



Setting the global standard for investment professionals

22 September 2004

Mr. John Stevenson
Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, Ontario M5H 3S8

Re: Request for Comment—Fair Dealing Model Concept Paper

Dear Sir:

The Canadian Advocacy Committee (CAC) of CFA Institute¹ is pleased to respond to the request for comments on the OSC's Fair Dealing Model Concept Paper. In theory and in principal, the proposed Fair Dealing Model seeks to achieve a laudable goal—to establish a greater “level playing field” between clients and their investment representatives, through a new set of principals that define responsibilities and expectations based on the level of advice sought by the client. We unequivocally support the creation of strong working relationships between clients and their representatives that are based on trust, transparency, and full disclosure. This approach is entirely consistent with the CFA Institute *Code of Ethics and Standards of Professional Conduct*.

Thus, we strongly support many of the underlying objectives of the Fair Dealing Model. Like the Proposal, we recognize that not all relationships fall squarely within the three categories being proposed, and the difficulty in addressing situations when overlapping relationships occur. We therefore ask that further consideration be given to this area, given the legal implications to both parties of executing a Fair Dealing Document. We also urge the OSC to harmonize to a greater extent the duties owed by a representative to a client in Advisory and Managed-for-You relationships. Under the CFA Institute *Standards of Professional Conduct*, CFA Institute Members, holders of the CFA designation and candidates in the CFA Program must determine the suitability of investment recommendations and actions in advisory relationships, regardless of the degree or level of advice being offered. Finally, we commend to you for consideration the

With headquarters in Charlottesville, VA, and regional offices in Hong Kong and London, CFA Institute (formerly, the Association for Investment Management and Research[®]) is a non-profit professional association of more than 70,000 financial analysts, portfolio managers, and other investment professionals in 119 countries of which more than 57,700 are holders of the Chartered Financial Analysts[®] (CFA[®]) designation. The CFA Institute membership also includes 129 Member Societies and Chapters in 50 countries and territories.

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CFA Institute Global Investment Performance Standards (GIPS[®]) as a model for providing performance information in a consistent, recognizable, and uniform way.

These areas are discussed in detail below.

Discussion

I. Fair Dealing Model and the CFA Institute Standards of Practice

The Fair Dealing Model Concept Paper (Model) envisions a system by which the relationships between investor and investment representatives would be managed according to the level of investment advice sought by the client:

- ***Self-Managed*** relationships, where the client places no reliance on the financial services provider other than transaction execution;
- ***Advisory*** relationships, where the client is entitled to rely on objective, expert advice from the representative; and
- ***Managed-For-You*** relationships, where the client relies completely on the representative, who has full discretion and assumes a trustee-level responsibility for all investment decisions.

A second fundamental prong of the Model provides that the specific proposals and rules that will be promulgated under the Model would reflect three underlying principles:

1. There must be a clear, documented allocation of roles and responsibilities among the investors, the representative and the firm.
2. All dealings with the investor must be transparent. Transparency is disclosure that is understandable and meaningful to the investor, communicated at the time and in the manner most likely to be useful to the investor.
3. Any conflicts of interest that the representative has must be appropriately managed to avoid self-dealing.

We agree with, and support all of these principles. These principles lie at the heart of the CFA Institute *Code of Ethics* and *Standards of Professional Conduct* (*Code* and *Ethics*), with which all CFA Institute Members, CFA Charter holders and candidates in the CFA Examination Program must comply. As discussed below, we believe that determining the client's needs and always acting in the best interests of that client are fundamental to the adviser-client relationship. In addition, the client must receive information that provides the means with which to adequately assess expectations related to that account.

CFA Institute has long held the position that “those who either lack information or who do not understand the information that is available to all are at a distinct disadvantage in buying or



selling securities. Therefore, no matter how efficient or inefficient a financial market may be, information is its lifeblood.” Information must be presented with clarity and in a context that enhances, rather than obscures, its true meaning.

In addition, we believe that conflicts of interest must be managed in a way that not only avoids self dealing, but also avoids all outcomes that effectively disadvantage clients’ interests. The following sections from the CFA Institute *Standards of Professional Conduct* specifically address this subject matter.

Standard IV B.1—*Fiduciary* provides that

In relationships with clients, members shall use particular care in determining applicable fiduciary duty and shall comply with such duty as to those persons and interests to whom the duty is owed. Members must act for the benefit of their clients and place their clients’ interests before their own.

Moreover, **Standard IV B.3—*Fair Dealing*** expressly provides that

Members shall deal fairly and objectively with all clients and prospects when disseminating investment recommendations, disseminating materials changes in prior investment recommendations, and taking investment action.

These two Standards recognize fundamental fiduciary duties owed by the investment representative to the client. Thus, we are in agreement with the underlying objectives of providing investors with the information they need to make fully-informed investment decisions.

II. Issues Under the Fair Dealing Model

Suitability Determinations

(a) Standard

We appreciate that the “Fair Dealing Document” is intended to clarify the responsibilities between the client and adviser, including the investor’s financial situation and objectives. We believe that a full understanding of a client’s financial situation and investment objectives is fundamental to the adviser’s responsibility for making suitability determinations.

However, we do not believe that the Model sets the standard for determining suitability of investment recommendations high enough. Given that the appropriateness of investment recommendations and actions lies at the heart of the adviser’s responsibility to its clients, we urge the OSC to provide greater emphasis in this area.

Under the Fair Dealing Model, the investor and investment representative must sign a Fair Dealing Document that serves as a legal contract in confirming the type of advisory relationship, investment objectives, and services. Information contained in this document that defines the client’s investment objectives would provide the basis for determining the appropriateness of



investment recommendations made by the representative. As noted in this Concept Paper, “The appropriateness of individual transactions will be evaluated in the context of the investor’s overall portfolio.” Prior to the execution of any transactions, financial services providers would have to provide a summary of the essential features of the transaction to clients in an Advisory relationship (and to certain investors in Self-Managed accounts).

Although the Model recognizes that an investment representative who provides advice “has a general duty to advise carefully, fully, honestly, and in good faith”, we believe that representatives should take additional measures to “know their clients.” Specifically, we believe that each investment representative who advises clients on investment decisions, including recommending investments in certain stocks, owes those clients a duty beyond a general duty of good faith and care. They must exert considerable effort to ascertain the suitability of each investment recommendation that is made and to assess a client’s ongoing needs on a regular basis.

The CFA Institute *Standards of Professional Conduct* requires that, among other things, members shall

- Make reasonable inquiry into a client’s financial situation, investment experience, and investment objectives prior to making any investment recommendations and shall update this information as necessary, but no less frequently than annually, to allow the members to adjust their investment recommendations to reflect changed circumstances.
- Consider the appropriateness and suitability of investment recommendations or actions for each portfolio or client. In determining appropriateness and suitability, members shall consider applicable relevant factors, including the needs and circumstances of the portfolio or client, the basic characteristics of the investment involved, and the basic characteristics of the total portfolio. Members shall not make a recommendation unless they reasonably determine that the recommendation is suitable to the client’s financial situation, investment experience, and investment objectives.
- Disclose to clients and prospects the basic format and general principles of the investment processes by which securities are selected and portfolios are constructed and shall promptly disclose to clients and prospects any changes that might significantly affect those processes.

We believe that establishing this kind of relationship is important to ensuring that the clients’ needs are being addressed. In keeping with the Standards noted above, we urge the OSC to not only recognize investment representatives’ duty when providing investment advice to clients, but to require them to implement procedures to ensure the suitability of their recommendations, reviewed at least annually.



(b) Scope of Duty

The Model distinguishes the standard of care owed to the client based on the type of relationship agreed upon by the representative and client, as reflected in the Fair Dealing Document. As the proposal notes, “the conduct standards for representatives become more rigorous as the client’s level of reliance increases.” For example, in an Advisory relationship, the representative has the duty of making investment recommendations that “are in the investor’s best interest and conform to the Fair Dealing Document.” In a Managed-For-You relationship, the representative “has a duty of utmost loyalty to the client, comparable to the fiduciary duty owed by a trustee to a beneficiary.

While we appreciate the reasoning behind distinguishing a representative’s duty based on the level of reliance placed by the client, the CFA Institute *Standards* require the same standard of care once an advisory relationship is established. We therefore encourage the OSC to require the same standard for making suitability determinations when the representative is in the role of providing investment advice, regardless of the scope of advice being sought or provided.

Overlapping Relationships

We agree that creating “relationship” categories may be helpful in focusing on the different levels of involvement between the client and investment representative in terms of the degree of advice sought and relied upon. Under the Model, the scope of responsibilities assumed by, and the types of disclosure and services that must be supplied by, the investment representative is tied to each of these categories. By regulating on the basis of the relationships that people form, the paper notes that it attempts, to the extent practicable, to put the investor and the investment representative on a level playing field.

We strongly support the overall objectives presented in the Model that seek to provide investors with meaningful and transparent disclosure, recognizing that most investment-based relationships involve some form of providing advice. In general, we believe that use of these categories is a good attempt to correlate the appropriate types of disclosure with the level of advice being sought and provided. The commentary recognizes, however, that a representative and client may be in two relationship types simultaneously, and the “practical difficulties with the same representative wearing two hats with the same client.” In such situations, the commentary suggests that the objectives of the Model will be met if the parties record their understanding in the Fair Dealing Document. However, given the potential liability attached to breaches of this understanding, we ask that the Adopted Rule formally recognize these situations and provide clarification of (or even examples of) the language that should be used in the Fair Dealing Document to satisfy both parties’ obligations.

III. Mechanics of Implementing Provisions

As discussed above, we strongly support efforts to clarify and strengthen the investment representative-client relationship. We understand and appreciate that this Fair Dealing Model is a work in progress, and that industry working groups will be providing additional input. In particular, we commend to these groups the following three areas for their consideration.



(a) Transparency of Compensation Received

The Fair Dealing Model would require the investment representative to disclose in the Transaction Summary—prepared before each trade—the total incremental cost of each transaction to clients, including all amounts of compensation received by the adviser. We agree that where fees and other costs are fixed and known, investors should be provided the information ahead of the transaction. In some instances, however, this is not practical. For example, if there is a multi-fill order over the spread of a day, there is no way to know the average price during that day, much less prior to the transactions. Similarly, in the case of a partly filled order, shares are bought on different days often with differing commissions, which makes determining the price prior to entering an order almost impossible.

We appreciate the recognition in the Paper that where the precise amount of compensation that the representative will receive cannot be determined until after the transaction is executed, the representative's duty will be met by describing in the Transaction Summary how the fees are calculated or by providing an estimated dollar amount. We support this approach and urge that it be fully reflected in the Model that is adopted.

(b) Communicating Risk Levels of Securities

We support the requirement that the representative communicate to the investor meaningful information about the riskiness of securities prior to the completion of a transaction. We also appreciate the recognition that these communications may vary, based on the investor, and should be tailored to the audience, while the emphasis remains on providing information that provides the investor the information with which to assess investment decisions.

Three methods noted in the Concept Paper that would be acceptable for communicating the varying risk levels of individual securities to investors are: making a subjective analysis of a security issuer's prospects; applying a rule-of-thumb test based on a few features; and applying a mathematical formula (such as a standard deviation measure) to historical data. Also recognized in the Paper, is that each of the suggested methods has its strengths and weaknesses. Given the range of alternatives that would appear to satisfy the Model's objectives, we encourage consideration of the newer methods of risk measurement, including holdings-based analysis and stress testing.

(c) Performance Information

The Fair Dealing Model also requires the investment representative to provide personalized performance information to clients. We support this objective. We also recognize that providing performance information for only one year may encourage investors to focus on short-term results, rather than on developing a long-term investment strategy. We therefore recommend that, where available, investment performance be provided for as long a period as reasonably possible.

We agree with the statement in the Concept Paper that there are many practical challenges for financial services providers to overcome in order to provide this kind of reporting, and that the



required calculation “is inherently complex.” We also believe that the utility of performance information is lost when there is no uniformity in its presentation, and thus no basis for comparability among different asset classes. Given the importance of providing investment performance information in a manner that is credible, uniform, and that allows comparability, we strongly suggest consideration of the CFA Institute Global Performance Presentations Standards, which are recognized, relied upon, and accepted around the world.

Attached is a description of the CFA Institute Global Performance Presentation Standards.

Closing Remarks

We appreciate the opportunity to comment on the OSC’s Fair Dealing Model Concept Paper. As discussed above, we strongly support the principles upon which this Paper is based. However, in certain areas, we believe that a higher standard by the investment representative is warranted. We also encourage use of the CFA Institute Global Investment Standards as a means of standardizing investment performance reporting. If you have any questions or seek elaboration of our views, please do not hesitate to contact Linda L. Rittenhouse at 1.434.951.5333 or linda.rittenhouse@cfainstitute.org.

Sincerely,

/s/ David L. Yu

David L. Yu, CFA
Canadian Advocacy Committee Co-Chair

/s/ Linda L. Rittenhouse

Linda L. Rittenhouse
CFA Institute - Advocacy



Attachment A

The CFA Institute Global Investment Performance Standards (GIPS®)

Background: The Need for a Uniform Reporting Standard

Pension funds, insurance companies, and individual investors are constantly scrutinizing past investment performance returns in search of the best performers of tomorrow.

In the past, the investment community had great difficulty obtaining meaningful comparisons of accurate investment performance results. Several performance measurement practices hindered the comparability of performance returns from one firm to another, while others cast a shadow on the accuracy and credibility of performance reporting overall. Some examples of misleading practices:

- **Representative Accounts**: “Cherry picking” a top performing portfolio to represent the investment results of a specific mandate which is not indicative of the firm’s overall performance.
- **Survivorship Bias**: Presenting an “average” performance history that *excludes* accounts whose poor performance was weak enough to result in termination of the firm.
- **Varying Time Periods**: Presenting performance for a selected time period during which the fund produced excellent returns or out-performed its benchmark – making comparison impossible.

Even among the most ethical firms, making an apples-to-apples comparison of investment performance was problematic. A pension fund looking to hire an investment-management firm might receive proposals from five different investment management firms, all using different methodologies for calculating their results.

AIMR Performance Presentation Standards Introduced in North America

The need for a common, accepted set of guidelines for the calculation and presentation of investment performance to prospective clients led the Association for Investment Management and Research® (AIMR) to develop the AIMR Performance Presentation Standards (AIMR-PPS®)



in the late 1980s². The AIMR-PPS standards are the manifestation of two fundamental ethical principles: fair representation and full disclosure.

In 1991, after years of work on the complex issue, AIMR formally adopted the AIMR-PPS standards to serve as an industry yardstick for evaluating fairness and accuracy in investment performance presentation (see <http://www.aimr.org/standards/pps/pps.html>). **The AIMR-PPS standards are a practitioner-driven set of ethical principles that establish a standardized, industry-wide approach to how investment firms should calculate and report their investment results to prospective clients in a way that ensures fair representation** (or in other words, avoids any misrepresentation of the information) **and full disclosure** (telling prospective clients everything they should know in order to fairly judge the information).

Because the AIMR-PPS standards were always intended to be voluntary, early skeptics doubted whether investment firms would go to the trouble of adopting them. But by the mid-1990s, investment consultants and potential clients began to exclude from their competitive bids any investment-management firm that did not report their historical results in compliance with the AIMR-PPS standards. It was just too difficult to compare investment performance history otherwise.

Today, industry surveys indicate that nearly 80 percent of U.S. investment firms and 65 percent of Canadian firms comply with the AIMR-PPS standards.

SETTING A GLOBAL STANDARD

Initially, only a few countries outside North America adopted the AIMR-PPS standards as their local performance standards. Some countries undertook initiatives to develop performance standards to serve as their local standard (either based on or independent of the AIMR-PPS standards). This led to a proliferation of different standards with some countries establishing their own nationally accepted guidelines while others had (and in some cases, still have) few or no standards. The result was confusion, limited comparability of performance results from firms in different countries, and a hindered ability of firms to penetrate markets on a global basis. Institutional investors and their investment consultants faced the same problems on an international scale that they had previously faced in North America before the AIMR-PPS standards.

² In May 2004, members of AIMR voted to change the organization's name to "CFA Institute." The name change does not immediately affect the AIMR-PPS® standards or the claim of compliance that many investment management firms use on their presentations of performance; however, we expect the AIMR-PPS name to change in the next two years for different reasons, as the US and Canadian standards continue to converge with the GIPS® standards.



In 1995, with the increased globalization of the investment industry – as well as AIMR’s own membership becoming multi-national – AIMR began to address the need for one globally accepted set of performance standards. AIMR sponsored and funded an international committee of both AIMR member and non-member experts to create a set of ethical principles that promoted global competition and encouraged self-regulation. Committee members from more than 30 countries worked for three years, comparing the AIMR-PPS standards to other local standards and common practices from around the world as they created and proposed a uniform global standard based on the ethical principles of fair representation and full disclosure.

In February 1999, AIMR’s Board of Governors formally endorsed the resulting Global Investment Performance Standards (GIPS[®]) as the worldwide standard for calculating and reporting investment performance (see <http://www.aimr.org/standards/pdf/gips.pdf>).

With the GIPS standards serving as the guidelines that investment firms should follow, AIMR took the first step in moving toward a global investment performance standard by significantly revising the AIMR-PPS standards to bring them in line with the GIPS standards, ultimately leading to revising the AIMR-PPS standards as “the U.S. and Canadian version of GIPS.” Steps continue today to bring the two standards closer together – ultimately leading only one standard.

These changes made it possible for North American investment managers to “transport” their historical investment results to many other countries without having to restate them using different calculation and presentation rules. (Conversely, it also allowed investment managers in other countries to compete for business in the U.S. and Canada using the global standards without having to recalculate the numbers to different North American rules.)

Today, 24 countries in North America, Europe, Africa and the Asia Pacific have adopted the GIPS standards, encouraging investment management firms to follow when calculating and reporting their performance results. (For a list, visit <http://www.aimr.org/standards/pps/gips-translate.html>.)

A survey released by PricewaterhouseCoopers in June 2004 found that 90 percent of 94 global asset management firms surveyed were either compliant with the GIPS standards or actively working to become so. Survey respondents were mainly independent institutional asset managers, but also included retail money managers, insurance companies and private banks. (View the survey at (<http://www.pwc.com/images/gx/eng/fs/im/finalpm2004.pdf>).

Who Benefits

The GIPS standards benefit two main groups: investment management firms, and investing clients or prospective clients (along with the investment consultants whose job is to evaluate, supervise, hire, and fire investment management firms on behalf of those clients).

- ▶ By choosing to comply with the GIPS standards, investment management firms assure prospective clients that the historical “track record” they report is both complete and fairly



presented. Compliance enables the GIPS-compliant firm to participate in competitive bids against other compliant firms throughout the world.

- ▶ Prospective clients have a greater level of confidence in the integrity of performance presentations as well as the general practices of a compliant firm and can more easily compare performance presentations across different investment management firms. While the AIMR-PPS and GIPS standards certainly do not obviate the need for other in-depth due diligence on the part of the plan sponsor or consultant, compliance with the standards provides a level of credibility to the performance results of investment management firms that have chosen to undertake this responsibility.

Who Verifies and Enforces

Compliance with the GIPS standards is voluntary. Refusing to comply does not violate any law or regulation. However, a false claim of compliance does. For example, the U.S. Securities and Exchange Commission has warned investment advisers and managers against falsely claiming that their performance history complies with the Standards. The SEC has sanctioned firms for falsely representing that their performance returns were AIMR-PPS-compliant. (For example, <http://www.sec.gov/litigation/admin/ia-2023.htm>.)

CFA Institute develops and maintains the Standards, but does not conduct verification or “audit” of a firm’s claim. Rather, a new industry of verification specialists – including the biggest accounting firms – has sprung up in recent years to meet the need for third-party verification. (See <http://www.aimr.org/standards/pps/industry.html>).

How the Standards Are Set (and By Whom)

Over the years, CFA Institute has revised and updated the Standards in response to many comments and recommendations from industry practitioners. Potential modifications and expansions to new areas (e.g., real estate or private equity) are studied and proposed by the CFA Institute-sponsored Investment Performance Council (IPC), which consists of 36 members from 15 countries on five continents. (See <http://www.aimr.org/standards/pps/ipc/index.html>.)

The IPC’s members have diverse and in-depth investment experience, including members from firms of all sizes who specialize in mutual funds, private wealth management, pension funds, private equity and venture capital, real estate, investment consulting services, performance measurement and performance verification. The CFA Institute Board of Governors maintains final oversight on changes to the Standards, based on the input and recommendations from the IPC. (See “Process for Developing New Provisions and Guidance Statements” at <http://www.aimr.org/standards/pps/process.html>.)