# <u>Comments on the Fair Dealing Model Concept Paper</u>

March 1, 2004

I am a registered representative of many years experience, all with a bank-owned investment dealer.

First, let me say the OSC is to be congratulated for producing the FDM. It is a truly radical proposal that should result in very positive changes for our industry and investors if it is implemented. But because it proposes radical change, it will be opposed by many within the investment industry who prosper under our present rules. These forces will defend the status quo to the bitter end. However, all who work in this industry are aware that our clients are often not well served. Therefore, the FDM is a most welcome proposal. Frankly, I am amazed that such a proposal has come forth, rather than just a proposal for tinkering at the margins of our problems.

Here is my personal feedback on some of the subjects on which you requested comments:

Page 24 – "Should we allow representatives who do not meet the current ICPM compensation or proficiency requirements to form Managed-for-You relationships under the FDM? Would this improve access and reduce costs for investors?

**Comment:** I strongly believe that seasoned representatives who meet certain educational requirements and who have clean compliance records should be allowed to have Managed-for-You relationships. The education requirement should be a CIM or some other similar qualification, or possibly even a new designation. A CFA is simply too high a hurdle to meet, and in effect leaves the retail investment industry in its present state of affairs, with advisors being unable to operate on a Managed-for-You basis.

<u>All Managed-for-You relationships should operate on a fee basis, just as IC/PMs and institutional investors do.</u> For the first time ever, the much better governance of the institutional portion of the industry would be carried over to the retail side. It has always amazed me that the retail industry has historically run on commissions, a method of compensation that wouldn't be tolerated for a moment by institutions. Now that the retail business is starting to move towards fee-based accounts, the natural accompaniment to this would be discretionary management.

The reality of retail is this: the great majority of clients don't really understand how markets work. They don't understand, no matter how often it's explained, that when interest rates rise, bond prices fall. Most investors couldn't tell you the difference between a preferred share and a common share, and they don't know that fixed income securities are bonds and t-bills, and equities are stocks. They <u>*trust*</u> us to know; in effect we are in a fiduciary relationship already. But we don't act like fiduciaries, we act like stumbling amateurs who must get approval for every transaction that occurs, even if the client doesn't have a clue what he or she is approving. Why don't we just call a spade a spade and admit that we are already in a fiduciary relationship with most of our clients? Let's formalize it by working within the Managed-for-You relationship.

Many investment counselors and portfolio managers will undoubtedly suggest that permitting retail advisors to operate on "Managed-for-You" basis will result in the investing public being poorly served, in that some retail advisors have demonstrated a lack of professionalism by badly managing client accounts. What is being overlooked is that the traditional retail compensation model has been badly skewed with issues of third party compensation, as you point out so well in the concept paper. As well, it is almost impossible to try to act like a fiduciary when your livelihood has historically depended on the number of transactions you carry out in your client accounts each month. I would suggest that many IC/PMs would be just as unprofessional in their conduct if they operated under the retail industry's compensation schemes.

Let retail advisors operate on the same level playing field as IC/PMs, with the same fee-based compensation, and allow them to have "Managed-for-You" relationships. Only at that point will a true comparison of the qualities of IC/PMs and retail advisors be possible.

In terms of costs, clearly if retail advisors are able to operate "Manged-for-You" accounts on a fee basis, and if all third party compensation is eliminated so that all compensation is received from the client only, then investors will have a very clear picture of costs, and cost competition will definitely take place. If third party compensation continues in any fashion, then it makes it more difficult for investors to make cost comparisons. True competition will not occur because of a lack of transparency.

The Self-Managed relationship is suitable for the small number of clients who are truly educated about investing (although discount brokerage clients are probably no more educated about markets than other investors, and often use their accounts for casino-like activity). The Advisory relationship is appropriate for those clients who can actually contribute knowledge and ideas in a two-way relationship with their advisor; again this would be a relatively small number of clients. The majority of clients need a fiduciary relationship, whether they are willing to admit it or not, and the Managed-for-You relationship is the real heart of the reforms proposed in the FDM.

Page 41 – "What is the best approach to address the problems we've identified with third-party compensation?"

**Comment:** In Appendix F there is an excellent discussion of compensation biases. In the end, it becomes clear that the only real choice to make if we want to end third-party compensation issues is to require the industry to operate only with class F shares. Clearly, if this should take place, mutual funds for all three contemplated FDM client relationships will have to be held in fee-based accounts, not commission-based accounts; to have F class shares held in commission-based accounts would be a travesty. (As stated above, all Managed-for-you relationships must only use fee-based accounts, otherwise a fiduciary relationship will not exist.)

An incidental benefit of only permitting F class mutual funds is that it will also make it much easier to calculate fee costs for clients, as discussed on pages 72-74. As well, a good part of the FDM concept paper deals either directly or indirectly with the complications and problems of our present use of front and back-end loaded mutual

funds. A move to the exclusive use of class F shares, along with the creation of advisors being able to move into a Managed-for-You relationship, would be a tremendously positive step for the industry.

If advisors only receive compensation from their clients, it will greatly widen the kinds of investments considered for portfolio inclusion. For example, F class mutual funds and index-based ETF's would now be on a level playing field, so to speak, and I expect there would be a huge surge in the use of ETF's by advisors. Everyone knows that there is very substantial evidence that indexes tend to outperform most active managers over longer periods of time, but at the present our industry pooh-poohs this evidence, sweeping it under the rug. Of course, this is because ETF's don't have trailer fees, and they don't offer a 5% up-front commission hit like a back-end loaded fund.

I think we all know that DSC mutual funds are the "crack cocaine" of the industry. We all know the abuses that result from this method of compensation: the yearly 10% withdrawals, which are then reinvested in new DSC funds; the full redemption that occurs once the fund's commission schedule has expired, and the subsequent reinvestment in a new DSC fund; the high MERs; the expensive coddling and feeding of advisors by the mutual fund industry through wholesaler networks.

DSC mutual funds harm the industry in another way: advisors can come into the business and with a relatively small book of business, churn their way to a reasonable living. This reasonable living is achieved at great expense to clients and to our industry's ethics.

Of all the reforms contemplated by the FDM, a move to the exclusive use of class F mutual funds is going to be the most controversial. The howls and gnashing of teeth will be heard loudly from St. John's to Victoria. There will be predictions that it will mean "the end of the industry," and that thousands will be driven from their jobs. But you should hold your ground and proceed anyway, because you will have right on your side (which everyone will admit privately, but refuse to acknowledge publicly). There is a well-known precedent for such regulator-imposed radical industry change: the abolition of fixed commissions in the brokerage industry. Again, the industry loathed this change, but it had to be done, and guess what: the industry didn't disappear, in fact it grew and prospered. The key to this reform, once it's proposed, will be to not back down in the face of strong opposition. As you suggest in your concept paper, there may be a somewhat rocky adjustment period, but in the end we will have a better industry and our clients will be much better served.

How would we make the transition to the exclusive use of Class F shares? Regulators would have to give the industry reasonable notice (18 months?) in order to allow all firms to create fee-based accounts. Then, from the "Big Bang" day onward, only F class shares would be offered for sale in Canada. During the transition period leading up to the change there would have to be careful monitoring to ensure that client accounts weren't being improperly stuffed with DSC funds.

One final point on fee-based accounts: there is one form of "third party compensation" that you didn't discuss, and that is the purchase of new issue securities in fee-based accounts. Again, the FDM should require that that any new issues placed in fee-based accounts should result in the new issue commission being rebated to the client, against fees owing. I can tell you from personal experience that there is no ban on

"double dipping" at the present time with the industry's fee-based accounts. This cannot be allowed to continue under a FDM regime.

Page 68: "Is it important, or even possible, to achieve risk measurement consistency across the industry…"

**Comment:** To talk of betas and standard deviations to clients would be a complete waste of everybody's time. As you note, handing over a 335 page mutual fund prospectus is not a satisfactory solution to our problems and simply doesn't fit in the FDM mold; similarly, trying to explain betas and standard deviations to clients who cannot give you a definition of a dividend yield, is doing them a disservice. In a severe bear market, stocks with betas less than 1.0 get clobbered too – try telling Mrs. Client that her blue chip utility stock that went down 50% (TransCanada Pipe, Telus) was only "moderate risk."

Here is how I would convey risk to clients in all three FDM relationships: rather than use the terms "high risk," "low risk," and "moderate risk" which connote some kind of concrete quality, I would use the terms "higher risk," "lower risk" and "medium risk." These terms suggest a range of risk, rather than a precise level of risk. I think this subtle change brings us closer to the truth, which is that it is not possible to define the risk of any security or portfolio with total precision. The reason I say this is because it is possible to lose money on almost any security, even short-term government fixed-income securities. With the term "low risk" I think clients will come back and say, "Hey, you told me this 1 year Government of Canada bond was low risk, but I took a capital loss when we sold it early – what gives?"

Here is a "quick cut" on how securities could be classified:

**Lower risk**: all investment-grade government and corporate bonds/short term paper of less than 5 years maturity. All P-1 and P-2 rated preferred shares retractable within 5 years. All mutual funds that consist of one or more of the above.

**Medium risk:** all corporate bonds rated BBB of any maturity. All investment-grade government and corporate bonds longer than 5 years. All P-1 and P-2 preferred shares retractable beyond 5 years, and all P-1 and P-2 perpetual preferreds. All mutual funds that consist of one or more of the above.

**Higher risk:** all other securities, including (to name a few): common shares, equity-based ETF's, all corporate bonds rated less than BBB, all unrated bonds (this will encourage issuers to seek ratings), all other preferred shares, and all other mutual funds.

These classifications should be printed on every monthly statement for all three FDM relationships, and a graph of the client's "risk exposure" could be provided, like the graph on page 5 of Appendix E. In clear, large writing it should be stated:

- **The three risk classifications incorporate two measures of risk: *price volatility*, and *capital risk*.**

- **Notwithstanding the risk information provided for this account, it is not possible to precisely measure risk levels for particular securities or portfolios, and the classifications provided are simply one way to measure risk.**
- **It is possible to lose money on the securities of any risk classification, including "lower risk" securities.**
- **Securities can move from one risk classification to another.**
- **If you any questions about the risk composition of your portfolio, please call your advisor right away.**

Each security on the client's monthly statement could be marked "higher risk," "medium risk" and "lower risk." The client could glance from the graph to the securities, and back again, and get a real feel for how much risk is in his/her portfolio. As well, I think it's a great idea to have the "targeted" risk exposure of the client's portfolio, as defined in the FDM document, placed beside the account's current risk profile (as per graph on page 5 of Appendix E). Obviously, if there is a noticeable discrepancy, either the FDM documents will have to be modified by the client and advisor, or the portfolio will have to be rebalanced. The amount of "discrepancy" permitted before something has to be done will provide a good subject for debate.

Re: page 27 of Appendix A - I have a problem with the risk parameters for the account (percentages), as laid out in the box at the bottom of the page. First of all, the percentages inside the grid only add up to 95%, but even if they added up to 100%, the statements in the boxes are apples and oranges statements. The last statement, "I am willing to accept a little short-term price volatility in order to try to get higher returns" calls for a yes/no answer. The statement above it, "Percentage loss of principal at which I would like BigBank Securities to call me about reviewing this account," has nothing to do with the two high risk/low risk percentages above it. And if you're going to ask about high risk and low risk in this table, what about medium risk? Well, you've done that below, at the bottom of the page – but then doesn't that make the table above redundant? In summary, the lower half of page 27 of Appendix A is confusing. Final note on this page: I have a problem with the statement, "Percentage loss of principal at which I would like BigBank Securities to call me about reviewing this account." Some clients are going to want to hold large percentages of medium and higher risk securities, and then ask to be called when the portfolio drops 5 or 10%. This is like driving with your foot on the accelerator and the brake at the same time. We would be fools and unprofessional to accept such accounts. Any client who answers 5% or 10% to this question should be required to invest 100% in lower risk securities. There should be a mechanism in place to make sure that the answer to this question aligns properly with the risk profile.

Page 71 – Should we prescribe the formula for calculating personalized returns? Should we approve a number of acceptable alternatives?

**Comment:** Transparency is one of the core values of the FDM. As such, you should mandate one industry-wide formula for calculating personalized returns (which is a tremendously good idea, and high time). If firms use many different formulas, it will

become difficult for investors to understand returns and make valid comparisons. I don't think the OSC would tolerate the mutual fund industry using many different return formulas, so why permit more than one formula for the retail investment industry?

In fact, you should mandate the formula be the same as that of the mutual fund industry, with simple concepts that investors are already used to: 3 month, 6 month, 1, 2, 3, 5 and 10 year annual compound returns, and "since inception." This provides the best possible transparency for investors in that you could measure your personal account return against a mutual fund return, or some other benchmark. Armed with this kind of clear information, investors could make better decisions about who is doing a good job of investing for them.

Page 71 - Should performance information be provided to investors for each individual security, or only for the overall portfolio?

**Comment:** I believe you should only provide an overall portfolio return, not a performance return figure for each security. Again, the mutual fund industry and the institutional side of the business only provide overall returns, not returns on each security, and I believe the FDM should try to make retail practices more like institutional practices.

You have to work in the retail brokerage industry to fully understand why I take this position. Sophisticated investors understand that portfolios are made up of securities that have risen in price, and securities that have declined in price, and that the overall portfolio return is a weighted blend of all these returns. Many retail investors, on the other hand, become fixated with abnormally high returns, and abnormally low returns, on individual securities. And, I regret to say, their reaction to these abnormal returns can lead to actions that hurt portfolio performance.

*Typical client reaction to stock that has quadrupled in price (Nortel in 2000):* "Boy, that's a good one – sure wish I'd put more money into it a year ago. Do you think I should buy some more now?"

*Typical client reaction to stock that has declined 50% in price (CIBC in 1998):* "Jeez, I want to sell this bank. It'll be years before it recovers, now that the government has turned down bank mergers. What a dog!"

Clients are entitled to know how their portfolios have performed over time, and benchmarking is fine too. But if the FDM requires that each security carry a positive or negative return beside it, what you will find is that advisors will, under subtle client pressure, engineer the portfolio to the point where as many securities as possible have a positive return beside them. This focus would take away from properly managing the portfolio. It would become more of a "beauty show" than a portfolio. You wouldn't ask an institutional money manager to manage a portfolio in this way because ultimately it would harm overall returns. Would we ask Peter Cundill, Warren Buffet or Peter Lynch to operate in this way? Then why ask retail investment advisors to do it?

Page 71 – Should we consider requiring statements to provide gross and net returns?

**Comment:** As stated above, I think we should have a system for reporting portfolio returns that copies that of the mutual fund industry, which is one of net returns. The difference between gross and net returns is cost of management, and that can be provided as an aggregate dollar figure once per year, as you suggest on page 72. Again, the spirit of the FDM is transparency and clarity, and clients are entitled to know how much they pay for investment management. These costs will be much easier to calculate with the abolition of third party compensation, i.e. only class F shares being permitted for sale.

**Concluding comments:** Vigorous, real reforms always face stiff opposition from entrenched parties who have an interest in maintaining the status quo. My greatest worry is that the FDM will be watered down, following consultations with "important industry players." <u>You should ask these "players" why they have never demonstrated an interest themselves in the issues raised in the FDM.</u>

For example, my own firm cannot be bothered to provide proper software to calculate client portfolio returns. (Their present software is full of bugs, and the data must "cleaned up" manually before the calculation is made. I don't use it, because I simply don't trust it to be correct. A few months ago, the firm sent out a lengthy list of "fixes" that had been completed for this software; it must have been a real eye-opener for those advisors who had been using the software, thinking it was okay.)

Other questions I don't have answers for:

Why do the mutual fund ACBs on my client statements not match those on the records of the mutual fund companies? Why does my firm have an active policy of suppressing the account statements from mutual fund companies, statements which contain the only accurate ACB figures? How are we going to calculate portfolio returns if our mutual fund costs are not accurate?

Why does my firm still not prepare and send out an accurate Statement of Capital Gains/Losses? (And don't let them tell you that our desktop software can prepare such a statement. It includes such items as t-bills and strip bonds in its summary; these have to be manually deleted because they are interest income, not capital gains. Plus, it incorporates all the inaccurate mutual fund ACB's I just mentioned above. As well, it would only be sent out if the advisor chooses to send it out. And most advisors don't, because it's not worth the paper it's printed on.)

Why does my firm prepare deluxe client statements that have rate-of-return information, graphs, etc. for its expensive wrap programs, but not for ordinary accounts? Do clients have to pay a 3% MER to receive a statement that will actually tell them their rate of return?

Why does my firm's fee-based account permit additional fees (.25% - .50%) to be charged on Class A mutual fund held within the account? (These funds were probably transferred in from the client's old commission-based account. Shouldn't old DSC and front-end funds be "grandfathered" with a zero fee in such a case?)

Why does my firm make a huge marketing push on something called "Client Commitment," when in reality there is no commitment to the simple, basic things that all

clients should have (i.e. rate of return information, capital gains/losses statements, accurate security costs on their monthly statements, etc.)?

Good luck with the Fair Dealing Model. I'm sure you will be greeted with a chorus of "Can't be done," "That would be too expensive to provide," "We've never done that before," and "Are you sure clients really need this?" Just remember that Canada's bank-owned investment dealers have enormously rich parents. Surely they, and the rest of the retail industry, can afford to provide the basics for their investments customers, and then step up to the higher standard of the Fair Dealing Model. We'll all be better for it.

I want to thank you for the opportunity to provide comments on this proposal.