**COMMENT LETTER /SUBMISSION Statutory Best Interests**

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Dear Sir/Madame

*"The purpose of this Canadian Securities Administrators (CSA) consultation paper (the Consultation Paper) is to provide a forum for stakeholder consultation of the desirability and feasibility of introducing a statutory best interest duty to address potential investor protection concerns regarding the current standard of conduct that advisers and dealers in Canada owe to their clients*."

As noted in the 2004 Fair Dealing Model report, regulation of the "transaction based service model" (with its limited suitability process) fails to regulate the many "advice based" contractual relationships (with significant discretion over the suitability process) that exist in the advisory segment, and by implication fails to enforce the operational boundaries of transaction based regulation.

A best interests standard, accompanied by a fiduciary type duty, would better protect investors entering into advice based contracts with significant discretion over suitability processes, and would properly reflect the commitments, promises and complexity of these relationships.

The question is not whether a best interests standard with fiduciary type responsibility should be enshrined in securities regulation, but how it should be implemented, and to what extent the current transaction driven model should be allowed to remain as a separate stand alone, but clearly defined service option. As noted in Appendix A, the limited parameter to parameter suitability standards of transaction based regulation need to be clearly disclosed to clients, and regulators need to be fully aware of the realities of investor ownership of decisions under such a framework to better regulate and differentiate such models.

Unfortunately, development and discussion of these arguments have been deferred and delayed, post FDM, and recent deliberations are rushed, yet at the same time cognizant, to some limited extent, of how far behind the curve Canadian regulation is.

In fact, as implied in the first paragraph of this submission, the CSA consultation could also be a de facto reappraisal of the regulation of the transaction with respect to the development of services and promises with implied higher suitability standards and greater advisor responsibility and discretion. Regulators will either need to clamp down on the development of "more than the" transaction advice based services and more rigidly enforce regulation of the transaction, or to allow the development of advice based service processes through the evolution and introduction of best interests and fiduciary type standards, or both.

The argument for a best interests standard is more than a matter of opinion, it is a matter of fact, and should be a regulatory imperative.

Unfortunately the CSA consultation barely scratches at the surface of the issues involved in assessing the costs, the benefits and the dynamics of implementing a best interests standard, as well as assessing the costs and abuses of loose regulation of the transaction based suitability framework. The lack of substantive analytical detail and robust argument for or against a best interests standard, in this consultation, is a concern and this submission highlights a number of them.

Clearly, the transaction distribution dependent part of the industry does not want to move towards the recognition of best interests standards. They want to retain the ability to continue to sell securities with the minimum of "red tape". I reference, with regard to this, a recent talk by Thomas Caldwell of Caldwell Securities that a) criticized new regulation of the retail relationship (i.e. CRM regulations) while at the same time decrying both the repeal of certain regulation and the lack of other regulation that would better protect the margin of the transaction, and b) recommended the removal of financial support for consumer advocacy. I believe that this type of statement is not in the public interest and evidences the very real conflicts of interests that prevail in transaction driven industry circles. Nevertheless it is important that regulators understand precisely the processes that are being defended and why they differ materially from those services whose implied objective is in the best interests of retail investors.

## The complex nature of the suitability process

My first and preeminent concern with the consultation is that it fails to discuss the most important reason for the need for a fiduciary duty in advisory relationships: this is the relative complexity of the investment process, and the expertise, systems, knowledge and resources needed to perform a given suitability process. This is critical to understanding the dividing line between fiduciary type and investor responsibility.

There is in fact considerable discretion over decision making within the components of any given suitability process in advisory relationships. Suitability is a far more complex process than current regulation recognizes, and I see insufficient argument from regulators as to why "investors" should and can take responsibility for this process – See Appendix A. It is my opinion that a better understanding of the suitability process, and the rigid assumptions that would need to be satisfied to validate current regulation of the transaction, would leave regulators with no other option but to acknowledge the considerable advisor discretion existing in most advisory relationships.

Regulators need to acknowledge a) that the suitability process is complex and is not adequately regulated by the simple parameter to parameter model currently used and b) that the promised/contracted expectation of service is often at odds with the regulated contract. But we also need to acknowledge that a great many advisors who promise/promote a higher level of service lack the expertise, resources, systems and oversight to deliver the promise, largely because of the operational and cultural constraints of a transaction driven business model.

As such, we have four issues

- One is that the suitability process is complex and has various levels of implicit advisor discretion built into it;

- Two is that regulators appear to be ignorant over the relative complexity of this process and are failing to acknowledge and regulate the actual contractual relationship as a result.

  This also means that the regulatory framework, as is, is ill equipped to regulate the evolution of services and their contracts, and therefore that the current consultation into best interests standards is also a de facto reassessment of a) regulation of the transaction and b) regulation of services whose contracts imply a much higher level of discretion and hence responsibility;

- Three is that many advisors are overstepping the boundaries of regulation by promising a contract that is not regulated and which they are ill suited to deliver. These advisors would also be ill equipped, initially, to cope with a tougher more appropriate suitability regime (i.e. best interests and fiduciary responsibility);

- Four, by delaying change, the consequences of change have become greater. Companies and advisors have become more dependent, and, hence, have become more exposed, to changes in the distribution model, with all the attendant balance sheet and other risks that a change of model would bring. It is important to differentiate between the risks to an inefficient business model (in terms of total economic impact) and the costs and ultimate benefits of change towards a more efficient business model.

Appendix A was a document I developed in late 2011, and it analyses the current regulatory model in the context of investor responsibility. It argues that in order for the investor to be responsible for the investment decision to the extent that there is no advisor discretion, and hence fiduciary responsibility, that a number of very strict assumptions need to be satisfied.

## A best interests standard

A "best interests standard" is only a fiduciary duty because a fiduciary has control of the critical components of the decision, and where this is the case, the client is therefore vulnerable to these decisions and has to trust the integrity, expertise and judgment of the fiduciary.

Without a duty to act in the best interests of the client, the risk is that the fiduciary will make decisions that favour his or her interests, to lesser or greater extent.

But, the control over the decision initially arose from a promise, and not a coercion. This promise was to take care of the process and the decision that arose from that process, and hence it is the promise of a service (implied or otherwise to act in one's best interests), that is the contract, that defines the need for a best interests duty. An individual would not hand over control without the presumption of such a duty, that is, to act in their best interests.

It is the combination of the implied or express promise of service and the relative complexity of the suitability process that, in my opinion, argues for the institution of a best interests standard and a fiduciary type duty in advisory relationships.

Unfortunately the CSA report fails to attempt a definition of "best interests" in the sphere of discussion, which is required to validate the profundity of the promise, the need for integrity of process and the complexity or otherwise of such process.

"Best interests" is all about the outcome, and therefore all about eliminating influences that may detract or conflict with the achievement of that outcome. For example, in investment planning and management, the best interests objective, for the client, is the optimization (via, inter alia, asset allocation, security selection and modeling), of the ability of current and future assets to meet financial needs over time while optimally managing risk and return. The organization of the client's overall finances, and the organization of their assets and the management of the two combined, should be working towards this best interests outcome.

The outcome of a service therefore needs to be defined, and I must point out that there is no discussion, in the consultation, of what the outcomes of advisory services are or should be in the context of the discussion. Clearly, in the simple transaction model, the outcome is the suitable security (whether it is in the client's best interests or not). Again I would refer readers to appendix A to appreciate the ambiguity of the simple transaction model in setting the outcome.

To highlight the overall lack of consideration as to the outcome of a service or relationship in regulatory circles, the new IIROC CRM relationship disclosure rules do not appear to require a statement of intended outcome of the service, even though this is the most important reason for saving and investing and seeking professional help.

This lack of attention to the outcome (which is an implicit part of advisory relationship contracts) parallels regulators' lack of a clear vision of the industry of the future. This lack of vision compounds the failure to understand the industry of today as it applies to outcomes, interests and process dynamics.

## Can the industry accommodate a best interests standard?

A transaction based distribution business model is less likely to be able to support a "best interest" structure: there does not exist the skill set (amongst advisors), the culture (throughout), the infrastructure (technology and organisational accountability to name but a few) and business model to deliver best interests transactions let alone fiduciary type best interests outcomes.

While it is probable that implementing best interests standards, while attempting to retain the current distribution model and framework, will be impractical, logistically impossible, a compliance nightmare and will likely increase costs across the board, a best interests standard within an advice based service model, because of its compatibility, would work and would most likely be cost effective. Service based processes tend to have centralised decision making and quality control functions, making compliance and monitoring much easier.

Regulators need to understand that a change towards a best interests standard would change the business model and that this would not necessarily be a bad thing for consumers, capital allocation and the capital markets. Change would clearly be bad for those whose interests reside in the current transaction model. Indeed, one could argue that the returns of such a model have been higher and the costs lower than would have been the case if the transaction based model had been properly regulated: loose regulation has allowed greater latitude (advisors acting outside the confines of the transaction model without the regulatory oversight) for advisory services.

The competitive dynamics of the industry may therefore have been artificially skewed by regulatory ommission. Stricter regulation of the transaction would have significant ramifications for profitability in the retail sector and the efficiency of capital allocation/capital markets. Introduction of a best interests standard would better relate regulation to advice based service offerings, ultimately, and ensure that an appropriate and efficient business model for that service profile is developed over time.

## Best interests of the transaction, not the process

The consultation document states that "the existing suitability requirement would continue to apply to advisers and dealers (and their representatives)."

By failing to engender discussion of the importance of the suitability processes, over which the advisor has discretion, that are key to delivering the promise (*data gathering, risk assessment, asset liability modeling and assumption generation, a liability and risk appropriate asset allocation derived from valuation models or other structures, the investment planning and portfolio management disciplines et al*) it ignores the fact that a best interests outcome is primarily defined by the suitability process and not the transaction.

It is my opinion that the current minimum standard KYC suitability requirements, key to defining the limited parameter to parameter suitability outcome for securities transactions, is insufficient to support a broad best interests' standard.

What the consultation appears to be focusing on is whether or not the security selected is in the best interests of the client. If the suitability decision is incorrect with regard to the best outcome (i.e. buy risky assets instead of paying off the mortgage), then it is irrelevant whether the security selected is the most appropriate of its type. Besides, without a best interests outcome statement it is impossible to assess a best interests' outcome.

Restricting a best interests outcome to the transaction, risks impairing the fiduciary duty by its failure to properly assess the overall suitability context and set the best interests outcome within it.

There is a risk, that if we retain the current suitability framework, that we will end up trying to implement bests interests standards within the current business model. I believe that this is impractical given the many conflicts of interest within the model and the limited suitability standards.

Because a transaction driven best interests' outcome can impair a fiduciary duty (because it could plausibly run counter to a best interests' outcome) the limitations of the service and any promise would need to be clearly stated at outset.

I would argue that the investment process underpinning the suitability outcome, for most best interests outcome requirements, to be sufficiently complex as to accord a fiduciary duty even in instances where the client makes the final decision. Whether or not an adviser has discretion over the security transaction, they invariably have discretion over the processes and the process decisions leading to that security recommendation. The promise, to provide a best interests outcome cements the fiduciary duty.

The degree to which the client is able to take responsibility for the investment decision itself is dependent on the integrity of the process (i.e. focused on a best interests' outcome), but the client will only, in the vast majority of instances, be able to process and understand the generics of the risk and return profile of the best interests outcome. As such, a best interests' standard also depends on other factors such as communication of the process and the risks of the portfolio and the securities and strategy recommended.

The fiduciary duties within a best interest standard run to much more than merely recommending the optimal security, and especially so within an advisory structure where the investor is responsible for accepting and understanding the generics of the decision.

## Best interests of the transaction

If you retain the current limited transaction based suitability framework, you effectively retain the investor's supposed responsibility for the investment decision, while failing to regulate those services that fall outside the supposed regulated framework.

Applying a best interests standard to the transaction should raise standards for "suitable investment" recommendations. But, if you retain transaction based remuneration and only apply the best interests standard to the transaction and not the suitability process, it is difficult to see a) how this will be regulated and b) how the industry will continue to be able to transact within the imperatives of the distribution model. For example, the absence of proper benchmarks in point of sale documentation and proposed changes for performance reporting clash with best interests standards for the transaction while the core of the business model will remain largely the same.

Worse, while a best interests standard for the transaction might possibly force companies to develop higher standards, more sophisticated suitability processes and to move away from the transaction, the regulatory model as it stands will not accommodate this. Therefore, regulators may need to introduce a separate advisory segment with holistic best interests standards and fiduciary duty.to allow the industry model to bend and adjust to changing dynamics.

I see much conflict in this state of affairs (applying best interests only to transactions), and I also see little enough differentiation between current standards and prospective standards under the proposed best interests standard for the transaction as to justify the costs of these changes. I feel therefore that the costs of change may well outweigh the benefits, and that an opportunity to modernize both regulation and industry standards, with benefits for competition and service in the retail market place, could well be lost.

## Additional information

My comment letter/submission barely scratches at the surface of the issues discussed. As such, in addition to the comments made I have also attached a number of appendixes providing further analysis and detail on some of the relevant issues.

Appendix A – this analyses the realities of the current transaction based regulatory model and argues that it is more or less impossible for most investors to understand the suitability decision and therefore to effectively take full responsibility for the transaction.

Appendix B – this is a copy of a past submission to IIROC with regard to the CRM project and argues that regulation “constrains innovation by preventing companies and advisors from offering advisory based services with higher standards and fiduciary type responsibility.”

Appendix C – this provides excerpts, relevant to the subject matter at hand, from recent posts on my “Depth Dynamics” blog.

Appendix D – this is an excerpt from a 2009 report looking into the roles and responsibilities of advisors and analyses this within the context of transaction and service based business models. Understanding the role of advisors and their interaction with different business models is critical if you are a regulator looking to implement changes to regulation and hence the way the industry operates.

## Summary

What is so wrong about advisors who are providing advice being obliged to act in their client’s best interests right from the processes they use to assess asset allocations and generate risk and return, the models used to assess ability of assets to meet financial needs, the risk profiling and education used to align portfolios and withdrawal strategies to clients needs and preferences, they way advisors communicate their services, fees and their recommendations, to the way they review, manage and effect transactions?

What is so wrong with making advisors and firms responsible for the integrity of their suitability processes by recognizing the significant element of discretion that they have in making recommendations to their clients?

What is so wrong about making the service outcome independent of transaction returns?

Only by defining and validating the need for a best interests standard and fiduciary type responsibility can one hope to argue for their principled application. The arguments for best interests standards are a natural progression from the implied and express promises made by a great many advisors and not an imposition thwarting the goals and aims of their services.

What stands in the way of necessary change is the behemoth of vested interests and the power of a status quo that has much to lose. The costs of change, to what is an inappropriate (transaction) framework for the delivery of wealth management solutions and the allocation and management of economic capital, should not be the argument against change itself.

Whether or not a product survives in the market place should be a function of its ability to appeal to efficient portfolio dynamics and hence best interest standards. This means a product's ability to survive in a competitive market place is a function of its costs and its functionality: there are many products where the costs are high and where the functionality conflicts with flexible, efficient portfolio design.

In a competitive, efficient capitalist market place, transaction costs and function should not invalidate the outcome. As it is, we have allowed transactions and their remuneration to get in the way of saving/investment, consumption/production and hence capital allocation decisions in the market place. It has also deferred the development and introduction of wealth management tools, services, systems and processes that could lower the cost of delivering wealth management advice and hence the delivery of long term capital to capital markets.

The antiquated past stands in the way of a technologically advanced future for financial services, and so it is with a labour intensive, low skill set, transaction based industry that wishes to hold onto its hegemony over distribution and returns on transactions and products. This is all back to front.

But, because a best interests standard requires definition of the promise, we must also explore the ability of the industry as is to deliver that promise, and hence how, when and how much to apply and enforce best interests standards and fiduciary duties. Likewise we must also have an understanding as to how the business model will adapt as well as the costs and benefits associated with such change.

Whatever the eventual decision, the choice should be clear: regulators will either need to clamp down on the development of "more than the" transaction advice based services and more rigidly enforce regulation of the transaction, or allow the development of advice based service processes through the evolution and introduction of best interests and fiduciary type standards, or both. Clearly the latter is the more pragmatic option with the former marking a foreboding stagnation in financial services productivity and innovation.

The industry must realize that attempts to defend the indefensible will force regulators into providing yet more detailed and overarching regulation of the transaction. A move towards higher standards, greater advisor responsibility and accountability and a best interests/fiduciary type model may be the optimal long term solution for all, but there should be no doubting the short term costs and challenges.

My concern is that the regulators will keep tinkering with the transaction framework by only introducing best interest standards for the transaction and this will force further dysfunction onto an inappropriate business model. I believe that this will be costly and difficult to implement and will prevent the types of systems, processes and business models that can better handle best interests standards from developing.

Yours sincerely

Andrew Teasdale, CFA

## Appendix A - What is the Regulatory Model?

In 2004 the Fair Dealing Model stated that the advisory transaction based segment of the industry was developing along an advice based services model. This was a model that the transaction based regulatory framework was not set up to manage, and the report recommended changing regulation to adapt to the evolving model.

But nothing has happened since, principally, it would appear, because the industry wishes to retain, and regulators continue to regulate, a minimum standard transaction based service model. Defining the transaction based model, its regulation and the contract between investor and advisor is critical to effective regulation and "fair dealing". This is especially relevant with the introduction of point of sale disclosure documentation which would seem to help establish investor responsibility for transaction decisions.

A belief that the investor is responsible for their investment decisions, and that they are responsible for educating themselves to make informed investment choices, may be, under certain conditions, a rational solution to the problem of distributing products in the market place. Nevertheless, much of the research on disclosure suggests investors are not sufficiently educated to make complex investment decisions and disclosure has little material impact on the decision, and therefore, arguably, that the certain conditions are much more limited than current regulation perceives.

In a regulated business model where investors are responsible for the investment decision, I would recommend that the true nature of the regulated service be communicated to the investor, at outset, so that investors can choose whether to retain discretion over all, part or none of the investment decision process and the extent to which they wish, or are able, to better educate themselves to make their own discretionary decisions.

### Parameter to Parameter suitability

Regulation of the transaction in Canada would appear to be based on a simple parameter to parameter process. These parameters are those outlined in the KYC (time horizon, investment objective, risk profile, investment experience and net worth).

The parameters are used to drive product and security selection and are suited for investor initiated transactions: many might argue that the informational content of the KYC parameters are insufficient for an advisor to take responsibility for (or rather have discretion over) the construction, planning and management of a portfolio.

Under the parameter to parameter model, the investor is responsible for a) providing the parameters (that is for providing the suitability framework) that guide the advisor's security recommendations, in particular the risk aversion and investment objectives, b) for understanding the investment and associated disclosures and c) for making the decision to transact.

The advisor is responsible for a) recording the parameters, b) confirming that these are the client's parameters including the client's experience, expertise and investment knowledge, for these may constrain the transaction set, c) for providing a transaction recommendation that matches the parameters, and d) for providing sufficient information about the transaction to allow the investor to confirm that the recommendation's parameters matches the parameters of the KYC. The minimum information content of the process (minimum standards) and the strict division of responsibilities is key to the operational viability of this industry segment.

The investor is ultimately responsible for making sure that they understand how a recommendation meets their financial needs and risk preferences by understanding their own needs, the product and how the product or transaction fits into their needs. That they have also initiated the request effectively seals the deal.

The KYC would also appear to only focus on funds that require a transaction, and not overall finances from which investable funds can be derived. This is important, because the KYC and the transaction based service, and its regulation, is not structured to deal with wider financial advice and the responsibility that a transaction recommendation has in a wider context. Under the transaction based service, the investor is assumed to have already made these types of decisions. It is therefore important that the investor is aware of the boundaries of the "regulated service."

However, while a parameter to parameter model might under certain conditions satisfy a transaction request for a specific sum of capital, applying the set of parameters to wider spectrums, such as a portfolio, stretches the rationale of the model. Within a portfolio, there are a number of components ranging from low risk to higher risk, short term to longer term, low yield to higher yield, all of which to greater or lesser extent will form part of the portfolio spectrum: each of these components relate to a differing yield, time horizon and effective risk and investment objective. Expecting an advisor to delineate these components from a KYC is difficult: a process that did this would have a significant element of discretion, unless it used a process provided by the consumer or the parameters of the advisor's process were matched to the parameters of the investor's process; but such processes would imply varying degrees of sophistication which cannot be effectively detailed in the KYC. In these instances it is not really clear where discretion starts and ends in more complex scenarios: this is essentially the heart of issues concerning investor responsibility and advisor representation of services offered. It is therefore important, if responsibility is to be accepted by the consumer, for the consumer to be aware that they are responsible for bringing to the table a fairly sophisticated process to make these decisions.

## Point of sale disclosure

The current point of sales disclosure is therefore designed to interact with the basic KYC parameters: risk to risk, investment objective to investment objective, time horizon to time horizon etc. It is a quick check on the compatibility of the transaction with the KYC parameters.

Since the POS is being delivered within a sale's process, with the investor responsible for the decision, education and due diligence, and the parameters defining the decision, the process can remain focussed on turning over the transaction. The investor needs to be aware of this.

A quick decision would imply that the investor is making an informed asset allocation decision of significance and is able to quickly internalise issues of significance: they already know the parameters they are looking for and only need to make sure that these match their requirements; investors aware of their responsibility and looking for asset allocation vehicles would be more likely to make these types of decisions.

Providing for Point of Sale disclosure to be given to investors after a transaction is implemented means that there is no confirmed opportunity to match the parameters of the KYC to the product at the point of sale. Therefore, the investor cannot yet be proven to have taken responsibility for the investment decision. While acceptance of the decision once in receipt of the POS would imply such, the intervening period assumes a level of advisor discretion and responsibility over the decision that is not permissible under regulation of the transaction. This clearly places the interests of the product advisor above those of the investor without informing the investor of the significance of the event.

## Client's best interests

Under current regulation, advisors are not obligated to act in their client's best interests: that is to provide a solution which after disclosing and discounting service and transaction costs, provides an optimal balance of risk and return relative to a set of clearly defined parameters.

**A model that is not obligated to provide a best interest outcome assumes that an investor is a) aware of the constraints of the service in terms of products and securities recommended and other service options available, and b) that they are initiating the transaction with full awareness of the cost/benefit trade off, and c) they could choose to transact direct and avoid the product advice, assuming of course that all products can be transacted direct.**

Because they are assumed to be aware of the constraints of the transaction service option, this must mean that they have made a choice between a) having their money managed for them under the discretion of the advisor and b) managing their money themselves using the product advisor as a sounding board for product recommendations, assuming that they have processed the cost/benefit outcome.

The above assumes that an investor is aware of the parameter to parameter framework and its limitations. It also assumes that the investor has a suitability process sufficient to understand and incorporate the product into the financial universe from which they have derived the KYC parameters. If they do not have an adequate internal suitability process, they would need to seek the type of advice that would institute another's suitability process, which is a defining aspect of a fiduciary type responsibility.

It also assumes that the primary reason for the transaction request is for the advisor's product expertise and access to product distribution, which the consumer does not possess. It is important to note that many international regulators place consumer choice and a competitive market outcome (lower costs and higher standards) as a key objective of point of sale regulation.

This current transaction model is a simple one: its aim is to link the product and transaction industry with the investor without imbuing the process with responsibilities and costs that may impugn its viability. Consumers need to be made aware of the choices they have and the trade offs they are taking when they accept a particular service option.

## A simple framework of significance

The Canadian model is a simple framework of significance: significance in the sense that the parameters of the client and the parameters of the product are deemed to hold all the necessary information needed to provide a transaction recommendation. Yet, there is no direct reference to the information needed to process the parameter inputs, to assimilate the transaction within the whole, or when to seek to advice that would provide such. It is assumed that this information is already known.

International regulators appear to believe that consumers have less knowledge regarding the suitability framework, are less able to operate a simple parameter interface, depend more on advisors for the suitability process and require explanation of the rationale for suitability as well as greater explanation of the product profile and the limits and parameters of the service.

The current framework assumes a lot and it has significance. The investor needs to know what they are assumed to be responsible for in this framework, and when an advisor has crossed the line demarcating advisor and investor responsibilities.

## The model

If investors are to be held responsible for investment decisions under the current regulatory model, then the model would need to satisfy a number of assumptions.

1. The investor initiates the transaction, and knows they are initiating the transaction.

2. Investors independently determine the parameters to be delivered to the KYC and are not influenced by the product advisor. The KYC parameters and sums to be invested are summary outputs of an analysis of the investor's personal financial situation.

3. Investors have their own internal suitability processes which determine when and how much to invest, and how much to allocate.

4. Where leverage is part of the transaction process, the amount recorded in the margin/leverage agreement would need to be independently initiated by the investor.

5. Investors are aware of the processing and information requirements to satisfy 2 and 3 and 4, and would know when to solicit a fiduciary advice based service if they cannot meet these requirements.

6. Investors are engaging with the product advisor because of the product advisor's product knowledge and expertise with respect to aligning security selection with the KYC suitability parameters.

7. Investors are graded according to their expertise and knowledge and the product universe is expanded or constrained according to this expertise.

8. Investors are assumed to have access to a wider range of information on investments, investment styles, portfolio theories and other material to enable them to make informed transaction decisions and adequate financial and portfolio analysis, and they are aware of this.

9. On an ongoing basis, product advisors only make transaction recommendations based on the continuing suitability of the investments. The investor relates these suitability recommendations with their own processes to decide, independent of the advisor, whether to buy or sell.

10. With respect to Point of Sale disclosure, investors are aware that this disclosure provides basic information that is to be used to check compatibility with their KYC parameters, and that they still need to perform their own due diligence.

As noted, the model is simple and clearly demarcates responsibility. Also, as discussed, it is not clear how this model is intended to relate to suitability within a portfolio context and more complex products. It is critical that the investor be made aware of the assumptions of the regulated model to allow them to make an informed decision about the service they need and, if they accept the transaction model, the transactions recommended.

## Conclusion

The focus of this document is not to recommend the imposition of a fiduciary type duty on the transaction based segment per se, although a) it would agree with such for services that provide advice out of the context of the transaction framework discussed, and b) where the implication is that a transaction recommendation provided is in the client's best interests.

Regulators have a responsibility to regulate services governed by the transaction model, to define the model, its assumptions and boundaries, and to make sure that services operate within these boundaries and parameters/assumptions. One could argue that regulators have a fiduciary responsibility to properly frame regulation within the context of the business model, and to effectively communicate, monitor and manage such. Without adequate framing and detail regarding assumptions and boundaries of the business model and its regulation, it also becomes difficult to judge the effectiveness and adequacy of regulation.

I recommend that the investor be made aware of their full responsibilities within a given regulatory model and are able to make an informed decision as to the type of service and responsibility they wish to assume. I would also recommend that regulators fully define the model and its assumptions.

## Appendix B – IIROC CRM submission February 2011

While many would argue that industry standards need to be raised (or at the very least amended to allow companies to differentiate their suitability standards and service processes in the market place), for advice outside the parameters of the transaction to be regulated (it is not currently regulated), for “investment advisors” to act in their clients’ best interests (best interests do not necessarily mean a fiduciary responsibility) and to be held accountable for the suitability processes they use where such processes involve an element of advisor discretion (which implies a fiduciary type responsibility for the integrity of those processes), the current proposals make no such evolution.

On the contrary, the proposals can be seen as a re-definition of the regulation of the transaction based model that the 2004 Fair Dealing Model concept paper sought to differentiate advice based services from and make transparent to the consumer.

The CRM project is a clear move away from the modernising approach of the 2004 paper and represents a set back for investors and a competitive market place. Not only does it ignore the wider representation of services in the market place, but it constrains innovation by preventing companies and advisors from offering advisory based services with higher standards and fiduciary type responsibility.

A transaction based model limits retail financial services to simple transaction based outcomes and prevents the development of innovative solutions to the often complex needs of the individual investor. Such innovation would also reduce costs and enhance sophistication and hence place pressure on the current framework of product distribution, lowering costs and increasing competition.

Under a transaction based regulatory model it is important that investors are made aware of the nature of the advisory based relationship and the very limited nature of “suitability” and “advisor responsibility”. Unfortunately “suitability” is not clearly defined, although you can infer a definition of suitability from minimum industry standards. The current CRM project provides little definition of this obscure term and has to my knowledge neither performed nor commissioned research on the effectiveness, conflicts and limitations of transaction based suitability processes. It has not asked the question: “is this an optimal platform for delivering the full spectrum of wealth management solutions in the Canadian market place?”.

Suitability as implied, though not defined explicitly, by pre CRM rules and regulations and standard KYC documentation represented no more than a simple parameter to parameter based process: the investor stated their risk aversion, investment horizon and investment objectives and a couple of general pieces of information on net assets and income, and the advisor provided a product recommendation that met these parameters.

New rules require that the advisor consider “the account’s current investment portfolio composition and risk level” but provides no guidance as to the degree with which existing asset allocation and risk profile should be analysed. One would suspect that this is merely a simple process whereby all securities are re-fed through the KYC parameters; the only refinement being that if there is a risk allocation range selected by the client, that components of the account(s) that exceed the allocation range noted are reassessed with the investor. This is a refinement on existing rules, and is presumably designed to counter some of the most egregious practices.

However, irrespective of the amendments to suitability rules, the new set of rules, like the old, do not represent the range of services and processes delivered in the market place, and herein lies the rub: a perfect transaction based market place with rationale fully informed consumers with sophisticated suitability processes does not exist, though regulators, based on on-site investor education communication, presume it does – note the excerpt from the BC Securities Commission shown later in this document.

Given the very wide parameters that seem to be used to defend actions concerning unsuitable investments, it is difficult to visualise how the increased number of trigger points that require a suitability review (and the wider purview) will aid improved advisor monitoring of suitability and promote positive investor outcomes.

For example: portfolio management whereby a set of securities are combined within a portfolio to provide a balance of risk and return that matches a specific investment style, structured according to a specific portfolio discipline and personalised to individual investor risk preferences and financial needs is dependent on a set of processes over which the advisor has discretion; constructing such a portfolio (and communicating the risk and asset allocation benchmarks) is not covered by regulation of the transaction; yet, the reverse engineering required to ensure suitability of all securities within an account per the noted trigger points, is a portfolio process.

If the client is responsible for the investment decision, then the sum of all these decisions equals the portfolio: this means the client becomes responsible for the portfolio; this means the advisor needs to verify the client’s portfolio parameters and not just the transaction parameters.

We enter the relationship via the simple transaction, yet, over time, build up a set of assets whose responsibilities and complexities dwarf the ability of the simple construct to manage. In other words the KYC is not a transaction parameter set, but a portfolio parameter set with only a portion of the data and processes required being recorded.

Regulators are attempting to extend the transaction approach to the portfolio approach while retaining the limited nature of advisor and firm responsibility, which spells inappropriate management of the regulation of the actual service process in situ. This is surely a sleight of hand. Regulators, at the very least, need to provide guidance to both advisors and consumers as to what type of outcome and process should be covered by such reviews, and again the responsibilities of each party at each such review.

Therefore, despite the new rules, it would seem that all the advisor is responsible for, beyond correctly recording KYC parameters, is slotting the product into the right pigeon hole, for knowing and explaining the product, with the investor being held responsible for the rest of the process.

Please note the following excerpt from the BC Securities Commission Investor Education website “investright”.

*The advisor's suitability obligations require them to understand fully the products they recommend and trade on your behalf. Your advisor should know each product well enough to explain it to you and answer all your questions about its risks, key features, and initial and ongoing costs and fees. Remember: No matter how knowledgeable the advisor is about a product, it is only suitable for you if it supports your investment goals and fits your risk profile.*

*(Client) Your responsibility as a client is to play an active role in understanding your investments and managing your relationship with your advisor. You should also make sure that each of your investments contributes to your investment goals and that your portfolio remains within your risk tolerance. Be prepared to:*

- *Communicate clearly with your advisor about your financial situation, investment goals, and risk tolerance*

- *Read all research materials your advisor provides and do additional research on your own*

- *Ask questions (and keep asking questions) until you fully understand each investment you make and how it fits into your investment goals*

- *Thoroughly consider every purchase or sale decision that your advisor recommends to satisfy yourself that the timing and costs are in line with the proposed opportunity*

- *Pay attention to the information you receive from your advisor, especially your statements. Make sure you read them and check that the only transactions that appear are ones that you approved*

- *Act quickly if you notice an error on your statement, as some firms have a limited period of time in which to make corrections*

- *If you're not sure about any investment, consider asking for a second opinion from another qualified professional, such as a tax accountant, lawyer, or financial planner holding a professional designation.*

The path of regulators and regulation seems to be directed towards assuming greater responsibility and sophistication for investors while defining and supporting limited advisor responsibility. In fact, it is unclear (and disconcerting) as to why securities¡¦ commission educational content regarding investor responsibilities has moved in a way which supports the CRM project¡¦s retention of limited advisor responsibility in the wealth management process. Surely the individual securities commissions are responsible for protecting investor rights and interests? Who developed this communication and who approved them? An independent consumer panel would have challenged these developments.

A clear understanding of the often complex nature of aligning asset allocation and risk management with financial needs and personal investor risk profiles and preferences is missing from the regulatory tool kit. We are left with the implication (incorrectly) that suitability is a very simple issue that can be adequately managed by the current regulatory framework and simple information and relationship covered by the KYC.

- It is critical that the disclosure over the client/advisor relationship clearly states the limits of the suitability process and the responsibilities of both advisor and client within the regulatory context - it is clear that full disclosure will confuse and frustrate the transaction process, which is why it will probably not happen.

- Likewise, disclosure of the advisor/firm process used to define suitability is also critical in allowing investors to assess recommendations and services provided: the lack of a mandated disclosure of such places the investor at a significant informational disadvantage, robbing the investor of valuable information needed to facilitate an informed investment decision, not just about the product but about the type of advisor and relationship that best suits their needs. While this is clearly an imperfect (it assumes the investor can understand the communication) counterbalance, it is better than nothing. Required disclosure noted in the CRM proposals is insufficient and does not require disclosure of the actual process itself.

With the introduction of the CRM in its current form Canada has missed a golden opportunity to modernise and broaden the structure of retail financial advisory based services: investors need access to advisory based services with higher suitability standards and fiduciary type responsibility, and in the interests of competition, in the market place, there needs to be incentives to provide such differentiation.

Where are we going? Since 2004 when an attempt was made to modernise the retail financial services market place, all that has been achieved is an absurd strengthening of its defences.

## Appendix C – Blog Posts

### Mutual fund fees (Canada)–perspective makes it all the more complex and pressing an issue..

Clearly if you are in the business of facilitating “suitable” transactions, services must naturally wish to gravitate towards added added value frameworks that manage assets, relating them to the investor’s financial position and needs over time. Investors also need more than just simple KYC, paint by numbers, “suitable” transactions.

…Moving the industry to this higher ground, and those who advise in it, will not be easy. Such change will require different service processes, organisational structures, technology, skill sets and the interaction of these factors. It will also need to acknowledge the reality that differing abilities of clients to pay will also influence the client/”advisor” service interface.

Therefore, for many “advisors” it should be clear that there is no room, as is, under their current modus operandi, to move to higher service standards and still be able to earn current margins. It may be that they lack the systems, processes and expertise to deliver investment planning/proper financial planning/portfolio services, or that they lack clients with the assets and income level to afford the cost of these exercises.

### Too good to be true…again

….Some investors are suited to a transaction based system, but arguably, most are not. At a fundamental level however, even basic suitability standards cannot be delivered without complete product transparency and information about product impact on portfolio structure, and hence product relationship with other assets and financial needs and risk.

Many products would not be sold if an element of too good to be true, or a failure to represent the too bad, were not part of the package. In a sense this ability to sell products without adequate transparency lies at the heart of the inability of the limited suitability standards that frame the transaction business model to actually deliver “investor owned” suitable transactions.

….Investors, in general, will never be able to take responsibility for the investment decision in today’s transaction based industry because a) the necessary transparency about the product does not exist and b) because even if it were, most would be unable to understand the information to make a decision.

…..And so, really we come back to issues of fiduciary type duty, at a wider level, and the need to operate in the client’s best interests and, at a narrower transaction level, the requirement to ensure that the transaction is in the client’s best interests.

Current regulation of suitability standards and its codes, rules and processes are incapable of delivering the transaction and no amount of vigilance on the part of the ordinary investor can realistically change this outcome

### Products, should be no “Carrion Comfort”….

A market place based on high cost product distribution that relies on asymmetric information and meaningless disclosure cannot be good for the consumer. We need higher standards, a better definition of responsibility that acknowledges the complexity and realities of investment and the relationships that underpin its execution, and competition that spurs innovation to provide more efficient, appropriate and cost effective wealth management solutions.

## Anita Anand, “was” she not meant to be representing consumer interests as chair of the IAP?

…Now, I agree that under current regulation the investor is deemed to be responsible for the investment decision and that information passed to the investor is deemed to be sufficient to inform that client in making that decision, and that the investor is considered to be in the driving seat, but this is essentially what is wrong with regulation. It ignores the fact that many “advisors” represent their services in a far different light, that many products and investment issues are beyond the ken of the average investor, and that the information provided with an investment is often of very limited use in ascertaining the true risk and return profile of the investment, especially in a portfolio context. Most consumers are capable of understanding the generics of a solution and the generics of a product but are not capable of making informed investment decisions within the context of the complexity of a portfolio..

..It should not matter whether an investor truly understands the product or the complex dynamics of the portfolio, because an “advisor” focussed on providing a portfolio that manages risk and return for a given solution that meets the client’s risk and performance preferences and financial needs should already have recommended a solution that lies in the environs of one that meets the client’s best interests.

Canada’s retail financial service industry standards are not capable of providing the type of structure on which an investor, with their often limited understanding of the physical dimensions of risk and return, can make contextually informed decisions.

## Rob Carrick on best interests

…the CSA consultation, to my mind, is not about requiring “advisors” to act in their client’s best interests, but to implement a best interests standard for the transaction.

From what I understand, the current suitability process and standards remain the same! “Advisors” will continue, in the main, to be essentially sales people and the client will continue to be responsible for the investment decision, and the suitability process will continue to be a parameter to parameter process in the spirit of “pile ‘em high sell ‘em fast”, but unfortunately not “cheap”.

The difference between the two outcomes is, I believe, materially large: the former (Carrick’s interpretation) implies that the “advisor’s” whole raison d’etre will be to serve the client’s best interests, while the latter requires that the recommended transaction is one that best meets the client’s interests.

….Suitability of course comes before the transaction – it is the generics of the recommendation, the asset allocation etc – and it is arguably more important than the type of transaction. Carrick seems to think that “suitability” is a flawed standard, when in fact it is the minimum standards governing what the regulators consider sufficient to award a suitability sticker to the transaction that is flawed. Fiduciaries have to make sure that the generics derived from their suitability framework and the products/securities used to implement the framework both meet the client’s best interests. We are not replacing one standard with another here, that is suitability with best interests, but building onto the current weak suitability regime a supposedly more robust regulation of the transaction and the management of the transaction. In other words, you may still be able to make transactions that are in the “advisors” interests to recommend, but excessively churning them, or using inordinate leverage to do so, may be out.

## It is simple Ed!

Set up a new adviser registration under IIROC, one that has a fiduciary responsibility, much higher suitability standards, that allows advisors to provide advice as opposed to products, wealth management as opposed to transactions and charge fees and forsake commissions and keep it separate from the pirates and the booty.

## Failure to address suitability processes is in itself a breach of a regulatory fiduciary duty.

The integrity, transparency and accountability of the suitability process is where fiduciary duty matters most, and where its form, hegemony and influence reside. Also, if payment and process are in conflict so is fiduciary duty.

Representing to investors that "advisors" have a fiduciary duty to deliver a best interests solution while retaining the current very limited suitability framework would risk misrepresenting the truth and lead investors to place even greater faith in a deeply flawed parameter to parameter suitability process.

…..The suitability process is where fiduciary duty is born. The suitability process encompassing all the wealth management components relevant to your service, is what the investor is paying for, and why it cannot be the transaction. Retaining a commission based best interest platform is also obstructing proper pricing of the transaction, thereby impacting the evolution of fiduciary duty in the financial services industry. If payment and process are in conflict so is fiduciary duty.

## Trapped in the transaction mindset(?): Statutory Best Interests Duty, CSA Consultation Paper 33-403

Number 1 – The document fails to define what a best interests standard actually is. Even a principles based approach requires a framework and a structure.

Number 2- By retaining the current suitability standards, best advice would appear to be limited to the transaction, whereas, in fact, bests interests is the entire process of making a decision based on an overall assessment of the client's financial needs and risk profile in conjunction with an adviser's portfolio construction, planning and management disciplines.

Number 3 – The document appears to state that a statutory best interest clause is in itself a fiduciary duty. While a Fiduciary duty does require a best interests standard, a best interest standard with respect to the transaction does not in itself require a fiduciary duty. A limited minimum standards suitability process would inviolate the fiduciary duty itself and cloud an already tortuous road to restitution.

Number 4 – you cannot impose a best interests standard under Canada's product delineated SRO structure. Best interest standards should be product bias neutral.

## Regulate an advice based market place with a transaction framework and what do you get? Answer: farcical mayhem!

Most of the problems in financial services regulation here today stems from the fact that the industry has evolved into marketing advice based service processes while it remains regulated by a transaction framework. Advocis say as much in one of their key sentences in their submission, a fact which probably floats past the consciences of the CSA and our various governments:

> *"As a voluntary organization, Advocis is committed to professionalism among financial advisors. Advocis members adhere to an established professional Code of Conduct, uphold standards of best practice, participate in ongoing continuing education programs, maintain appropriate levels of professional liability insurance, and put their clients' interests first*."

In such a scenario industry lobbyists can use a whole host of contradictory and, at times, illogical competing claims to bamboozle regulators. Unfortunately, as things stand, many of the criticisms made by the industry are valid, but many by default only – that is the industry operates in a parallel universe outside of current regulation.

….In today`s regulatory framework the Fund Facts, as it stands, is insufficient disclosure for an investor to make an informed investment decision that would allow them to assume responsibility for the transaction. It might be sufficient as a simple primer for the average investor, where the advisor is responsible for the quality of the advice and the processes that govern that advice. But both current regulation and the level of disclosure are woefully inadequate in terms of protecting investors against a) unsuitable advice and b) products and securities that are not in their best interests.

….However, the introduction of common law fiduciary duty is indeed an interesting argument. Many do argue that the discretion over the selection of the product, the process that determines suitability, asset allocation and ultimately portfolio construction, the risk assessment process and much other suasion and discourse initiated by the advisor is indeed considered sufficiently discretionary to imply a fiduciary type responsibility and hence fiduciary duty. However, in the arena of products and securities in the advisory segment, regulators do not consider there to be a fiduciary, fiduciary type or even best interests obligation on registrants.

## CSA Cost disclosure and performance reporting update, part 3: the costs and benefits of advice!

….but the current definition of advice within the advisory segment of the market place is one which is very narrowly defined and regulated, and certainly not as accountable or as client focussed as many investors would believe.

Advice is limited to the suitability of the product within a narrow parameter to parameter framework, which is no more than a simple mechanism designed to match products with client profiles. The vast majority of these products add little competitive value and the CSAs proposals continue to allow the real value equation for most of these services to be obscured from view.

## No Fiduciary Standard needed in Canada? In whose best interests are these legal arguments?

I agree that with a simple and transparent parameter to parameter transaction model, presuming the investor is fully aware of the relationship (see previous blogs), it is difficult to argue that there is an element of discretion and hence there can be no discernible fiduciary responsibility, a great many relationships are however founded on much wider processes and service precepts requiring, to varying degrees, discretion and hence resulting in vulnerability to “advisor” decisions and processes. Once we move out of the simple transaction (where the paper trail of KYC and product disclosures are meant to suffice) we are often in a land where there is little or no audit trail of “advisor” deliberations, and as previously discussed, a presumption of almost omniscient discretion.

…The trouble is, because regulation does not acknowledge the existence of anything other than a transaction based relationship, investors have to take their disagreements to court, where it is the burden of the client to prove and the courts to discern whether a wider contract or relationship did in fact exist. Many investors are misled about the true nature of transaction based services and regulation. The relationship needs to be made very clear at outset so that the client can make an informed decision as to whether they want a transaction or an advice based relationship: I discuss this issue in my post “Just What is the Canadian Regulatory Model-“

…Again these duties are bound within minimum regulatory standards where “advisors” are permitted to sell financial products as long as they pass through the parameters of the KYC. With many of these parameters influenced by the “advisor”, what can be termed fair and honest and transacted in good faith can indeed be wide: remember the objective of the transaction, in the absence of a requirement to act in the client’s best interests, is first and foremost to sell and to earn a return on that sale. Many industry practices are anything but “fairly, honestly and in good faith”. Punishments can be fair and so can a prison sentence.

…If "advisors" are indeed providing wider than transaction based services underpinned by processes that are determined at the discretion of the "advisor" and that lie outside the expertise and knowledge of the investor, and the "advisor" represents these services are being in the interests of the client, and the relationship is such that the client depends on the "advisor" with the understanding of the "advisor", then there is a fiduciary type relationship, irrespective. If the process has integrity, if the generics of the process and the risks of the outcome and solution have been fully communicated, and the information in total provided by the "advisor" fully represents the service and the responsibilities of the service, then there is no way an "advisor" could be held liable for losses due to market events, because there would be no negligence: risk is risk and risk by itself is a not a reason for restitution. The imposition of a fiduciary standard will likely only impact those who act without discipline and process and who try to impose solutions and transactions that are either inappropriate or reckless.

…The arguments for the imposition of fiduciary type responsibility need to acknowledge the wider range of services that "advisors" provide clients and the actual level of discretion that they are exercising with respect to recommendations, timing, portfolio composition and a great many other actions that comprise the advice and structures delivered to investors. These arguments need to realise that there is a significant element of discretion, vulnerability and dependence in the relationship, but that there are also limits to fiduciary responsibility.

A well structured investment management process that is responsible for aligning a portfolio solution to the client's financial needs and risk preferences while managing risk and return over time, and that allocates portfolio profiles to client risk preferences and financial needs, and effectively communicates the generics of the process, is not going to be at risk of a breach of fiduciary responsibility. But an attempt to provide a higher level of service without these underpinnings would expose "advisors" to such and this is the only reason why I can see the need to advocate against the imposition of a fiduciary type responsibility. Yep, such a responsibility would air the "dirty laundry" we are so keen to hide.

## IIROC's New Client Relationship Model: a CYA memorandum ultimately lacking in transparency

Many mistakenly believe that their "advisor" is acting in their own best interests, and many also believe, to lesser or greater extent, that they are relying (in the fiduciary sense of the word) on the "advisor's" investment expertise and experience to fashion a portfolio of investments to meet their financial needs, investment preferences and risk profiles.

Quite how the average investor becomes responsible for the process as well as the ultimate decision is anyone`s guess, but I am intrigued by the recent addition to suitability guidelines:

`"a client's current financial situation, investment knowledge, investment objectives and time horizon, risk tolerance and the account's current investment portfolio composition and risk level must be considered when assessing the suitability of orders and recommendations."

Just what does the text emboldened in red actually mean? If the "advisor" is using their expertise and their own investment processes to determine what is appropriate, bearing in mind the composition and risk level of the investment portfolio, surely this is an action conducted at the discretion of the "advisor".

So, just what analysis is required to determine the composition, who is responsible for it, how is this to be communicated to the investor, what benchmarks and disciplines and processes are being used to determine an appropriate composition and risk level and how is the client expected to "own" the outcome?

I can understand how a simple product/security recommendation can pass through a KYC and still retain a perverse integrity (perverse in the sense that such a narrow frame of reference is going to yield imperfect outcomes in aggregate), but I fail to see how these wider suitability parameters are going to work in practise. Who is responsible, what level of discretion is being accorded to each party and what are the rules regarding transparency of communication regarding these determinations? Nothing still needs to be in writing!.

## Fiduciary duty: will it make a difference?

An important defining characteristic of a fiduciary type relationship is the extent to which the potential fiduciary concerned has discretion over decisions and processes.

In the simple transaction, parameter to parameter based suitability process of the Canadian retail advisory model, there is no presumed “advisor” discretion over the process: the relationship is a “simple” transaction relationship; the process is “transparent”; the client delivers the parameters; the “advisor” recommends suitable products within those parameters; the client “accepts” the recommendation after verifying parameter match and completing due diligence. In these laboratory conditions it is difficult to ascribe a fiduciary responsibility to this process.

If only it were this simple, and it is in the realm of relevance and context that the Groia report misses the point: most client/”advisor” relationships are one where the “advisor” has a considerable amount of discretion with respect to the determination of the KYC parameters, to what they recommend, to how often they transact, to the strategy and the mix of assets and hence risk and return the client ends up with. The process is wider in scope and complexity than the regulated process assumes. Additionally, it is this type of “discretionary” relationship which the “advisor” is selling and which the investor accepts.

When an eventual decision is made by the investor in these “wider” service relationships, it is often in the absence of the type of information needed to help them fully understand the nature of the recommendation, its integration within the portfolio and its interaction with their financial needs over time. This lack of information over the actual suitability process and rationale/discipline for the strategy, security selection and portfolio structure planning and management that is effectively being provided, also obscures the decision making process and enhances the level of discretion taken by the “advisor”. The information that would otherwise help reduce the level of discretion taken by the “advisor” in managing the investor’s financial needs and assets is just not there.

The transaction based model presumes that the investor has an adequate suitability process through which they manage their transaction decisions – it has to rest on some fundamental does it not?

In truth, most investors do not possess such a “working process” and this is substituted by the “advisors’” own processes. Furthermore, because portfolio construction planning and management is a much more complex process than a stand alone transaction, most investors are only able to understand and accept the generics of a process: this means that disclosure of information necessary to help investors make decisions over outcomes derived from “advisor” processes is not sufficient a condition for the investor to effectively take control over the process. In the realm of more sophisticated processes, the “advisor” will always be responsible for the integrity of the process.

In other words the “advisory process” in which securities and products are recommended and positioned is a much more involved and complicated process than that assumed under the simple parameter to parameter transaction model. A fiduciary type responsibility needs to be accorded to these types of relationships, for they possess the necessary level of discretion, and where there is such discretion and reliance, there is also the implication that the “advisor’s” actions place the needs of the client first and foremost. Importantly, these are not decisions over which discretion has been accorded by virtue of convenience (make these decisions, I do not have the time!), but they are process derived decisions which the client is incapable of making on their own, and hence the client is both dependent on and vulnerable (where these processes are without integrity) to this discretion – note Lac minerals ltd. v.

International corona resources ltd.

A greater focus on investor education will not solve the problems in the advisory segment, neither will the type of disclosure noted seen to date in mutual fund Fund Facts, nor the cessation of commissions on its own. The latter point, however, is more likely to force a move towards fiduciary type services and its regulation as “advisors” are forced to justify their fees, either going the way of more efficient product/transaction distribution or advanced service differentiation.

But, as I have argued before, trying to impose blanket wide fiduciary duty at the present moment in time is impractical – the industry is not ready for it – but there is an argument for allowing advisors and firms to deliver such and be regulated to such a higher standard accordingly. At the same time, we need the true nature of the regulated transaction relationship and its responsibilities to be communicated to the client and to prevent those “advisors” operating in this segment from “selling” any other service.

A fiduciary type responsibility should not be imposed on a simple client initiated transaction relationship, but should be applied to those services where there is considerable discretion and reliance on outcomes dependent on sophisticated services and processes and the integrity of those services and processes. Change will not happen overnight and unless there is wholesale change in regulatory structure, culture, vision and the balance of power between industry and consumer rights, change will not happen at all.

## Appendix D – The Role of Advisors – 2009 report excerpt

The roles, responsibilities and relationships of advisors are complex and lie at the heart of the retail financial services' market place in Canada and, indeed, most other countries: **regulation**, current business and service processes and objectives, **established distribution methods and culture**, technological innovation and development, **portfolio theory and investment software**, and many other factors impact and influence the functionality and utility of this isthmus between the industry and the investor.

Understanding advisor roles and anticipating their evolution in the face of a burgeoning dual imperative (*the current financial crisis and competition for the retirement income planning market)* requires the ability to assess advisor roles from a number of perspectives. For example, as resources and components of a business and service process (*many advisors have direct or indirect relationships with brokerages and product providers,*) the questions are many;

1. How efficiently are advisors being resourced, organised and utilised and to what extent are organisations and advisors concerned over productivity?

2. If their roles, tools and services need to change, are the parent companies/distributor relationships aware of these dynamics, and if they are aware of these dynamics, what are the dynamics of the relationship that will facilitate or obstruct the necessary changes?

3. Conversely, are advisors themselves aware of these relationships and to what extent do they obstruct or enhance the evolution of their own roles?

4. To what extent are both parties aware of the dynamics of their relationships and their impact on the market place?

5. What is the long term brand that advisors and their employers are trying to build and what risks are they willing to take with regard to their brand? Brand risk occurs when the outcome expected by investors with a product, portfolio, solution, strategy or service deviates significantly from the actual outcome: a combination of high costs, inappropriate risk management solutions, and financial, market and economic turmoil can all create the necessary margin.

A large of part of financial services marketing research is essentially spent delivering the intelligence and analysis to unlock the details and the dynamics that answer many of these questions.

### Roles of advisors

The **economic role of advisors** is to facilitate the allocation of capital within the capital markets; the **specific role of advisors** in the retail financial services market place is to take advantage of the need to allocate capital via one or more of the following:

a) To generate commission based revenue by selling products and initiating transactions (*retail, transaction driven*).

b) To increase asset based revenues (*investment counsellors/portfolio managers*).

c) To generate fees for services and advice.

Where advisors and their institutions promote themselves as providers of personalised and appropriate (*to risk aversion and financial needs*) wealth management solutions (*in particular retirement income* *planning*), advisors (*including institutions*) are also effectively responsible[1] for the planning and management of structures that can manage the short and long term risks of assets relative to client income and capital needs.

Advisors *(as well as institutions and product providers)* are ultimately responsible for making sure that the stated claims of a transaction, product and/or service with respect to that solution are, within reason, capable of being met[2].

The roles of advisors becomes more complex once they promote themselves as responsible and able to manage the short and long term risks to financial security central to wealth management and retirement income planning.

But, to what extent are advisors (*with parent institution/product provider relationships*), who promise wealth management solutions (*and who depend on a firm's investment resources*), responsible for making sure that the advice they give is appropriate, responsible and reasonable? This is important if we are to consider the appropriateness of roles and responsibilities for those roles, and relationships between advisors and the companies they operate within or are employed by.

> This question is important once advisors and their "employers" move from a transaction based service promise to a wealth and retirement income planning service solution framework: the responsibilities and the sophistication needed to deliver the services are much greater. Periods of financial, market and economic crisis can expose frameworks that are inappropriately structured to deliver wealth management and retirement income planning services.

In order to provide wealth management solutions, many advisors will depend on their institutions or employers to provide them with the market and economic risk assessments, the portfolio allocation tools and securities/products they can sell: most advisors do not in fact have the time, the resources or the necessary expertise to perform all the functions necessary to provide a responsible, reasonable and appropriate wealth management solution. In fact, advisors could find it increasingly difficult to compete in the wealth management/retirement income planning market, in the current environment, without such support.

> Again consideration as to the level of support advisors need to deliver services in a more competitive industry is important to defining roles and relationships, the structure of the business and service model and the integration of its components. It is also important to note that times of stress are also associated with regulatory change and regulatory change could have a significant impact on advisor and institution roles, responsibilities and relationships.

Institutions (*that aim to be competitive in the wealth management/retirement income planning market*) will ultimately be responsible for ensuring that advisors have processes and procedures that allow them to implement, responsible, reasonable and appropriate wealth management solutions. It is also a moot point as to what extent institutions can and should make sure advisors follow these processes and procedures: deviation from appropriate investment disciplines and structures poses a risk for both advisors and institutions, but system design (*integrated processes with hard and soft coded decision*

[1] Market participants assume a brand liability risk where they fail to ensure that advisor roles and services manage the risk of a significant deviation from advisor initiated expectations of outcomes and actual outcomes.
[2] The liability for failure being dependent a) on regulation, and b) the impact of the omission on the ability to compete in the market place and the cost of rebuilding confidence.

*rules*) can allow for variation in disciplines and styles whilst managing such liabilities[3].

**However, where advisors are involved only in selling transactions, the above is not the case. But, can advisors stay rooted to the transaction model and survive?**

While much of the Canadian retail financial services industry is still considered a brokerage/transaction orientated industry, it has become much more involved in promoting itself as a provider of wealth management solutions, and is developing more sophisticated retirement income planning solutions. In other words, its legacy framework is one structured around transactions, while its promoted business objectives and service solutions are service driven; the two are in conflict, with significant potential liabilities to market participants who fail to recognise the liabilities associated with such a shift.

> Admittedly, it has been easier, for a short period of time at least, for the industry to retain the legacy infrastructure to deliver a bigger message (change is not without initial costs and risks), but this bigger message requires a different platform and the liabilities of operating under two competing paradigms are significant.

Advisors and institutions who still operate a largely transaction driven model while trying to deliver a sophisticated solution are likely to be experiencing the greatest challenges and risks in the current environment.

The roles and responsibilities of those who only sell transactions and individual securities, without selling the risk/return management benefits of the whole package, are much simpler, but the business model is most likely in decline. Selling complex stand alone products may well provide a backstop to the transaction model, but these products are also much more easily sold direct to the consumer, and, indeed, much of the marketing in these new products has been directed at the consumer – this issue is addressed in specific subject perspectives on transactions versus service processes and internet delivery.

Whether "*what an advisor can and cannot do*" remains appropriate, depends on competitive market forces, the advisor's position within the market place (*niche and operational model*[4]), and the needs, wishes and objectives of suppliers (*if advisor is constrained by suppliers or corporate structure*) and buyers of products and services. Regulation also impacts "*what an advisor can and cannot do*" – issues regarding regulation and the impact of regulation on the industry will be explored in subject specific perspectives.

It is possible for advisors and institutions to remain within a transaction driven framework while promoting a service orientated business model, as long as the liabilities (risks) associated with such a framework are not exposed.

## Dual Imperatives

The roles of advisors and their associated business models are currently being questioned (*and exposed*) by dual imperatives;

a) the financial, market and economic crisis (*which is exposing liabilities associated with flaws and weaknesses in existing frameworks and services*), and

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[3] Development of processes (and systems) needs to be able to accommodate differences in advisor disciplines and processes while making sure that portfolio outputs are appropriate, responsible and reasonable.

[4] Sales reps, investment counsellors, financial planners/MFDA, independent, brokerages, commission/fee based etc.

b) the drive to develop products and services capable of managing retirement income planning (*which are improving and integrating business and service processes*) and ultimately total asset, life cycle wealth management.

The first has exposed the validity of existing transaction based distribution frameworks, practises, tools and solutions in providing wealth management solutions; the second is set to improve, challenge and change processes and control of the components of the process.

**The current financial, market and economic crisis**

The immediate financial crisis is an exogenous event that is placing stress on the competitive fabric of the market place; some of these consequences will be positive[5]. An industry with a large transaction based component structure is exposed to and less able to prepare for and manage the risks of the current event.

The significant gap between investor expectations of product and service outcomes and actual outcomes, that has arisen in the current environment, risks causing a reappraisal of industry standards, regulation, advisors' roles (*whether they be investment counsellors, portfolio managers, investment/insurance advisors, financial planners with securities licences*[6]), their expertise, disciplines and the products, solutions and services they provide.

- Should individual advisors (*or even small advisor groups*) be determining their own asset allocation, security selection, portfolio construction, planning and management strategies (*even where the building blocks are provided by their parent firms*) where **a)** this role can be better handled by a centralised resource and service process (*distributed via sophisticated software or complex stand alone products*) within a parent organisation, **b)** many of the loosely structured wealth management solutions developed under a transaction framework are unlikely to be able to manage the risks they once promised to deal with, especially when set against the benefits of centrally resourced platforms.

- Is the transaction based model conducive to delivering effective wealth management solutions, can it be adapted to be so, and, if not, how can it be restructured to meet the future direction of the industry?

    - Many of the structures and strategies (*as well as service components such as effective communication*) needed to manage retirement income planning effectively do not lead to transactions, meaning there is no return in a transaction structure, while a transaction driven business model often runs counter to the consistency and discipline appropriate to long term retirement income planning. Further discussion of transaction and service based models and retirement income planning are discussed in specific subject perspectives.

- The scale of the current crisis is seeing a large fall in demand for retail financial services in general: this will place stress on all components of the industry, especially on transaction driven

[5] If productivity rises, costs come down, (long term) gains to shareholders and value to customers rises and the transaction cost of capital in the market falls.
[6] This spectrum may appear diverse but all advisor roles and relationships are governed by the same fundamental factors impacting the delivery of wealth management services and solutions.

infrastructures, and, force it to seek more efficient distribution methods and/or more efficient distribution channels.

- Both advisors and institutions are likely to see pressure on earnings and margins and hence focus will need to be on improving the productivity of process while cutting operational costs.

This final reappraisal of the industry is likely to come from a number of quarters; consumers, regulators, product and service providers and advisors themselves.

### *Transaction based roles in upward and downward markets*

In a rising market, returns to transaction based business models increase the fewer restrictions there are on advisor roles and responsibilities (*the likely liabilities to brand will also increase*), but in downward markets, the risks associated with a prior excess will become evident, and the ability (*in a transaction model*) to provide the necessary discipline required to develop and support brand in the market place, will be less.

Additionally, if we consider that transaction models can become overly focussed on short term themes, we have yet another reason why wealth management and retirement income planning in particular require service based models with greater consistency of earnings as well as investment solutions: that is if a company wants to compete effectively in the retirement income planning market.

## Retirement income planning products and platforms

There has been an increasing focus on retirement income planning, and on what this perspective would term total life cycle wealth management. This focus is seeing financial services move into process driven service/complex product structures; whether or not a move to process driven service structures is intentional or not is unclear.

The trend towards process will impact the roles and responsibilities of advisors: providing a service that manages all an investors needs over time involves directly or indirectly managing the disposition of all assets and all financial needs over time; such a process is a big responsibility and implies managing all factors impacting risk to the ability of assets to meet financial needs, something which a transaction framework is not designed to do. Such a responsibility is also a liability if the framework cannot deliver, within reason, the expected contractual obligations.

Process implies a focus on automation *(needed to make implementation of process viable),* integration *(needed to effectively deliver process)* and formalisation (*of rules, structures and disciplines underpinning structures, relationships and/or solutions*). Process, and its automation, ultimately implies hard coded decision rules[7] for virtually every component of the financial and investment planning process.

Advanced processes are highly competitive methods of distributing wealth management expertise, solutions, services as well as transactions and products; these frameworks are also flexible with respect to the mode of distribution (*either on line, or by various levels of advisor input*). Should process driven solutions take centre stage, advisor roles will in future be beholden to such platforms, and, hence, advisor relationships with those that control process and the resources needed to fund process will become much closer.

When implementing process, care needs to be taken with respect to current advisor roles and relationships; this is especially the case with complex products with closed processes[8], since part of the advisor role is to add value over a long term relationship with their clients. Open processes (flexible platforms) are more appropriate for advisors looking to add value – discussion of open and closed processes is dealt with in specific subject perspectives dealing with integrated systems.

The development of process is likely to split into two components, complex stand alone products capable of being delivered within the current transaction framework and flexible wealth management platforms. Both these formats will ultimately challenge advisor roles and relationships.

Complex products such as the Variable Annuity with a GMWB rider were originally introduced to manage the retirement income problem (*and to reinvigorate segregated fund sales*) and have spread to life cycle wealth management objectives. While these products are designed to be sold within a transaction based distribution model, they are really heavily process orientated. While this particular perspective is not intended to discuss particular products, this will be dealt with in specific perspectives, it is intended to introduce factors that impact advisor roles and relationships. As such, both complex products and sophisticated processes tie the advisor into much closer relationships with product and platform providers and much more closely with process orientated service outcomes than stand alone simple transactions.

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[7] Hard coded decision rules imply much greater functionality, flexibility and higher levels of personalisation for wealth management services: they also mean less freedom to move outside those core decision rules in structuring, planning and managing assets. Soft coded (the ability to amend parameters and rules) for advanced users is a must.

[8] Closed processes provide limited advisor input once instituted and are less flexible.

## Advisor spectrum and business model relevance

Much of the retail market is transaction driven: advisors are remunerated by the number of transactions they execute and organisations look to maximise the number of transactions their advisors execute. Advisors are therefore important to those companies that directly or indirectly derive their livelihood from transactions and product sales[9].

Other areas of the retail market are fee for service based (or a hybrid of commission and fees), with advisors remunerated by assets under management, and organisations looking to maximise assets under management.

- Services that charge fees have fixed costs associated with substantial non transaction service components for which value is received and consideration needs to be made.

- Transaction based services focus on the transaction and have limited (*or rudimentary*) non transaction service components: it is therefore difficult for a transaction based service to provide an optimal wealth management/retirement income planning service model (*you may not be getting paid for much of your service component work)* or to move to a fee basis *(you would need to enhance non transaction service components*)**[10]**.

- Those that intend to stay transaction and commission driven will need to use complex process driven products such as GMWBs (with rudimentary product biased wealth management platforms), while those who intend to be service process driven will need to use sophisticated wealth management platforms.

- Both areas, the future transaction and the future service based components, will be pressured by any development in online wealth management systems and services and regulatory changes that foster greater competition in the market place.

    - Note that there are a whole host of pressures on the current business model that may ultimately favour much lower cost integrated, automated service processes that will impact both transaction and service based processes.

Both basic models (*transaction/service based*) are looking to maximise revenue growth and shades of both models operate at different levels of most organisations: discount brokerages, full service brokerages and investment counsellors are options available on most financial services entities' websites.

The reasons for the number of different models operating under one roof are many and include (as a major factor) the cost and complexity of providing optimal asset and liability management solutions.

If there were systems in place that took away the complexity of delivering sophisticated asset and liability

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[9] Most companies that sell products generate their returns from longer term activities (asset management) and not the transaction, which, is a cost of doing business and not a return: the more notable of these activities is the return on managing assets or insuring liabilities. A move towards process would shift competition away from remuneration towards value added by financial services' providers.

[10] It is important to note the differences between a transaction driven sale's process and a service based process in terms of the rationale for charging and the limitations and scope of the services provided. This is addressed further in the perspective dealing specifically with the differences between transaction based and service based processes.

management (*key to delivering optimal retirement income planning*), there would be fewer reasons to retain a transaction driven infrastructure at the wealth management service level, and fewer reasons for complex process driven products; in fact, in such an instance, processes for structuring, planning and management could ultimately be uniform throughout the net worth spectrum[11].

In terms of the physics of the wealth management investment solution, the output for a high net worth investor should be no different for that for a low net worth investor: personal service and the trappings of a personal service would differ, but the fundamental investment solution should be the same.

> The barriers to implementing advanced systems and more efficient processes are significant in well established transaction driven market places.

While this perspective focuses specifically on advisor roles and responsibilities, competitive business models and processes (*which are assessed in separate specific subject perspectives*) for the retail financial services industry are joined at the hip with advisor roles and relationships. Also, as implied by the above discussion, industry service segregation (*broker/investment counsellor/hybrid, transaction/assets under management/competitive fee based)* is a function of physical characteristics of delivering a service and the regulation, technology and competition specific to each service segment. Awareness of each relationship is key to understanding the dynamics of advisor roles, responsibilities and relationships.

Institutions therefore need to be clear as to the future viability of a particular business model with respect to advisor roles and relationships and the reasons why their business model continues to remain relevant or not, as the case may be. They also need to be clear as to how their business model and the role and responsibilities of their advisors within that business model will need to change in response to changes in factors impacting the physical delivery of wealth management solutions.

In Canada advisor roles are heavily influenced by **a)** the special relationships between advisors and the business arrangements in which they operate, **b)** the specific regulated industry segment (IDA, MFDA, Insurance) that determines the securities and products available, and **c)** regulation, industry standards and transparency.

Any factor that can impact competition in the market place (*regulation, market environment, technology, supply of services and products, needs and preferences of consumers*) will impact the viability of a business model and hence advisor roles and relationships within that business model. The current dual imperatives discussed are significant, and, in this context, firms need to proactive with regard to the direction and development of advisor roles and responsibilities; in a changing or exacting market place, advisors should embody the culture, disciplines and ethos of their business model and brand. Brand, as discussed in the specific subject perspective is far more important in an organisation looking to develop wealth management and retirement income planning services in particular, than an organisation looking to merely provide a receptacle for client transactions and product sales.

## Points for consideration and research

Advisor roles are under stress for two main reasons as discussed: the financial, market and economic crisis and the drive towards more sophisticated processes for the management of the retirement income planning/wealth management problem. These two reasons will also impact regulatory and technological factors associated with competitive markets as well as the important consumer demand preferences for

[11] Making retirement income planning services profitable for lower net worth investors depends on high levels of automation and less advisor interaction: this reduces unit costs and increases volume with lower fixed costs.

financial services and products. If advisor roles are stressed, so will the business models under which they operate.

Advisor roles could clearly change with greater control moving towards providers of advanced service processes (platforms) and with advisors favouring added value service process offerings in preference to higher transaction remuneration. Therefore, building advanced service offerings, offering training and facilitating assimilation into new service programmes are also issues the retail financial services industry needs to consider.

Understanding your own business model, its current and future direction, its strengths and its weaknesses relative to dynamics forcing change in the industry is a prerequisite to understanding advisor roles and responsibilities.

Advisor roles and responsibilities are under pressure to change and given their importance in revenue generation, it is important that both advisors and institutions are geared towards enhancing their ability to compete in a much more competitive market place.

But, change will not be without challenge as much of the current distribution framework and culture is incompatible with higher productivity, integrated business service processes. Awareness by both advisors and parent company/employers is key to dealing with these challenges.

This series of perspectives and reports will look at the dynamics impacting the roles, relationships and responsibilities of advisors, with future research mapping and exploring the developing dynamics of change and the issues likely to impede, help or shape change itself.

Companies that operate integrated process driven service solutions would likely centralise security selection, asset allocation, investment and investment planning decisions leaving advisors to implement this and to develop client advisor relationships.

This type of structure would limit advisor say in selecting products, and tie the advisor to the institution or wealth management solution provider concerned.

Many advisors may resent such intrusion and view it as a limitation of their roles (which it would be for transaction based advisors), but it is reasonable to assume that many advisors would also appreciate the greater flexibility (afforded by advanced systems in terms of planning and risk management), and control over factors likely to impact service and asset management outcomes.

Advisors who compete on service would decide who to align themselves with service providers with competitive processes and services as opposed to greater share of transaction remuneration. Many advisors would no longer be brokers or transaction conduits but investment planners, relationship managers and communicators of a service process. Aspects of the transaction market place would continue to operate for some time but would likely be at risk as marginal demand for services moved to service based frameworks.

Of course, not all advisors are looking to provide solutions to the management of retirement income planning issues: many just want to be able to sell products and transactions. Institutions will need to decide what type of advisors they will be looking to attract or focus on within their business models, since this will impact the service process they can deliver, the experience clients will receive and associate with their brand.

With much of the current distribution system focused on transaction based relationships, as opposed to advanced service based processes, moving towards a service based process could risk alienating distribution based advisors, but it could also risk alienating companies from their future market place.

## Summary conclusion

If companies believe that advisors continue to represent a very important source of revenue, a very important method of distribution and an important method of delivering their brand message, they will need to seriously address how the current crisis and the drive towards process are likely to impact the role of advisors, and how advisors can be used to support their own competitive position in the market place through development of appropriate products, services and processes.

Some will no doubt see no need to change their roles, whereas other companies may start pushing the envelope in their attempt to develop their business model, their wealth management brands, their competitive position and their service proposition with a view to maintaining margins and protecting and growing revenue.

It is important to note that if companies are to develop a wealth management/retirement income planning brand, they will need to make sure that this is directly reflected in advisor processes: advisors roles will effectively be determined by business and service process disciplines and decision rules under pinning systems delivering services.

If solutions are indeed to be found in automated integrated processes, this will allow for lower costs to investors, higher added value and lower costs to wealth management service providers. Automated integrated processes will protect margins and enhance competition, but they will significantly change advisor roles from those found in transaction based models.