Borden Ladner Gervais

THE CANADIAN SECURITIES REGULATORS' PROPOSALS FOR A "BEST INTEREST" STANDARD FOR DEALERS AND ADVISERS: THE LONG ROAD AHEAD.

Over 70 financial services and investment industry participants commented – some in great detail – on the Canadian Securities Administrators' Consultation Paper 33-403 *The Standard of Conduct for Advisers and Dealers: Exploring the Appropriateness of Introducing a Statutory Best Interest Duty When Advice is Provided to Retail Clients* (the Consultation Paper) [available here]. The Consultation Paper was released in October 2012 and describes the CSA's concerns with the current regulatory regime that applies to registered dealers and advisers (portfolio managers) and the CSA's various options to resolve those concerns. While the Consultation Paper is ostensibly aimed at all registrants – dealers and advisers alike – it is quite apparent that the CSA's main preoccupation is to respond to long-standing criticisms that current regulations do not always result in a fair deal for retail investors interacting with dealing representatives of investment dealers and mutual fund dealers (also known as "advisors"). The CSA's main option is to impose a new statutory best interest standard that would apply to dealings with retail investors and would require all registrants – firms and individuals – to act in the "best interest" of the retail investor.

Our reaction to the Consultation Paper and the proposed statutory "best interest" standard has been echoed by many: introducing a uniform statutory best interest requirement – one fraught with uncertainty and potentially rife with adverse consequences for market participants, as well as investors – is not only unnecessary, but would result in an unwelcome detour from the current enhanced regulatory scheme that is still in the process of being implemented.

In this Bulletin we review the CSA's proposals as set out in the Consultation Paper, the responses from industry to those proposals, other relevant regulatory developments, and consider the next steps in respect of this challenging issue.

RECENT REGULATORY DEVELOPMENTS

Since the publication of the Consultation Paper there have been other regulatory developments which are inextricably linked to the CSA's proposals. One is the January 2013 study released in mid-March by the Ontario Securities Commission's Investor Advisory Panel and the Investor Education Fund (also based in Ontario) entitled *Strengthening Investor Protection in Ontario – Speaking with Ontarians* [available here]. The Investor Advisory Panel's press release highlights that the research carried out through the study will *inform our [the IAP's] positions regarding investor protection initiatives, including the introduction of a statutory best interest duty to replace the current inadequate suitability regime and reforms to mutual funds' compensation structures in Canada.*

On March 28, 2013, the CSA released the final client relationship model (CRM) amendments to the national registration rule (National Instrument 31-103) [available here]. These amendments, which become effective on July 15, 2013, include enhanced requirements for disclosure on cost and performance, as well as financial literacy initiatives and will be implemented over a period of 3 years. Watch for BLG's Investment Management Bulletin on these CRM amendments.

And also linked to the Consultation Paper, but on a different trajectory, is the CSA's Discussion Paper and Request for Comment 81-407 *Mutual Fund Fees* [available here] released in mid-December 2012. Comments close on this Discussion Paper on April 12, 2013. A roundtable discussion with OSC staff has been organized for June 7, 2013 on the concepts raised in the Discussion Paper, which will no doubt slide quickly into topics covered by the Consultation Paper.

HIGHLIGHTS OF THE CONSULTATION PAPER

THE CSA'S PERCEIVED PROBLEMS WITH THE CURRENT REGIME

The CSA highlighted five principal concerns they have with the investor protection regulatory regime in Canada as part of their rationale for proposing a best interest standard:

1. The current regime is not based on the most principled foundation, but rather is based on concepts of "buyer beware" supported by prescriptive prohibitions and key disclosure obligations;
2. Current standards of conduct do not address the problems associated with asymmetry in investment knowledge between advisers and dealers and their retail clients, particularly if the low levels of financial literacy in Canada are taken into account;
3. Investors mistakenly believe that advisers and dealers already have a duty to act in their best interest, which leads to a gap between investor expectations and legal requirements;
4. The suitability standard is not functioning to provide investors with the investments that may be in the client's best interest; and
5. The conflict of interest disclosure requirements are not being employed effectively, particularly in a commission-based environment and when proprietary products are being distributed.

GLOBAL REGULATORY RESPONSES

The Consultation Paper goes into detail about other global regulators undertaking similar policy projects – most notably, in Australia, the United Kingdom, Europe and the United States. Some of those global reforms are in place and others, such as in the U.S. are still in development. The Consultation Paper does not highlight to any great extent the problems that the global reforms were intended to resolve or the existing state of regulation; therefore, it is impossible to determine whether the factors that lead the global regulators to move forward with reforms exist in Canada.

CSA'S PROPOSED BEST INTEREST STANDARD

The CSA requested comments on the following proposed best interest standard aimed at remedying the deficiencies they consider exist.

Every adviser and dealer (and each of their representatives) that provides advice to a retail client with respect to investing in, buying or selling securities or derivatives shall, when providing such advice

a) act in the best interests of the retail client, and

b) exercise the degree of care, diligence and skill that a reasonably prudent person or company would exercise in the circumstances.

The duty to "act in the best interests" of clients would constitute, in the views of the CSA, a fiduciary duty that would not be open to contractual variation. Constituent elements of this duty would include ensuring that

(i) clients' interests are paramount

(ii) conflicts of interests are avoided – this may have significant potential implications on the way fees are charged and borne by investors in mutual funds and other issuers.

(iii) clients are not exploited

(iv) clients are provided with full disclosure, and

(v) services are performed reasonably prudently.

The CSA contemplate that this duty would only apply when a registrant gives any kind of "advice" to a "retail" client. A "retail" client is a client that is not a "permitted client" within the meaning of National Instrument 31-103 (permitted clients are generally institutions and ultra- high net worth individuals). The duty would not apply to discount brokers who are mere order-takers. The CSA also contemplate that not only would the duty be an "on-going one", existing suitability requirements would continue to apply to advisers and dealers.

THE CSA'S NEXT STEPS

It is clear that the Consultation Paper is only step one on the long road ahead before this standard would be effective. The Consultation Paper acknowledges this by explaining that the CSA will need to consider how to supplement the proposed "principled" based standard with additional guidance and rules, which includes considering how to amend existing rules. In particular the CSA explain that they will need to consider what qualifications will have to be made to the standard for different business models and different firms. Very little definitive analysis is provided on these missing pieces – indeed the fact that the CSA asks 52 detailed questions in the Consultation Paper – many of which would not be out of place on a higher level law school exam – indicates that there is much work to be done to move forward with any real proposals.

The recently published draft Statement of Priorities of the Ontario Securities Commission for the 2013/2014 fiscal year describes this "best interest standard" as one of the OSC's priorities. The OSC proposes to "work with investors and SROs to examine and better understand the impact of imposing a best interest duty on dealers and advisers", which will include publishing an "initial assessment of the application of the best interest standard" with a "regulatory impact analysis".

COMMENTARY AND ANALYSIS OF THE CONSULTATION PAPER AND ITS CONCEPTS

The over 70 comment letters on the Consultation Paper, including BLG's [**available here**] can be viewed on the OSC website. The comments are detailed and thoughtful, representing a cross section of industry, investor advocates, individual investors, trade associations and service providers to the industry.

Comments fall loosely into the following categories.

WHEN IT AIN'T BROKE, THE CSA SHOULDN'T FEEL THEY NEED TO FIX IT

Most commenters support the CSA's efforts to protect retail clients by ensuring registrant compliance through a robust securities registrant regulatory regime, which includes compliance checks and enforcement action. However, many submit that the Consultation Paper fails to produce *evidence* of the failures of the current model, and does not demonstrate how the best interest standard will be more adept at addressing the CSA's concerns.

One point of focus for many commenters was the adequacy of the current suitability requirement. Proponents of the proposed best interest standard assert that the suitability standard does not set the bar high enough to ensure that investors are receiving appropriate investment advice. The CSA's concern is that registrants may be tempted to advise their clients to purchase products that, while suitable, are priced higher than other suitable products and are not necessarily the "best" products for their clients.

Industry groups note that no evidence is advanced in the Consultation Paper to support this proposition. Further, this concern is short-sighted: it fails to recognize that such behaviour would be contrary to the registrant's duty to act fairly, honestly and in good faith, and to the rules of the self-regulatory organizations (SROs), which impose high standards of ethics and conduct on member firms and their approved persons. Generally recommendations that are not in the best interest of investors cannot, by definition, be suitable for them. While no single rule or standard of conduct alone is sufficient to protect investors, the concurrent operation of the statutory standard of care, suitability requirements, relationship and compensation disclosure, as well as product disclosure requirements, to name a few, provide a sufficient framework on which to build a strong investor protection regime.

Some commenters submit that the proposed best interest standard would not in fact resolve the issues identified by the CSA. Many express concern about the carve-outs that would need to be drafted into the best interest standard to make it operational and thereby "muddy the waters" regarding expectations in the industry, and provide no help in filling the expectation gap identified by the CSA.

There is little to no evidence to support the proposition that the asymmetry between investor and registrant investment knowledge will be resolved by introducing a best interest standard. In fact, the new standard may reduce access to investment advice, which will in turn produce greater financial illiteracy amongst retail investors. Further, a statutory best interest standard may also remove the incentive for investors to engage with their advisors and learn about the investing process, which may result in increased asymmetries.

Strengthening the current regime is currently underway. The CSA's Client Relationship Model (CRM) is now final and will be implemented over 3 years. We agree with many commenters that the CSA should not introduce a new standard before CRM is fully implemented and before the CSA have had the opportunity to fully assess its impact. Many consider that the implementation of CRM and the recent addition of Fund Facts requirements under the CSA's mutual funds point of sale disclosure project have the potential to alleviate many, if not all, of the CSA's stated concerns.

POTENTIAL FOR SIGNIFICANT DELETERIOUS EFFECTS

As recognized in the Consultation Paper, a fiduciary duty may be imposed on registrants at common law. Generally a court considers the following factors in making this determination: (1) the vulnerability of the client; (2) the degree of trust reposed in the advisor; (3) the level of reliance on the advisor's advice; (4) the discretion given to the advisor over the client's accounts or investments; and (5) the rules and codes of conduct that apply to the advisor.

Fiduciary obligations are less frequently found for registered dealers than they are for advisers (portfolio managers with discretionary authority to manage the client's assets). A uniform statutory best interest standard would impose a fiduciary relationship where courts have previously found, for good reason, it does not exist. We recommend that more extensive analysis be performed by the CSA before prescribing a blanket best interest standard for all registrants because of the unintended consequences that could accompany the new standard, in particular for registered dealers.

We consider that the best interest standard has the potential to make registrants guarantors or insurers of their advice. Introducing this higher standard could produce a perception that advisors should be responsible for the losses suffered by clients, even when these losses are wholly a product of market outcomes. The Supreme Court of Canada has noted that damages may not be reduced to account for contributory negligence where a breach of fiduciary duty is found. If the CSA's proposed standard comes to fruition for dealers, will investors no longer be expected to bear responsibility for their investment decisions?

Another concern is the impact a best interest standard would have on various business models, with commenters focusing extensively on the effect on embedded compensation related to mutual funds.

Conflicts of interest are inherent in the embedded commission model. As such, the requirement to avoid conflicts in a fiduciary relationship could result in the abolition of commission-based accounts, forcing clients to utilize fee-based accounts. This would likely result in reduced access to investment advice. It may be that the implementation of CRM may alleviate some of the concerns regarding compensation structures.

Additional compliance and supervisory costs that would flow from the proposed standard are a major concern. Firms may also see increased costs for training and proficiency, systems development, client documentation, disclosure, insurance and complaint-handling.

Closely related are the foreseeable litigation costs associated with this new standard. Under the current common law standard, in order to recover for a breach of fiduciary duty, investors must first establish that fiduciary obligations are owed by the registrant. This acts as a reasonable barrier to litigation and removing this barrier may result in a flood of claims. The result may be higher legal fees and more resources – including time and attention of registrants – being devoted to these claims, regardless of their merit.

These costs will undoubtedly be passed on to consumers, making investment advice less accessible for retail investors.

WHAT CONSTITUTES "BEST"?

How is "best" in the proposed best interest standard to be defined? There are many factors that go into determining the best investment for a client and this is an inherently subjective determination, with no single solution. Indeed, reasonable people might come to different conclusions about the best product for an investor given the variety of factors considered in making investment decisions, including investment strategy, experience of the portfolio management team, stability and history of the fund manager, as well as the investment objectives, risk tolerance, and time horizons of each investor.

The concept of "best" is further complicated when coupled with the CSA's statement that the standard would be an "ongoing" obligation. The application of this standard to daily trade supervision will be difficult in practice, and constant readjustment to portfolios to attain the best product mix runs against long-term investment goals. Further, this requirement has the potential to undermine the CSA's efforts to push for lower costs, as this obligation could increase trading fees and charges.

If this standard is to be imposed, the CSA must provide guidance on how regulators expect registrants to achieve this best interest standard and how it differs from the well-established suitability standard. However, with a focus on principles-based regulation, the CSA may resist articulating more specific guidelines. The CSA explain in the Consultation Paper that the proposed principles-based standard "obviates the need for more particularized guidance".

NEXT STEPS

Many commenters encourage the CSA to monitor and review the investor protection regime and augment the current framework where, after thorough investigation, deficiencies are noted. Other commenters suggested that the costs to market participants are too high to impose new requirements without a thorough analysis of the implications of the new standard and its alternatives.

The United States Securities and Exchange Commission ("SEC") has taken exactly this approach. Over two years ago the SEC recommended a uniform fiduciary standard for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers. However, the rulemaking has yet to commence, and on March 1st, 2013, the SEC requested additional input from market intermediaries, soliciting quantitative and qualitative data, as well as economic analysis to help inform the SEC about the economic impact of its recommendations. The SEC Release No. 34-69013 *Duties of Brokers, Dealers and Investment Advisers* is [**available here**]. The Release provides additional insight into the SEC's reaction to the issues raised about the potential impact of a best interest standard, including the potential for additional regulation of disclosure to be provided to investors by broker-dealers and investment advisers.

Regardless of the response to the SEC's request, many commenters caution the CSA against using evidence in other jurisdictions as a basis for rulemaking in Canada. While there is evidence to suggest that consumers in the U.K., Australia and the U.S. have suffered losses due to regulatory failures, the CSA should not accept their regulatory solutions as the best course without firm evidence of similar deficiencies at home.

We also recommend that the CSA ensure that it focuses on the right issues with the right registrants. As many commenters noted, registered advisers (portfolio managers) generally are in a fiduciary relationship with their discretionary managed account clients – and indeed provincial securities regulation in some jurisdictions acknowledges this. If this current conversation is about registered dealers and their dealing representatives (advisors), then we recommend that this point be clarified and acknowledged to ensure that appropriate nuances and approaches can be discussed by the right industry participants.

In the aggregate, the comments received by the CSA highlight that further consideration of a best interest standard is required before a firm proposal is put forward. The comments and discussions about mutual fund fees that will result from the Discussion Paper on mutual fund fees will have significant relevance to the discussions of a statutory best interest standard, and any CSA proposal in either realm must be made consistent and coordinated. The issues are important for both investors and industry alike.

Please contact any of the authors of this Bulletin listed below, your usual lawyer in BLG's Investment Management group or the leaders of BLG's Investment Management group noted below if you have any questions about the Consultation Paper, the Mutual Fund Fees Discussion Paper and how these potential reforms may affect you. You may also contact any of BLG's securities litigation lawyers, including those named below.

AUTHORS

David Di Paolo
Partner and Toronto Leader
Commercial Litigation Group
416.367.6108
ddipaolo@blg.com

Rebecca Cowdery
Partner
416.367.6340
rcowdery@blg.com

Marsha Gerhart
Counsel
416.367.6042
mgerhart@blg.com

Whitney Bell
Student-at-Law
416.350.2572
wbell@blg.com

INVESTMENT MANAGEMENT GROUP

National Leader

John E. Hall	Toronto	416.367.6643	jhall@blg.com

Regional Leaders

Brad J. Pierce	Calgary	403.232.9421	bpierce@blg.com
Fred Enns	Montréal	514.954.2536	fenns@blg.com
Lynn M. McGrade	Toronto	416.367.6115	lmcgrade@blg.com
Jason J. Brooks	Vancouver	604.640.4102	jbrooks@blg.com

SECURITIES LITIGATION GROUP

National Leader

James D.G. Douglas	Toronto	416.367.6029	jdouglas@blg.com

Regional Leaders

John Blair	Calgary	403.232.9723	jblair@blg.com
Georges R. Thibaudeau	Montreal	514.954.2560	gthibaudeau@blg.com
Larry A. Elliot	Ottawa	613.787.3537	lelliot@blg.com
David Di Paolo	Toronto	416.367.6108	ddipaolo@blg.com
Gordon R. Johnson	Vancouver	604.640.4117	gjohnson@blg.com

Borden Ladner Gervais

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BORDEN LADNER GERVAIS
LAWYERS | PATENT & TRADE-MARK AGENTS

Calgary
Centennial Place, East Tower
1900, 520 – 3rd Ave S W
Calgary, AB, Canada T2P 0R3
T 403.232.9500
F 403.266.1395
blg.com

Montréal
1000, rue De La Gauchetière Ouest
Suite 900
Montréal, QC, Canada H3B 5H4
Tél. 514.879.1212
Téléc. 514.954.1905
blg.com

Ottawa
World Exchange Plaza
100 Queen St, Suite 1100
Ottawa, ON, Canada K1P 1J9
T 613.237.5160
F 613.230.8842 (Legal)
F 613.787.3558 (IP)
ipinfo@blg.com (IP)
blg.com

Toronto
Scotia Plaza, 40 King St W
Toronto, ON, Canada M5H 3Y4
T 416.367.6000
F 416.367.6749
blg.com

Vancouver
1200 Waterfront Centre
200 Burrard St, P.O. Box 48600
Vancouver, BC, Canada V7X 1T2
T 604.687.5744
F 604.687.1415
blg.com

Waterloo Region
Waterloo City Centre
100 Regina St S, Suite 220
Waterloo, ON, Canada N2J 4P9
T 519.579.5600
F 519.579.2725
F 519.741.9149 (IP)
blg.com