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June 11, 2004

Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, Ontario M5H 3S8

**Attn.: Mr. John Stevenson**
**Secretary**

Dear Sirs/Mesdames:

**Re:** ***The Fair Dealing Model: Concept Paper of the Ontario Securities Commission* - January, 2004**

## INTRODUCTION

We are writing on behalf of The Investment Funds Institute of Canada ("IFIC") and its Members to provide our comments on the *Fair Dealing Model* ("FDM") *Concept Paper* (the "Concept Paper") released for comment by the Ontario Securities Commission ("OSC") on January 29, 2004.

IFIC is the national association of the Canadian investment funds industry. IFIC's membership includes fund managers representing nearly 100% of the $464.6 billion in mutual fund assets under management in Canada[1], retail distributors of investment funds and affiliates from the legal, accounting and other professions.

[1] As at March 31, 2004 – source IFIC Member Statistics.

## EXECUTIVE SUMMARY

### GENERAL COMMENTS:

Fair dealing concept (page 5)
We support improvements to transparency and disclosure of compensation, conflicts of interest and risk. Designating this new initiative as the "Fair Dealing Model" unfairly implies that industry participants are not presently dealing "fairly" with their clients.

Cost/benefit analysis (page 5)
The Concept Paper notes that a cost/benefit analysis of the FDM will be completed when specific requirements are finalized. Such an analysis is essential to a full evaluation of the model by industry participants.

Harmonization (page 5)

(i) General - Significant reforms should only be implemented when they can be implemented on a "national" basis. To do otherwise, undermines the progress that the CSA has achieved to harmonize securities regulation across Canada.

(ii) Dually-licensed registrants - Harmonization also includes the development of like rules for like products. Implementing radical changes to securities laws subjects the dually-licensed adviser to two very different regulatory regimes even though they are providing similar products and advice to the same client.

(iii) Achieving OSC objectives by other means - Several regulatory initiatives, both current and proposed, can achieve the OSC's goals more quickly, less expensively and with less industry disruption than the FDM proposals.

(iv) Role of SROs - MFDA and IDA rules and oversight must be analyzed in order to determine whether the reforms contemplated by the FDM are justified.

Industry consultation process (page 8)
The FDM development process should be expanded to permit more opportunity for industry consultation.

Licensing and registration issues (page 9)
Relegation of detailed discussion of licensing, registration and proficiency issues to a second concept paper is a significant weakness in the FDM consultative process. These issues are integral to any assessment of the FDM yet they remain unknown variables.

Investment advice and financial planning (page 10)

(i) Advice-driven relationship model versus product/transaction model - We are unable to determine which aspects of the advice-driven relationship will be subject to regulation and how compliance will be ultimately determined since the FDM does not define "advice" nor does it propose to circumscribe its limits.

(ii) Investment advice versus financial advice/planning - We are unable to distinguish among the ranges of activities intended to be encompassed by advisers who provide "investment advice", "financial advice" and "financial planning". These terms are frequently referred to in the Concept Paper, but are not defined.

Costs (page 12)

(i) Small dealer firms - Increased costs resulting from the FDM will force small dealers out of the market thereby restricting investor choice and access, and reducing competition.

(ii) Investors with small accounts - Increased dealer costs will also force advisers to forego dealing with clients with small accounts.

(iii) Compliance providers - FDM suggestions that dealers could engage third-party service providers to assist with compliance responsibilities may not lead to rigorous compliance since the service provider may find itself in conflict.

Closing Remarks (page 14)

## DETAILED COMMENTARY:

Appendix A - Conflicts of Interest Issues (page 15)

(i) Compensation - Proposals concerning current industry compensation practices appear to be biased. Advice-giving, financial or otherwise, is a vocation like any other and advisers should be paid for their services.

(ii) Self-managed accounts - The Concept Paper inappropriately extends the self-managed accounts category to include a range of services beyond mere execution.

(iii) Unsolicited orders - Current industry practices for unsolicited orders serve investors well.

(iv) Mutual fund dealers who sell proprietary products - Will firms that only sell proprietary products be considered to be different from firms that sell proprietary securities *and* those of third party issuers?

Appendix B - The Transaction (page 18)

(i) Point of sale - It is inappropriate to require dealers and their advisers to "interpret" mutual fund manager initiated information, the form of which has already been passed upon by regulators.

(ii) Information Sheet - We question the practicality of the requirement to "quiz" the investor to ascertain whether the investor understands the disclosure set out in the proposed Information Sheet.

(iii) The client/adviser meeting - Requiring face-to-face meetings each and every time a client and adviser discuss and agree to execute a transaction is impractical and does not reflect industry practices, other than initial client and account opening meetings.

Appendix C – Compensation (page 20)

Third party compensation - Transparency with regard to third party compensation is an important aspect of any adviser/investor relationship. However, prohibition of such compensation as a means of facilitating transparency is unnecessary. The payment of commissions and trailing commissions to dealers by fund managers is an efficient way for advisers to be compensated and should not be interfered with absent: (i) compelling evidence that the current system is flawed; and (ii) a careful and comprehensive analysis of the impact on both investors and industry participants, and of the costs as against the benefits.

Appendix D - The Fair Dealing Document (page 25)
KYC forms in current use by dealers may be outdated. However, the proposed FDD is unnecessarily cumbersome. Its objectives could be achieved by modifying and standardizing the current KYC form. Detailed comments on the proposed FDD sections are also provided.

Appendix E - Transaction Summary (page 29)
(i) Responses to specific requests for comments - Many of the transaction summary proposals are impractical and will be difficult to implement.
(ii) Verbal transaction summaries - If transaction summaries are mandated, the FDM proposals should make allowances to permit verbal transaction summaries and transaction summaries by telephone as is the current practice.

Appendix F - Trade Confirmations (page 31)
(i) General - Current practices with regard to trade confirmations serve investors well. We disagree that additional and detailed information on trade confirmations is required.
(ii) Compensation disclosure - We have several concerns with regard to the compensation disclosure proposed to be required on a trade confirmation.
(iii) Trailing commission disclosure - Trailing commission disclosure statements should be provided to investors at the point of sale.

Appendix G - Account Statements (page 33)
(i) Performance calculations - Standardized performance calculations are necessary to create a level playing field among all investment products.
(ii) Risk information - Risk reporting should only be mandated once regulator-sanctioned and enforceable calculation standards are put in place.
(iii) Target returns - Requiring advisers to state target returns on account statements conflicts with current disclosure requirements intended to warn investors against reliance on past performance, and any such statement is sure to be construed as some sort of guarantee.
(iv) Trailing commission disclosure – The system changes required to produce trailing commission disclosure on account statements are significant and, in our view, not justified by any incremental benefit that would accrue to investors.
(v) Responses to specific request for comments - Responses to specific request for comments are provided.

## GENERAL COMMENTS

### Fair dealing concept

We support improvements to transparency and meaningful disclosure with respect to compensation, conflicts of interest and risk. While the Concept Paper indicates that the development of the FDM was motivated by a perceived need to update the current regulatory structure, it does not provide information as to the problems perceived to exist that would, in our view, justify the wholesale changes to the regulatory structure contemplated by the Concept Paper. In addition, we are concerned that designating this new initiative as the "Fair Dealing Model" unfairly implies that industry participants are not presently dealing "fairly" with their clients and could engender public confusion and mistrust in the securities industry.

We are also concerned that many of the examples of practices singled out for special attention in the Concept Paper appear to relate to the mutual fund industry, to the exclusion of other financial or investment products. We remind you that mutual funds in Canada today represent perhaps the most transparent and regulated of investment products available to investors. For example, Canadian mutual fund disclosure, a key focus of the Concept Paper proposals, is defined by a complete code of mandatory and prescriptive rules that exceed those applicable to most other investment products and virtually all other non-investment financial products.

### Cost/benefit analysis

Part V of the Concept Paper *Transition to the Fair Dealing Model* notes that a cost/benefit analysis of the FDM will be completed when the specific requirements of the FDM are finalized. We are of the view that such an analysis is essential to a full evaluation of the model by industry participants. Such an analysis will be particularly helpful in determining whether enhanced transparency and more meaningful disclosure could be achieved more economically by other means, including through regulatory initiatives already proposed or underway.

### Harmonization

(i) General

The OSC publicly supports the establishment of a "national" system of securities regulation and the harmonization of securities legislation across Canadian jurisdictions.[2] Similarly, the OSC has acknowledged the negative impact of "single-jurisdiction" initiatives on the goal of harmonization.[3] The Concept Paper describes the FDM as a "significant reform"[4] of the regulation of the retail investment industry. To our knowledge, no other Canadian jurisdiction has expressed public support for the FDM. Accordingly, this represents a contradiction of the

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[2] For example, the OSC is a member of the Uniform Securities Legislation Project Steering Committee, which is working towards establishing nationally uniform securities laws.
[3] See, for example, the letter of June 27, 2003 from D. Brown, Chair, OSC, to D. Hyndman, Chair, British Columbia Securities Commission, re B.C's *Proposals for Securities Regulation Reform*, which asserts: "To be effective, reform needs to be accomplished on a harmonized and national basis." (at 2).
[4] *Concept Paper*, at 1.

OSC's stated views on the desirability of harmonization and we do not comprehend why the OSC has decided to propose the implementation of the FDM without the endorsement of the Canadian Securities Administrators ("CSA"). We assert strenuously that this, and any other significant reforms, must be implemented only when they can be implemented on a "national" basis. To do otherwise, undermines the progress that the CSA has achieved to harmonize securities regulation across Canada.

(ii) Dually-licensed registrants

Many life insurance products have attributes similar to those of investment products and many individuals are currently registered to sell securities *and* licensed to sell life insurance products. The OSC does not have jurisdiction over the sale of insurance products but, nevertheless, proposes to regulate these products. Implementing radical changes to securities laws, like those proposed under the FDM, will subject the dually-licensed adviser to two very different regulatory regimes even though they may be providing similar products and advice to the same client.

Obligations imposed by the FDM on both the adviser and the client for securities transactions are more onerous than those applicable to the sale of insurance products. It is foreseeable that this will encourage dually-licensed advisers *and* clients to favour insurance products over securities resulting in the anomalous situation that a regulatory structure intended to eliminate conflicts that could influence advice would actually foster such influence. It is also possible that dually-licensed advisers will simply abandon their securities businesses to avoid the additional costs and other requirements of the FDM thereby reducing public access to the capital markets.

(iii) Achieving OSC objectives by other means

As proposed, the FDM assumes a need for wholesale changes to the way that investors and their advisers[5] deal with each other. We suggest that many current and already-proposed regulatory initiatives could achieve the stated goals of the FDM more quickly, with less industry disruption, and likely at far less cost to industry participants.[6] For example, we believe that the following initiatives could be applied (either as they exist today or with minimal, incremental revisions) to achieve the FDM's goals of enhanced transparency and investor information, meaningful disclosure, more easily understood information for investors and the limitation and disclosure of conflicts of interest in the adviser/investor relationship:

- Proposed National Instrument 81-106 *Investment Fund Continuous Disclosure* ("NI 81-106"), which proposes to implement a new continuous disclosure regime for

[5] As in the *Concept Paper*, the term "adviser" will be used in this comment letter to denote an individual registered under current securities legislation as a salesperson of a mutual fund dealer, or a salesperson of an investment dealer.
[6] We also acknowledge statements made in the Concept Paper that, if adopted, the FDM is intended to *replace* existing regulation, not merely add an additional layer. We are of the view that, should the FDM be adopted in the form of a new set of rules, the removal of existing, duplicative regulatory provisions must occur concurrently with such adoption.

investment funds thus providing investors and advisers with timely and useful financial and non-financial investment fund information;

- The Joint Forum of Financial Market Regulators' Consultation Paper 81-403 *Rethinking Point of Sale Disclosure for Segregated Funds and Mutual Funds* ("CP 81-403"), which proposes to address many current concerns with the provision of timely, understandable information to consumers in a practical and cost-effective manner. This initiative has the added benefit of achieving a degree of harmonization between mutual funds and similar products that would otherwise be outside the purview of the CSA;

- Proposed National Instrument 81-107 *Independent Review Committee for Mutual Funds* ("NI 81-107"), which proposes to require mutual funds to have an independent committee charged with reviewing any conflicts of interest that may arise out of the management of the funds and making recommendations to the fund manager as to how these conflicts may be fairly resolved;

- Investment Dealers Association of Canada ("IDA") working group initiative, which is currently working on revising the "know your client" ("KYC") information collected by IDA members;

- OSC Rule 31-505 *Conditions of Registration*, which imposes, in subsection 2.1(2), an obligation on advisers to deal fairly, honestly and in good faith with clients;

- National Instrument 81-105 *Mutual Fund Sales Practices* ("NI 81-105"), which ensures that industry participants give priority to investor interests and sets standards of conduct for mutual fund distribution activities; and

- National Registration Database ("NRD"), which is a web-based system that permits dealers and advisers to file registration forms electronically under a harmonized and improved process thus facilitating enforcement of existing and future rules across most Canadian jurisdictions.

(iv)Role of SROs

The Concept Paper proposes a move away from "product-based" regulation. However, in our view, it does not adequately deal with the effect that such a move would be expected to have on the two existing and product-based self-regulatory organizations ("SROs")- the Mutual Fund Dealers Association ("MFDA") and the IDA. SRO membership was mandated as crucial to investor protection by the OSC only three years ago in 2001. Since that time, the IDA has significantly increased its resources and the MFDA has built and brought into operation a new organization intended to, *inter alia*, "[enhance] investor protection and [strengthen] public confidence by mandating, monitoring compliance with, and enforcing rules and practices to ensure high standards of conduct by its Members."[7]

[7] MFDA Mission Statement, see: www. mfda.ca\about the mfda.

The creation of the MFDA harmonized, to a great extent, the regulatory regime applicable to mutual fund dealers and their salespersons. The creation of the MFDA provided hitherto unavailable dedicated compliance and enforcement resources to the mutual fund dealer constituency. The creation of the MFDA was effected at great cost to the industry. These costs included start-up costs and direct fees paid to the organization by members, the costs borne by industry participants in adapting their systems to MFDA rules and the countless hours of consultative input provided by industry volunteers.

In our view, it is still too early to judge the overall effect that the MFDA has had on the industry. Likewise, the MFDA's future role in implementing the goals of the FDM cannot be discounted. In addition, any regulatory proposal that would undo the inter-provincial harmonization engendered by recognition of the MFDA and the IDA in multiple jurisdictions, in the absence of the fully-formed proposal for a new licensing/registration model (discussed below under the heading "Licensing and registration issues") would be viewed by industry participants as a step away from serving the best interests of both investors and the industry.

Prior to proceeding further with the FDM, we submit that the OSC should undertake a rigorous analysis of the body of existing and proposed regulation, including SRO rules, to determine whether the investor-focussed goals of the FDM could be accomplished within the current regulatory structure. We submit that the OSC should also conduct and publish for comment a rigorous analysis of the effectiveness of the current SRO system, including any oversight concerns, before moving ahead with the massive structural changes that the FDM proposes. Each of these analyses would assist industry participants in understanding and evaluating the FDM proposals. Absent such analyses, we submit that the OSC has not justified that reforms of the scope proposed in the Concept Paper are necessary to address the perceived problems set out in the Concept Paper.

## Industry consultation process

We commend the OSC for establishing six industry working groups (the "Working Groups") as a means of obtaining industry input. As the recommendations of these Working Groups may have an impact on the final form of the FDM, we reserve comment on any issues that may emerge from the Working Groups until such recommendations are made public. At this stage, we would like to raise the following concerns relating to the consultation process:

- We understand that the Working Groups have been established to consider issues surrounding the *implementation* of the FDM and are aware that such Working Groups have already commenced meeting. Given their implementation-focussed mandates, we are concerned that these Working Groups may be hesitant to address broad policy issues which, we would submit, are the appropriate focus for such Working Groups at this stage in the consultation process. Consultation focussed on implementation issues surrounding aspects of the FDM should only go forward once broader industry concerns raised in the public comment process have been assessed by the OSC and the FDM amended to take valid comments into account;

- We believe that it may be necessary for the OSC to create additional Working Groups including (i) a Working Group whose focus would be solely on the FDM's compensation disclosure and reporting proposals (discussed in Appendix C of this submission); and (ii) a Working Group to establish standardized risk definitions and measurements for all types of securities (discussed further in Appendices D, E and G of this submission);

- There should be an opportunity for commenting parties to identify other issues requiring Working Group input. For example, the Concept Paper states as an assumption that the mutual fund industry is currently preparing to invest in broad technology upgrades to accommodate straight-through processing ("STP") and that these new infrastructures and systems can easily be adapted to achieve FDM objectives[8]. We note that many issues relating to STP, particularly in the context of investment funds, remain unresolved and believe that the FDM's blanket assumption to the contrary is inaccurate[9];

- The Concept Paper is extensive at 258 pages and was released for a three-month comment period during the Registered Retirement Savings Plan/tax season when financial services firms are traditionally preoccupied with client matters. We are appreciative that the OSC has granted IFIC a comment extension. However, other industry stakeholders might not have been able to devote the time required to properly review and comment on the FDM thus distorting the comments that the OSC does receive. To this end, we submit that the comment period should be extended until at least September 30, 2004 to permit all constituencies to canvass the many issues raised by the FDM. Such an extension would also permit discussion of the Concept Paper at the many industry association conferences scheduled to take place between now and September 30, 2004; and

- We question the apparent weight assigned to the comments in the Concept Paper's Appendix G *Feedback from Fair Dealing Model Website*. These comments were obtained anonymously via electronic mail and, in our view, should not be overly relied upon.

**Licensing and registration issues**

In our view, one of the most significant weaknesses in the FDM consultative process is the relegation of detailed discussion of licensing, registration and proficiency issues to a second, and as of yet unpublished, Concept Paper. These issues are integral to the FDM and to any assessment of the FDM yet they remain unknown variables. As a result, we are not able to comment on these key aspects of the FDM proposals. We are particularly hampered in our ability to assess any additional costs, barriers to entry or barriers to client access/service that may flow from FDM-mandated changes in these areas. We, therefore, reserve final comment on these issues until an opportunity to review the second Concept Paper has been provided. Examples of key questions that remain unanswered and may considerably change our views on other aspects of the FDM include:

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[8] *Concept Paper*, at 17.

[9] CSA Request for Comment- Discussion Paper 24-401 *On Straight-Through Processing*, (2004) 27 OSCB 3977, at Section F *Modifying Investment Fund Transaction Processing Rules*, number 2: *CSA Response*.

- Changes to proficiency requirements for dealer personnel and individual advisers;
- Availability of the three proposed relationship types (self-managed, advisory, managed for you) to firms/advisers who restrict their product offerings to specific product lines (*e.g.* mutual funds);
- Changes to registration and proficiency requirements for dually-licensed advisers; and
- The effect, if any, of the FDM on individuals who sell other products that do not require registration (*i.e.* GICs) in addition to securities.

In addition, the FDM proposes a "single service provider license based on a business reality test"[10] but does not describe what this means in any detail. The Concept Paper also speaks to proficiency requirements flowing from "the services provided". Again, no definition of "services" is provided save through the simple lists set out in the sample Fair Dealing Documents. This lack of definitions does not provide sufficient detail for the fair evaluation of the nature and extent of services that a firm would be expected/could choose to provide, nor does it permit an accurate assessment of the resources and proficiencies that would be required to support such services. We acknowledge that it may be possible for a "service provider" to decide not to offer *all* services to be made available throughout the industry and believe that many industry participants will ultimately choose to take this route.

OSC staff have, from time-to-time, suggested that the single service provider license will be augmented with "tickets" that will entitle the dealer or adviser to offer other services. We question whether these services correspond to the current "product-based" registration categories (mutual funds, individual securities and options *etc*.)? In this case, we wonder what the substantive differences from the current system will actually be. In the alternative, we question whether these tickets encompass both products and services such as "financial planning" and "estate planning" *etc*., which requires the need for clear definitions (see discussion below under the heading "Investment advice and financial planning").

**Investment advice and financial planning**

(i) Advice-driven relationship model versus product/transactions model

While we agree that many industry participants are holding themselves out as offering "financial planning" or analogous services, we question the implied assumption underlying the FDM that investors are being misled on a large scale into believing that "product salespeople" are in fact delivering comprehensive financial advice. We also question whether a survey of 27 advisers, in a realm of some 170,000,[11] is sufficient to indicate that the industry could make a seamless switch from an "embedded" to a "fee-for-service" compensation model. Finally, we question whether the compensation biases are as pronounced as suggested by Appendix F *Compensation Biases* of the Concept Paper.

[10] *Concept Paper*, at vi.
[11] A survey of securities commissions, life insurance regulators, industry associations and SROs conducted by Advisor.ca in October 2002 concluded that there were as many as 173,000 "financial advisers" currently servicing the public in Canada. Of these, 160,890 advisers (or 93%) were licensed to distribute securities.

The FDM purports to switch the regulatory focus from a product-sale model to an advice-based relationship model. We suggest that advice is already a significant focus of the current regulatory model. Registered salespersons are permitted to engage in the delivery of advice incidental to a trade. Current KYC and suitability rules require the adviser to consider, *inter alia*, the client's financial situation and investment goals and make recommendations that take into account these considerations. In many respects, the current regulatory structure can, therefore, be said to already focus on the regulation of advice. One could argue, in fact, that the "trade" is used as a proxy for advice as the trade itself merely provides concrete evidence that an investor has relied on the advice received. The trade in a security is also important in the evaluation of the "quality" of advice received as it provides the framework for evaluating whether the advice met suitability requirements.

The FDM appears to be proposing that advice should somehow be regulated even in the absence of a trade. The FDM, however, does not define "advice" or propose to circumscribe its limits yet the Concept Paper specifically states that the OSC does not intend to regulate advice, merely the advice-driven relationship.

We are, therefore, unable to determine which aspects of the relationship will be subject to regulation and how compliance will ultimately be determined. This conundrum is similar to that which confronted OSC staff and industry associations that participated in the development of proposed Multilateral Instrument 33-107 *Proficiency Requirements For Individuals Holding Themselves Out As Providing Financial Planning Services*. In the development discussions, it was quickly agreed that it would be unwise, if not impossible, to attempt to categorize and define the various types of advice that an investor might expect to receive. Instead, it was agreed, that it was appropriate to opt for a "holding out" rule where the apparent offering of financial planning services by an industry participant triggered proficiency requirements relating to those services. It should be noted, however, that a dealer's compliance responsibilities under this model were satisfied when the dealer ascertained that any sponsored salesperson purporting to offer the services had met the proficiency requirement. These responsibilities did not include ascertaining whether the proffered services were actually being provided or assessing the competence of the services beyond the requirements of KYC and suitability.

With regard to the FDM, it is important for the industry to understand how the advisory relationship will be assessed. We question if the OSC's intent is to make dealers responsible for the quality of the advice? If so, does this include advice that does not result in a trade in a security or that results in the client continuing to hold a security? If this is the case, there is a significant broadening of the dealer's current responsibility and liability, which creates a regime that will impose significant new dealer liabilities without the compliance guidance offered by comprehensive and binding definitions. Such a regime does not achieve the FDM's stated objectives to reduce the number of disputes and to strengthen the client's evidentiary burden in such disputes.

(ii) Investment advice versus financial advice/financial planning

As an illustration of the difficulties we face in interpreting the intent of the FDM, we offer the following: the Concept Paper frequently refers to "investment advice", "financial advice" and

"financial planning" – apparently as unique services. Given that the KYC requirements, which are clearly attached to "investment advice", involve investigation by the adviser of many aspects of a client's financial situation and goals, and absent concrete definitions of each term, we are at a loss to distinguish among the ranges of activities intended to be encompassed within each of these terms.

## **Costs**

(i) Small dealer firms

The FDM proposals significantly increase dealers' and advisers' operating costs by requiring, at a minimum, enhanced investor information, complex new documentation, a time-consuming account opening process, the re-engineering of trade execution documentation and substantial changes to client reporting. If the FDM were also to result in the wholesale re-engineering of current compensation practices into a strict, fee-based model, the many mutual fund dealers who currently operate economically in a "client name" environment may be forced to adopt a "nominee" platform with significant additional costs including increased capital requirements and increased costs for infrastructure and systems.[12]

The imposition of increased dealer costs also conflicts with the FDM's stated goal of promoting healthy competition for investors' business based on quality and value for services. In fact, we believe that increasing costs for smaller dealers will force such smaller dealer firms, which for the most part are independent of financial institutions and mutual fund management companies, out of the market, severely restricting investor choice and access as well as reducing competition.

(ii) Investors with small accounts

Requiring advisers to spend significant time educating clients and potential clients, and requiring the completion and updating of lengthy account opening and transaction documents imposes significant additional costs onto dealers in respect of each account. These increased dealer costs will have the effect of forcing advisers to forego dealing with clients with small accounts as it will no longer be profitable for advisers to maintain relationships with clients whose accounts do not merit the expense and effort required to comply with the FDM. Investors with small accounts will be forced out of advisory relationships and into self-managed relationships whether or not they have the expertise to be in a self-managed relationship with their advisers[13]. This movement denies investors with small accounts access to the markets and to the advice that they need to take advantage of the markets.

(iii) Compliance providers

The Concept Paper appears to suggest that the impact of many new costs imposed under the FDM could be somewhat mitigated by the engagement of third-party service providers to assist

[12] For example, dealers operating solely in "client name" registration as such dealers do not operate trust accounts or hold client assets in trust and would not be able to deduct fees owed from client accounts in an efficient manner.

[13] This trend is already apparent among larger investment dealers operating in high cost environments.

with dealer compliance responsibilities. We submit that such arrangements may not lead to rigorous compliance since the service provider may find itself in conflict with the interests of its client and that the OSC itself may find such arrangements unacceptable.

## CLOSING REMARKS

We believe that the principles underlying the FDM are already embraced by industry participants in the Canadian investment funds industry and, to a large extent, are embodied in our current regulatory structure and rules. Areas where gaps exist between the current regime and the goals of the FDM could be effectively addressed through incremental changes to current CSA or SRO rules.

The OSC's stated objectives of regulation that: (i) support current business structures; (ii) reduce the number of disputes; (iii) do not impose an additional layer of regulation on registrants; and (iv) promote healthy competition will not be achieved by the FDM proposals in their current form. As presented, the FDM proposals will substantially increase the costs for dealers and their advisers to conduct their businesses. These costs are far beyond any benefits that investors could expect to obtain since the costs will be ultimately passed on to the investor. In addition, implementation of a FDM-type regime on securities registrants only will continue and exacerbate the current lack of a level playing field between securities registrants and other financial services industry participants.

* * *

We thank you for this opportunity to comment on the FDM Concept Paper. We look forward to the opportunity to discuss these matters with you further. Please contact the undersigned directly by email at thockin@ific.ca or by telephone at (416) 363-2150 Ext. 241; John W. Murray, Vice President, Regulation & Corporate Affairs by email at jmurray@ific.ca or by telephone at (416) 363-2150 Ext. 225; or Stacey Shein, Legal Counsel by email at sshein@ific.ca or by telephone at (416) 363-2150 Ext. 238 should you require further information or wish to discuss our comments.

Yours truly,

**THE INVESTMENT FUNDS INSTITUTE OF CANADA**

"ORGINAL SIGNED BY HON. THOMAS A. HOCKIN"

By: Hon. Thomas A. Hockin
President & Chief Executive Officer

TAH/jwm.

Encls.: Appendix A - Conflict of Interest Issues
Appendix B - The Transaction
Appendix C - Compensation
Appendix D - Fair Dealing Document
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## APPENDIX A

## CONFLICT OF INTEREST ISSUES

### Compensation

The Concept Paper's focus on third-party compensation in the mutual fund context, to the virtual exclusion of conflicts inherent or attaching to other investment products[14], can scarcely be construed as "fair dealing." In addition, the proposals concerning current industry compensation practices appear to be biased. Specifically, compensation that advisers receive for advice and execution services is described as "incentives" and current contractual compensation systems are described as "schemes". Advice-giving, financial or otherwise, is a vocation like any other and advisers should be paid for their services.

The Concept Paper recognizes that "it is not the regulator's place to prohibit conflicts entirely".[15] NI 81-105 provides a complete code governing, *inter alia*, the relationship between a mutual fund and its third-party distributors. This relationship will be augmented by proposed NI 81-107, which will regulate conflicts of interest between a mutual fund manager and the fund's investors and supported by the increased/enhanced disclosure that will become available under NI 81-106 and CP 81-403. Given these initiatives, we submit that the proper focus of the FDM with regard to compensation should be to encourage equivalent and meaningful disclosure among all investment products.

### Self-managed accounts

The Concept Paper provides for salespersons offering self-managed accounts to provide a range of services beyond mere execution. These services are stated to include, *inter alia*, the provision of investor information and "asset allocation advice". We submit that this is entirely inappropriate. Dealer/adviser responsibilities within the "self-managed" relationship should only extend to receipt and execution of orders on an "unsolicited" basis and appropriate account reporting.

Investment advice, including asset allocation or the putting forward of a subset of financial products (as opposed to the whole range of investment products offered by the financial services provider), is advice and should not be offered or provided to clients in a self-managed relationship. If the self-managed relationship is appropriately restricted in this way, obligations to deliver investor information, assess suitability or conduct KYC inquiries beyond those necessary to establish a client's creditworthiness for margin, if offered, can (and should) be eliminated. This approach is in accordance with the concept of the self-managed relationship originally offered by the OSC through www.fairdealingmodel.com, which implied that such relationships would exist solely via the telephone or computer.

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[14] For example, the conflicts that can arise from financial and performance-driven rewards or those resulting from meeting sales targets under the self-managed model have been entirely overlooked.

[15] *Concept Paper*, at 10.

We also note that the proposed Fair Dealing Document ("FDD") relating to the self-managed relationship does not appear to require the collection of KYC information concerning the financial situation, goals or objectives of the investor in such a relationship. We question how a salesperson would be able to provide even simple asset allocation recommendations in the absence of acquiring this information.

**Unsolicited orders**

The Concept Paper suggests that advisers should not be permitted to accept unsolicited orders from clients with which they have an advisory relationship, but should be required to advise the investor to open a self-managed account. The Concept Paper also suggests that it may be a conflict of interest for an investor to have both an advisory and self-managed account with the same dealer and adviser. We do not believe that either of these suggestions is a practical alternative for the following reasons: (i) Investors will balk at the additional effort required to open two accounts; (ii) It is inefficient to require dealers to incur the expense and redundancies of formatting themselves to offer multiple account types when the existing structure does not appear to be broken; and (iii) The potential for investor confusion increases exponentially with each separate account.

Current rules permit advisers to accept unsolicited trades. It is a long-standing principle of equity that disclosure and investor consent remedy breaches of fiduciary duty. Current industry practices for unsolicited orders, which involve disclosure of the adviser's views, investor consent and increased dealer scrutiny serve investors well and the Concept Paper offers no evidence to the contrary.

**Mutual fund distributors who sell proprietary products**

Page 37 of the Concept Paper states "firms must insulate their retail investment business by treating their other businesses as separate and at arm's length and by extending them no preferential treatment". We request clarification of this statement, particularly as it would apply to integrated mutual fund firms that both "manufacture" mutual fund securities and "distribute" those securities through captive or related-party sales forces.

We also request clarification on whether the FDM proposes that firms that only sell proprietary products would be considered to be different from firms that sell proprietary securities *and* those of third party issuers (including all of the bank–owned brokerages and many mutual fund managers with related distribution channels) and note that NI 81-105 already governs these issues.

Comments on page 21 of the Concept Paper appear to indicate that the OSC is of the opinion that the sale of proprietary financial products should be relegated to the self-managed relationship only. We disagree with this assertion and suggest that the "buyer-beware" car dealership analogy set out in the Concept Paper[16] applies equally in an advisory or managed-for-you

[16] *Concept Paper*, at 21.

relationship. Again, we believe that appropriate disclosure and client consent is the correct approach.

## APPENDIX B

## THE TRANSACTION

**Point of sale**

Fund management companies are required to prepare and disseminate prescribed information about their products in the simplified prospectus and other documents. Dealers are required and are relied upon by fund managers to distribute the majority of these documents to investors. As noted, the form and content of such information is prescribed. It is inappropriate to require dealers and their advisers to "interpret" information, the form of which has already been passed upon, as this could result in investor confusion and dealer liability.

In addition to the prescribed prospectus information, a large volume of other information about mutual fund investments is also available to investors through the media and other publicly available sources. Given that there are approximately 1,907 mutual funds[17] offered for sale to the Canadian public, we request further guidance on the degree to which advisers will be expected to "interpret" this information and the standards to which such interpretations will be held. As we note earlier in this submission, more information as to the proficiency standards to be applicable to advisers is required before these proposals can be adequately analyzed.

In our view, dealer firms would also likely seek to limit their liability for the "interpretation" of investment materials provided by others by producing their own standard materials. Since the FDM does not appear to contemplate relieving mutual fund managers of the duty to prepare such materials, we submit that the net result will be an unnecessary duplication of effort and expense.

We acknowledge that changes to the lengthy point of sale and other documents that investors currently receive may be appropriate. We continue to work actively with the CSA[18] to make these documents more useful to and understandable for investors. We believe that the best way to achieve this goal is to offer investors simple and well-crafted documents similar to the documents that would be mandated by proposed NI 81-106 and CP 81-403, and we urge the OSC to embrace these proposals.

The point-of-sale disclosure requirements proposed under the FDM appear to extend beyond those proposed in CP 81-403. The FDM proposals appear contrary to proposed NI 81-106 as they appear to place the onus on advisers instead of fund managers to provide information to investors regarding fees and periodic filings. Consideration should be given to avoiding such unnecessary duplication of effort and expense that, in our view, will provide no added benefit to investors.

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[17] As at March 31, 2004, source: IFIC statistics.

[18] Most recently, through submission of comments to and discussions with OSC staff regarding CP 81-403 and through development and presentation to the OSC of proposals for a risk classification methodology for mutual funds.

**Information Sheet**

The FDM proposals appear to require that an adviser "quiz" the investor to ascertain whether the investor understands the disclosure set out in the proposed Information Sheet. We question the practicality of this requirement and expect that the typical investor would find such a process offensive. In addition, the Information Sheet itself appears to duplicate the point-of-sale disclosure documents that an investor would receive under CP 81-403. The point-of-sale disclosure considered under CP 81-403 was developed with significant industry and Joint Forum input and has the attraction of attempting to achieve a level playing field among mutual funds and life insurance segregated funds. For these reasons, we believe that the CP 81-403 proposals are superior to the proposed FDM Information Sheets and recommend their adoption instead of the FDM proposed Information Sheet.

**The client/adviser meeting**

The FDM appears to anticipate face-to-face meetings each and every time a client and adviser discuss and agree to execute a transaction. This is entirely impractical and does not reflect industry practice, other than initial client and account opening meetings. The FDM also anticipates that each client meeting will include a "teachable moment"[19] that the adviser will be mandated to utilize. However, investors regularly and forcefully complain about the length and density of current disclosure and KYC documents. In this context, we think that it is likely that this FDM requirement, particularly when undertaken alongside the proposed FDD completion and update requirements, will only increase investor frustration and promote non-compliance. Again we suggest that such a process would be perceived to be offensive by investors.

[19] *Concept Paper*, at 13.

## APPENDIX C

## COMPENSATION

### Third party compensation

(i) General

We agree that transparency with regard to third party compensation is an important aspect of any adviser/investor relationship. However, the prohibition of such compensation as a means of facilitating transparency is unnecessary. We believe that providing investors with understandable and plain-language disclosure of what they have paid for their investments results in clients having a better understanding of the value provided by their adviser and their investment and eliminates the conflict of interests that could result from undisclosed compensation practices.

Furthermore, we take issue with the assertion that mutual fund managers are misleading investors. The Concept Paper, at page 40, states that "fund management companies pay dealers compensation out of management fees paid by investors - ultimately, out of investors' assets - that are usually portrayed as being expended for expert advice and client services". This statement is a clear mischaracterization. Pursuant to National Instrument 81-101 *Mutual Fund Prospectus Disclosure* and National Instrument 81-102 Mutual *Funds*, mutual fund prospectuses must fully disclose the expenses paid out of the management fee and all sources of dealer compensation, including trailing commissions.[20]

(ii) Compensation Working Group

The FDM proposes three possible approaches to address the conflicts arising from third party compensation.[21] Regardless of the approach adopted, the impact on and costs to the industry of any of the compensation proposals set out in the FDM will be substantial. We suggest that a specific Working Group for compensation be established to review the potential impacts and costs before any decision is made as to which approach(es) should be adopted.

(iii) Transparency and disclosure

We disagree with the FDM's assumption that there are practical limits on transparency. However, we submit that it is likely that the current density of disclosure results in investor confusion and apathy. This reality, in part, will be addressed as the CP 81-403 initiative proceeds.

We acknowledge that disclosure documents could be made clearer to investors if terms such as "loads" and "trailer commissions" were replaced by industry-wide plain language alternatives,

[20] See, for example, Item 9 *Dealer Compensation* of Form 81-101F1, which sets out detailed, mandatory disclosure with regard to all compensation received by the dealer in connection with the sale of a mutual fund security.
[21] *Concept Paper*, at 39.

and we are willing to work with the CSA, as we have in the past, to develop such alternative terminology.

(iv) Fund company responsibility for advisers and dealers

We submit that the FDM proposal to make fund companies responsible for the actions of unrelated dealers and advisers is impractical and should not be considered for the following reasons:

- Mutual fund shares or units are first and foremost "securities". A mutual fund is the "issuer" of those securities in the same sense as a public corporation is the issuer of its own shares. To make mutual funds responsible for the actions of unrelated dealers and advisers creates an un-level playing field among investment vehicles that are viewed by investors as essentially similar;

- A regime where a fund manager becomes responsible for the activities of dealers and advisers is, we submit, akin to the "captive agents" structure found in the life insurance industry. This system has been often criticized for unduly limiting client choice;

- There are currently many different modes of distribution of mutual fund securities. In some cases, a fund management company will employ individuals or related firms to distribute their securities on either an exclusive or non-exclusive basis (the "integrated model"). In other instances, a fund management company will adopt the role of "manufacturer" and an unrelated third party will distribute its mutual fund securities on a discretionary and non-exclusive basis (the "independent model"). The choice of structure is a business decision made by the individual manager and dealer firms. Removing this choice would unfairly limit competition in the industry- a result that the FDM states it is designed to avoid;

- Regardless of the model chosen, the FDM clearly recognizes that the investor's direct relationship is with the "distribution end" of the mutual fund equation. The industry's current and longstanding regulatory and SRO structures recognize this reality and focus supervisory responsibilities relating to this client relationship on the dealer firm and, in some cases, individual advisers. Generally, these duties focus on the duty of the adviser/dealer to *each individual investor*.[22] The fund manager, on the other hand, is required to adhere to statutory and other duties to *the mutual fund* or, in other words, to investors in its fund(s) *as a class*.[23] Accordingly, the fund manager and the fund distributor both have duties to investors, although at different levels.[24] Extending a fund manager's responsibilities to the individualized relationship formed between an investor and an adviser or dealer has the potential to generate conflicts among these duties - again a result that the FDM states it is designed to avoid;

[22] See, for example, OSC Rule 31-502 *Proficiency Requirements for Registrants*
[23] See, for example, *Securities Act* (Ontario), s. 116(1).
[24] Current securities regulation recognizes these conflicts and prescribes both limits and disclosure to ensure fair treatment of investors, see, for example, Part 4 of NI 81-105.

- Extension of a fund manager's responsibility to dealers and advisers may be practical in integrated-model firms that restrict sales activities to proprietary products (*i.e.* those operating under the "captive agent" structure discussed above), but would be impractical, if not impossible, for firms (either integrated or independent) operating on a non-exclusive basis. This extension would, in effect, require dealers and their advisers to be supervised by multiple fund companies. This will be an entirely unworkable intrusion into the dealer/adviser and client relationship and could prove to be detrimental to the provision of unbiased investment advice - a result that is clearly inconsistent with the FDM's stated goals;

- As noted earlier, dealer/adviser regulation is supplemented by a vigorous SRO structure. Requiring a fund company to assume a supervisory role with regard to distributors usurps the SRO function; and

- Requiring a fund company to assume a supervisory role would cause confusion as to which entity is ultimately responsible for the client. This confusion would be heightened where advisers perform a variety of services and would increase where the client portfolio comprised various holdings from various fund managers. These results contradict to the stated goals of the FDM to allow investors and their financial service providers to have a better understanding of mutual expectations, roles and responsibilities, to reduce the number of disputes and to strengthen the client's evidentiary burden in such disputes.

(v) Prohibiting third party compensation

We note and support the OSC's assertion that "it is not the regulator's place to prohibit conflicts entirely, nor interfere in the industry's long-established compensation practices"[25].

In our view, eliminating third-party compensation, as is one of the proposed approaches in the Concept Paper, would represent *substantial interference* and cause significant upheaval to current business structures and objectives and the industry's long-established compensation practices. The current practice of fund companies paying commissions and trailing commissions to dealers is an extremely efficient way for advisers to be compensated and should not be interfered with absent: (i) compelling evidence that the current system is fatally flawed; and (ii) a careful and comprehensive analysis of the impact on both investors and industry participants and of the costs as against the benefits.

The Concept Paper suggests that conflicts of interest arise when a fund offers an adviser an opportunity to receive a deferred sales charge ("DSC") payment or trailing commission. We note that payment of such incentives does not flow directly from the fund manager to the adviser, but from the fund manager to the dealer firm. Subject to the rules set out in NI 81-105, dealer firms establish what the adviser's compensation will be. Most fund companies' compensation schedules are identical, and where differences do exist, they are usually so negligible that they cannot reasonably be considered to be "incentives." In any event, all amounts paid by investors

[25] *Concept Paper*, at 10.

are clearly disclosed in point-of-sale documents and publicly available sources that compare fee/commission levels among mutual funds are available to investors.

In addition, we submit that the wholesale elimination of third party compensation structures will have the following negative impacts:

- Impact on dealers - On page 27 of the Concept Paper, the question is posed "will all representatives in advisory relationships have to become fee-based financial planners?" While the response given is negative, the question and other statements in the Concept Paper appear to imply a preference for fee-based accounts. This would negatively impact the large number of mutual fund investments that are held in "client name" registration as such dealers do not hold client assets in trust and would not be able to deduct fees owed from client accounts in an efficient manner;[26]

- Impact on investors – Mutual funds are structured as long-term investments. Long-term investors *do* benefit from the DSC option which allows their fee schedules to decline to zero over time. Eliminating funds sold on a DSC basis would eliminate a client's ability to defer or eliminate costs with respect to long-term "buy-and-hold" investment strategies. This elimination could also encourage short-term investing on the part of the investor and/or churning on the part of the adviser. Again, we submit that transparency of compensation rather than reduction of choices is preferable for the achievement of the FDM's stated goals to "promote healthy competition for investors" and to "promote quality and value for services for investors"; and

- Negotiation of commissions – Moving dealer commissions/fees to a front-end-only model does not guarantee that fees will decrease. Prior to the introduction of DSC sales, non-negotiable front-end commission schedules, at rates much higher than those levied today, were the rule throughout the industry.

(vi) Compensation biases

We are strongly of the view that the types of compensation biases discussed in the Case Studies in Appendix F *Compensation Biases* of the Concept Paper represent rare exceptions rather than the rule. We also question the representative validity of a survey based on the responses of only twenty-seven advisers. Furthermore, we note that the survey was conducted in 2001, before the MFDA commenced the rigorous enforcement of its standards and securities rules. We believe that the situation is much different today.

Our specific comments on the Case Studies are set out in the following:

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[26] Fee-based accounts are rarely registered in client name. While fee-based models do exist in client name where advisers collect the fees directly from investors, fee-based accounts are most efficiently managed in "nominee name" since fees can be deducted directly from accounts held on the dealer's books. A switch to nominee operations from a "client name" model results in significant costs to the dealer. These costs are discussed in more detail above, under the heading: "Costs - Small dealer firms."

Compensation Case Study 1 - Converting assets under administration to assets under management presents legitimate problems. However, eliminating third party compensation does not solve the conflicts of interest that result when a dealer sells both proprietary funds managed by itself or another firm in its corporate group and funds managed by firms with which it is unaffiliated.

Compensation Case Study 3 – This case, which discusses the perceived lack of transparency of third party compensation, suggests resolution by better disclosure, as discussed above.

Compensation Case Study 4 – This case discusses the perceived lack of transparency of management fees and also suggests resolution by better disclosure. This case study also illustrates how funds sold on a DSC basis reward investors who hold their mutual funds for the long-term.

## APPENDIX D

## FAIR DEALING DOCUMENT

### General

We accept that KYC forms in current use by dealers may be outdated and should be reworked. However, we submit that the proposed Fair Dealing Document ("FDD") is too detailed and unnecessarily cumbersome to complete and that the FDD's objectives could be more effectively and efficiently achieved by modifying and standardizing the current KYC form.

Many investors currently complain about the length of time involved in completing the necessary detail in the current KYC forms. As the FDD proposes to require substantially more detail than current KYC forms, we anticipate dealers and advisers receiving many complaints from investors about the length and level of detail of the FDD. Therefore, we believe that a modified KYC form that sets out the relationship between dealer/representative and client and that describes the roles and responsibilities of the adviser and client would provide the appropriate level of transparency.

The proposed FDD also contains much information that is irrelevant to a specific investor/adviser relationship. This detracts from its usefulness to the individual client.

### Specific FDD Comments

Our specific comments on the proposed FDD follow:

(i) My choice of relationship

The advisory FDD includes a requirement that the Financial Services Provider ("FSP") will not make recommendations that are self-serving. We believe that this requirement will cause unnecessary investor alarm. Registrants have a specific duty to deal honestly and in good faith with their clients. If any representation is required, it should be to "deal according to the law" or words to that effect.

In addition, in the advisory FDD, the FSP undertakes to provide the client with the level of financial advice that the client chooses. The level of financial advice that the client may choose is too subjective to be measured in a practical way. Use of the phrase "level of advice the client chooses" also specifically implies choice. We seek clarification on whether the OSC contemplates specified levels of service, proficiency and activities for each level and how service levels will be standardized across the industry.

(ii) Adviser's qualifications

Mandating a listing of an adviser's qualifications is unnecessary as we assume that the regulatory system will continue to mandate the qualifications required for an individual to engage in certain activities. In this context, confirmation of registration should be the only qualification required to

be disclosed to clients. Requiring disclosure of all of an adviser's qualifications on the FDD may cause investor confusion as to the services that are actually being offered/provided. For example, many advisers hold accounting or financial planning designations. Disclosure of such designations may lead an investor to assume that he or she is receiving advice in those areas regardless of any service restrictions set out in the applicable FDD.

(iii) Services provided

The above stated argument also applies to disclosure in the FDD of the services that the firm and adviser will provide. Requiring the FDD to list all financial services available in the marketplace, regardless of whether or not these services are offered to the investor by the dealer/adviser, will cause confusion. Accordingly, only those services that are actually being offered to the client by the particular FSP should be included in the FDD. Also, in order to achieve the FDM's objectives of enhanced transparency, the information set out in the FDD relating to services must be relevant to the client's individual relationship.

In addition, we are concerned with the requirement to include non-securities-related services (*i.e.* banking or insurance) on the FDD. These are, in many respects, subject to other regulatory regimes and should not be confused with services subject to the jurisdiction of the CSA as different rules and legal precedents may apply.

(iv) Fee schedule

We agree that clients should understand how their advisers are compensated. However, we do not believe embedding specific commission and fee schedules into the FDD accomplishes this end. Commission and fee schedules are very detailed documents with different commission and fee schedules for each security type including mutual funds, equities, options, bonds and individual securities. In addition, Canadian and U.S. securities often have different commission and fee schedules.

We are of the view that it is more appropriate for those schedules applicable to a particular investment or service to be discussed with and provided to the investor at the time the investment is purchased or when the service is agreed to be provided. This discussion could include disclosure in the FDD if investment and service decisions are made at the time the FDD is initially executed, but would more likely be accomplished at the point of sale of each particular, subsequent investment. For example, it is irrelevant for the FDD of an investor interested in mutual funds to include compensation information that relates to take-over bids or underwriting fees. Inclusion of such irrelevant information will not accomplish the OSC's objective to provide information to investors that will be easily understood.

(v) My investment goals

There is currently no industry standard or regulation that defines portfolio "risk." Since risk is very subjective and complex to measure and to understand, we submit that it is inappropriate to require information relating to risk to be included in the FDD in the absence of meaningful

standards imposed on an industry-wide basis.[27] Such standards must provide for an "apples-to-apples" comparison of all investment vehicles. We are aware that one of the OSC's FDM Working Groups is studying this issue further and look forward to reviewing their work in due course.

(vi) What the Financial Services Provider will do for me

During our review of the proposed FDD, we have identified proposals that imply the proposition of new requirements which do not exist under current regulation. We request clarification on whether the OSC intends to create new responsibilities with which FSPs must comply in the following areas:

- Will the current rules governing the frequency of sending statements to clients be changed? The "managed-for-you" FDD stipulates that summary statements are to be sent to the client every month yet the advisory relationship's FDD stipulates that summary statements should be sent every three months. We question whether the FDM will establish different standards for each relationship type or simply provide a reasonable minimum standard, leaving industry participants to meet or exceed it as they choose. We recommend that the FDD should provide that the FSP will send to the client all necessary point of sale disclosure documents that meet the client's needs and that comply with securities regulation; and

- Statements in the "managed-for-you" relationship's FDD include foreign content information, which is currently not required on account opening documents. However, nominee name dealers currently provide foreign content on account opening documents as a competitive service offering. If foreign content information is required to be included on the documents, rules or industry practices must be established to standardize such information. Note that client name dealers do not currently include foreign content on their documents because the fund company is the trustee and each fund has its own foreign content. Requiring such information on client name statements would be an enormous challenge.

(vii) Information the Financial Services Provider will give me about investing

We believe that it is unnecessary to require the inclusion of educational information in the FDD. The FDM's proposed Information Sheet contemplates the type of information included in CP 81-403 documents, which will be provided to investors at the point of sale, and, therefore, the FDM proposal is redundant.

As mentioned above in our discussion about the *My Choice of Relationship* section of the FDD, advisers should only be expected to list in the FDD the types of investments that are relevant to the individual. In addition, as we have indicated above in our discussion concerning fee and commission schedules in the *Fee Schedule* section of the FDD, it is our view that the inclusion of

[27] For example, IFIC has recently established the Fund Risks Classification Working Group whose mandate is to establish one objective standard by which risk for mutual funds can be assessed. Once completed, it is hoped that this methodology will be accepted for use in mutual fund prospectuses, providing an "apples-to-apples" basis for comparison for all Canadian mutual funds. Currently, all fund companies measure risk subjectively on an individual basis as there are no mandated definitions for high, medium or low risk.

irrelevant information results in lengthy and ineffective communications, which is not aligned with the OSC's objective of providing relevant information that can be easily understood.

(viii) What to do if I have a problem

It is appropriate that the FDD include information about investor complaint mechanisms. We assume that this obligation will replace the current IDA/MFDA requirements for dealers to inform their clients of how complaints can be handled and to inform clients about the Financial Services OmbudsNetwork.

As discussed above under the "Costs" section of this submission, it is our view that outsourcing compliance functions under a service provider/client arrangement is impractical and imprudent, and that supervision is best carried out by the dealer, not an outsource entity.

## APPENDIX E

## TRANSACTION SUMMARY

We have concerns with the practicality of some of the transaction summary proposals and the logistics of implementing certain aspects of these proposals. These concerns are set out below:

**Responses to specific requests for comments**

(i) Transaction summary- mandatory or best practice? (page 59)

The transaction summary requirement should not be mandated, but should be left to firms on a voluntary basis. The important information that investors must be made aware of is already included on the trade confirmation. An additional requirement to distribute transaction summaries does not provide the investor with any additional information or benefit.

(ii) Opting out of receiving transaction summary (page 59)

If a transaction summary is mandated, investors should be permitted to opt out of receiving it. As noted above, investors currently complain about the amount of correspondence that they receive regarding their investments.

(iii) Information included on the transaction summary (page 59)

If the transaction summary is to be mandated, we note the following concerns with the proposed required information:

- *Risk descriptions* - As stated above in Appendix D "Fair Dealing Document", we have concerns with the proposal to include risk descriptions on transaction summaries and trade confirmations. The lack of standardization and regulation of risk measurement creates a system of subjective risk measurement that belies accurate comparison among individual investments and among types of investments. Until industry standards are established and regulated, risk information should not be required to be included on the transaction summary as it will not be useful and could be confusing; and

- *Reasons for recommendation* - We also believe that it is impractical to include the adviser's reasons for recommending a particular transaction on a transaction summary. This is a novel requirement and we are not aware of any precedent in this area that would be helpful. It appears to us that dealers and their advisers would quickly adopt boilerplate wording like: "the transaction was appropriate based on the investor's risk profile and investor's goals". Such a statement does not provide the investor with any useful information. Given the foregoing, given that advisers have a duty to recommend "suitable" investments, and given that the investor's acceptance of the recommendation is evidenced by the occurrence of the transaction that gives rise to the production of the summary, we see no added value in requiring an adviser's reasons for a recommendation to be articulated on the transaction summary.

We submit that it is appropriate for an adviser to discuss his/her reasons for recommending a particular transaction with his/her client and the point of sale. Requiring the articulation of the reasons for a recommendation after the transaction has already taken place does not provide investors with any added protection, and contrary to the FDM objectives, it will increase the likelihood of investor complaints and disputes.

**Verbal transaction summaries**

If transaction summaries are mandated, we believe that the FDM proposals should make allowances to permit verbal transaction summaries and transaction summaries by telephone as is the current practice. However, we are concerned about the exposure and liability that a dealer might be subject to with respect to such verbal summaries. We look forward to the OSC's views on note-taking/keeping and other evidentiary requirements should the current voluntary and non-mandated best practices be subsumed in a mandatory requirement.

## APPENDIX F

## TRADE CONFIRMATIONS

### General

As discussed above in Appendix D "Fair Dealing Document" and for reasons similar to those set out above in Appendix E "Transaction Summary", we believe that it is impractical to include items such as risk and reasons for recommendations on trade confirmations. We also note that the FDM inaccurately assumes that trade confirmations are issued on the settlement date.[28]

We believe that current practices with regard to trade confirmations serve investors well. Accordingly, we disagree with the proposal to require additional detailed information on trade confirmations. Other specific comments with respect to trade confirmations follow:

### Compensation disclosure

We have the following comments with regard to the compensation disclosure proposed to be required on a trade confirmation:

- We believe that investors are most interested in comparing the total cost of the investment against the return on investment. These comparisons permit investors to effectively evaluate the services that they have received. Disclosure of segmented amounts viz the portion earned by the dealer or the portion earned by the adviser on a per transaction basis is at best irrelevant and likely to be confusing to the investor;

- Disclosure of the constituent parts of a fund's Management Expense Ratio ("MER") depends on information that is not readily available to dealers or advisers; and

- In the fund industry, as permitted by securities laws, many trade confirmations are issued on a per trade basis on behalf of dealers by fund companies, carrying dealers or other service providers. These service providers do not collect sufficient data to be able to report compensation on a "per adviser" basis as such amounts are determined by individual compensation systems or commission pay-out grids maintained by the dealer and not disclosed to such service providers. Many of these service providers (*e.g.* fund companies), will not have sufficient information to issue confirmations reflecting the aggregate compensation paid by a investor as they will not have knowledge of trades relating to other funds or investment products.

[28] The following statement appears on page 59 of the Concept Paper: "under current requirements, upon settlement of a transaction, investors receive a written confirmation of its final terms." This is inaccurate as current trade confirmations are actually issued on trade date +1, and not on settlement date as the statement suggests.

**Trailing commission disclosure**

Since information about trailing commissions is most relevant to an investor at the point of sale, we support full disclosure of the rates at which trailing commissions are calculated and statements along the lines of the following to be provided to investors at the point of sale: "whether or not your investments increase in value, your dealer receives compensation in the form of trailing commissions" and "based on last year's information, if you invest $x.xx, you pay $y.yy". If an investor is informed at the point of sale that Fund Company A pays X% to dealers, but Fund Company B pays X+1%, the investor has the comparative information required to make an informed decision.

For the reasons set out above under the above section "Compensation disclosure", disclosure of trailing commission amounts, either on a per security or aggregate basis, on trade confirmations is both impractical and potentially confusing to investors.

## APPENDIX G

## ACCOUNT STATEMENTS

### Performance calculations

As discussed above with regard to FDM proposals relating to compensation and risk measurement, we are of the view that the complexity of performance calculations and various methods of calculation in use today warrant further study. The development of standardized performance calculations is necessary for the existence of a level playing field among all investment products. We look forward to the recommendations of the OSC's Investor Reporting Working Group and will make further comments when their work is made public.

### Risk information

As discussed above, we re-iterate our submission that, to be effective and fair, risk reporting should only be mandated once regulator-sanctioned and enforceable standards are put in place. These standards are key to the proper and fair comparison of risks associated with different types of investment products and key to the development of effective oversight of risk reporting and compliance systems.

Risk classification by security, as proposed in the Concept Paper, may not include a consideration of risks arising from other factors such as taxation status or duration of holding. Also, it may be ambitious to expect investors to understand the complicated calculations of risk-adjusted returns that would be required under the FDM proposals. Again, we look forward to reviewing the Working Group's recommendations.

### Target returns

Many market and non-market forces beyond the adviser's control will affect an investor's actual returns. Requiring advisers to state target returns on account statements is distinct from current disclosure requirements intended to warn investors against reliance on past performance,[29] and any such statement is sure to be construed as some sort of guarantee.

Inclusion of target returns on account statements will encourage, rather than reduce, litigation when targets are misjudged, and thus is incompatible with the stated goals of the FDM.

### Trailing commission disclosure

The Concept Paper suggests that reporting trailing commission amounts on account statements would be both possible and inexpensive. This suggestion relies, in large part, on a study conducted by the Investment Company Institute ("ICI"), the trade association for American

[29] Subsection 15.4(6) of NI 81-102 requires that mutual fund sales communications that include performance information disclose that "mutual funds are not guaranteed, their values change frequently and past performance may not be repeated".

mutual fund managers. The ICI study, discussed on page 73 of the Concept Paper, does not translate directly into the Canadian context. Mutual funds in the United States operate on a vastly different scale than mutual funds in Canada. The American capital markets, too, are very different from their Canadian counterparts in both size and composition.[30]

As the Concept Paper acknowledges, many fund managers do not calculate trailing commissions on a client-by-client basis. Payments are currently based on the aggregate amount of a fund or funds held by all of the clients of a particular dealer or adviser. The systems changes that would be required to produce the proposed trailing commission item on account statements are significant and, in our view, not justified by any incremental benefit that would accrue to investors as a result.

**Responses to specific request for comments**

(i) Personalized returns (page 71)

If performance criteria are required to be included on account statements, the OSC should prescribe a standard formula for calculating personalized returns. We are of the view that a list of alternatives is a cumbersome, complex and confusing approach that would not facilitate ready comparison of investments.

These concerns are heightened if different dealers are permitted to use different methods of calculations. In addition, requiring a dealer to disclose why one particular calculation formula was chosen over another would only add to investor confusion.

(ii) Securities included on account statement (page 71)

We have concerns with the FDM proposal to require that performance information be calculated at the individual security level. Requiring such information to be included on an account statement requires lengthy and complex calculations, which would be irrelevant to investors since individual securities are almost always part of a diversified portfolio and are intended to be viewed collectively within that portfolio. In addition, this requirement is inconsistent with the FDM's relationship-based approach to regulation since requiring performance information at the level of each individual security reflects a product-based approach to regulation.

(iii) Return calculations (page 71)

Both the proposed option of either calculating returns on the basis of the past year or calculating returns on the basis of the date of purchase appear to be based on the misconception that only

[30] Were one to assume, for the sake of argument, that the ICI study was directly and properly applicable to the Canadian mutual fund industry, the $1.00-per-account initial cost plus the $0.35-per-account annual cost of sending clients quarterly reports projected in the ICI study would still amount to over $US69.5 million in the first year, based on the current number of 51.5 million mutual fund investor accounts in Canada. These additional costs, which do not include costs to dealers, would be passed on to investors.

one trade can be completed at a time. These approaches do not contemplate that investors may make periodic and/or pre-authorized contributions to their accounts. As well, there could be many switches during any given time period.

In addition, many dealers may not have access to all of the information required to calculate return information. Book values of securities are very difficult or impossible to determine in many instances such as when an account has been transferred from one dealer to another or when an adviser changes dealer firms. The assumption, implicit in the Concept Paper, that book values are readily available due to the management of foreign content, does not take into account dealers who operate in client name as such dealers do not operate self-directed registered plans, maintain RRSP foreign content records or track purchase cost information. Book values are also not provided in nominee-to-nominee transfers in every case.

Note also that if returns are required to be stated on a dollar basis, in order for information to be consistent, mutual fund simplified prospectuses must be altered to reflect dollar amounts and not percentages.

(iv) Frequency of personalized performance information (page 71)

We suggest that personalized performance information should be provided to investors annually, to coincide with an adviser's annual review of an investor's KYC information. Most mutual funds are intended to be long-term investments and providing investors with performance information more frequently than annually encourages investors to conduct short-term trades, which may be inappropriate for their investment goals. In this context, the suggestion that performance information should be required to be available daily or in real time over the Internet is not optimal.

We request clarification on the FDM proposals regarding the frequency of personalized returns and client reporting which we believe are inconsistent. On page 68, the Concept Paper states that the OSC is not proposing to suggest changes to the timing of providing periodic reports to investors. However, on page 70, the Concept Paper states that personalized performance information would be mandatory on a daily or real time basis. We question whether or not the OSC proposes to change or impose new timing requirements.

We also note that statements for accounts held in client name are *not* issued quarterly by every industry participant at the present time. Again, issuing quarterly performance statements, as contemplated on page 70 of the Concept Paper, is inconsistent with a view that mutual funds are intended to be long-term investments.

(v) External benchmarks and account statements (page 71)

Account statements should not be required to include external benchmarks. A portfolio of various securities will not necessarily match an existing benchmark. Thus a comparison between the investment and a benchmark would generate confusion. In addition, many investment products use various broad based securities indices as benchmarks and in some instances, more than one index is used to create blended-benchmarks. Requiring inclusion of a benchmark for a

portfolio, which contains various underlying investments, is of no use to a client since the result could well be a blended-benchmark of blended-benchmarks.

(vi) Gross and net returns (page 71)

Account statements should not provide both gross and net returns, and the OSC should not consider requiring both these returns. We believe it is unrealistically ambitious to expect investors to understand these very complex calculations. In addition, the lack of industry standardization for return calculations and the variety of ways that the calculations can be performed lead to investor and industry confusion.