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50 Wellington Street W.
5th Floor

Toronto, ON M5L 1B1
Canada
+1 416 364 8420
canada@aima.org
canada.aima.org

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission of New Brunswick
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Registrar of Securities, Yukon Territory

The Secretary
Ontario Securities Commission
20 Queen Street West
22nd Floor, Box 55
Toronto, Ontario M5H 3S8
Fax: 416-593-2318
comments@osc.gov.on.ca

Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, Square Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal (Québec) H4Z 1G3
Fax: 514-864-6381
consultation-en-cours@lautorite.qc.ca

Dear Sirs/Mesdames:

RE: Client Focused Reforms—Proposed Amendments to National Instrument 31-103 and Companion Policy 31-103

About AIMA

AIMA was established in 1990 as a direct result of the growing importance of alternative investments in global investment management. AIMA is a not-for-profit international educational and research body that represents practitioners in alternative investment funds, futures funds and currency fund management – whether managing money or providing a service such as prime brokerage, administration, legal or accounting.

AIMA's global membership comprises over 1,900 corporate members in more than 60 countries, including many leading investment managers, professional advisers and institutional investors and representing over $2 trillion in assets under management. AIMA Canada, established in 2003, now has more than 150 corporate members.

The objectives of AIMA are to provide an interactive and professional forum for our membership and act as a catalyst for the industry's future development; to provide leadership to the industry and be its pre-eminent voice; and to develop sound practices, enhance industry transparency and education, and to liaise with the wider financial community, institutional investors, the media, regulators, governments and other policy makers.

The majority of AIMA Canada members are managers of alternative investment funds and fund of funds. Most are small businesses with fewer than 20 employees and $50 million or less in assets under management. The majority of assets under management are from high net worth investors and are typically invested in pooled funds managed by the member.

Investments in these pooled funds are sold under exemptions from the prospectus requirements, mainly

the accredited investor and minimum amount exemptions. Manager members also have multiple registrations with the Canadian securities regulatory authorities: as Portfolio Managers, Investment Fund Managers, Commodity Trading Advisers and in many cases as Exempt Market Dealers. AIMA Canada's membership also includes accountancy and law firms with practices focused on the alternative investments sector.

For more information about AIMA Canada and AIMA, please visit our web sites at canada.aima.org and www.aima.org.

Comments

We are writing in response proposed amendments to NI 31-103 and its Companion Policy referred to as Reforms to Enhance the Client-Registrant Relationship (Client Focused Reforms) (the "Proposals"). While AIMA Canada supports the overall objectives of the Proposals, we have concerns about specific aspects and the CSA's expectations as to how the various proposals are to be implemented.

We have divided our comments between those of an overall general nature and comments with respect to specific proposals. Comments have not been provided regarding all of the Proposals, but rather those of most relevance to our members. References to page numbers are to the pdf of the CSA Request for Comment from the OSC website.

A. General Comments

In general, we are concerned by the CSA position that "it is a conflict of interest for a registered firm to trade in, or recommend, proprietary products" (Companion Policy pg. 194). This is similar to the position adopted by the CSA in respect of "captive dealers" in CSA Staff Notice 31-343 *Conflicts of interest in distributing securities of related or connected issuers*.

It seems to us that this treatment of registrants with proprietary business models stands in stark contrast to the policy perspective that allows non-registrants increased access to the capital markets on a proprietary basis under capital raising prospectus exemptions including the crowdfunding exemption and the OM exemption.

On the one hand, registered firms are being subjected to increasing regulation and a policy perspective that threatens a proprietary business model while, on the other hand, direct issuers are being given more access to the retail market.

In our view, the Proposals should be clarified as they pertain to the business model of the majority of our members, i.e. a small business offering only proprietary products that they manufacture and sell. Clarifications that will assist the small alternative asset manager include:

- an express recognition that manufacturing and selling only proprietary products is a valid business model and that the conflicts of interest inherent in such a business model are within the reasonable expectation of investors. This is a long-standing regulatory view which is why:
    - NI 33-105 does not apply to mutual fund securities; and
    - Companion Policy 31-103 provides that "Firms do not have to disclose to clients their relationship with a related or connected issuer that is a mutual fund managed by an affiliate of the firm if the names of the firm and the fund are similar enough that a reasonable person would conclude they are affiliated."
- guidance setting out the CSA's reasonable expectations of small firms selling only proprietary products to implementing many of the KYC, KYP and suitability proposals.

We submit that the conflict of interest inherent in selling any security can be addressed through appropriate disclosure and compliance with the relevant standard of care. In this regard, we note that

many of our members are registered portfolio managers and, in that capacity, are subject to a fiduciary best interest standard. In that context, it seems that these highly prescriptive rules that seek to achieve a best interest outcome on paper—"as an extension of the duty of registrants to deal fairly, honestly and in good faith with their clients"—are inappropriate for portfolio managers and the benefits of these Proposals do not out outweigh the costs.

The Proposals are based on flawed assumptions that all registrants are privy to an investor's entire portfolio or that investors will share such information. In our experience, that is rarely, if ever, the case for an alternative asset manager.

We further submit that requiring suitability determinations to be made on a "portfolio basis":

- creates a documentary burden that most firms cannot achieve;
- unduly increases costs without a demonstrable benefit; and
- may prove so time consuming and annoying for investors that they will choose not to invest in an alternative strategy at all.

We ask that the CSA review the Proposals with this in mind and provide appropriate guidance for small firms that distribute only proprietary products on exactly how the Proposals are "scalable to fit registrants' different operating models" and procedures that better align with the actual client-registrant relationship and the level of service desired by clients.

B. Specific Comments

Set out below are our comments on specific items from the Proposals. For ease of reference, they appear in the order of the headings in NI 31-103.

1. <u>Firm's Obligation to Provide Training</u>

Proposed Section 3.4.1 imposes an express obligation for firms to provide training to their registered individuals on compliance with know your client (KYC), know your product (KYP) and suitability, including on the structure, features, returns and risks as well as initial and ongoing costs and impact of the costs of securities available through the firm to clients. Additional guidance in the Companion Policy further provides that the effectiveness of the ongoing training program should be reviewed at regular intervals and additionally contemplates outsourcing training.

While we acknowledge the specific carve-out for firms with one registrant, we submit that these training requirements would create an increased compliance burden for smaller firms in terms of financial and human resources and believe that further distinction should be made between smaller firms and larger firms. Smaller firms should be able to discharge their obligations in this regard through alternative arrangements which would be more in line with the size of their business and human resource capabilities. This could be facilitated by acknowledging that the comment in the Companion Policy with respect to the carve out, i.e. "…we do not expect the firm to have a training program in place. However, we expect a small firm to still be able to demonstrate that it has all the required elements of an effective compliance system", is equally applicable to smaller firms with more than one registrant.

In addition, we request the CSA to set out clear expectations for how a small firm is expected to test effectiveness of a training program, particularly when costs of an outside review are not reasonable.

2. <u>KYC—Personal Circumstances and Financial Circumstances</u>

Pursuant to the additional requirements provided under Section 13.2(2)(c)(i) and Section 13.2(2)(c)(ii), a registrant must take reasonable steps to obtain information with respect to, among other things, the client's personal and financial circumstances. The Companion Policy provides additional guidance with respect to the kind of information that a registrant should obtain in order to have a meaningful

understanding of the client's circumstances. However, we submit there is a disconnect between the scope of information to be collected and the business model of most pooled fund managers.

If a registrant is not a client's principal financial advisor or dealer and is only distributing one or more pooled fund investments that form part of a larger investment portfolio, we expect that most high net worth or institutional clients may be unable or unwilling to divulge certain information, including a breakdown of their overall financial assets. In this context, a financial planning, portfolio basis approach to KYC is not consistent with a client's reasonable expectations.

Accordingly, we submit that further guidance should be provided to make it clear that a registrant will discharge its obligation to obtain information with respect to the client's personal circumstances and financial circumstances where it takes reasonable steps to request such information from the client. Furthermore, the registrant would not be required to refuse to take on a client if such further additional information is not divulged to the registrant by the client after having made such reasonable inquiries. We suggest that in such circumstances, the Companion Policy make it clear that it is acceptable practice to ask the client to sign a confirmation/waiver with respect to such an information request, to confirm that that size of the investment and/or the nature of the registrant-client relationship does not merit KYC on a portfolio basis and to acknowledge that any recommendations and advice are based on limited information. In terms of the "nature of the registrant-client relationship", we submit there are substantial differences in client expectations associated with a transaction such as one-time allocation to an alternative investment strategy as compared to engaging a dealer or portfolio manager as an adviser to provide on-going financial planning and advice.

3. <u>KYC—Client's Risk Profile</u>

The Companion Policy provides guidance (pg. 182) under the heading "Resolving conflicts between a client's expectations and risk profile" for registrants relating to managing client expectations and assessing client risk profile. We submit that additional guidance should be provided to confirm that a registrant has discharged its suitability obligation and may act in accordance with client instructions if, after advising a client that an investment is outside of the scope of what the registrant perceives to be the client's risk tolerance, the client wishes to proceed with an investment. The guidance would either repeat, or direct the reader to, section 13.3(2.1) of the Instrument and the associated guidance in the Companion Policy.

4. <u>KYP—How Recommended Securities Compare to Similar Securities Available in the Market</u>

Pursuant to the KYP requirements set out in Section 13.2.1 and the extensive commentary in the Companion Policy (pp. 183-188) registrants are required to take reasonable steps to understand each security made available to a client. In our opinion some of the expectations outlined would be overly burdensome for our members offering only proprietary products and ask that the CSA provide clarification in the guidance with respect to the following:

a) Proposed Section 13.2.1(2) requires that a registered firm must maintain an offering of securities and services that is consistent with how the firm holds itself out. In our view the guidance in the Companion Policy (pg. 187) is not clear what market issue the CSA is attempting to address with this requirement. We submit that additional guidance with respect to this requirement and CSA expectations for compliance are needed.
b) Extensive documentation expectations are outlined in the Companion Policy (pp. 184-185) in order to demonstrate a firm's understanding of the securities being made available to clients. For firms offering only proprietary products that they have developed and manage, we submit that many of the expectations are effectively addressed as part of the preparation of an offering memorandum ("OM") or similar documents, e.g. the applicable legal and regulatory framework, what investment needs the product meets, the risks of the security, the initial and ongoing costs etc. We ask that the CSA include comment that the preparation and approval of an OM would generally be considered sufficient to demonstrate compliance with these requirements.

c) Guidance in the Companion Policy (pg. 185) states that a firm must understand how the securities of related and connected issuers generally compare to similar securities available in the market, without regard to whether the firm makes non-proprietary products available to its clients. While we understand and support the requirement for a comparison of both proprietary and third-party products when a firm offers both, we believe that requiring an overall comparison to the market is unreasonable and overly burdensome to our members offering only proprietary products.

We submit that, given the nature of privately offered proprietary investment funds, the information necessary to make such comparisons may not be available for competitive reasons or due to the amount of disclosure available when securities are sold under a prospectus exemption (as noted in the Companion Policy). We believe that this issue is largely addressed through the conflict disclosure requirements that highlight that a registered firm is only offering proprietary products. We ask that additional guidance be provided with respect to the applicable scope and frequency of due diligence that a registrant must undertake to satisfy its obligations in this regard, taking the proprietary product model into account, as well as relating to novel investment products where there are limited or no market comparables.

We ask the CSA to consider giving weight to the fact that a proprietary product has one or more permitted clients as investors or that the fund is available to the dealer network through the facilities of Fundserv, each of which are indications that (sophisticated) third parties have conducted due diligence reviews and that performance will be monitored over time. We submit that such market-based, objective facts are more persuasive than internal reviews or analyses.

5. <u>Suitability—Holistic Suitability Assessment</u>

Proposed Section 13.3(1)(a)(v) prescribes what we view as a holistic assessment of suitability when making a recommendation or taking an investment action for a client. The Companion Policy indicates that this is expected notwithstanding that a client's investment needs and objectives, time horizon or risk profile may not be identical for all of the accounts. Given the fact that different account types are generally opened for a specific objective and/or time horizon, it is unclear how a registrant is expected to assess the liquidity needs or concentration of an RRSP account for a 40 year old in conjunction with a cash account held for short term or emergency needs. In addition, a client may and likely will maintain accounts with other registrants and information about these accounts would be unavailable for the purpose of this analysis. Therefore, the usefulness of such an analysis, if it could be done, is questionable. We submit that the assessment of suitability on a consolidated, portfolio basis is unreasonable and the requirement should be removed.

6. <u>Suitability—Suitability Contingent on KYC</u>

Proposed Section 13.3(1)(a)(i) provides that an appropriate suitability determination is contingent upon, among other factors, collecting the KYC information required by Section 13.2. If a registrant is unable to obtain the full range of KYC information from its clients as contemplated by the Proposals, the registrant will accordingly be unable to meet suitability requirements under Section 13.3(1)(a)(i). We propose that the registrant should be able to make a suitability determination based on the information provided by the client. The registrant should potentially be able to add disclosure that investment suitability determination may be impacted by its part of the client's total assets, which information the client has declined to provide (see comment #2 above).

7. <u>Suitability—Recommending the Lowest Cost Security Available</u>

The Companion Policy provides that, unless a registrant has a reasonable basis for determining that a higher cost security will be appropriate for a client, the registrant is expected to trade or recommend the lowest cost security available to the client in the circumstances that meets the requirements of Section 13.3(1). While we acknowledge that registrants should be required to recommend a lower cost security if the securities involved were identical, this is not a realistic or typical occurrence. We note that securities have various features and may be different to varying degrees and cost cannot be viewed in isolation. It is

common among our members that a pooled fund will have various classes or series, generally distinguished by a different required minimum level of investment, with different fees etc. The requirement would be difficult to satisfy when there are lower cost options that have other features such as a higher investment levels to be eligible to invest in a series or class of securities that the client does not satisfy. We ask that the guidance indicate that, when there are multiple classes of a fund with differing fee structures with varying minimum investment amount requirements, that recommending or placing a client in a class with a higher cost due to the minimum investment requirement is acceptable.

8. Suitability—Best Interests and Cash in Accounts

The Companion Policy (pg. 189) states that maintaining inappropriate amounts of cash in the client's account or leaving cash in the account uninvested for unduly long periods of time would not meet the requirement of putting the client's interest first. Maintaining cash in client accounts may form part of a conservative portfolio strategy that is appropriate given a particular client's investment objectives, such as easy access to cash for emergency situations. We submit that maintaining cash in client accounts for an extended period of time may in some circumstances be appropriate, including during a market period where valuations are high and there is an expectation of a market pull-back. We submit that the CSA should instead indicate that while they would be concerned about such a situation it is a matter of professional judgement and that the rationale for such situations should be documented as part of a suitability review.

9. Suitability—Client Investments in External Accounts

The Companion Policy (pg 189) provides that a registrant should inquire about the client's other investments or holdings held elsewhere in order to inform its suitability determination. As noted above, clients may be unwilling to provide some or all of this information to a registrant. Accordingly, we submit that this guidance should be modified to provide that if a registrant is unable to obtain this information from clients that it will not prohibit the registrant from fulfilling its suitability obligations.

10. Conflicts of Interest—Requirement that all conflicts of interests must be addressed

Pursuant to the proposed changes to Section 13.4(1), a registered firm will be required to take reasonable steps to identify existing conflicts of interest, as well as conflicts of interest that are reasonable foreseeable, between the firm and each individual acting on its behalf, and a client. The reference to "material" conflicts has been removed and the Companion Policy (pg. 193) states that "**All** [emphasis added] existing and reasonably foreseeable conflicts must be addressed in the best interest of clients." The emphasis on addressing **all** conflicts is repeated in s. 13.4.2(1) and 13.4.3(1).

We note that in s. 13.4.5 relating to the disclosure of conflicts of interest it is stated that a registrant must disclose to a client "…such conflict where a reasonable client would expect to be informed of such a conflict".

We submit that it is unclear why it is necessary to expand the obligation to take reasonable steps to identify conflicts beyond those that are material. This will likely be extremely onerous for registered firms and will result in increased costs with little benefit to the end client. We suggest that the standard should be to identify all "reasonably identifiable or foreseeable" conflicts, or alternatively all conflicts that a reasonable or prudent person (consistent with pension investment management standards) would consider important to an investor or of which a reasonable client would expect to be informed.

11. Conflicts of Interest—Best interest of the client – Proprietary products

Pursuant to the proposed section 13.4.2(1), a registered firm must address, in the best interest of a client, all conflicts of interest between the firm and each individual acting on its behalf, and the client. As noted above, the Companion Policy (pg. 194) states that "It is a conflict of interest for a registered firm to trade in, or recommend, proprietary products. Such firms must be able to demonstrate that they are addressing this conflict in the best interest of its clients." We request that the CSA clarify that registrants selling only proprietary products, with the inherent fee conflict, are not in violation of this best interest standard, nor

is only offering proprietary products, provided there is adequate disclosure to clients and such conflicts are adequately addressed.

Under the heading "Proprietary product disclosure" in the Companion Policy (pg. 203), the CSA state that in such instances "The firm must also disclose how they are addressing this conflict in the best interest of their clients." We request that the CSA provide examples of when or how they would consider such a firm to be acting in a client's best interest and what disclosures might be expected to demonstrate that the conflict is being adequately addressed.

The Companion Policy sets out examples of controls that registered firms that only trade in, or recommend, proprietary products could implement when determining how to address the conflict in the best interests of the clients (pp. 194-195). One example provided is conducting periodic due diligence on comparable non-proprietary products available in the market and evaluating whether proprietary products are competitive with the alternatives available in the market. Assessing "competitiveness" could be a very difficult exercise as alternative investment products may have unique features or there may be little public information available about specific product attributes due to the confidentiality of how the market operates. In addition, there may be very specific reasons why a client chooses a particular niche manager.

Another example provided is obtaining independent advice on, or independent evaluation of, the effectiveness of the firm's policies, procedures, and controls to address this conflict. As noted above in our opinion this is not a reasonable expectation, particularly for small managers, given the costs of such an exercise. We suggest that the Companion Policy also note that, particularly for smaller firms, the responsibility for the effectiveness of controls is management's, with oversight from the Board of Directors.

12. <u>Conflicts of Interest—Conflicts of interest that must be avoided</u>

It is common among AIMA Canada's members, and expected by clients, that the firm and/or its staff (particularly the founder or CEO) have "skin in the game" through investments in the products offered. As such they would be considered clients.

Pursuant to proposed Section 13.4.4(1), a registered firm may not borrow money from a client unless certain conditions are met. This would prohibit a registered firm from obtaining a loan from a firm owner, staff or other parties who are also clients of the registered firm. This is particularly problematic if these parties want to provide a loan to the registered firm to address capital deficiencies or to provide general funding through a subordinated loan.

Similarly, pursuant to proposed Section 13.4.4(2), a registered firm must not lend money to a client. This provision would prohibit a registered firm from lending money to staff who are also clients of the registered firm as part of an employee benefits program (e.g. a housing loan). The ability to offer such benefits is important to smaller firms in a competitive market for labour.

We request that the CSA amend these provisions to allow loans from staff, and other parties who may be clients, in the event that the loan is to remedy a capital deficiency or is made on a subordinated basis. We also request that the provisions be amended to allow loans to staff of the registrant if the loan is made under the provisions of an employee benefit program.

13. <u>Prohibitions on acting as trustee or pursuant to powers of attorney</u>

We think Section 13.4.4(3) should be clarified to provide carve outs of industry standard practices including circumstances where (a) clients that purchase units of an investment fund formed as a trust where a manager acts as trustee become beneficiaries of such trust; and (b) powers of attorney are granted to general partners of limited partnerships or investment fund managers pursuant to subscription documentation for ease of administration. Without an express carve out, these standard practices could be considered to be offside the Proposals.

14. Referral Fees—Requirement that referral fee can only be paid to a registrant

Pursuant to the proposed amendments to Section 13.8, a referral fee will only be able to be paid to a registered firm or individual. We are uncertain why this restriction is required and why a referral fee cannot continue to be paid to an unregistered firm or individual, provided that such a party is not engaging in activity requiring registration under securities legislation. We also note that compared to the exhaustive consultations and studies that accompanied embedded compensation reforms, the referral arrangement proposals are being introduced with little or no consultation.

There are many scenarios where referral fees are paid to an individual or firm (often registered under other legislation to provide services, such as an insurance broker or accountant) who refer their clients to a registered firm to provide securities-related services and in return receive a fee for such referral. Clear disclosure is provided to clients regarding the referral fee arrangement as required by NI 31-103 and it is unclear why such arrangements ought to be prohibited.

15. Referral Fees—Requirements regarding timing and amount of referral fee

Proposed Section 13.8.1 will impose limitations on referral fees. We are supportive of Section 13.8.1(b), which provides that the referral fee cannot result in an increase in the amount of fees or commissions that would otherwise be paid by a client to the party who received the referral for the same product or service. However, we are not supportive of Section 13.8.1(a) which would limit the payment of the referral fee to 36 months, or Section 13.8.1(b) which would limit the referral fee to 25% of the fees or commissions collected from the client by the party who received the referral. The terms of the referral fee are negotiated between the parties to the referral agreement and do not impact the services provided to, or fees imposed on, the client. We respectively submit it is not the role of the CSA to be imposing these types of restrictions that do not impact the client. We also submit that there are a number of alternatives to the CSA Proposals that could be considered by the CSA that may better address the stated policy objectives. We would be pleased to discuss such alternatives with CSA Staff.

16. Misleading Communications—Corporate titles

Pursuant to Section 13.18(2)(b) and the Companion Policy (pg. 211), a registered individual must not use a corporate officer title unless their sponsoring firm has appointed that registered individual to that corporate office pursuant to applicable corporate law. It is very common in the industry for individuals to hold titles such as "Vice President" to indicate seniority, without being appointed a corporate officer of the company. It is often a business decision to restrict those individuals who are appointed to corporate officer positions, because corporate officers often have the ability to bind the company under a company's by-laws. We do not believe an individual holding a VP title is deceptive or misleading. We also submit that this provision is inconsistent with the CSA's comment that they will be reviewing the use of titles as part of separate reforms in the future. In our opinion this provision should be removed from the Proposals pending the completion of the future project.

17. Misleading Communications

The Companion Policy states (pg. 212) that "If a registered firm holds itself out as independent but offers proprietary products, this could reasonably be expected to mislead a client as to the products to be provided and as to the nature of the relationship." We do not think this is entirely accurate. In our view, a statement of independence is widely understood to mean the firm is not owned or affiliated with another firm. It does not imply that it offers a wide range of products from various providers. Proprietary product conflicts of interest are addressed through related / connected issuer and conflict of interest disclosure. We ask that the CSA modify or clarify the statement.

18. Transition

We appreciate and support the phased implementation schedule outlined for the final amendments. However, given the very competitive nature of the Canadian market, we ask that the CSA ensure that the amendments only come into force at the same time that equivalent rules come into force for members of

the SRO's. Given the scope and impact of the amendments on operations our members would be at a competitive disadvantage to SRO members if the SRO's implemented the requirements at a later date.

We appreciate the opportunity to provide the CSA with our views on these Proposals. Please do not hesitate to contact the members of AIMA set out below with any comments or questions that you might have. We would be pleased to meet with you to discuss our comments and concerns further.

Yours truly,

ALTERNATIVE INVESTMENT MANAGEMENT ASSOCIATION

By:

Darin Renton, Stikeman Elliott LLP
Supriya Kapoor, West Face Capital Inc.
Ian Pember, Glen Williams Consulting
Jason Chertin, McMillan LLP
Ron Kosonic, BLG LLP
Sarah Gardiner, BLG LLP
Norbert Knutel, Blake, Cassels & Graydon
Alex Bruvels, McMillan LLP