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Alberta Securities Commission
Authorite des marches financiers
British Columbia Securities Commission
The Manitoba Securities Commission
Financial and Consumer Services Commission (New Brunswick)
Nova Scotia Securities Commission
Ontario Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan

Dear Friends:

Re: CSA Consultation Paper 33-404

We thank you for this opportunity to submit our thoughts on CSA Consultation Paper 33-404.

Pacific Spirit Investment Management Inc. is licensed as a Portfolio Manager in the Provinces of British Columbia, Saskatchewan, and Ontario. Our firm works exclusively with individual investors and we do not manage funds for institutional investors. We manage approximately $170 million for approximately 170 client families.

We manage each client account separately – each account holds its own investments which are consistent with the Investment Policy Statement for that account. We do not offer any proprietary products – no proprietary funds, no proprietary pools. We are fee-only. The only compensation we receive is the portfolio management fee that we invoice our clients quarterly. We do not receive any commissions, referral fees, trailer fees, or soft dollars.

We generally prepare a basic retirement plan for clients as part of the onboarding process when we enter into a new client relationship. We believe that the preparation of a plan serves as an excellent communication tool between ourselves and our client and the plan provides inputs for the Investment Policy Statement.

We have two registered Advisers (Portfolio Managers) who both hold the CPA, CFA, and CFP designations.

Our clients may hold individual equities and fixed income investments as well as mutual funds and ETFs. We also invest in mortgages and mortgage investment corporations. We have invested in real estate limited partnerships.

Conflicts of Interest – General Obligation

We recommend that a definition of **material** conflict of interest be included.

We ask that registrants be able to rely, in the absence of any evidence to the contrary, on a signed statement by a client that they understand the implications and consequences of a conflict and that they consent to the course of action.

Know Your Client

We disagree with the proposal that a registrant gather information related to the basic tax position of a client. We do not believe that most registrants are capable of understanding a client's tax position or providing tax advice. In addition, most registrants are not lawyers or accountants licensed to provide tax advisory services to a client. If we identify a tax issue for a client, we advise them to review the matter with their tax adviser; we do not provide tax advice to our clients.

If a registrant collects information about a client's tax position, will a court subsequently determine that if you collect information on tax position and do not act on it, that you are liable for any loss (or unrealized opportunities) incurred by a client.

Most portfolio managers are not financial planners; they are not trained to perform an overall assessment of a client's financial position and provide advice. Many portfolio managers work as part of a team with a client's other advisers who provide advice as necessary in relation to taxes.

A few of our clients hire a number of portfolio managers to manage their assets – not wanting to put all of their eggs in one portfolio manager's basket. Having several managers collect and act on tax information creates a situation that is rife for errors – duplicate steps taken or steps taken by one manager being negated by the steps taken by another manager. A few clients hire us as managers for a specific mandate – such as US equities or fixed income. If the mandate is focused, should the portfolio manager be required to take a holistic approach to the client?

We disagree with the proposal that a registrant gather information related to the debt position of a client. Most portfolio managers are not financial planners and are not trained to perform an overall assessment of a client's financial position and provide advice.

Are we portfolio managers or are we financial planners? If you determine that we are both, you should ensure that your proposals are consistent with the work being done in Ontario concerning the regulation of financial planning advice, and that you allow sufficient time for registrants to complete the necessary education – likely 3 to 5 years.

You should ensure that key terms are defined and well understood. For example, what is risk attitude and what is loss aversion?

If a client sends in a signed KYC form by mail, are you really asking the Portfolio Manager to sign the form **and** return the signed KYC to the client to ensure that the client has retained a copy of the KYC? This seems like a waste.

We believe that the CSA is focusing on the wrong definitions of risk. The CSA is focusing on volatility (as the measure of risk) and also the risk of permanent loss. Volatility is a short-term measure, whereas most client investment goals are longer-term. Volatility isn't risk and temporary declines can only be turned into permanent loss by behavioural mistakes.

We would argue that the proper risk to focus on is the risk that the client will not meet their investment objectives. For example, the risk that the client will outlive their money, or the risk that the client will not be able to maintain their inflation-adjusted draws from their portfolio. When our clients identify that their financial goals are that they "do not want to eat dog food" in their retirement or they "do not want to be a financial burden" on their children this confirms to us that the long-term objective, and therefore the risk of not achieving the long-term objective, is the proper focus.

We would argue that a portfolio constructed of quality stocks and bonds will have little or no risk of permanent loss. The behaviour of the markets over time has confirmed this. We work with our clients to ensure that their anticipated cash needs can be sourced from their portfolio without having to sell equities at a loss. The role of equities in the portfolio is to generate long-term returns and growth in income. The role of fixed income in a portfolio is to provide income and to serve as a source of cash when equity markets are troubled. The behavioural investment counselling services of the Portfolio Manager are important to the

achievement of long-term goals. The dominant determinant of long-term, real-life return is not investment performance but investor behavior. Behavior modification is an advisor's value proposition, because great behavioral advice — at critical moments in an investor's lifetime — is crucial to the achievement of long-term goals.

We tell our clients that we spend 50% of our time managing their portfolios and 50% of our time managing our clients – helping them stay faithful to the long-term plan and counselling them from making poor investment decisions at all points in the market cycle. We believe that the effects of short-term volatility can be significantly reduced or eliminated through Behavioural investment counselling and proper portfolio construction. We commend you to read the collective work of Nick Murray (www.nickmurray.com).

In your Proposals document you ask (Question 56) whether additional guidance should be provided in respect of risk profiles. We believe that if you proceed with the proposals in the risk profile area, you should provide extended guidance so that there is a good understanding as to what the regulators are seeking.

In our opinion the sum of the proposals in the Know Your Client section of the Notice will move registrants into the financial planning area. It is our opinion that if you genuinely desire to improve the outcomes for investors you should:

1. Mandate that every client have a personalized financial plan that includes sections for goals, retirement planning, insurance, debt management, estate planning, and risk tolerance assessment. The plan should be sufficiently detailed that it will serve as a road map for the client and a guide to the advisor. The plan should be reviewed with the client.
2. The registrant be required to report annually to their clients about progress against the plan.
3. The plan should be reviewed and updated periodically and whenever there is a significant life event.

The proposals state that “firms and representatives should not simply assume that their client will understand the KYC form and related discussions or interactions. The obligation is on the firm and representative to confirm that the client has a reasonable understanding of the KYC form, including its completed content, and the outcome of the KYC process”. Would this not require the registrant to discuss with the client the effects of different choices that a client may have made in completion of the KYC form? For example, if a client is too

conservative with their risk tolerance assessment they may, unknowingly, be giving up future growth and a better lifestyle in the future. I believe that a good adviser has an obligation to discuss this with the client, yet the Proposals state that "if the representative encourages the client to increase his or her stated capacity for risk in order to achieve the required rate of return so the client meets his or her stated investment needs and objectives, this would not comply with the KYC and suitability obligations or the general duties owed to clients". Many clients do not understand risk. Many clients have difficulty with the mathematics relating to the long-term nature of retirement planning. Many clients do not understand the long-term effects of inflation. Isn't it the role of the adviser to explore these with the client and help them come to the optimum decisions for them and their families? A good adviser will counsel the client in ways (including tweaking asset mix) that will benefit the client for the long term.

Know Your Product

It is our opinion that the Proposals in the Know Your Product section are too focused on assessing the security in isolation and not as a part of the overall portfolio. It is important to consider the question: what does the security contribute to the client's overall portfolio?

Our firm has no proprietary product. There should be a third category of classification beyond proprietary and mixed/non-proprietary. We are offended that we will be classified as mixed/non-proprietary. Grouping us in this classification will impair our relationship with our clients. We do not want to give them any reason to believe that we will be investing their funds in a proprietary product. To us that is an irreconcilable conflict.

The Proposals also state that we will have an obligation to assess whether the range of products is representative of the range of products most likely to meet the investment needs and objectives of its clients." Given that crafting a portfolio involves tailoring the portfolio to our client it may be that the portfolio is not the one "most likely" to meet the client`s investment needs, but may be one that satisfices in order for the client to remain faithful to the investment program throughout the market cycle. The Know Your Product requirements do not consider the risk tolerance of the client, and this is a mistake. It may also be that the client will specifically exclude certain assets from their mandate (tobacco, munitions, environmentally unfriendly, Enbridge, etc.) which may have the effect of making the portfolio less than optimal to meeting the client's investment needs.

Also, the Know Your Product requirements appear to assume that the Portfolio Manager is working in an environment with a higher degree of clarity than what we experience in reality. Also, a Portfolio Manager cannot know every stock, bond, or mutual fund in the investable universe. They cannot know about every real estate opportunity, alternative investment, hedge fund, annuity, insurance product, or derivative vehicle. To ask them to meet the "most likely" test is demanding too much. A Portfolio Manager should be required to disclose how they go about making their investment choices so that the investor can determine if the fit is appropriate.

We manage portfolios which include stocks and mutual funds. There are thousands and thousands of stocks and mutual funds. How can we be expected to know all of the "products" that are available? Nobody can. Like other professionals, a **registrant should be held to the standard of their profession**. What would another Portfolio Manager acting reasonably do?

Registrants should not be required to identify a target rate of return that the client will need to achieve his or her investment needs. This is a gross simplification of the world of investing. We do not control the markets and, in fact, we take what the markets give to us. Forecasts that assume a single rate of return do not reflect the real world. When planning we have to assume a range of possible outcomes. In reality there can be significant periods of bull, bear, and range constrained markets during an investor's life.

The problem with retirement planning is that no one can predict the future. Will future equity markets be more like the equity markets from 1975 to 1987 where the stock values grew virtually every year, or will they be more like the equity markets of the Great Depression? How do you plan when there can be such a broad range of future outcomes? The retirement planning software that we use projects possible outcomes based on historical returns from the markets. The model assumes that the future will look something like the past. If the retirement plan will work under the worst case scenarios from the past (defined as the 10% worst historical outcomes) then you can take great comfort that it will work in the future.

If you are lucky and the future unfolds more positively than your plan (which is based on 10% worst historical outcomes), then you can increase your spending over time. If you are unlucky and the future unfolds in line with the worst case scenarios then you can take comfort knowing that your plan will work and you will not outlive your money. As Portfolio Managers we are constantly working with

our clients to improve upon the worst case scenarios so that the client's retirement outcomes are improved.

You will do a grave disservice to investors if you hold up a single rate or return as the goal. Reality is that you need to project a range of outcomes as no one knows what will happen in the future. We need to ask if the plan will work under most foreseeable conditions, not just the median projected outcome.

Selecting a target rate of return also overlooks the sequence of returns risk, the risk of market volatility (returns are not consistent year to year), and longevity risk.

We incorporate by reference into this submission the writings of Jim Otar (http://www.flip4u.org/docs/Unveiling%20the%20Retirement%20Myth.pdf) which we commend to you for reading.

The Suitability requirements suggest that the registrant consider basic financial strategies that the client could use to meet their investment needs and objectives …such as paying down high interest debt or directing cash into a savings account. We question why the regulators have only considered the strategies outlined and have not considered life insurance requirements, long-term disability coverage, critical illness insurance, and other strategies that may have more significance to the investor than those listed in the Proposal document. We do not believe that most Portfolio Managers have the capability to be financial planners, and they also do not have the appropriate credentials.

The Proposal sets out that if an adviser steers a client to a product other than a securities product they need to be able to substantiate why the recommendation not to buy a securities product is suitable for the client. We believe that the Portfolio Manager should only be held to the test that the product recommended is suitable to client and will assist in the achievement of the financial goals of the client. Why do you need to substantiate the non-purchase of a security? In many cases it is not an either or case. Often there is no security alternative to an insurance or banking product. When we invest in securities we do not have to substantiate why we did not buy one security over another. We substantiate why we purchased the specific security that was purchased. Why should the test be different if the product is not a security?

There is faulty logic in the General Suitability guidance in that there is a proposed requirement to ensure a recommendation is of a product that is **most likely** to achieve the investment needs and objectives. Once you use the word **most**

there can be only one strategy that is **most** likely. There cannot be several strategies or products that are equally suitable and that are equally effective as only one can be the **most likely**.

There is too much emphasis on cost in the Proposals. In addition to cost, there are many other factors to consider including liquidity, reputation, performance, trading cost, bid-ask spreads, etc.

Titles

Registrants should be allowed to use titles that are descriptive and meaningful to clients. We presently use "President" and "Portfolio Manager and Economist" to describe the roles of our two registrants. We use President in order to communicate that John S Clark is in overall charge of the firm. We use Portfolio Manager and Economist to describe Dennis Wan`s role managing portfolios and his substantial knowledge in Economics as he holds a Master's Degree from the University of London. These titles provide the client with much more information than the prescribed "securities adviser – portfolio management".

Designations

Our registrants hold the CPA, CFP, and CFA designations. John S Clark is also a CIM. All of these designations should be accepted for use as they indicate to the client the level of training achieved by the holder, the professional status and responsibility of the holder, the skill set of the holder, and the holder`s dedication to education.

Best Interest Standard

We fully support the requirement that a registrant managing funds on a discretionary basis should have a fiduciary duty to their client. This should be the case whether the registrant is regulated by a CSA member or IIROC.

Portfolio managers already owe a fiduciary duty to their clients under common law as well as under statutory provisions in certain provinces. Accordingly, portfolio managers conduct their businesses pursuant to this higher standard – a standard that is principles-based and which has a long and developed history of jurisprudence surrounding its meaning and application.

We support higher levels of investor protection and believe that **all persons providing investment advice to clients**, regardless of that client's level of sophistication, should be subject to the fiduciary duty.

We are confused as to how a regulatory best interest would work. Does this mean, as some in the industry and a practicing lawyer have advised us, that the investment solutions that we provide to our clients must be the best available? If that is the case, then the standard is unrealistic. You should only be held to the standard of your profession, not to the best available.

We also have difficulty with a system whereby the creation of the law and the interpretation of the law rests with the same body – the Canadian Securities Administrators. Case law on the fiduciary duty accounts for the facts of each specific client-registrant relationship in a nuanced fashion. Case law is based on decisions by the independent court system.

In addition, how the regulatory best interest will be assessed is quite unclear. Guidance on what best interest means is lacking. The lack of clarity means litigation and shortfalls in investor protection.

Costs of Compliance

Complying with the new regulations will be costly. We presently offer our services to families with at least $500,000 to invest. If the proposals are enacted as circulated we would immediately increase our minimum threshold to at least $750,000 and likely to $1,000,000. In our opinion, the net effect of the proposals would be to deny sound investment advice to many Canadians.

Disclosure Fatigue

When we started in the portfolio management business over 20 years ago our Investment Management Agreement was about 4 to 5 pages. Clients would read the entire agreement before signing. I know because I would sit in our boardroom as they read the document and we would discuss the document. Now we provide our clients with a Client Relationship Disclosure document (10 pages) and our Investment Management Agreement is about 15 pages. Clients are overwhelmed by the paperwork and do not read the documentation. Increased disclosure is resulting in less informed and less engaged clients.

Thank you for this opportunity to submit our thoughts.

Sincerely,

PACIFIC SPIRIT INVESTMENT MANAGEMENT INC.

John S Clark

John S Clark CPA, CA, CFA, CFP
President