PMAC
PORTFOLIO MANAGEMENT ASSOCIATION OF CANADA
Advancing Standards™

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Paige Ward
General Counsel, Corporate Secretary and Vice-President, Policy
Mutual Fund Dealers Association of Canada
121 King Street West, Suite 1000
Toronto, Ontario M5H 3T9
pward@mfda.ca

-and-

Anne Hamilton
Senior Legal Counsel
British Columbia Securities Commission
701 West Georgia Street
P.O. Box 10142, Pacific Centre
Vancouver, British Columbia
V7Y 1L2
ahamilton@bcsc.bc.ca

Re: Proposed Amendments to MFDA Rule 2.3.1(b) (Discretionary Trading)

The Portfolio Management Association of Canada (**PMAC**) is pleased to have the opportunity to submit the following comments regarding the Mutual Fund Dealers Association of Canada (**MFDA**)'s proposed amendments to MFDA Rule 2.3.1(b) (Discretionary Trading), referred to in our letter as the **Proposal**. Capitalized terms used but not defined in this submission have the same meaning given to them in the Proposal.

As background, PMAC represents over 270 investment management firms registered to do business in Canada as portfolio managers. Collectively, they manage in excess of $2.7 trillion in assets for investors. Each of our members is registered as portfolio managers, able to provide discretionary asset management on behalf of clients and regulated by the various members of the Canadian Securities Administrators (**CSA**) pursuant to the requirements in National Instrument 31-103 – *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**NI 31-103**).

OVERVIEW

PMAC supports regulatory flexibility and burden reduction that enables improved service, innovation, or a reduction in costs borne by investors. We understand that the MFDA is seeking to permit its Members to rebalance model portfolios in a time and cost-effective manner. We believe that finding solutions to issues of this nature are important. At the same time, we believe that managing client portfolios through discretionary authority should be subject to the requirement to act fairly, honestly and in good faith toward the client *and* in the client's best interest.

As a result of a lack of detail in the Proposal with respect to certain of its elements, we struggle to assess: 1) the true scope of the permitted limited discretionary trading, compliance systems, and proficiency requirements; 2) whether the Proposal would have a positive outcome for investors and be beneficial for the Canadian capital markets as a whole; and 3) how the Proposal would be operationalized.

PMAC members have identified the following aspects of the Proposal requiring additional clarity before a full evaluation of the Proposal can be made.

CLARITY OF THE PROPOSAL

A. Nature of permitted fund substitutions and scope of permitted changes to asset allocation

We take the view that the Proposal would benefit from additional clarity regarding the degree of permitted fund substitutions. It is not clear whether a discretionary fund substitution in a client's existing portfolio must use a fund having characteristics that match - or closely match - those of the replaced fund, such that both the client's risk tolerance and asset mix remain the same after the substitution.

We also believe that the MFDA and CSA should consider whether is it necessary to prescribe certain constraints on an MFDA Member's ability to make changes to asset allocation, or whether the intention of the Proposal is to allow for substantial changes to asset allocation. For example, does the MFDA intend to permit each Member to individually determine what changes may be made within the pre-established parameters of the model portfolios, or does the MFDA intend to provide rules, principles, or other guidance on this point? For instance, would the MFDA consider prohibiting monetary gain to an Approved Person for fund substitution?

B. Registration, exemptions, and proficiency

i. Firm registration

PMAC is pleased to see that the Proposal requires MFDA Members to register as restricted portfolio managers in order to engage in limited discretionary trading. Theoretically, we believe that this establishes an appropriate standard of capitalization, insurance, and regulatory oversight. We are unclear however, on the exact nature of the registration, exemptions, and proficiency contemplated in the Proposal.

The section of the Proposal titled "Comparison with Similar Provisions" explains that MFDA Members wishing to engage in discretionary trading must register as restricted portfolio managers *or be granted an exemption from that requirement*. We query under which circumstances exemptions from registration will be granted and which regulator – a CSA member or the MFDA – will be tasked with reviewing and granting such exemptive relief. Given that the CSA members are tasked with registration of MFDA member firms and individual dealing representatives (Approved Persons), it is not clear how the relevant securities commissions and the MFDA would coordinate the registration and granting of exemptive relief and how this additional regulatory responsibility will be managed by the CSA members.

Part 8 of NI 31-103 sets out the exemptions from the requirements to register with the CSA and we query, which, if any of these exemptions would be applicable in the context of an MFDA Member wishing to undertake limited discretionary trading. If the exemptions referred to in the Proposal are not those set out in Part 8 of NI 31-103, we believe that the MFDA and/or CSA should publish guidance as to when an exemption from the requirement to register as a restricted portfolio manager may be granted. From an investor protection point of view, PMAC is concerned about MFDA Members and their Approved Persons not having the same proficiency and regulatory obligations of restricted portfolio managers while still being permitted to manage client assets on a discretionary basis.

ii. Individual registration

We further believe the Proposal should explicitly confirm that all Approved Persons engaged in discretionary activity on the MFDA Member's behalf will be required to be registered as either associate advising representatives (**AARs**) or advising representatives (**ARs**).

The CSA has consistently – and we believe correctly – taken the position that high proficiency and relevant investment management experience standards are critical to protecting the capital markets and investors. Part 3 of the Companion Policy to NI 31-103 (**CP**) states that the education and experience required for registration of a representative of restricted portfolio managers will be decided by the regulator on a case-by-case basis. In order to maintain investor protection and market integrity, the MFDA and CSA should codify their expectations regarding the appropriate education and relevant investment management experience expectations to permit the registration of Approved Persons under the Proposal.

We respectfully submit that the current proficiency requirements for registration as a dealing representative of an MFDA Member are objectively considerably less stringent that those required for ARs and AARs. We believe that, at a bare minimum, additional proficiency must be required in order to ensure that qualified professionals are making discretionary decisions regarding the funds being held in the investment portfolios of Canadians.

Similarly, since the CP provides broad discretion to the regulator to determine the education and experience required to register as the Chief Compliance Officer (**CCO**) of a restricted portfolio manager, we believe the Proposal requires greater detail about what minimum proficiency criteria will apply to the CCOs of a MFDA Member firms to support the discretionary trading being done by the firm.

C. Compliance framework and regulatory oversight

With respect to ongoing compliance obligations, we note that the compliance systems, disclosure and reporting requirements to investors under MFDA rules and those under NI 31-103 differ on numerous points. Portfolio managers have developed knowledge, infrastructure, testing, sophisticated client agreements, disclosure, and reporting - all of which support the discretionary relationship. The Proposal is ambiguous about the extent to which MFDA Members would need to amend their policies and procedures in connection with exercising the proposed discretion. On the one hand, the Proposal explicitly notes the requirement to enhance certain limited relationship disclosure and to describe the extent of the discretionary authority being exercised by the Member. Conversely, there is a more general statement about the requirement to establish policies and procedures compliant with applicable securities regulation. This creates confusion as to whether MFDA Members will also be required to develop, implement, and oversee policies and procedures manual akin to those of a restricted portfolio manager regulated by the CSA.

Additional clarity regarding the MFDA and CSA's expectations around compliance policies and procedures, registration, and proficiency will assist stakeholders in evaluating the Proposal. Moreover, were the Proposal to be adopted, this clarity will also provide more certain regulatory expectations for firms to comply with and for regulators to oversee.

It is unclear how the MFDA proposes to balance achieving efficiency and maintaining investor protection and confidence in our markets in the context of CSA/MFDA oversight. The Proposal notes that the MFDA and the CSA will work to ensure appropriate regulatory oversight of discretionary trading. PMAC believes that a level of CSA oversight would be necessary and appropriate. Further details as to how that oversight would be achieved and enforced should be published. For example, would an MFDA Member registered as a restricted portfolio manager be subject to audit by the Ontario Securities Commission and be required to complete its bi-annual Risk Assessment Questionnaire?

INVESTOR PROTECTION & MARKET CONCERNS

A. Fiduciary Duty and Client Expectations

The nature and applicability of the standard of care in the Proposal is nebulous and requires clarification. The Proposal refers to the applicability of the "portfolio manager standard of care in respect of any discretionary trading done the model portfolio(s) in which the client was invested".

Did the MFDA intend to impose a fiduciary standard of conduct on Members engaged in limited discretionary trading? If that is the case, we believe the language should be amended. We point to the wording in the *Securities Act* (Alberta)[1] which codifies a fiduciary duty in connection with discretionary management.

[1] Section 75.2 of the Securities Act (Alberta) provides:
Duty of care
75.2(1) Subject to subsections (2) and (3), a registrant shall deal fairly, honestly and in good faith with its clients.
(2) A registrant that manages the investment portfolio of a client through discretionary authority granted by the client *shall act fairly, honestly and in good faith toward the client and in the client's best interest.*
(3) Every investment fund manager shall

PMAC strongly believes that all registrants entrusted with managing client assets on a discretionary basis should owe those clients a fiduciary duty of care. Moreover, PMAC believes that it is inappropriate to treat the fiduciary duty as a transactional duty.[2] The fiduciary duty is and ought to be a legal expectation that permeates the entire culture and operations of a registered firm for the good of investors.

Furthermore, although the Proposal states that Members will be subject to the portfolio manager standard of care, there is no mention of the duty of care to which Approved Persons will be subject. PMAC is of the view that Approved Persons exercising discretion must also be held to the same standard of care as ARs and AARs who manage client assets on a discretionary basis.

With that in mind, we ask CSA and the MFDA to:

1) consider how the fiduciary duty would be imposed on MFDA Members exercising discretion since that duty of care would be neither statutory (other than in four Canadian jurisdictions), regulatory, nor contractual and;

2) carefully consider whether it is appropriate from a policy perspective – or feasible from a firm, investor, and regulatory oversight perspective - to make the fiduciary duty a transaction-based duty of care that applies to discretionary trades in a client's account in certain circumstances.

We also have questions as to what duty of care an investor could reasonably expect considering the statement in the Proposal that the portfolio manager standard of care would apply "in respect of any discretionary trading done in the model portfolio(s) in which the client was invested." It is not clear how a regulator, an investor, or a court would be able to parse out the portions of a portfolio in respect of which an investor should expect that his or her best interests were put ahead of those of the MFDA Member. We question what outcome that would provide investors.

The U.S. Securities and Exchange Commission (**SEC**)'s recently-approved regulation best interest standard for broker-dealers contains a particularly telling interpretation of the "solely incidental" provision, noting that when a broker-dealer exercises discretion on behalf of a retail client, that broker-dealer has tripped the requirement to register as an investment adviser (the U.S. equivalent of a portfolio manager) under the Investment Advisers Act of 1940 (**Advisers Act**). For the SEC, discretion triggers the requirement to register as an investment adviser and to be subject to the terms of the Advisers Act. In addition to the

(a) exercise the powers and discharge the duties of its office honestly, in good faith and in the best interests of the investment fund, and (b) exercise the degree of care, diligence and skill that a reasonably prudent person or company would exercise in the circumstances. [emphasis added]

[2] The U.S. has recently struggled with how to implement a transaction or product-based fiduciary duty and, ultimately, this plan was set aside by the courts for a number of reasons. The Department of Labor (**DOL**) in the U.S. had proposed a fiduciary duty that would have applied to registrants in the course of providing products or services for retirement accounts. Part of the consternation caused by DOL rule was the question of how a registrant would be able to effectively change hats, so to speak, from a fiduciary on certain transactions back to owing the lower "suitability standard" under the SEC to that same investor on other transactions. It is indeed a perplexing problem that the MFDA and the CSA should neither create nor cause stakeholders – including investors - to grapple with.

numerous requirements under the Advisers Act, investment advisers owe a fiduciary duty to their investors, as the SEC has recently affirmed and clarified.

Furthermore, we support and appreciate that the Proposal is meant to avoid repapering of client documentation and filing applications for exemptive relief by MFDA Members, but without repapering client documentation, we query how clients will be able to meaningfully consent to this limited discretionary management. In opposition to clients of portfolio managers who have entered into contractual arrangements regarding a wide variety of critical matters related to discretionary management, it does not appear from the Proposal that clients of MFDA Members would have such protections or agreements in place.

B. KYC, KYP, COI, RDI, and Suitability Obligations

The CSA have stated that know your client (**KYC**), know your product (**KYP**), conflicts of interest (**COI**), relationship disclosure information (**RDI**) and suitability determination obligations are:

> fundamental obligations of registrants toward their clients and are essential to investor protection. They are designed to work together throughout the client-registrant relationship, as an extension of the duty of registrants to deal fairly, honestly and in good faith with their clients[3].

The Proposal is silent regarding the extent, if any, to which MFDA Members will be required to enhance their KYC, KYP, COI, RDI and suitability obligations in the context of a discretionary account. Section 9.4 of NI 31-103 currently exempts MFDA members from several requirements under that instrument – including suitability determinations and relationship disclosure - provided they comply with the corresponding MFDA provisions in effect. The CSA's proposed amendments to NI 31-103 (the **Client Focused Reforms**) would remove many of those exemptions for MFDA Members. However, the exemption for compliance with the CSA's requirements for suitability determinations would stand. Given the centrality of these obligations to investor protection, we believe that further consideration should be given to whether certain enhanced requirements matching those under NI 31-103 regarding these fundamental duties should be codified in the context of limited discretionary authority. Moreover, it is not clear from the Proposal what procedures would be implemented to ensure that these duties are met, whether the account is held in a fund company's client name program or is in a dealer's in-house or third-party nominee program.

C. Potential for Regulatory Arbitrage

The following comments are directed at the members of the CSA reviewing the comment letters on the Proposal. We have concerns that the Proposal could lead to increased regulatory arbitrage resulting in fewer firms registering with the CSA.[4] While somewhat

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[3] See "Overview and scope of the Proposed Amendments" in CSA Notice and Request for Comment – Proposed Amendments to National Instrument 31-103 – Registration Requirement, Exemptions and Ongoing Registrant Obligations and to CP 31-103, Reforms to Enhance the Client-Registrant Relationship (Client Focused Reforms).

[4] We note that, unlike self-regulatory organizations (**SROs**), the members of the CSA are independent bodies created by provincial statute.

outside the scope of the Proposal, we believe it is important to flag the overall trend PMAC members have noted towards IIROC registered firms registering discretionary managers.

The goal of achieving certain efficiencies in one realm needs to be weighed against the risk of regulatory arbitrage that results from approving measures at the self-regulatory organization (**SRO**) level making it less onerous and costly to become registered – and maintain registration - under an SRO, such as the MFDA or the Investment Industry Regulatory Organization of Canada (**IIROC**), than it is under the CSA, while being permitted to provide similar services to investors.

We view distinct registration categories as important ways to provide different services and approaches to investment management for Canadian investors. However, we strongly caution against creating back-door channels for providing discretionary investment management to these investors without comparable duties of care, proficiency, compliance, and regulatory oversight requirements. To do so may provide incentives for firms and individuals to assess the regulatory landscape for the easiest route to performing discretionary asset management.

PRACTICALITY OF THE PROPOSAL

Lastly, PMAC raises the following questions about the practicality and ability of the CSA and MFDA to operationalize the Proposal:

- How practical it will be for MFDA Members to be able to evidence their Approved Persons' proficiency to be registered as restricted AARs and ARs without additional training / hiring and therefore, overall cost;
- The ability to impose a fiduciary duty on some, but not all transactions, in a client's account when an MFDA Member is exercising limited discretion;
- How cooperative oversight of the implementation of the Proposal at each MFDA Member by both the CSA and the MFDA can be achieved without incurring additional and onerous registration, audit and/or reporting requirements; and
- How investor consent to this limited discretionary authority can be obtained without repapering at least some client documentation, thereby increasing the compliance burden and cost.

CONCLUSION

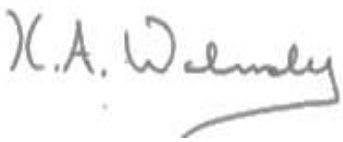
PMAC is cognizant that there are many opportunities in the asset management industry to revisit existing restrictions and to disrupt current practices to provide better service and outcomes to investors. We are supportive of consultations such as this to explore new possibilities and ways of delivering services to investors while reducing costs to firms and, ultimately, to investors. Cost savings and efficiency, however, cannot and should not come at the price of investor protection or at the risk of creating nebulous duties towards those investors.

We believe the questions and issues raised in our submission are important ones that merit further consideration and elaboration in order to ensure that a high level of investor protection and confidence in our markets is maintained.

If you have any questions regarding the comments set out above, please do not hesitate to contact Katie Walmsley at (416) 504-7018 or Melissa Ghislanzoni at (416) 504-1118.

Yours truly,

PORTFOLIO MANAGEMENT ASSOCIATION OF CANADA



Katie Walmsley
President

Margaret Gunawan
Director
Chair of Industry, Regulation & Tax Committee,

Managing Director – Head of Canada
Legal & Compliance
BlackRock Asset Management Canada Limited