific rule that OEO dealers should not receive such payments? Rule 3303 (2) (i) seems to broadly exempt OEO's from KYP obligations. There are clearly products like A series mutual funds that are not intended for the OEO channel. In addition, a new CSA rule bans such payments to OEO's. A OEO dealer should not offer such products on its platform as a result of its CFR KYP analysis.
- Do the rule amendments to accommodate CFR also reflect the realities of stay-at-home work protocols?
- The proposed rule says "Within a reasonable time after receiving the information collected a Dealer Member must take reasonable steps to have a client confirm the accuracy of such information ..". We strongly recommend that the rule specify how such confirmation is to be confirmed. An acceptable way would be for the client to sign off (including date) on the information and retain a signed copy of the information. Too often we encounter KYC information that does not match what the clients claim they have related to the dealing representative.
- Do CFR conduct requirements meet or exceed the Ontario Financial Title Protection Act? If not, are additional rule changes required? Example: The title *Financial Advisor* is a protected title under Ontario law yet is used by IIROC Registered Representatives. The use of this title requires credentialing

by a FSRA approved credentialing body. **NOTE**: IIROC itself uses the term ***advisor*** in its rules .

- Another Kenmar area of concern is cost and how the risks associated with particular financial products would be communicated to clients. Firms have to think of cost more broadly; costs like markups, deferred sales charges, liquidation costs need to be explained and disclosed to clients and income tax implications.
- Definition of "order execution only account": ADD (a) An account where no personalized investment advice is offered or fees collected for advice or unsolicited services and (b) An account that does accept facilitating payments from product providers ( this would include. but not be limited to, ETF's, mutual funds, GIC's, PPN's and segregated funds). We recommend that the label *order execution only* be changed to *self-directed* to better reflect the full range of services and tools contemporary discount dealers provide.
- Are rule changes ,additions or guidance required in order to address reverse churning? Reverse churning is certainly a sensitive client touch point where major conflicts -of-interests arise and where CFR would require the conflict to be resolved in the best interests of clients. What kind of disclosure/analytics should be required when converting a client from a commission to a fee-based account?
- The definition of an OEO seems to suggest that such dealers have no legal, social or moral obligations to clients regarding transactions. That implies they would have no role in protecting vulnerable clients or dealing with suspicious transactions. Is this the intent of the terminology?
- Consider including Trusted Person contact to KYC documentation or at least to the NAAF form

**Other related questions/ observations/ considerations:**

## Cataloging ,addressing and monitoring conflicts

Do Firms require a documented process to identify and assess conflicts-of-interest that exist in their business or involve their staff? Should the identified conflicts be required to be catalogued and made available for IIROC review upon request? [In an April , 2017 guidance note, IIROC revealed that Firms can point to a high-level analysis of certain conflicts, most notably those involving related-party products, but few could provide evidence of conducting a detailed review of their overall compensation program, including all aspects of the compensation grid together with other incentives. Furthermore, IIROC also found few Firms have implemented special monitoring processes to address the conflict risks identified through internal review. *Managing Conflicts in the Best Interest of the Client – Compensation-related Conflicts Review*
https://www.iiroc.ca/Documents/2017/5365cb5b-e384-477f-8fc0-8c2b9450424a_en.pdf ]

Should Firms be required to have a documented process of developing and implementing measures to avoid, manage and/or control each conflict in the best

interests of the firm's clients? Should the measures for each defined conflict be required to be documented in a matrix and made available for IIROC review upon request?

## NAAF-KYC documents

New Account Application has been changed to Account application. Is there an opportunity here to add "and Know Your Client Form"? This would permit clients to better understand the intent of the questions being asked and incent them to be more thoughtful in their responses.

Time and again we see how investors are duped right at the front end of the client-advisor relationship. The NAAF is improperly completed, often in haste. Investors ought to be warned just how important every response and tick mark is when they first open an account. IIROC should require Firms to provide BOLD plain language conflicts-of-interest warnings on NAAF documents so that the retail investor is informed of the true nature of the client-Rep relationship. Viz *"Your account is a brokerage account . Our interests may not always be the same as yours. Before completing the form please ask us questions to make sure you understand each data block. Enquire about your rights and our obligations to you, including the extent of our obligations to disclose conflicts of interest and to act in your best interest. We are paid both by you and, sometimes, by people who compensate us based on what you buy. Therefore, our profits and our compensation may vary by product and over time. In the event of a dispute, the information provided herein can and will be used against you. Ensure your responses are accurate. "* Such an upfront clause could help increase the chances of making CFR a successful initiative.

We recommend that NAAF terminology should be standardized throughout the IIROC member constituency with a clear, plain language definition of key terms used so the clients understand the questions to the extent informed responses can be made.

Rules should make it clear that KYC information must be obtained for <u>each</u> account held by the client unless there is clear evidence that such differentiation is not required. For example, the time horizon for a RESP account may be different than that of a RRSP account or the objectives of a RRIF account may be quite different than that of a margin account. The beneficiary designation or POA authorizations may differ as between accounts etc.

We also recommend that IIROC include a requirement that the year end account statement should include a reminder to clients to inform the Firm of any significant changes to their personal or financial circumstances or objectives. A pro-active approach by Firms should help ensure that KYC information is up-to-date.

As to para 3209 "*Compliance with the IIROC requirements relating to know-your-client is primarily the responsibility of the Registered Representative, Portfolio*

*Manager or Associate Portfolio Manager assigned to the client account…"*, it should be recognized that the Firm has the responsibility for RR training, NAAF/KYC form design, provision of KYC tools such as risk profiling, KYC validation processes and RR supervision. We see the KYC process more as a shared responsibility but agree that the focus should be on the client-facing RR.

## Complying with CFR risk profiling

Risk tolerance and risk capacity are two concepts that need to be understood clearly before making an investment recommendation. Together, the two help to determine the amount of risk that should be taken in a portfolio of investments. That risk determination (profile) is combined with a target rate of return (or how much money a client wants her/his investments to earn) to help construct a suitable investment plan / asset allocation. In many complaint cases, we find that the risk profile is developed but without assessment of the target rate of return. This leads to complaints on the basis of "unsuitable "investments, the top cause of complaints reported by OBSI. IIROC may want to beef up its rules and/ or guidance in this aspect of risk profiling.

CFR explains that "risk profile" encompasses risk tolerance (willingness to accept risk) and risk capacity (ability to endure loss). It will be important for the related documentation (e.g. NAAF, risk tests, KYC questionnaires and registrants' written analyses) to explicitly address risk capacity. Ref. **INVESTOR RISK PROFILING: AN OVERVIEW**: CFA Institute https://www.cfainstitute.org/-/media/documents/article/rf-brief/rfbr-v1-n1-1-pdf.ashx

Firms should have a process that maps a client's risk tolerance score against a risk-rated portfolio but we have never seen a process that maps the client's capacity for loss. This aspect is usually dealt with by tacking a few questions on to the end of the risk questionnaire. Often, this appears to be almost an afterthought and we do see some risk profilers that do not obviously address capacity for loss at all, which raises the question of how salespersons using those tools will meet the CFR requirement in this respect. Kenmar recommend that IIROC provide guidance / questionnaire (or a rule) on how Firms are to determine loss capacity and to use that calculation to assess suitability. We are of the view that capacity for loss, i.e., whether the client can or cannot absorb the loss without 'material detriment' to his/her standard of living is an objective and quantifiable fact. Ref FG 11-05 *Assessing suitability: Establishing the risk a customer is willing and able to take.* https://www.fca.org.uk/publication/finalised-guidance/fsa-fg11-05.pdf

As an aside, we put forward the idea of adding risk "need "to the risk profile. Risk need, unlike tolerance and capacity, is the amount of risk that the investor "must" take in order to reach their financial objectives. The rate of return necessary to reach these goals can be estimated by examining time frames and income requirements. Then, the rate of return information can be used to help determine the types of investments to engage in and the level of risk to take on. In some cases, while the client may have high risk tolerance and capacity, there may be no

need to take on risk at all in order to meet financial objectives. If the objective is capital preservation, then only products with guarantee features would be suitable recommendations.

## CFR and Complaint handling

Does IIROC consider prevailing Member loss calculation methodologies to be consistent with resolving client complaints in the best interests of current/former clients (i.e. Fairness)? Kenmar consider the book-loss calculation process as fundamentally inappropriate in an advisory relationship.

On October 10, 2019 IIROC published Guidance advising its Members to review their retail client account agreements and to change or remove clauses that absolve them of liability, or that are inconsistent with regulatory obligations. During reviews of agreements from a variety of firms, IIROC discovered clauses that raise regulatory concerns by excluding a firm's liability for losses, including those caused by the firm, or relieving a firm from its securities law obligations, such as suitability. This certainly qualifies as not acting in the best interests of clients. Should there be a rule that specifically addresses this particularly harmful type of breach of CFR's regulatory intent?

## Mitigating Conflict-of-Interests

Under CFR, a conflict also exists where a registrant may be influenced to put their interests ahead of their client's interests; or Monetary or non-monetary benefits available to the registrant, or potential detriments to which a registrant may be subject, may compromise the trust that a reasonable client has in the registrant. Are the requirements of NI81-105 *Mutual Fund sales practices* adequately embedded in current and amended rules? A very high percentage of IIROC Firm assets are in mutual funds; this percentage will grow if the MFDA and IIROC are combined into a new SRO.

How will enhanced conflicts-of- interest standards apply to referral arrangements? These arrangements involve conflict-of-interests and disclosure issues.

How would a Member apply the proposed "best interests" rules in the case of a deferred sales charge mutual fund? (it is our understanding that the OSC consider it a material conflict-of-interest for registrants to accept upfront commissions associated with the sale of mutual fund under a DSC option.)

Of particular interest to advocates are the suggested disclosure for registered Firms that only trade in or recommend proprietary products such as conducting periodic due diligence on comparable, non-proprietary products and evaluating whether the firm's proprietary products are competitive with available alternatives. Should IIROC take this opportunity to add greater clarity in its rules?

CFR emphasizes registered individuals and their sponsoring firms each have a distinct obligation to address material conflicts in the client's best interest. But what

if a  Firm puts in place measures intended to address material conflicts arising from its compensation practices but a registered individual believes that these practices still influence them despite the controls, to put their interests ahead of the client?

CFR states that as part of a registered Firm's practices to address material conflicts, they could consider having a system for confirming that effective disclosure of material conflicts is provided to clients. Despite the surprisingly soft language (i.e. " could consider"), we believe that IIROC should expect Firms to have systems that are appropriate to their business model and scope of operations and reasonably designed to ensure effective disclosure.

Kenmar are deeply concerned that while CFR almost always considers a salesperson acting as a POA, executor or trustee for a client a material conflict-of-interest, such arrangements are permitted .The CSA expect Firms to have policies and procedures in place to ensure that these conflicts are identified and are either avoided or otherwise addressed in the client's best interests. Based on our experience, seniors and vulnerable investors are most impacted by this questionable CFR provision, one which the MFDA does not permit. We request that IIROC OSC reconsider this clause and limit its applicability to immediate family. There is no reason that IIROC cannot have a more demanding standard than the CSA CFR's.

## CFR and client communications

What confuses investors is dozens of misleading "advisor" tiles and designations, multiple registration categories and the obligations representatives have to deal fairly and honestly with clients. A September 2015 OSC mystery shop observed an extensive variety of business titles approved by SRO Member Firms across all platforms. In all, 48 different titles were used by "advisors" on the four platforms shopped. From the perspective of an investor, the number and variety of business titles encountered when shopping for advice makes the process of choosing an "advisor" a confusing and complex one. https://www.osc.gov.on.ca/documents/en/Securities-Category3/20150917-mystery-shopping-for-investment-advice.pdf Title confusion has been going on for years and requires action. Kenmar recommend that title reform be an objective of IIROC's CFR program and incorporated into rules.

New section 13.18 of NI 31-103 reflects the securities regulators' conclusions that this principles-based approach to titles is inadequate. The new rule will prohibit registrants from holding out their services in any manner that could reasonably be expected to deceive or mislead any person as to: (a)Their proficiency, experience or qualifications; (b) The nature of the person's relationship or potential relationship with the registrant; or (c) The products or services provided or that might be provided. Misleading titles and designations have been a major issue for investor advocates. Perhaps IIROC should amplify this point as part of the redrafting, stressing, in the positive, that titles should be meaningful and representative of the services provided.[In the previously cited 2017 Guidance note, IIROC found that "*In approximately one quarter of the compensation programs reviewed, representatives who achieved certain sales targets were rewarded with a*

*prestigious business title. Generally, the title granted was that of Vice-President."* ] Enforcement will be a key success factor since even under current rules ,IIROC has never, to our knowledge, taken enforcement action on misleading titles and designations usage.

## Suitability determination

CFR states that if the securities being sold are illiquid or highly risky, more information on a client's financial circumstances, including investments held elsewhere, might need to be gathered to support a suitability determination. Kenmar believe that exempt market securities are "illiquid and/or highly risky". We therefore think that registrants who deal in or advise on exempt market securities should be expected to collect information about their clients' investments held elsewhere, whenever practicable, unless there are clear and well-documented reasons not to do so.

Under the CFRs' suitability determination provisions, salespersons will be required to consider a "reasonable range of alternatives" before recommending an investment to a client- and will have to document that work. How much is enough? Without robust guidance, this could be a major challenge for Member Firms.

## Supervision and compliance

Rule 3962 is sound as written and complies with CFR :
*3962. Supervision of retail options accounts (1) The designated Supervisor is responsible for ensuring that all recommendations made for an account are and continue to be suitable for the client and put the client's interest first.*

BUT , in most Dealers reviewed ( according to a 2017 guidance note) , IIROC saw supervisors compensated partly (to varying degrees) on revenue generated by registrants subject to the supervisor's oversight. In response to this finding IIROC stated " *It is understandable that the compensation of a supervisor who is also a branch manager is based partly on the overall profitability of his or her branch. However, the Dealer should consider other factors in determining supervisor compensation that would offset any undue bias towards branch profitability at the expense of client best interest.".* We question whether this logic should be permitted under CFR. Kenmar recommend that the IIROC state that Firms should arrange for supervision compensation to be independent of branch sales and instead be primarily based on such performance parameters as client satisfaction ratings ,client retention and growth, low client complaint levels, absence of disciplinary actions against those supervised, and compliance robustness with Firm policies / procedures IIROC rules and securities laws. Such a position should be a salaried position. It is one thing for salespersons to be conflicted but if supervision is also conflicted , we are of the firm conviction that rule 3962 is just a set of words that is not likely to be achieved in practice. It would be like having a quality control inspector be compensated by the amount of units found to be acceptable.

The CSA now permit firms to share CCOs; broaden the experience requirements to allow for more specialized CCOs in certain niches (such as fintech); and enable large firms to use multiple CCOs for various business lines. Having one person serving as both CCO and ultimate designated person of one firm as well as CCO of a rival firm could lead to conflicts-of-interests and divided loyalties. For example, if both firms ran into compliance issues simultaneously, the shared CCO might prioritize the Firm where they have more extensive duties/ fees- at the expense of the secondary firm, A Firm could hold back certain information from the shared CCO for competitive concerns. We suggest that IIROC stay closely attuned as to how shared CCO's can undermine CFR's regulatory intent. Kenmar urge IIROC to make sure that it , CCO and Firms are all comfortable that there are controls in place to manage any CCO conflicts. Without robust compliance, CFR will fail to achieve objectives.

## Other CFR related issues/ observations

The existence of undisclosed sales bonuses, trips ,prizes , titles for sales quota achievement or sale of certain products could become a regulatory issue under CFR.

Are IIROC approved courses impacted by CFR? In this case, it is possible that the courses need revision say, for instance, as related to ethics, cost disclosure and risk profiling.

NASAA recently released results of a *Benchmarking Initiative To Help Measure Effectiveness of Regulation Best Interest* ( a near equivalent of the CSA CFR). The examinations found notable differences between broker-dealers operating under a suitability standard and investment advisers operating under fiduciary duties Among other things, the regulators found that "investment advisers ( as opposed to broker-dealers) generally took more conservative investment approaches overall, avoiding higher cost, riskier, and complex products." When complex products were sold, broker-dealers were twice as likely as investment advisers to recommend the purchase of leveraged and inverse ETFs, seven times as likely to recommend private placements, eight times as likely to recommend variable annuities, and nine times as likely to recommend non-traded REITs. These kinds of Firms also had more robust due diligence, disclosure and conflict management practices. "https://www.nasaa.org/55758/nasaa-releases-results-of-benchmarking-initiative-to-help-measure-effectiveness-of-regulation-best-interest/ Hopefully, the amended IIROC rules and guidance will help prevent such harmful sales practices from taking root in Canada under the CFR regime.

With respect to Standards of Conduct 1403
*"For purposes of IIROC requirements: (i) Dealer Members are responsible for all acts and omissions of their employees, partners, Directors and officers, and .."*
Does this apply when the salesperson has effected non-approved Off book transactions? Does it apply if the salesperson is not an employee ( e.g. an agent)? It has been our experience that Dealer Members do not accept such responsibility.

The effectiveness of CFR will be dependent on robust IIROC compliance oversight and enforcement. In our opinion, IIROC need to step up compliance monitoring, get to the root causes of non-compliance, improve Rep professionalism/ standards and focus on corporate culture. In enforcement , the emphasis should be on client compensation and corrective action , meaningful sanctions with a laser focus on Firms rather than individuals , increased enforcement intensity and enhanced collaboration with OBSI ( to improve complaint resolution ) and the MFDA /insurance regulators ( to reduce regulatory arbitrage). Kenmar acknowledge IIROC's decisive steps to include investor representation on its Board and to establish an expert investor issues advisory panel.

We hope this feedback is useful to you.

Consent is given for public posting of this letter.

If there are any questions, feel free to contact us.

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**REFERENCES**

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http://www.canadianfundwatch.com/2016/01/the-naaf-and-know-your-client.html

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Know your client (KYC) and Suitability Guidelines: SIPA Comment letter
https://www.iiroc.ca/Rulebook/ProposedPolicy/PPolicy-Notice09-0293-Comment-2009-12-03-SIPA_en.pdf

Canadian Fund Watch: Investment Time horizon- simple concept but…
http://www.canadianfundwatch.com/2020/03/investment-time-horizon-simple-concept.html

A Guide to Risk Profiling for Advisory Firms | EValue
https://www.ev.uk/guide-to-risk-profiling

OSC IAP Risk Profiling Report
"Most of the questionnaires (83.3%) in use by the industry are not fit for purpose - they have too few questions, poorly worded or confusing questions, arbitrary scoring models, merge multiple factors (75%) without clarity or have outright poor scoring models. Fifty five percent had no mechanism to recognize risk-averse clients that should remain only in cash."
https://www.osc.gov.on.ca/en/Investors_nr_20151112_iap-releases-research-risk-profiling.htm

OSC IAP Risk profiling Roundtable report
It is interesting to note that virtually none of the recommendations contained in this 2016 summary report have been implemented by the wealth management industry or the OSC/CSA.
https://www.osc.gov.on.ca/documents/en/Investors/iap_20170123_risk-profiling-report.pdf