May 3, 2004

John Stevenson
Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55

Dear Mr. Stevenson:

We are writing you to provide the comments of our Association on *The Fair Dealing Model* Concept Paper ("Paper") of the Ontario Securities Commission ("OSC"). We are pleased to have the opportunity to comment on the Model, and at this time we are providing our views of the concepts raised.

Our Organization and Its Members

To provide you with some background on our organization, Independent Financial Brokers of Canada ("IFB") is an association comprised of independent life insurance and mutual fund agents – financial services professionals. As our name suggests, our members (about 3,000 in Ontario) operate as "independents" who are not bound by a proprietary contract to market the products and services of any one mutual fund or life insurance company.

Our members answer directly to their clients – not to the financial institutions, and this, in itself, is a protection for investors. Most of our members have left 'captive' firms for the very reason that they want to serve their clients in a better and more ethical way than was possible with their previous firms, which did not value independence. They want to offer their clients the best product for the client, not what they are limited to by their employer.

Our members and other 'independent' advisors (to a large extent) offer their clients financial advice and products from areas besides mutual funds, including life insurance, deposits, property and casualty insurance, financial planning, etc. Few deal with their clients regarding securities.

It is not recognized in the Paper that such a distribution system exists. We suggest that consideration of this system would prove useful in considering client/advisor

relationships especially in light of the increased responsibilities on representatives recommended in the Paper. These responsibilities appear to require the representative to have a large base of financial and technical resources – which our members and other independents do not have, ought not to be expected to have (based on revenues), and are not required to have under present regulations.

IFB has previously stated that we object to a Model that appears to be predicated on the false notion that advisors are unethical and dishonest, and clients are not knowledgeable about investing.

Our Comments on the Model

In our response, we will comment primarily on the concepts that are set out in chapters I, II and III. We believe that consideration of the Practical Details and Transition considerations should await a review by OSC after considering industry responses to the Paper, which might effect changes in the overall concepts.

Consultation

In the Introduction it is alleged that consultation has been "broad and deep", when, in our view, there has been a dearth of consultation with industry associations and other regulators. We believe that consultation with industry associations individually or together in the Joint Industry Group ("JIG") would have resulted in a more practical approach, that might have been more widely accepted and would have recognized the role of SROs to a greater extent.

As invited in the Paper we have attempted to engage some of our members in the Working Groups, but have been told that the complement of the Groups is full and that we'd be placed on the waiting list.

At the one meeting we did have with the OSC (through JIG) we suggested that the underlying concern of the *Fair Dealing Model* (namely consumer protection) has been addressed in a more rational and realistic fashion by the Joint Forum of Market Regulators and its Practice Standards Sub-Committee in its concept paper, released in July 2002 entitled, the *Practice Standards Project*. This initiative seeks to develop a common set of standards and principles throughout the financial services industry and throughout the country (which we believe is a worthwhile goal). These practice standards measures, such as 'holding out' provisions, disclosure, and confidentiality, are more practical and workable than the heavy-handed approach we are seeing in the Fair Dealing Model ("Model").

We are pleased to see that the OSC has changed its mind on some of its initial proposals, most notably, the early proposal that the ideas and concepts put forward in the Model be applied to the life insurance industry (an area over which the OSC has no jurisdiction). We do not believe that the Model would be appropriate for the life insurance area. However, we are now left with the impression that dual licensed individuals may find themselves regulated in different ways in servicing the same client.

II. The Need for a New Approach to Regulation

We found the section on conflicting interests and loyalties to be disturbing in its assumption that, because there may be conflicting interests seen in the industry, representatives are motivated by them. In fact, the biggest motivating factor for the representative is to serve the client in a way that will build up an atmosphere of trust and keep the client happy. It is a well know axiom that the client most likely to provide business opportunities is a current client – not a prospective one. Most independents pride themselves on the trust their clients have in them. For a representative to act as is suggested in the paper would be, at best, shortsighted.

Please also see our comments regarding conflicts on Page 9. Structural conflicts of interest exist in the 'captive' or employer-employee relationship, which is biased to the products of the employer.

Further, while the "Know Your Client" form and procedures have their limitations, they are similar in concept with what's being recommended in the Paper.

<u>Regulations Have Been Less Responsive to Industry Evolution Than the Courts</u>

This section is an aspect of the Paper that concerns us. We do not object to the concept that the courts have been more effective at setting standards of practice. The courts have the advantage here in that their reviews of the regulations are done on an ongoing basis, so that there is a constant state of evolution. They also consider individual cases through which the problems with particular regulations may be more clearly illustrated. In citing the cases on page 14 of the Paper, there is a lack of rationale to suggest that new regulation would change the way the courts will look at advice issues between a representative and the client, bearing in mind the courts' propensity to look to equity. We deal further with the interpretations of the courts under "Three Relationships" below.

III. Core Principles of the Model

<u>Three Relationships</u>

The Model proposes that in setting up an account "investors and representatives would select the relationship type they find most appropriate" from three categories. Our comments on this limitation to three relationship types follow:

We do not believe that limiting the types of relationships between investor and representative is essential to bring clarity to the division of responsibilities between them. Further, we do not believe that limiting the type of relationships in this fashion would make disputes easier to resolve, as set out on page 30 of the Paper. In the recently decided Ontario Court of Appeal case of Sprott v Adams, Mr. Justice Cronk stated as follows:

> The extent of the duty of broker to client beyond the bare duty of executing instructions and being honest is thus a question of fact in each case of what passes

> between broker and client. A duty to warn does not arise from the mere relationship of broker to client, but from the facts.
>
> In essence, the existence of a duty to warn is dependent on the standard of care owed to a particular client. Accordingly, the specifics of the relationship between the broker and the client must be analyzed to determine whether a broker has a duty to warn a client...For example, it cannot be said that the same standard of care exists between [a discount brokerage firm, which does not provide advice, and its client] as would exist between a broker and a client who relied on the broker to manage a discretionary trading account. Nor can it be said that the standard of care for a client who is interested only in speculating is the same as that for a client who relies upon the broker for advice on a long-term investment.

In any event, we are of the view that it is unrealistic to condense the relationships of investors with their representatives to only three (3). There are many relationships now in existence that work well for both parties and both would probably view a change of the order being suggested here as a diminishment of the service to be provided. An example is with 'wrap accounts', which are often complex and offer more than one 'type' of service and, thus, relationship. Besides having a 'wrap account' relationship with a client, a representative might also serve as his/her financial planner. Further, it is not rare for such relationships to evolve with clients slipping into and out of the advisory/self-managed aspects of the relationship over time.

Also, the Model does not take into account areas of the financial services business the OSC does not regulate. There would be relationships outside of the Model, which might impact advice within the Model and perhaps liability for the representative. As stated above, many representatives are dual licensed, some give income tax advice, etc.

Forcing common standards on investors ignores the fact that they are engaged in an exercise they hope to profit from, and are not looking for "standard" relationships or advice. Many want (and are willing to pay for) custom relationships in order to further their goals. It should be recognized that financial and investment plans for each client are as different as a fingerprint. While it is stated in the Paper (page 53) that: "(T)here is flexibility within the model for investors and representatives to accept different levels of responsibility for asset allocation decisions, as long as they document their choice", it is difficult to see how this relates to the "3 relationships" concept.

While some investors might wish to avail themselves of a self-managed type of account for mutual funds, current regulations allow this only through discount brokers. Other representatives are required by regulators to discuss the suitability of the investment with the client, and in doing so would probably be held by a court to have been providing advice. The proposed duties on an investor to take on responsibility for 'critically assessing any communications from the representative" and for "verifying, through the information the firm provides, that trading instructions have been properly completed and that confirmations and account statements reflect those trades" would make it tempting for a court to find the actual relationship to be "Advisory". The potential for increased liability would make it risky for a representative to enter into such a relationship, despite the need for such account types by investors.

We do not believe that by defining what constitutes “advice” (as set out on page 25) by the regulators will likely constrain the courts in their interpretation.

Fair Dealing Principles

Principle # 1 – Clear allocation of responsibilities

As mentioned above, we do not believe that the establishment of three categories is necessary to have clarity in the area of responsibility in the relationship between the customer and the representative. We think it is important to recognize that the customer ought to be able to have an equal voice in his/her relationship with the advisor, and as the investor, ought to be able to “custom build” that relationship if desired.

We note the comment on page 29 of the Model as follows:

> We would consider responsibilities to be “clearly established and documented” if both the investor and the representative are aware of them, and document them plainly and concisely in a contract. It is important for each of them to understand both their own and the other party’s responsibilities.”

Further on page 53, we note the comment not seen earlier in the document under “Client suggestions” that: “there is flexibility within the model for investors and representatives to accept different levels of responsibility for asset allocation decisions, as long as they document their choice”. This seems to suggest flexibility, or possibly a “fourth” category or relationship, which in our view wouldn’t be a bad idea.

Principle # 2 – Transparency

We note that the Paper suggests “that all dealings with retail investors should be transparent”. One dictionary definition of the word “transparent” is: “easily seen through or detected; obvious”, and another is “free from guile; candid or open”. The Paper’s definition seems to relate solely to disclosure by the representative, which implies that all the investor knows about the dealings and the subject of them, is disclosed by that representative.

There are many factors which might allow the investor to perceive financial dealings with clarity: previous experience, other parties, the media, the company or fund being invested in, etc. In such situations, communications such as are set out on page 32 of the Model are not only not required by the average investor, but not wanted. It is recognized that a representative should assist an investor to have a clear understanding of the situation and that a neophyte will require more attention. The amount of disclosure should relate to the investor’s level of sophistication relative to investments.

In the Joint Forum Principles (mentioned above) this issue was simply dealt with as follows, under the heading “Needs of a Client”: “In order to understand the client's interests, the intermediary must obtain or confirm information about the needs of the client and, when making a recommendation, must reasonably ensure that any product or

service offered is suitable to fulfill those needs." The accompanying note says: "In assessing the needs of the client, the intermediary should take into account the financial significance and complexity of the product or service being sold."

The four key areas OSC has set out are dealt with below:

Essential features of the investment – in the context of the Model, our members advise their clients regarding mutual funds. We believe that the essential features are well understood by the public generally. Again, where the proposed client is a neophyte, care is taken to clarify this means of investing.

Risk Transparency - this is a recommendation that is fraught with difficulties. The relationship between the investor and the representative does not, of course, exist in a vacuum. There are many sources of investment information made available to investors. It seems ironic that the very people the OSC accuses of being motivated by self-interest are the ones chosen in the Paper to be the educators of the public. Education is not the role of the financial advisor, whose time should be spent being an expert at his consultative position to help clients achieve their goals and objectives. Time spent in the classroom educating consumers is time spent away from this goal. An advisor's time and value to clients is best spent learning, studying and observing the financial world, not teaching it. If the extra task of 'educating' is put on advisors, clients will be the ones who pay for it, putting a burden on their investment returns.

The public is considered in this Paper to be ignorant and in great need of protection. Perhaps this view comes from the 'bear market' that has caused losses in the equity markets over the last few years or the economic times and/or the failure of securities laws and regulators to protect the public against the Enrons and Tycos of the world.

Media companies spend millions of dollars on investment-related material for the public – including daily listings of securities sold in Canada and the United States, as well as an incredibly large amount of information on mutual funds. The major financial institutions (i.e. globefund, morningstar, etc.) all provide daily updated information on the internet. In the Toronto area, there are four daily newspapers with this information, as well as a Canadian television station and U.S. station (available on cable) that are dedicated to the dissemination of information which is clearly intended for public consumption and, from the amount of material available, is clearly popular. As well, there are companies such as Thomson involved in the gathering and dissemination of such information. These sources of financial information offer the advantage of being viewed by the public as being fair and without bias. Surely, it is to these sources the OSC should look for public investment education - not the representatives.

The huge amount of information available in our society was recently illustrated in an article written by the editor of the Globe & Mail dated Saturday, April 3, 2004, where he stated as follows:

> Business reporting is one of the most challenging areas of newspaper journalism because of the flood of commoditized information coursing across screens at all hours of day and night, including the offerings from the family of Globe and Mail

> websites. As such, we will be striving throughout the week to bring more meaning to our business stories….

Compensation transparency – IFB believes that the method by which the client directly compensates the representative, whether it be by front or back-end load, ought to be disclosed to the prospective client and the client.

It is a stated objective that "transparency is a key tool for managing compensation-related conflicts of interests". If such is the case, then compensation transparency should be required of salaried employees of financial institutions who are incented through contests, trips, salary increases, performance bonuses etc., based on the sale of financial products. Proprietary vendors and their affiliates should also disclose when they are benefiting.

Account Performance – we agree that the account statements many firms put out could and should be improved upon in terms of letting investors know how their investments have performed. However, dealers pass along the costs of such 'tweaking' to our members and other independents who, in turn, receive their revenue from some of the sources the Paper proposes to modify or eliminate. Our members and other representatives in the mutual fund area have recently been subjected to large increases in costs brought about by the creation of the Mutual Fund Dealers Association and the compensation fund.

We do not believe that the client should be put to the cost of an analysis of portfolio risk to be included with account statements.

Principle #3 - Management of Conflicts

We mentioned above that the Commission should consider the work and concepts of the Joint Forum of Financial Market Regulators (of which it is a member) for regulation in the financial services area. The Joint Forum Practices and Principles considers conflicts of interests and recommends principles to deal with them.

Here is principle number 1 entitled "Interests of the Client" and it states: "The client's interests take priority over the intermediary's interests and should not be sacrificed to the interests of others." An appended note states that this principle is paramount and that "all remaining principles and practices expand upon this fundamental principle."

Under the heading "Conflicts of Interest" the Principles set out as follows: "The intermediary must avoid situations where the underlying circumstances could tend to prejudice or bias the direction of advice he or she provides. In the case of a conflict of interest, the client must be made aware of the nature of the conflict before the transaction takes place." The accompanying note explains that if a situation arises where a conflict exists and cannot be avoided, the condition can only be mitigated by objective, plain-language disclosure to the client of the nature and impact of the conflict. The client must then be given an opportunity to halt the transaction, to seek other professional advice, or to knowingly proceed with the transaction.

We believe that such Principles, while simpler than the proposed Model provide equal or greater protection for the client, and are in line with what a court would look to in order to see what duty the representative owed to the client. It would thereby serve as one of the goals of the OSC, as enunciated in the Model, in providing a court, tribunal, etc. with specific rules by which to measure the conduct of the representative.

We believe that the recommended requirement outlined in the section "Conflicts arising from the structure of firms" is appropriate as it would prohibit tied-selling, which is often an odious practice through which an advisory relationship is used to sell other products at a higher than market cost.

Third Party Compensation

Third Party Compensation is set out on page 38 of the Model as a "Special Case". In this section, compensation paid by investment funds to representatives is dealt with – particularly the practice of "back-end loads" and "trailing fees".

As mentioned above, in line with our views on transparency, we believe that the method through which the client directly compensates the representative, whether it be by front or back-end load, ought to be disclosed to the prospective client.

With respect to "trailing fees", which are paid by the mutual funds, we believe that these should be disclosed as part of the MER of the fund, much like the other cost items of the fund. We do believe that it'd enhance the understanding of the client if the various aspects making up the MER were to be provided in an easy-to-understand form on a dollar cost basis or percentage basis (or both) – to include compensation paid to representatives, administrative costs, compliance and regulatory costs, taxes, etc. We think that trailing fees are no more of a direct cost to the investor than the other costs listed above which are paid by the dealer.

We note that the marketplace, recognizing that some investors do not need the ongoing advice and other benefits offered is offering F-class funds, which have a lower MER by about 1%.

IV. Practical Details: How the Model Would Work

Although we set out above that we believe that Practical details should be worked out only after the concepts have been reconsidered, we do have some comments to make here as they relate to or expand on the concepts found earlier in the Paper.

In particular we would like to comment on the area "Increased responsibilities for representatives", found on page 51. Here we are concerned about the "greater responsibility … for informing investors, and for assessing and interpreting information they provide to their clients, including information received from third parties". One concern is the suggestion that they "take a more active role in assessing and explaining issuer information". This information is prepared by the issuer based on legal and regulatory requirements, which are presumably there to benefit investors. Lawyers, financial experts, compliance people, etc are involved in the preparation and

dissemination of this information to protect the issuer from liability. It is unrealistic to expect a representative to ignore all of this and reduce it all to simple terms. It is arguably the role of the regulators to enable such documentation to be simplified for investor understanding.

Communicating the risk levels of individual securities – This is an area where we see real difficulty. There are too many variables involved to be able to assign a risk number on individual securities. To accomplish this in our opinion would require the national rating services and an agency such as the Toronto Stock Exchange. It certainly would be beyond the resources of independent representatives such as our members to perform such an onerous, weighty and risky role. It is doubtful that an errors and omissions insurer would insure our members for this at any price, thus robbing investors of an important protection.

V. Transition to the Fair Dealing Model

A second concept paper will follow

The single service provider license

We were interested to read the proposal for a single license, but were concerned about the one idea on page 84 which seems to contemplate solely an employer-employee relationship. We suggest that the OSC consider the models which now exist in the life insurance business whereby there are independent as well as 'captive' or employed agents. As mentioned above, independents (such as our members) are not subject to direction from financial institutions as to what products they offer to their clients – they can, and do, offer what's best for their clients, which is an additional protection for investors. Employees must operate under instructions from their employer even if this conflicts with the client's best interests. They must conform to solely offering their employer's products and are not trained or educated on other products in the industry. They cannot offer objective advice. This is an excellent way to avoid conflicts – particularly structural ones.

A general comment is that the greater burden of regulation and educational responsibilities, that the Paper recommends, will make it more difficult for the small investor to procure advisory services and will make what services they can procure more expensive. It is arguably this category of person who needs the mutual funds advice the most. Representatives won't want to service them without adequate compensation, which the customer with small assets probably cannot afford.

Regulators should not be in the business of prescribing compensation and should not be involved in the commercial aspects of the contracts. Pricing is best left to a free, open and competitive market. Creation and innovation in an industry is not brought about by a government agency. For present and future generations to be able to meet their financial goals, they will need new and innovative products which can only emerge from a free market. It is the current market which has brought commissions down from the original

9% front-end loads investors once paid. Closed markets are not innovative, open or price competitive.

We appreciate the opportunity to have submitted our comments to you, and will be pleased to discuss them with you. Please feel free to contact John Whaley at the address shown on the letterhead, by phone at 905-279-2727 (toll free – 1-888-654-3333), fax 905-276-7295 (toll-free 1-888 424-2359)or by Email at jaw@ifbc.ca.

Sincerely,

David Barber
President

John Whaley
Executive Director