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By Email

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Dear Ms. Josée Turcotte and Ms. Anne-Marie Beaudoin,

Please find enclosed McBride Bond Christian and Harold Geller's Correspondence letter to Canadian Securities Administrators Consultation Paper 33-404 – Proposal to Enhance the Obligations of Advisers, Dealers, and Representatives Towards their Clients.

Kind regards,

Monica Kaur
Legal assistant for Harold Geller

Encl.
Correspondence Letter

RE: Canadian Securities Administrators Consultation Paper 33-404 – Proposal to Enhance the Obligations of Advisers, Dealers, and Representatives Towards Their Clients

Introduction

McBride Bond Christian LLP and Harold Geller are pleased to comment on the Canadian Securities Administrators ("CSA") proposal for targeted reforms to enhance the obligations of advisors, dealers, and representatives toward their clients ("Reform Proposal") as well as the potential introduction of a regulatory Best Interest Standard ("BIS").

The Reform Proposal is a welcome step towards protecting investors from unfair, improper and fraudulent practices. It should foster both efficiency of and confidence in capital markets. Without improved protections for retail investors, confidence in capital markets should and will continue to erode.

Best Interest Standard

It is our opinion that the existing suitability standard (as amended by CRM2) fails to provide basic protection to Canadian retail investors. Advisers and dealers rely on the suitability standard ("Suitability") to justify poor advice and compliance failures. Most importantly, they use Suitability to excuse conflicts of interests. For example, a high-cost solution may be suitable for the client, but only in the best interest of the adviser and dealer. Another example is an adviser who recommends a product that the adviser is licensed to sell, which may be inferior (for the client) to one the adviser cannot sell.

Canadian retail investors are told by the financial services industry that their advisers and dealers are "professionals" who provide advice in their clients' best interest. Retail investors rely on their advisers and dealers, due to the imbalance of knowledge and sophistication. This makes them vulnerable to abuse. Mere disclosure of conflicts cannot overcome this imbalance unless the investor is both financially and legally sophisticated. Investor protection rules must put the onus on the financial adviser and the firm– as is common in most other recognized professions. Right now in Ontario there are stronger protections when a consumer buys a car than getting advice from a financial adviser or firm. This must change.

In the absence of a BIS, the industry has exploited the many loopholes in Suitability to return retail distribution of financial products to a "buyer beware" "sales" environment. This is true for the vast majority of individual investors. There is no reason to believe that any of the recent reforms will affect this industry-wide exploitation.

Markets are complex, and becoming more so. The evolution of financial products has increased the imbalance between adviser and client knowledge. So called advisers and their dealers have access to information and analytical tools and expertise in their back offices. In contrast, retail investors lack the information, tools and the necessary skill to analyze choices, risks and rewards. This rising imbalance accounts for the rapid growth of the many-labelled financial advisers (and planners) and their respective dealers. In short, retail investors have to and do rely on advisers and dealers to steer them in the right direction. Advisers and dealers get this. Reliance coupled with an imbalance in knowledge lead to vulnerability. In the CSA system, regulators mandate advisers and dealers to govern themselves as professionals. The reliance and mandate trigger the CSA Proposal.

As defined benefit pension plans disappear, the public recognizes the importance of financial planning for individual investors. The financial services industry promotes this recognition together with the necessity of advice from advisers with their special education, knowledge and skills. The real question becomes: is the quality of that advice undermined by the asymmetric knowledge and conflicts of interests? If so, the present policy and rules have failed to improve the outcomes for consumers.

Limits and Assumptions of this Submission

We are consumer advocates. We do not have the support of industry parties who pay for submissions of this kind. Although this response is not formatted as requested in the CSA's proposal, it represents the investors' perspective. We hope and trust it will be considered as it is intended – to address the basic policy decisions.

Fortunately, the CSA will have excellent input from organizations which are widely considered to advocate for the consumer including: FAIR, SIPA, Kenmar and the OSC's Investor Advisory Panel.

This submission will address 3 themes that are common to CSA members:

1. Strong Investor Protection
2. Responsive Regulation
3. Effective Supervision and Enforcement

This submission makes these assumptions:

1. Retail investors rely on financial advice from regulated advisers and their firms. This is true not only in IIROC, MFDA, exempt market dealer and ICPM channels, but also insurance companies and their agents. It also applies to the largely unregulated and problematic area of financial planning.

2. The Canadian public believes that financial advisers are professionals who are required to and do act in the best interests of their clients.
3. The complexity of products and strategies put them beyond the understanding of most Canadians, who are therefore unaware of related conflicts of interests.
4. There is no evidence that the present disclosure system (or the anticipated disclosure mechanism under CRM2) will change assumptions 1-3. This is particularly true as dealers do not make disclosure in plain language. This will not change under CRM2. For example consider the well-intentioned Fund Facts, which are highly complex. As a further example, "Risk Disclosure" is defined by Fund Facts as being volatility only. This is misleading, as only partial disclosure of this foundational concept is required.

Strong Investor Protection

The status quo must change. The system in place relies heavily on Suitability. This is a low standard for advisers and dealers. Suitability ignores self-interest, a proven driving factor in sales by advisers and firms. Sales people follow incentives, in all industries. Regulators must overcome this Prime Rule of Sales. Suitability places the onus on the investor to know when an adviser or firm does not act in the client's best interest. This is rarely obvious at the time when the key paperwork is or should be created. From the investor's point of view, the rules governing sales of securities and disclosure/analysis of financial products are a barrier to self-protection. They do not protect. They confuse.

In effect, the only way for an investor to challenge poor KYC records and investment advice is to become expert retroactively to when the steps occurred. To be blunt, after the fact, the SROs, Dealers and advisers rely on the imbalance in knowledge to defend sales techniques that were in the adviser and dealers' best interests (sales and revenues) at the expense of the investor (cost and risk of loss). It is not the current intent of SROs to defend their members. However, industry and SROs have the same view: clients have to prove what went wrong, as if this were a Court of law where the plaintiff has to prove its case. The proper approach should be to consider what went wrong and how to avoid that outcome in the future. To adopt the proper approach requires a change of perspective. What is needed is to change the standard. Put the investor's best interest first. This is the BIS.

The BIS must be two parts:

1. an overarching principle that the adviser and firm must always act in the best interests of the client; and
2. an evolving rule which keeps the spirit of the principle relevant to the changing role of advisers and dealers. Consider how self-serve brokerages emerged in the late 1990's, thoroughly impacting the KYC obligation of dealers. The emergence of robo-advisers

(and other Fintech advances) may require amendments to how the rule is applied to remain relevant.

The BIS must not be limited to product evaluation. Few investors go to a financial adviser or dealer for a specific product – they go for advice. From first contact to termination of the relationship, the BIS must apply to all financial advice. No loopholes or exceptions. The adviser or dealer can choose not to offer services to a client. Consider the initial discussion in which the client is trying to decide whether to retain the adviser/firm. The client usually thinks that what the adviser says is advice. The adviser may think that this was a promotion that was not subject to the BIS. They were just discussing whether to enter into a retainer contract. The BIS must be absolutely clear. Advisers and firms must adhere to the BIS from the point of the initial contact.

The CSA and its members across Canada should conduct an audit of the adviser's and the dealer's responses to complaints with a critical review – not a check the box exercise.

The paperwork will demonstrate how registrants failed to meet the regulatory obligations when dealing with client complaints. In other words, they do not put the best interests of their clients first. They prefer their own bottom line to client protection. Here are some illustrative examples:

- Dealers routinely claim "litigation privilege" over all documents related to both of the advisor's and the dealer's obligation, pursuant to IIROC and MFDA rules and policies.

  After investigating and responding to investor's complaints, the current obligation of the dealer is to investigate the complaint "fairly, honestly and in good faith." In our experience, investigations appear to be incomplete. Dealers use the complaint process to prepare for potential litigation. What the client says will be used against the client, although the client does not know this. The dealer is acting in the best interest of the dealer and not of the client. This is confirmed when disclosure of these investigations is required under PIPEDA and provincial equivalent privacy laws. Commonly, dealers and advisors defend their refusal to disclose complaint investigation documents that are prejudicial because their "primary purpose" when dealing with investor complaints is to defend their own self-interests. This practice is known to the SROs, yet there are no actions taken. It appears that the SROs do not feel they have the tool to act in the investor's interest. The existing duty and standard is inadequate.

- Dealers deny even clear claims where the client does not have the skill to describe the exact nature of the claim properly.

In short, the industries' response is to find a defence based on the litigation analysis in respect of the claim advanced. Not whether there is a claim, but whether has been expressed perfectly by the client. Again, recall that the duty to act "fairly, honestly and in good faith" is set aside when the dealer determines that a complaint (not a threat of a lawsuit by the investor or an actual lawsuit) can be defended based on some of the paperwork and the word of the adviser. Often, the dealer knows that the word of the adviser is suspect. Routinely, the dealer's response to the client ignores:

a. Incomplete and blank forms;
b. Errors in key documents;
c. Absence of key documents;
d. Absence or errors in respect of records of trade components;
e. Confusing or complex language in records to disclose risk or warnings against investor's poor decisions.
f. Analysis of what went wrong and why. Clients are often correct to complain, but incorrect on what they complain about.

The strategy applied by dealers most commonly is to defend their own interests despite objective evidence of poor advice and compliance breaches. Often, we see dealers rejecting complaints as meritless when there is no recorded support for the advice (such as buy, hold, sell and associated strategies). CSA and SRO regulations require that dealers keep records to support what advice was given when, how and why. Dealers should show that they have acted honestly, fairly and in good faith, but there are rarely any records to show this.

Often dealers reject complaints despite objective evidence that the recommendation was not based on adequate KYC and KYP. We have seen cases where dealers actually know their advisers' evidence is unreliable, yet they present that evidence as being accurate where it suits the dealers. If the standard is Suitability, then dealers can reverse-engineer their advice to argue that – regardless of breaches – the recommendation was suitable for the client. This is a conflict of interest as between the dealer's self-interest to defend a potential claim and the client's interest to know what happemed and why.

<u>For example:</u>

i. Advisers recommend leverage loans, in which retirees (or those near retirement) with limited funds borrow money to buy mutual funds. Dealers consider this to be suitable if the forms completed by the adviser

suggest that the client has good investment knowledge and high risk tolerance.

To compound this problem, advisers often recommend return-of-capital mutual funds that spin off distributions that cover the loan costs. The distributions appear to be income, but the MERs equal the dividends, so that there is no "income" as such.

Most retail clients actually have limited investment knowledge or awareness of the risks. Usually, clients do not appreciate that the MERs of the funds plus the interest on the loans combine to overcome the expected returns from the mutual funds. Rarely do clients understand that the dealer earns 5% up front plus referral fees from the lender.

Dealers and the SRO (here, the MFDA) allows the KYC form with 3 boxes checked off and a disclosure form signed, to serve as a shield to a complaint that the KYC process broke down. All this despite MR-69, which has been in effect since 2008.

ii. Advisers recommend clients commute their employment pensions without warning of the inappropriateness of this strategy in almost all cases. These are sales based strategies that are usually driven to create fees. The recommendation conflicts with the best interest of the retail investor. It has been our experience that dealers claim that clients made the commutation decision before the client-dealer relationship arises. They create the KYC forms after commutation, and this becomes the start date for their Suitability obligations.

- Investor complaint handling both by dealers and SROs is fundamentally flawed because of internal conflicts of interest. The problem is that they rely on the investor to frame the complaint. This assumes that an investor has sufficient sophistication to frame the complaint. In our experience representing hundreds of investors, it is rare that the client can define what went wrong. Clients only know that they sought advice, relied on that advice and suffered a loss. In cases of fraud, they may know a bit more, but not what role the dealer played or should have played.

  In our experience, when the complaint fails to encompass the technical wrong, then the dealer and SRO dismiss it.

We advocate that the dealer and SRO conduct a careful review of the file without predetermination of what to look for. This will uncover any regulatory breaches that occurred. Clearly, some cases will lack merit upon careful independent review. However, some breaches that concern regulators and should concern dealers do not lead to loss. These should have been disclosed and reported.

Both dealers and SROs should use the complaint as an opportunity to conduct a wider review than just this one case. It is common that a complaint serves as a "red flag" to alert the investigator to more widespread problems. There may be more than one affected client, more than one account, more than one incident.

When we investigate dealer responses to our requests for information we routinely find that the records disclose repeated regulatory breaches. How could these not have been discovered and reported? As litigators, we often obtain proof of complaint handling errors during the discovery process where the evidence cannot be shared with regulators as a result of the "deemed undertaking" obligation. We therefore know that complaint responses are inadequate but that SROs have not received complaints, but we cannot point the SRO to a reconsideration of their cursory investigation. On the other hand, an audit of complaint handling by dealers would uncover significant evidence for policy maker's consideration.

These examples show how Canadian investors are not adequately protected by either the historical consumer protection initiatives or by CRM2 reforms. These examples show failure to deal with complaints "fairly, honestly and in good faith".

These examples reflect the sales environment of dealers. From our point of view, dealers are in a conflict of interest and have preferred their own interests when confronted with complaints. Targets of complaints are expected to confess all to both their complainants and their regulators, yet they do not. Consider the promise of "peace of mind" in dealers' promotions to their "fortress defence" attitude when something goes wrong. Dealers will not treat their clients fairly until they are compelled to do so. The BIS is the tool to make this happen.

Responsive Regulation

The CSA's members are faced with a challenging environment. One group of stakeholders – retail investors - is disorganized and lacks a sophisticated, funded voice. The other group is a financial services industry that defends its profit model with unlimited resources, a common interest and unified voice.

Regulators seek to explore the impact of current regulation, and to grapple with alternative solutions to problems raised. The financial services industry conducts extensive lobbying and makes detailed submissions, stemming from its motivation to protect its profit model.

The countervailing side is that of the retail investor, represented by uncoordinated, well-intentioned investor advocates. None have access to substantial resources to make their case to the CSA. Two groups that form part of this side are FAIR and the OSC's Investor Advisory Panel (IAP). Other volunteer commentaries are provided by the Small Investor Protection Association (SIPA) and KenMar. There are several individual volunteers who provide comments in support of fairness for Canadian Investors, such as John DeGoey and Dan Hallett. However, regulators have only occasional access to the positions that should be advanced by retail investors.

The regulators themselves consist to a significant extent of former members of the financial services industry. This suggests some level of industry bias when regulators consider lobbying and submissions from their former colleagues. The issue is not whether this is wrong – there may be no other way to find qualified people to lead and staff regulators – but how the foreseeable bias is managed. While it is appreciated that the CSA seeks input in responses to proposals (such as this one), the CSA cannot rely solely on submissions to appreciate the issues. Such submissions will likely be imbalanced and favour those whose financial self-interests are at stake.

Simply put, regulators have little input from consumers. Only the OSC has recognized the need to raise the profile of investor issues through direct contact with investors and their advocates. The OSC has created and funded the work of the Office of Investor and the IAP. These two arms of the OSC raise issues from the perspective of the investor. They have conducted empirical research to inform regulatory decision making. The research has been unbiased, ground breaking, and disclosed problems with the current investor protection regime.

A recent example has been the Mystery Shopper exercise, confirmed by a separate inquiry by the Globe & Mail. The results belie the submissions of the dealers that retail advice to consumers is suitable and professional. In addition, this research raises fundamental questions about supervision and compliance failures which, in our view, lead regulators to doubt SRO and dealer willingness to deliver effective compliance, supervison and enforcement.

The CSA's member commissions need more and better presented investor input. Each member should replicate the OSC's Office of the Investor and the IAP. Regulators should also fund consumer protection organizations such as FAIR. FAIR representatives, IAP members (from across Canada) and other consumer advocates should be included in the governance structures of the CSA, the provincial Securities Commissions and especially SROs. Where industry dominates, proactive action is necessary to provide investor input as well. Increased audit of complaints will also provide specific examples and empirical data to support Responsive Regulation.

Conclusion: The CSA Should Adopt a BIS

Two of the major CSA members are at odds over adoption of the BIS. While Ontario has repeatedly stated that BIS is a priority, the BCSC released a statement of its opposition. Those provinces that prioritize meaningful Investor Protection should, for their residents, adopt the BIS. It can only be hoped that other provincial regulators will follow suit.

Two themes recur when investors are consulted:

1. The vast majority of investors believe that their dealers already are governed by the BIS; and
2. The BIS and concurrent increases in the standards for education, training, and complaint handling are key to investor protection.

A survey of advertising and promotions by dealers across Canada projects the image that they act in the investor's best interest. When they promote a standard, they should be held to it through regulatory enforcement. This should occur in plain view, not in backroom suggestions.

Based upon the above, investor advocates uniformly support the adoption of the BIS. On the other hand, the financial services industry has long fought to defeat and delay CRM2. It is expected the industry will use the same approach in opposition to a proposed BIS.

While some CSA members believe that the watered-down CRM2 initiative is sufficient for investor protection, they dismiss investor advocates while they accept the representations of the industry to support the status quo. If these commissions supported independent and funded submissions on behalf of retail investors, then their conclusion might appear to be better balanced and informed.

Any argument against BIS must be based on market efficiency. Regulators should compare the loss experience of Canadian investors to the costs saved by the financial services industry. The consequences of investor losses should include loss of tax revenues, increased poverty and related social issues, and market inefficiencies. We are not aware of any research to assist the CSA in its consideration of those consequences.

Investor advocates, including the authors, submit that the CSA, its member commissions and its SROs should reconsider how the effectiveness of present Compliance, Supervision and Enforcement is determined.

We submit that raising the bar to require a BIS and higher professional standards is long overdue. Effective Compliance, Supervision and Enforcement require the CSA to adopt the BIS.

A BIS should be robust. It should include both a principle and a regulation.

The principle is easily defined. The two clearest and most widely accepted standards are proposed by the Chartered Financial Analyst Institute and Financial Planning Standards Council. These two definitions are reasoned, widely acceptable and appropriate for the defining of the BIS by the CSA. We urge that these standards serve as the BIS to be adopted.

All of which is submitted by McBride Bond Christian LLP and Harold Geller.