30 September 2016

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Autorité des marchés financiers
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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

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Regarding: **CANADIAN SECURITIES ADMINISTRATORS CONSULTATION PAPER 33 -404 PROPOSALS TO ENHANCE THE OBLIGATIONS OF ADVISERS, DEALERS, AND REPRESENTATIVES TOWARD THEIR CLIENTS, April 28, 2016**

Please accept my submission on the above noted proposal.

The Consultation discusses a "best interest standard" for the Canadian Retail Financial Services Market place. The standard is stated as a standard of care and is effective in regulation as a principle (as per statements made in the benefits of a best interest standard) and not a rule. The proposed best interest standard is an about turn from the 2012 statement of intent which was framed as a fiduciary standard and a marked change in direction from the 2004 Fair Dealing Model which acknowledged that the relationship in the industry had transitioned from that of providing transactions and incidental advice to that of advice and incidental transaction.

The proposed standard is not a best interest standard. The CSA or rather the OSC and the FCNB have distanced it from a fiduciary duty and thus removed its regulatory intent and have clearly stated that it will not interfere with current registration categories. This is material. One of the reasons for introducing a best interest standard was to acknowledge that the advisory relationship no longer remained that of an arm's length commercial relationship where common law would only grant a fiduciary relationship under extreme circumstances, but one where the representation of service had moved to that of the provision of advice and the duties thus elevated. The consultation provides clear instructions to the courts that the relationship is transactional, of the product, where advice is episodic and incidental.

Instead, the consultation, as part of the Proposed Targeted Reforms, has recommended that services that provide advice under a discretionary authority be accorded a clear statutory fiduciary duty. Investors receiving advice under non discretionary mandates, which rely on the same processes, should not be accorded less protection and lower standards of care. The fiduciary liability with respect to advice is represented by the gap between service representation and the integrity of a firm's service processes to deliver the represented standard of service. These are processes over which the advisor and firm have complete discretion. We know that service representation does not promote the advisor as just a product seller, but this is the relationship which the CSA are regulating and failing to disclose.

To have a fiduciary duty for the provision of investment advice means that you are responsible for making sure that the representations of service are matched by the processes that construct, plan and manage. The Consultation has therefore framed the advisory service as one focused primarily on the point of the transaction. The act of according fiduciary status to the discretionary form of the advice has thus isolated the non discretionary service as one without discretionary process worthy of reposing trust, and placed investors advised under these services to a far lower standard of investor protection and regulatory care. The CSA has effectively prioritised the interests of the industry over those of the client. In this instance, and given the presumption that transaction remuneration is set to continue (note the extensive work on conflicts of interest in the consultation) it is difficult to see how instructions to registrants to prioritise investors' best interests possess any rigour or tone from the top.

Instead of noting the fiduciary liability that exists via industry representations of service, the consultation chooses to focus on consumers' misplaced trust and behavioural issues as two of the core reasons behind impaired service outcomes; that and a need to make regulatory expectations with respect to suitability clearer and enforcement of rules more effective. The consultation appears to ignore its own research, with the exception of the Brondesbury report laden with bias over investor responsibility (support for which was not found in any of the research referenced in the report), and the burgeoning literature in this area.

Canada stands alone in the world with its intent to distance itself from imposing fiduciary standards and higher professional standards for the provision of investment advice, and I detail the arguments for this in the submission. In Australia, UK and the US there is clear legislative intent to establish fiduciary standards and while the term fiduciary does not appear in UK and Australian rules for reasons of definition, it does appear in legislative intent. In the US there is both legislative intent and common law precedent for fiduciary duties for non discretionary investment advice. Canada is the only jurisdiction where there is a complete absence of legislative involvement, where the blame for impaired outcomes fails to mention the role of advisors and industry. What would a reasonable person think? A reasonable person would think that regulators are not concerned about advice, but about maintaining the market for products as is.

The proposed best interest standard is nevertheless a progress of sorts. But it is not a best interest standard, rather it is a best product standard and should be inserted as such, either as principle or as a rule into current regulation. It should not be termed a best interest standard as it will further the misunderstanding and misrepresentation of service, exacerbating the existing and unattended fiduciary liabilities within the system. Likewise the Proposed Targeted Reforms, irrespective of how unwieldy and complex they are going to be to regulate and comply with, represent some progress with respect to the standard of care in the suitability assessment.

But the progress is minor and the fractures in the system are clear. We cannot continue to stretch the transactional model. Investment is process driven, if the industry is to evolve regulators needs to encourage the development of process for the construction planning and management of assets, not regulations for transaction compliance. The Proposed Target Reforms talk of pushing transaction ideas through a suitability assessment, but the reality is transactions should come out of such a process. This is all back to front. In order to solve issues such as the advice gap, a problem not occasioned by regulatory change, but a persistent and long standing problem of the masses, we need to develop process. The reason why the advice gap has taken centre stage is because process has taken centre stage and the imperative of process is where the future of the industry lies.

The CSA may have good intent but its ignorance over investment process and construct is obscuring its understanding of the problem. It wishes to keep the horse and cart and forsake the car, to regulate the car as if it were the horse and cart, to blame the outcome and to effectively enforce consumers to comply with an archaic understanding of the financial services industry.

I address the consultation as follows:

- An analysis of global regulatory change
- An analysis of the importance of rules and regulation for common law deliberation.
- Comments and analysis on Section 8 and question, the proposed best interest standard (Parts 1 to 5)
- Comments on Section 5, Key Investor Protection Concerns
- Comments on Section 9 and questions
- Comments on Section 7 and questions
- Response to questions 44 onwards
- Summary and recommendations

My comments are detailed and break down and explain the fiduciary liability in terms of investment process and how this liability can be managed. It addresses the many concerns of those jurisdictions who are concerned over the impact of implementing a best interest standard and should give thought the those who have for the moment thought to limit its impact.

Contents

Global regulatory change

UK

In the UK there has been clear legislative intent behind a fiduciary standard for financial advice:

> Note recommendation 7 of the UK Government response to the Kay review[1]: "Regulatory authorities at EU and domestic level **should apply fiduciary standards to all relationships** in the investment chain which involve discretion over the investments of others, or advice on investment decisions. These obligations should be independent of the classification of the client, and should not be capable of being contractually overridden."

The reason why the term fiduciary is excluded from regulation and statute is also clearly explained:

> "the Government accepts the view that there should be common minimum standards of behaviour required of all investment intermediaries, but believes that describing these standards as 'fiduciary' has the potential to cause some confusion, and has therefore defined these standards in the following principle: All participants in the equity investment chain should act:
>
> • in good faith;
>
> • in the best long-term interests of their clients or beneficiaries;
>
> • in line with generally prevailing standards of decent behaviour.
>
> This means ensuring the direct and indirect costs of services provided are reasonable and disclosed, and that conflicts of interest are avoided wherever possible, or else disclosed or otherwise managed to the satisfaction of the client or beneficiary. These obligations should be independent of the classification of the client. They should not be contractually overridden.

The best interest standard is noted as a specific rule, COBS 2.1.1 in UK regulations:

> The client's best interests rule
>
> (1) A firm must act honestly, fairly and professionally in accordance with the best interests of its client (the client's best interests rule).
>
> (2) This rule applies in relation to designated investment business carried on:
>
> (a) for a retail client; and
>
> (b) in relation to MiFID or equivalent third country business, for any other client.
>
> (3) For a management company, this rule applies in relation to any UCITS scheme or EEA UCITS scheme the firm manages.
>
> [Note: article 19(1) of MiFID]and article 14(1)(a) and (b) of the UCITS Directive]

In the proposed CSA Consultation the best interest standard noted is only a principle. This is also relevant. In the UK the standard is a rule and according to the Law Commission review into the Fiduciary issue :

[1] The Government Response to the Kay Review, November 2012, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253457/bis-12-1188-equity-markets-support-growth-response-to-kay-review.pdf

COBS 2.1.1R contains the regulatory equivalent of the “best interests” duty: A firm must act honestly, fairly and professionally in accordance with the best interests of its client. As we explained in the Consultation Paper, **a private person who has suffered loss as a result of a breach of this rule may bring an action for breach of statutory duty under section 138D of FSMA.**

So in the UK we have a best interest standard with a legislative fiduciary intent supported by regulatory rule, whereas in Canada we have a best interest standard, without legislative support or intent, specifically designated by the regulators as a principle and not a rule. Additionally we have had the removal of commission (transaction remuneration) and the institution of higher educational and professional standards supporting the ability to deliver fiduciary standards in the advisory market place.

Australia

In Australia, in the document “Future of Financial Advice: Best interests duty and related obligations”, December 2012, we again have a specific legislative intent with respect to fiduciary standards even though regulation specifies the duty as one of best interest standards.

> “The PJC found that the law relating to how personal advice is provided could be improved, noting that: **The committee supports the proposal for the introduction of an explicit legislative fiduciary duty** on financial advisers requiring them to place their client’s interest ahead of their own. There is no reason why advisers should not be required to meet this professional standard, nor is there any justification for the current arrangement whereby advisers can provide advice not in their clients’ best interests, yet comply with section 945A of the Corporations Act. A legislative fiduciary duty would address this deficiency: paragraph 6.28.”

In Australia the best interest standard is not just codified in regulation but also in Statute, in the Corporations Act 2001, Sections 961B to J. As with the UK Australia has also removed embedded commission from products.

Europe & MIFID II

Europe will be introducing MIFID II in 2017. It has a specific Best Interest Standard in Article 19 (1).

> “Member States shall require that, when providing investment services and/or, where appropriate, ancillary services to clients, an investment firm acts honestly, fairly and professionally in accordance with the best interests of its clients and comply, in particular, with the principles set out in paragraphs 2 to 8.”

MIFID is a legal directive meaning that it is a legal act of the European Union. Additionally MIFID also differentiates between tied and independent advice, with independent advice no longer being allowed to receive transaction based returns. The following is from Norton Rose Fullbright on the new MIFID regulations:

> “firms providing independent investment advice or portfolio management are prohibited from receiving and retaining any fees, commission, or monetary or non-monetary benefits from third parties – these payments / benefits can be received but they must be passed on in full to clients as soon as possible following receipt”

The new MIFID rules complement recent legislation in Germany, the Fee Based Investment Act described below in an excerpt from a Department of Labor (US) report into Financial Advice Markets:

> To increase transparency about adviser compensation and promote unconflicted advice, German lawmakers introduced the Fee-Based Investment Advice Act, effective August 1, 2014. The regulation introduces “fee-based investment advice” as a legally protected

designation and imposes specific restrictions on those seeking to become fee-only advisers. As the name of the act suggests, fee-only advisers are prevented from receiving commissions or remuneration from third parties and must receive payment only from clients.

Also, fee-only advisers must consider a sufficiently broad set of financial products when issuing recommendations to clients (i.e., fee-only advisers cannot exclusively offer financial products from issuers with whom the adviser is associated). Advisers are not prevented from offering financial products issued by their institution, but they must consider other providers' products when constructing advice. Should a fee-only adviser recommend a product from a firm the adviser is affiliated with, the adviser must disclose that affiliation.

To further promote the provision of investment advice in the clients' interest, institutions providing fee-based investment advice must segregate fee-only advisers from conventional advisers to help ensure that fee-based investment advice is not influenced by commission-based investment advice**. Moreover, firms are prevented from setting sales targets for their fee-only advisers that may conflict with the interests of clients**.

Holland has also banned most commissions and introduced a statutory duty of care into their own Financial Supervision Act, "The Amendment Act 2014 provides for a statutory general duty of care for parties which provide financial services...The general duty of care shall apply in addition to the existing specific duty of care provisions.... The proposal introduces a new provision which contains the obligation for financial services providers to take into account the justifiable interests of the consumer or beneficiary in a prudent manner. For financial services providers that provide advice, the proposed provision further elaborates by stating that an adviser is required to act in accordance with the interests of the consumer or beneficiary" This statutory duty of care also notes that it is one that requires financial services providers to act in the interests of the consumer, effectively a best interest standard.

The US

Regulation, legal precedent and legislative intent in the US concerning the regulation of personalised advice, and otherwise, has had a much longer and clearer pedigree. Legislative intent with respect to fiduciary standards for the provision of personalised financial advice has been noted in the many US Supreme Court decisions that have helped establish the Federal Fiduciary Standard in Common Law. The legislative intent referred to is that which led to the development of the 1940 US Investment Advisor Act, even though the act itself did not mention the term fiduciary or specifically create the federal standard itself.

Note the following From Arthur B Laby's SEC v. Capital Gains Research Bureau and the Investment Advisors Act of 1940 (2011), 91 B.U.I. Rev. 1051, 1088

"After quoting passages from legislative history, Justice Goldberg, quoting Louis Loss, concluded that the Advisers Act reflected a congressional recognition "of the delicate fiduciary nature" of the advisory relationship and a congressional intent to eliminate or expose conflicts of interest. Goldberg wrote that it would defeat the purpose of the Act to hold that Congress meant to require proof of intent to injure, and actual injury, as conditions of liability. Such requirements might be necessary in damages actions, but not in cases seeking equitable relief. Nor was it necessary in a case against a fiduciary – which, the Court wrote, Congress "recognized" an investment adviser to be – to establish the elements of fraud that would be necessary in an action stemming from an arm's length transaction"

"The Capital Gains Court neither stated nor implied that the Investment Advisers Act created a fiduciary duty governing advisers – the Act merely recognized that a fiduciary duty existed between advisers and their clients"

> The Advisers Act, the Court explained, "reflects a congressional recognition" of the fiduciary nature of the advisory relationship.161 Similarly, the Court wrote, "[it is not] necessary in a suit against a fiduciary, which Congress recognized the investment adviser to be, to establish all the elements required in . . . an arm's-length transaction."162 This passage plainly states that the Court believed Congress recognized that advisers had a fiduciary duty to clients, a duty which pre-dated passage of the Act. Finally, the Court described committee hearings leading up to passage of the Act and wrote that prominent investment advisers emphasized their relationship of "trust and confidence" with advisory clients.163 This testimony necessarily predated passage of the Act and therefore described a duty in existence before the Act was adopted.
>
> "There is little doubt that an investment adviser covered by the Act is considered a fiduciary. Arguments bearing on the advent of a fiduciary relationship, such as sophistication of the parties or communications between them, will be unavailing.328 All advisers are broadly considered fiduciaries."

The Dodd Frank Act provides specific legislative intent to raise the standard of care for broker dealers to that of fiduciaries. Note the following excerpt from the Arthur Laby's Sec V Capital Gains Research:

> Section 913(g), entitled Authority to Establish a Fiduciary Duty for Brokers and Dealers, amends the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 to authorize the SEC to establish enhanced duties for brokers.
>
> Section 913(g)(2) of Dodd-Frank amends section 211 of the Investment Advisers Act to allow the SEC to adopt rules providing that the standard of care for brokers, dealers, and advisers, shall be to act in the "best interest" of their customers.

The Department of Labor (US) has now published its new rules, effective April 2017, with respect to retirement investment advice:

> "The Department's conflict of interest final rule and related exemptions will protect investors by requiring all who provide retirement investment advice to plans, plan fiduciaries and IRAs to abide by a "fiduciary" standard—putting their clients' best interest before their own profits..
>
> The final rule defines who is a fiduciary investment adviser, while accompanying prohibited transaction class exemptions allow certain broker-dealers, insurance agents and others that act as investment advice fiduciaries to continue to receive a variety of common forms of compensation as long as they are willing to adhere to standards aimed at ensuring that their advice is impartial and in the best interest of their customers."

In the Securities Exchange Commission's Study on Investment Advisors and Brokers (2011), they also supported the introduction of a uniform standard:

> "Investors have a reasonable expectation that the advice that they are receiving is in their best interest. They should not have to parse through legal distinctions to determine whether the advice they receive was provided in accordance with their expectations. Therefore, in light of this confusion and lack of understanding, it is important that retail investors be protected uniformly when receiving personalized investment advice or recommendations about securities regardless of whether they choose to work with an investment adviser or a broker-dealer.
>
> It also is important that the personalized securities advice to retail investors be given in their best interests, without regard to the financial or other interest of the financial professional, in accordance with a fiduciary standard."

The CFA Insitute have also commented on the global move towards implementing uniform fiduciary standards for the provision of personalised investment advice

> "In the US, we support a single fiduciary standard for those providing personalized investment advice to retail investors that is at least as stringent as that required by the Investment Advisers Act of 1940, and caution against excessive reliance on disclosure. We continue to urge the SEC to move forward with such a standard....We favor consistent descriptions for independent investment advice and those who provide it, and would require advisers not adhering to a best-interests duty to describe their services in a way that does not connote independent advice"

In conclusion, Europe, Australasia and the US have all exhibited legislative intent with respect to implementing best interest/fiduciary standards for part or all of the investment advisory market place; Europe to date is set to implement best interest standards for the wider market place and much more restrictive and higher standards for those who wish to be seen to be delivering independent financial advice.

Canada is the odd one out! It neither has legislative interest in best interest standards nor does it have unified regulatory interest in best interest or fiduciary standards. Indeed, its best interest standard, as should become clear, is not a best interest standard per se but a best product standard, which places Canada's regulation, in say UK regulatory time, somewhere in the mid 1980s.

The importance of statutory/regulatory standards

Many Canadian commentators, Bessner, Paglia, Groia, Advocis, IFIC, IIAC etc talk about the robust common law framework that supposedly exists in Canada to deal with advisory relationships that fall under a fiduciary standard.

There are a number of issues with relying on this line of thought. Number 1 is that the cost of litigation is a clear and obvious deterrent but not in essence the most important. The most important reason why we cannot rely on common law to define the client/advisor relationship is that common law draws very much on legislative and regulatory intent to define the customs and rules of the relationship.

The following comments are taken from the 2004 FAIR Dealing Model report and are still relevant today with respect to a regulatory system designed for the transaction and a service and professional culture focused on advice:

> ....We continue to regulate most registrants on the basis of the products they sell, even though investors, firms and the courts consider the relationships formed and the advice given to be far more important than the actual sales transactions.......Most retail financial services, including investment advice, are delivered by firms registered as dealers and their individual representatives. But the OSC's regulations only focus on advice as a business activity for a limited number of portfolio managers, investment counsellors, and newsletter publishers. For the majority of financial services providers, Ontario's existing product-based regulatory model has become outdated, yet we continue to tack new regulations onto it. .... In its original form, the Act sought to prevent fraud by regulating trading, on the assumption that transaction execution is the primary reason people seek the services of the investment industry. This remains the basic thrust of the Act and its regulations....Another way to appreciate the limitations of product-based regulation is to consider what it does not do. Most significantly, it does not concern itself with advice..

The issue of how courts interpret regulatory rules is discussed in the UK Law Commission's 1995 review of Fiduciary Duties and Regulatory rules

> "**Should fiduciary law take account of rules made by regulatory bodies operating in the public - law sphere**? **Our provisional view is that it should**: either **because there is statutory authority for rules to modify common law and equitable obligations** ... or **because the court should take account of reasonable regulatory rules in ascertaining the precise content of the common law or equitable duty**...our provisional view that problems of mismatch between what is required or permitted by regulatory rules and the obligations imposed on fiduciaries by the common law and equity lie principally in the field of financial services."
>
> "the decision to use a particular form of regulation and a particular regulatory body was a legislative one, and the regulatory bodies to whom Parliament has delegated the achievement of the new statutory purposes are likely to have expertise in the areas remitted to them....Thus, although the new system is described as self-regulating, it is the product of legislation and is a form of public law regulation. It is, therefore, appropriate to take some account of regulatory rules when assessing liability for an alleged breach of a fiduciary obligation."

These comments are further substantiated in the Law Commissions most recent review (2014), Fiduciary Duties of Investment Intermediaries, that extended its analysis to the treatment of commercial (or arms length) relationships:

> **There is some reluctance to assign fiduciary obligations to a commercial relationship**. In Vercoe v Rutland Fund Management Ltd, Mr Justice Sales explained that:
>
> > In ordinary commercial relationships, such [fiduciary] obligations have not been bargained for and agreed, and create rights and remedies going well beyond the ordinary contractual rights and remedies which have been recognised and worked out over the years by the common law to strike the appropriate balance between the competing interests of parties to such relationships.
>
> **The courts treat the parties to commercial transactions as already having had an adequate opportunity to prescribe their obligations, and to outline what remedies will be available to them.** In commercial relationships, the parties are expected to be the authors of their own rights and obligations.

The above comments are particularly relevant when we acknowledge the fact that the majority of investors cannot tell the difference between those advisers/ors accountable to a fiduciary standard and those held accountable to a weaker suitability standard. Note the SEC comments on its commissioned studies:

> **Siegel & Gale, LLC and Gelb Consulting Group (2004**):"groups did not understand that the roles and legal obligations of investment advisers and broker-dealers were different. In particular, they were confused by the different titles...and did not understand terms such as "fiduciary."
>
> **RAND Report**: "RAND concluded that it was difficult for it to identify the business practices of investment advisers and broker-dealers with any certainty....noted that the differences in the services provided by financial firms and their affiliations could be difficult for investors to understand...
>
> RAND's interviews with investment adviser and broker-dealer firms found that the firms believed that investors tended to trust a particular firm, without necessarily understanding of the firm's services and responsibilities....

RAND's survey respondents and focus-group participants reported that they did not understand the differences between investment advisers and broker-dealers....Participants noted that the common job titles for investment advisers and broker-dealers were too similar and therefore confusing....interchangeable titles and "we do it all" advertisements made it difficult to discern broker-dealers from investment advisers. The participants' confusion persisted even when RAND provided participants with fact sheets on investment advisers and brokers that included a description of their common job titles, legal duties, and typical compensation.

RAND **concluded that the financial services market had become more complex over the last few decades in response to market demands for new products and services and the regulatory environment. ... the distinctions between investment advisers and broker-dealers have become blurred**, and participants had difficulty determining whether a financial professional was an investment adviser or a broker-dealer and instead believed that investment advisers and broker-dealers offered the same services and were subject to the same duties, although generally investors were satisfied with their financial professional.

CFA Survey: "CFA Survey asked "if a stockbroker and an investment adviser provide the same kind of investment advisory services, do you think they should have to follow the same investor protection rules?" to which 91% of survey participants responded affirmatively. The CFA Survey also asked that whether participants agreed with the statement that "when you receive investment advice from a financial professional, the person providing the advice should put your interests ahead of theirs and should have to tell you upfront about any fees or commissions they earn and any conflicts of interest that potentially could influence that advice" (85% of participants strongly agreed, 12% somewhat agreed, 1% somewhat disagreed or strongly disagreed). The CFA Survey also found that a majority of investors surveyed incorrectly believed that stockbrokers and "financial advisors" are held to a fiduciary duty (66% and 76% of investors surveyed, respectively)

It seems highly unlikely that the majority of investors, let alone the average investor, is capable of making these contractual determinations to satisfy the courts that an actual commercial relationship, between advisor and investor, is a well informed one.

The Law Commission's 2014 report goes into even further detail with respect to interpretation of rules made by regulatory authorities:

"In our 1995 report on Fiduciary Duties and Regulatory Rules, we looked in detail at whether regulatory rules could be incorporated into contracts, to take effect as contract terms. We took the view that, **in some cases, the courts might incorporate regulatory rules into a contract on the grounds that they represent trade custom**. **Where the courts give regulations the status of contract terms, contravention of the rules becomes actionable at common law as a breach of contrac**t.

As the judge put it in Gorham v British Telecommunications plc, **the courts can be expected to "attach considerable weight" to the content of codes drafted by "those concerned with the maintenance of proper standards",** but they are not excluded from making their own assessment of the situation

Clearly here the issue is one of standards. If regulation is out of step with services being offered and the representation of services being offered then common law that relies on rules and regulations to define "proper standards" and de facto relationships risks erroneous rulings.

The law commission further explains its position in the following comments:

> "**the courts are reluctant to hold intermediaries liable where they have acted in accordance with the rules**. The opposite side of the coin is that intermediaries who break the rules have been held liable to their clients in negligence, because the courts have interpreted their duty of care in line with the rules....
>
> "**the courts ... are reluctant to impose fiduciary duties in ordinary commercial relationships, and have been heavily influenced by the regulatory regime**. Where an IFA, for example, is required to consider the suitability of an investment for a retail client, the courts will incorporate the suitability requirement into the IFA's duty of care towards the client. However, where intermediaries have acted in accordance with the rules, they have been reluctant to find them liable."

In a sense the hands of common law are bound by the determination of regulation. This is likely a key reason why the financial services industry in Canada and its legions of legal counsel do not want a change in regulation. It is not that the best interest standard will obviate common law rulings but that common law rulings will take account of the new standards and will no longer treat the advisory relationship as one of a limited transactional dimension and hence limited fiduciary obligation. Recourse to the courts to properly define the fiduciary relationship under enhanced regulation will still be available to plaintiffs and defendants alike.

Historical framework

There is also another reason why we should not rely on common law precedent. The dynamics of the investor/advisor relationships have changed and the rulings of yesteryear would not always have graced the outdated regulations of today. Many of today's regulatory changes are not forward looking changes to the way we expect the industry to evolve but to reflect the way it has and the gaps that have opened up with respect to its regulation.

Note in the US

In Arthur Laby's2010 essay, Fiduciary Obligations of Broker-Dealers and Investment Advisers, he comments on the changes in the business of a typical brokerage:

> "...in the 1930s, a brokerage firm's relationship with a customer had four aspects.
>
> 1. First, it acted as a broker in the purchase and sale of securities and in borrowing and lending stocks.
> 2. Second, it acted as a pledgee, lending its own capital to the customer or advancing capital borrowed from banks.
> 3. Third, it was the custodian of the customer's cash and securities.
> 4. Fourth, it exercised, "to some extent," the function of investment counsel. The advice component is last on the list and qualified in scope.20 6
>
> A history of the Merrill Lynch firm explains that, in the early part of the twentieth century, many brokerage firms did not do much more than execution-their sales forces were primarily intermediaries arranging trades on secondary markets-and the information available to investors seeking advice was rather meager. Open a modern description of the activities of broker-dealers and advice often is paramount.
>
> A primary reason for this shift is technology.....As a result, the advice component of brokerage business has eclipsed transaction execution in importance.
>
> Arms length broker-dealer registered representatives began to label themselves as financial advisors (etc).....These titles imply that the individual is not acting at arm's length. They are meant to induce a customer to repose trust in the professional as a neutral source of research and recommendations....

Note in the UK

The UK in 1986 transitioned from a "regulatory framework...**designed mainly to regulate issues of and dealings in securities, but not to cover other types of investments or investment advice**. The statutory provisions were created piecemeal over the years in response to specific problems and abuses. These provisions were not far-reaching and were **generally based on the principle of caveat emptor...[2]",** a principle that the White Paper of the time (the Gower Report) and the government of the day were keen to change**.**

Note in Canada

It is difficult to actually discern the history of regulatory change in Canada given the dearth of legislative involvement in rule making. However if we refer to the "Report of the Standing Committee of the Ontario Legislature on Government Agencies" we can get a sense of attitude of the legislature at the time with respect to the financial services system.

> "The overall objective of securities legislation is to protect the investing public...One method is to proscribe and control certain fraudulent activities such as manipulation, misconduct or fraud in the market place. Another requires that **investors be fully and truly informed of any appropriate facts in disclosure documents relating to publicly-offered (new) securities and that investors be advised on a continuing basis of information they need in order to make investment decisions in the secondary market**.
>
> .... the Act requires that those involved as intermediaries in the selling and buying of securities be registered with the Commission, and that the Commission supervise the standards imposed upon registrants by the Act and regulations, the Toronto Stock Exchange and the Investment Dealers' Association, the self-regulating professional body. The Commission also seeks to impose a standard of fair dealing in the marketplace by issuing policy statements that constitute a legislative response by the Commission with respect to some abuse.
>
> These objectives and purposes must, however, be set beside several other values which implicitly compete with the objectives of any securities legislation. It has been pointed out that investor protection should not be achieved at too high a cost to the participants in the market; and that a degree of risk is inherent in the securities market. These concerns can be subsumed under the general principle that one should not overregulate.
>
> An investor, in order to buy and sell securities, must contact a firm or individual registered with the Ontario Securities Commission. That person or firm may be a stock brokerage house, a securities firm or a mutual fund sales organization. The salesperson with whom the investor

We note that there is no discussion of investment advice and we note that methods of protecting investors, aside from fraudulent activities, is more or less or less limited to disclosure, something which the UK Gower Report was specifically against.

Likewise note the following comments taken from the Registration Reform Project working group papers:

> Client relationships **are currently governed by common law, the civil code in Quebec and statutory and SRO requirements regarding KYC and suitability rules**.
>
> **These rules are account and transaction-by transaction focused. As a result of this regime, a portfolio view of the relationship and suitability in the context of the total portfolio is not fostered.** With respect to this point, **the WG agreed that the focus on the**

[2] THE REFORM OF INVESTOR PROTECTION IN THE U.K. – AN EXAMINATION OF THE PROPOSALS OF THE GOWER REPORT AND THE U.K. GOVERNMENT'S WHITE PAPER OF JANUARY, 1985

entire portfolio of the client as opposed to individual accounts would be desirable but not required. The practical implications of implementing such a structure would be significant, especially due to the range of client types and portfolio sizes which vary from firm to firm and client to client. The WG acknowledged the costs to support such a regime could have a significant impact, particularly on smaller firms. The impact on larger firms would also be significant due to the volume issues that they would face.

The Fasken Martineau 2005 report "Liability and Damages in Unsuitable Investment Advice Cases": is also traces an interesting change in common law decisions over the decades:

> "**a duty to "know your client" and avoid unsuitable investment advice has not always existed.** In 1972 in R.H. Deacon & Co. Ltd. v. Varga, 32 the Ontario Court of Appeal rejected the idea that there was an obligation to "know your client" and ensure suitability... The court held that, absent reliance by the client, an investment dealer and IA were "the same as any other agent acting for a principal" and had the duties limited to following instructions and avoiding conflicts of interest"
>
> **"In 1991, one of the last rejections of the "know your client" and suitability requirements appeared in the common law**. At trial, in Reed v. McDermid St. Lawrence Ltd. 33 ("Reed") the judge held: (i) that an IA has a "duty to warn" a client of exceptional risks, (ii) that the "know your client" rule was the "basic ethic of the [IDA]", and (iii) that the "know your client" rule requires an IA to be "**genuinely persuaded that the customer knows what he is doing**." However, the British Columbia Court of Appeal reversed this decision and held that, absent the existence of a fiduciary relationship, the sole purpose of the "know your client" rule is to serve as a credit check to protect the investment dealer. The Court of Appeal stated:
>
> > It is not doubted that brokerage firms need to know a good deal about their clients for their own purposes, especially for the purpose of avoiding purchasing stock for a client who cannot pay for it. That is a far cry from saying that a broker owes a duty to the client to put his nose into his client's business before taking instructions from the client for the purpose of protecting the client from inadvisable transactions initiated by the client.
>
> In 1992, near the beginning of this new era of common law liability for unsuitable investment advice, the Ontario Court of Justice - General Division in Nesbitt Thomson Deacon Inc. v. Haupt44 discussed the duty of care owed by an IA in advising a client:
>
> > The relationship between a stockbroker and customer is one of simple agency in the first instance. The broker's primary duty is to carry out the instructions of his client. His remaining obligations are few and simple: like any agent, he has a duty to act in the interests of the principal and is not permitted to allow personal interest to conflict with the interest of the principal unless this is done with the full consent of the principal. But, like any relationship it can evolve into more varied or complex duties and responsibilities, both in scope and intensity.
>
> Keenan J. in Varcoe stated: "Suitability is governed by the amount that the client can afford to lose in a risky business without doing significant harm to financial obligations or lifestyle…"

One of the key takeaways from the 2005 report "Liability and Damages in Unsuitable Investment Advice Cases": is that common law rulings can lag regulatory change and that regulatory change can lag the development of services and the representation of services in the market place. Today we have numerous representations from firms who not only imply that they are advising on the management of investor's assets, on advisory basis, but are actually explicitly stating it in their marketing communications. The last CSA Best Interest Standard Consultation had numerous submissions stating that firms were already acting in their client's best interests.

Even though the report claimed large strides had been made with respect to rulings with regard to suitability and know your client and standards of care with respect to dealing it is poignant that the report still classified retail investors as "***individuals who buy or sell securities for their own account. The retail investor is type of client this paper will focus on***. It is he or she who, in increasing numbers, is suing their IA for unsuitable investment advice."

Indeed, it is this framing of the investor as someone who buys or sells securities for their own account as opposed to someone who seeks advice on the allocation and selection of securities to best manage risk and return given their financial objectives, assets and risk profile that is a key concern with respect to the mismatch between regulation and service representation and common law judgements and implied regulatory definition of the relationship.

Comments on section 8, Best Interest Standards, Part 1

The proposed best interest standard is noted as follows:

> A regulatory best interest standard would require that a registered dealer or registered adviser shall deal fairly, honestly and in good faith with its clients and act in its clients' best interests, and that a representative of a registered dealer or registered adviser shall deal fairly, honestly and in good faith with his or her clients and act in his or her clients' best interests. The conduct expected of a registrant in meeting her, his or its standard of care would be that of a prudent and unbiased firm or representative (as applicable), acting reasonably. In complying with the standard of care, registrants would be guided by the following principles:
>
> 1. Act in the best interests of the client
>
> 2. Avoid or control conflicts of interest in a manner that prioritizes the client's best interests
>
> 3. Provide full, clear, meaningful and timely disclosure
>
> 4. Interpret law and agreements with clients in a manner favourable to the client's interest where reasonably conflicting interpretations arise
>
> 5. Act with care

A couple of points here: the standard uses the term "deal fairly, etc" and not to "advise fairly etc". To deal places the standard firmly within the realm of the transactional suitability standard, the standard that has, if we look at common law, determined legal liability for transactional advice since the early 1990s and which in the US has governed broker dealers since the 1930s.

The issue raised in the FDM was that registrants were no longer offering primarily product/transactional advice but a much wider representation of advice that stretches to the portfolio and its ability to meet financial needs over time, including investment and or financial planning.

The suggested titles noted in the Proposed Targeted Reforms are restricted to a number of permutations around securities advisor, sales person or the use of current category registrations.

It would seem therefore probable that, in this context, the best interest standard noted in the consultation is with respect to the transaction not the advice process. Keeping the focus of best interest standard on the transaction is a somewhat delicate procedure if one is also at the same time responsible for assessing the wider suitability of the advice. But again we note the carefully graded definition of the expanded suitability requirements of the proposed targeted reforms:

We have a basic financial suitability which is meant to look at other basic financial strategies that may or may not be better than a transaction in securities and we have the identification of a basic allocation strategy for the client. This is rounded off with a product selection suitability standard that for the purposes of this section of my submission I will quietly term an enhanced standard of care term. I will address my other concerns with respect to the bounded/constrained suitability process noted in the Proposed Target Reforms.

The best interest standard denoted in this consultation is a very finely graded one tuned to the boundaries of the suitability standard, albeit one enhanced with an explicitly marginally higher standard of care. It is extremely difficult to envisage how this standard of care is going to be communicated to investors whose idea of a best interest standard may not be the one envisaged in the current proposal.

In the light of the above analysis the following qualifications made are clearer:

- *Any best interest standard in the context of Canadian securities legislation would be formulated as a regulatory conduct standard and not as a restatement or formulation of a fiduciary duty. This approach is preferable since:*

It is clear from the qualification and the framing of the standard (given the definitions noted in the Proposed Targeted Reforms) that the intent is not to create a fiduciary standard. In other words the intent is not to acknowledge the professional liability for processes required to construct plan and manage portfolios optimally and trust in those processes but to flesh out the current suitability standard. I state intent in that the success of this strategy depends very much on a) the extent to which you can successfully communicate the limits of such a best interest standard, b) the effectiveness of disclosure delineating the legal limitations of such a relationship, c) the ability to constrain advisory based service processes to conform to the boundaries of the stated suitability frame and d) the extent to which regulators can pare back representations made by the industry to such that more adequately reflect the sterilised version of the proposed suitability framework.

- *the content of the regulatory best interest standard is more comprehensive and tailored to the client-registrant relationship than a statutory fiduciary duty would be;*

On the one hand the consultation appears to ignore the fact that the suitability standard itself, in terms of its representation and de facto operation, has been stretched well beyond its limited transactional operational frame. Yet here we are attempting to stretch it even further, so that it can survive as the lynchpin of a transaction distribution regulatory culture. On the other hand the proposed standard ignores the actual much wider representation of services and process.

The regulatory best interest standard, if indeed the intent is to meld it around a tempered suitability standard would of course, if found to be practical, be more comprehensively tailored to the current defined registrant relationship than a fiduciary one. But this is not necessarily a physically desirable outcome

- *the fiduciary duty and its content have developed primarily through case law. Securities regulators can appropriately express a regulatory best interest standard, where the regulator imposes the existence and content of the standard, separate from the process undertaken in particular cases by the courts;*

I can also see how it would be impractical for a court to be able to express such a regulatory standard. In a frame where conflicts of interest are tolerated, where numerous rules entertain the absurd notion that embedded commissions can be massaged to accommodate a best interest outcome, it would be sheer madness for a court to attempt to parse the multitude of differential outcomes.

- *fiduciary duty remedies are potentially too harsh for all instances of registrant misconduct; and*

With respect to fiduciary remedies being potentially too harsh for all instances of registrant misconduct, I note the reference to the following from The Fasken Martineau 2005 report "Liability and Damages in Unsuitable Investment Advice Cases :

> "The principal difference between calculating damages when a breach of fiduciary duty has been found versus simply a tort such as negligence is that equitable compensation is not subject to the limiting principles of foreseeability, contributory negligence or the duty to mitigate."

A duty of care may not specifically be a fiduciary duty but it is still a duty owed by fiduciaries. Likewise an intent to define the advisory relationship as one that is not intrinsically in nature a fiduciary one is bound by the intent to limit the standard of care, to leave an element of liability in the hand of the investor. To a large extent it does depend on how clearly the limitations of the relationship are defined at outset and whether the representations made at the time obscured or misrepresented the responsibilities of the parties. I certainly see no disclosure with regards to duty to mitigate, or contributory negligence or cases where it should have been obvious that what the advisor was recommending that the harm you might decide to complain about was clear at the start.

If, if you have a viable process for determining risk profiles, for constructing portfolios with respect to asset and liability and risk profiles, for communicating (and recording such) and for educating the investor over the nature and risk profile of the solution and how it applies to the investor, then it is difficult to see how an advisor could be exposed to a breach of fiduciary responsibility. Issues of foreseeability, contributory negligence and duties to mitigate should be capable of being well handled by well defined investment processes. The noted in this qualification risks are due to gaps in the advisor's own representations, processes, procedures and record keeping.

- *fiduciary duty, as a common law concept with a long history and application across various disciplines and situations, lacks the upfront clarity and specificity we require, and that registrants expect, regarding registrant conduct standards that apply on a day-to-day basis.*

It would seem that the issue of concern is not that common law lacks the upfront clarity but that defining the proposed best interest standard as a fiduciary standard would impair the CSA's ability to limit the liability of a regulatory frame whose standards are below those needed to manage the liabilities associated with financial advice. The intent to distance the standard from a fiduciary standard may have more to do with the limitations for the intended regulatory framework than anything else.

Best interest standards and systemic issues of relatively complex structures

With respect to one of the above qualifications and its support "The principal difference between calculating damages when a breach of fiduciary duty has been found versus simply a tort such as negligence is that equitable compensation is not subject to the limiting principles of foreseeability, contributory negligence or the duty to mitigate.[3]"

These legal niceties ignore the reality that professional investment advice is part of a structured process. Errors in outputs tend to be systemic and lodged at the data collection, risk profiling, portfolio construction and planning level as well as the critical decision rules and assumptions defining

[3] The Fasken Martineau 2005 report "Liability and Damages in Unsuitable Investment Advice Cases :

risk/return and relative valuations (i.e. correlations/covariance): if there is an issue of negligence it is likely to permeate throughout all clients and unless checked likely to be repeated over time. Note the conclusions from the research report, One Size Fits All, quoted in the consultation itself and also the research Plan Plus Report on risk profiling. A greater focus on making risk questionnaires fit for purpose and elevated attention and training on risk profiling disciplines per se would go a long way to eliminating this aspect of professional liability at this level of the process.

Outputs from structured processes (that will vary in degree of complexity depending on the level of service represented) are different from errors in simple outputs based on limited relationships. This is different from say where someone who buys a car, only to find that the car is overheating as soon as he leaves the show room but continues to drive it and then claims damages for the damaged engine, or the case of someone who crosses the road without due care and attention and gets hit by someone who is driving dangerously.

The greater the relative complexity of a process, where a given error exists, the greater the probability that the error will lie in the process and hence be systemic. Essentially attempting to manage a complex process without structure will create the liabilities the CSA's best interest proposals are clearly looking to avoid. Errors in professional application and management of process, given the discretion over the process and hence the responsibility for oversight of that process are likely breaches of fiduciary duties that are also likely incredibly difficult for investors to spot in advance (foreseeability), to compound (contributory negligence) and to avoid when the errors compound or become "evident" (to mitigate).

Likewise attempts to stretch the boundaries of the parameter to parameter suitability standard from one focussed on each transaction at a time to the wider suitability environs of the portfolio and the clients size and timing of financial needs will create an increasing array of errors especially where regulation does not emphatically enforce best interest standard with respect to the process itself.

Best interest standards and enforcement

Surely the introduction of best interest standards in an industry where the represented service is one of trusted, professional, expert advice, should be such as to enforce liability for those standards and service processes.

As widely discussed in this document the services provided by brokers/salesmen has moved from one where advice was incidental to the transaction to one where the transaction has been incidental to the advice.

We have seen a global pushback from the traditional caveat emptor transactional service structure (as per the recommendations of the Gower Report regarding the reform of the UK financial services industry in the 1980s) and a recognition that the development of more sophisticated advice based service processes and their representation implied a change in the way relationships and standards of service needed to be judged and enforced. A best interest fiduciary standard is the most effective way of enforcing higher standards of service required under such processes.

The SEC clearly delineated the boundaries of brokers in its 2011 Study on Investment Advisers and Broker Dealers:

> "The Advisers Act excludes from the investment adviser definition any broker or dealer: (i) whose performance of its investment advisory services is "solely incidental" to the conduct of its business as a broker or dealer; and (ii) who receives no "special compensation" for its advisory services"

The CSA Consultation has noted a number of issues with respect to compliance with existing rules, rules "Non-compliance with key areas of the client-registrant regulatory regime, such as obligations relating to suitability and conflicts of interest, remains stubbornly high. These requirements are therefore not currently protecting investors as regulators intended or as expected by investors."

The OBSI and the Independent Review of the OBSI also noted issues with respect to pushback by industry on compliance issues.

> "Much of the debate in Canada has focused on "low-balling" – that is, firms making excessively low offers of compensation. But in our view, this is not the mischief. Rather, the mischief is systemic – the system enables consumers to be put in a weaker position, contrary to the purpose of an ombudsman scheme.... we have found that, contrary to international expectations of an ombudsman, OBSI is not able to level the asymmetric playing field. Nor can OBSI and its overseers, the regulators, assure the public of OBSI's ability to secure redress. A more effective mechanism for securing fair redress is therefore required. Absent that, we would expect the investment industry to risk greater government intervention and higher compliance costs.[4]."

One of the principles of investor protection is to enforce standards that match the requirements and the representation of service. Additionally accepted professional standards and representation of those standards must also be inputs. To allow gaps between the actual services and the representation, between represented care, skill and responsibility/accountability to develop is a breach of a regulators responsibility to protect investors and foster trust in the financial services market place.

A best interest standard would enforce the contracts actually being represented in the market place. It would also force firms and advisors to close gaps in processes, procedures, communication and documentation. Far from creating uncertainty over the liabilities associated with a fiduciary standard, a best interest duty would serve to minimise the total liabilities associated with the provision of financial advice.

It would a) force clearer definition and representation of service, b) engender greater discipline and structure of processes to limit liabilities associated with respect to personalisation and risk/return management, c) restrict those investors who actually do wish to take outlandish risks to well defined contractual terms and finally e) carefully define the risks and liabilities that naturally fall out of the contract and that cannot be reasonably managed through sensible wealth management structures.

The liability universe needs to be clearly defined and a best interest, fiduciary type standard, would help develop the boundaries of such a universe. Issues that would normally give rise to liabilities under breach of contract would be identified earlier at the process development stage and on an ongoing basis via the central monitoring of process and its inputs. The wealth management industry with the advances in technology, professional standards and wealth management disciplines is now more or less one of process and structure.

A best interest standard is a critical enforcement tool. Just as the suitability standard was once introduced to reduce the liabilities associated with transaction based sales processes (the firms liability for failing to make sure the transaction was suitable to the client and note the fact that in Canada it took some time for the courts to even recognise this development) so must we introduce a service based, structured process orientated best interest standard to make sure that service and representations of service that we see in the market place are appropriately met with for purpose processes and structures.

[4] Independent Evaluation of the Canadian Ombudsman for Banking Services and Investments' (OBSI) Investment Mandate https://www.obsi.ca/en/download/fm/539/filename/2016-Independent-Evaluation-Investment-Mandate-1465218315-e9fa5.pdf

Best interest standards and service based processes versus suitability standards and transaction based services

It is much easier to regulate a centralised service process with its limited number of decisions rules (that determine how asset allocation and security selection relate to risk and asset liability profiles, how rebalancing is conducted and more) and other clearly defined inputs (risk/return assumptions, risk profiles, financial needs etc) as well as well defined due diligence re security and product selection that effectively disassociate advisors from security and product selection as well as asset allocation and risk management, than it is to regulate each transaction at a time.

A best interest standard, which is process focused, captures deviation from process occasioned by any one of the inputs involved in the process, is different from a suitability standard which is transaction focussed and aims to evaluate all the rules and inputs governing that transaction at the point of the transaction.

The issue is that we have a business model focussed on transaction remuneration that delegates more or less all decisions with respect to asset allocation, personalisation and risk management to the individual advisor. Regulating each transaction is much more complex and time consuming than regulating the process. Note the following prescription taken from the Proposed Target Reforms

> In order to evidence compliance with the suitability requirement, registrants must be able **to produce evidence that they had a reasonable basis for concluding that the suitability analysis was conducted in a manner that complies with the registrants' other duties toward their clients, including their conflict of interest obligations. The scope and nature of the client engagement and a client's investment needs and objectives, financial circumstances and risk profile will be central to the breadth of analysis required**. The documentation should record all relevant facts, including key assumptions, the scope of data considered, and the analysis performed

A centralised process would provide clear reasons as to why area A is overweight and why security a needs to be sold and reinvested in area B and security b, or indeed, sold with proceeds being used to buy either a lower risk asset to meet shorter term income needs or passed to the client if in need of funds for immediate expenditure. The rationale for the transaction would be provided by the process, by the interaction of client relevant data and investment relevant data for a given structural investment planning and management discipline.

The current proposals, both the Best Interest standard and the Proposed targeted Reforms are still transaction focussed and do not measure up to the processes standards implied in a great many of the representations of service that exist in the market place. It almost feels that regulators are constrained in terms of what they can do by an industry that wishes to continue to be remunerated by transaction returns.

One of the key objectives of regulatory change in other jurisdictions has been to encourage innovation, especially with respect to the provision of low cost investment solutions for the smaller investor. While many in Canada suggest that regulatory change in these jurisdictions has led to the smaller investor being jettisoned into the wilderness the reality is that the improvements in regulation have allowed for a focus on the needs of the smaller investor.

The guides and their climbers: we must end the abberrant investment culture

One of the issues that I see too often in Canada are those instances of so called “experienced” “sophisticated” investors ending up with wildly inappropriate security and product selection.

Under the suitability standard with its emphasis on investor responsibility, foreseeability, contributory negligence and duty to mitigate, is that for a so called “experienced” investor the positions that were taken would have been so “obviously” errant and risky that even though the advisor provided the advice and led the way, the investor is ultimately responsible. The trouble is these individuals quite often know next to nothing about the rules and disciplines of investment and have typically received no instruction on how to manage and mitigate the risks associated with the advice they have received. The experience and direction they have received is invariably from their advisors.

I believe that we have an issue of culture, an issue that allows at times for extreme positions to be taken with respect to securities and leverage that bears no relation to professional standards. You can easily cross reference the deviation between what an advisor would recommend for a client with a given risk preference selection from that which would be recommended by the institution for the same risk profile. It is not uncommon to see quite extreme differences between what the parent financial institution would consider a higher risk strategy and what the advisor has recommended.

A KYC with its often limited set of risk options and investment objectives can be easily manipulated to support the most extreme asset allocations imaginable yet still apparently, according to the institution's internal ombudsman, satisfy their compliance with suitability standards.

I have seen advisors provide the same extreme portfolio positions for a whole range of family members, with all family members with clearly differing attitudes to risk all preselected with higher risk options in their KYCs. This reflects the Foerster Report, the "One Size Fits All" research.

A best interest standard is needed to ensure that disciplined wealth management solutions are consistently provided to individuals seeking personalised investment advice and to avoid the liabilities associated with what I can only describe as a Wild West investment culture amongst a number of advisors. A best interest standard with fiduciary type obligations would enforce greater consistency of advice and standards of advice. Investors who still wish to take extreme positions should be dealt with on an execution only basis, with advice incidental to the transaction on a transaction by transaction basis. As should be clear, within well structured investment processes investors with willingness and ability to accept well communicated higher risk strategies are still able to be allocated greater exposure to higher risk/higher potential return securities and allocations.

Under a suitability standard investors are more like climbers tied to guides on a climb up a mountainside where the route, instruction and safety of the climb is highly dependent on guide selected. A best interest standard is a regime where the guides are properly vetted, have pre-assigned routes and procedures for climbs of varying degrees of difficulty and can only select higher risk climbs where climbers have been properly vetted as being both willing and able to accept the risk.

The Canadian system with low suitability standards and lack of accountability for the decision has created a system where investors are tied to the culture and actions of their advisors. A seemingly sophisticated investor tied to a good advisor with good habits and disciplines would be responsible for a much better range of investment decisions than an advisor with poor habits and disciplines.

Comments on Section 8, Best Interest Standards, Part 2

Volte face with respect to 2012 Consultation

The 2012 CSA Consultation introduced the Best Interest Standard as a "statutory" fiduciary duty or best interest standard" yet the current consultation has stated "our express intention is not to establish a statutory fiduciary duty for registrants". This is some turnaround. As discussed in the section dealing with global regulatory change, most other jurisdictions have stated that the best interest standard does have a fiduciary intent and where this is not explicitly noted, in particular with respect to MIFID, there is a) no explicit reference that the standard does not establish a fiduciary duty or obligation and b) sets up an independent advice category that specifically denotes the higher standards to be addressed by that category.

The 2012 Consultation even went as far as stating that "a statutory fiduciary duty would likely support a private law cause of action for damages by a beneficiary against a fiduciary for breach of the duty" and "imposing a statutory duty on an adviser or dealer to "act in the best interests" of clients constitutes imposing a fiduciary duty." It also left scope for the courts to address the issue of fiduciary responsibility with respect to "the particular circumstances and business models of advisers and dealers"..

2016 Best Interest Standards Not a Fiduciary one

The current consultation refers to cases where the phrase best interests "has been interpreted in some contexts as a fiduciary" and in others where it has not, notably where it refers to IIROC's definition of best interest standard.

IIROC as a reference point

In the 2012 Consultation IIROC noted that the phrase best interests

> "IIROC does not believe that the phrase "best interests of the client" on its own creates a fiduciary duty relating to existing or potential material conflicts of interest, and it is not IIROC's intention to do so. Whether or not a fiduciary duty exists in an account relationship depends on the facts of each case, including, among other things, the services being provided to the client and the degree to which the client relies on the firm/adviser in making investment decisions. While the standard of conduct established by the proposal is not as high as the fiduciary standard, it is intended to strengthen investor protection by clarifying IIROC's expectations on how existing or potential material conflicts of interest are to be addressed as between the Approved Person and the client, as well as between the Dealer Member and clients generally."{54}

In a recent rules guidance notice, Managing Conflicts in the Best Interest of the Client, IIROC made the following claims with respect to Best Interest Standards.

> We believe that, taken together, our Dealer Member Rules and guidance put the best interest of the client before the interests of IIROC-regulated dealers and their representatives. ...This principle is also specifically reflected in our rule that requires a firm's representatives to address material conflicts of interest – whether existing or potential – in a manner that is consistent with the best interest of the client. **Recognizing that firms must balance the interests of multiple clients simultaneously, our rule requires them to address such conflicts in a manner that considers the best interest of the client**. ..... We expect that each firm will have appropriate policies and procedures in place to ensure compliance with our "best interest" requirements. Dealers and Approved Persons should not act in a way that benefits them to the detriment of their clients.

Our principle-based conflicts of interest rule Dealer Member Rule 42 is a principle-based rule that is supplemented by guidance . Under the rule and guidance, Dealer Members must address conflicts of interest that do, or could, arise with different business models. For example, the rule requires that all existing or potential material conflicts of interest between a Dealer Member and a client must be addressed

> "in a fair, equitable and transparent manner and considering the best interests of the client or clients",

and that those between an Approved Person and a client must be addressed

> "in a fair, equitable and transparent manner, and consistent with the best interests of the client or clients".

Further, any existing or potential material conflict of interest that cannot be addressed in that manner must be avoided (emphasis added).

IIROC does not specifically state what their best interest rules actually mean, especially given the many breaches of its own conflict of interest rules. The following was noted in the same document:

> Areas for improvement In late 2014: we reviewed the conflict-of-interest-related issues that arose during our normal course examinations of Dealer Members during a 13-month period in 2013-14...Our review showed deficiencies in: (i) policies and procedures concerning conflicts of interest; (ii) documentation concerning the analysis of specific conflicts; and (iii) disclosure of conflicts to clients. These findings suggested weaknesses in the oversight of the conflicts of interest management process within some IIROC-regulated firms.
>
> As a follow-up, in June 2015: we conducted a targeted survey of a representative sample of IIROC regulated firms ... when it came to compensation-related conflicts, most firms sampled lacked a meaningful process to identify, deal with, monitor and supervise compensation-related conflicts. For example, most firms did not have mechanisms in place to identify advisors who recommend products that yield higher fees and bonuses, when there are other suitable but less expensive alternatives available.

With reference to its best interest standard I refer to a CFA Institute letter to the SEC "Re: Duties of Brokers, Dealers, and Investment Advisers (File No. 4-606) of July 2013

> The Investment Advisers Act of 1940 envisioned a separate regulatory structure for investment advisers...The Securities and Exchange Act... sets out requirements for broker..... When these Acts were created, broker-dealer activity was primarily confined to execution of transactions and did not encompass the range of services offered by brokers, including providing advice to the extent they do today.
>
> This "blurring of the lines" between adviser and broker-dealer providing similar "investment advice" is further exacerbated by advertisements and the descriptions often used by broker-dealers referring to themselves as trusted financial advisers, often using such titles in formal and informal communications with clients.
>
> In the interest of fairness and integrity of markets, we do not believe that Congress ever intended a difference in standards for providing the same services.
>
> **Therefore, we encourage the SEC to restore the Congressional intent by clarifying through regulations that the originally-mandated fiduciary duty standard applies in the provision of personalized investment advice, particularly in the case of retail investors,**

regardless of whether the provider is a registered investment adviser, a broker-dealer or other type of investment professional.

Clearly the CFA Institute would consider those brokers providing personalised investment advice to be subject to a fiduciary standard. The CFA Institute also provided the following caution:

> "The SEC should be cautious in adopting any standard of care that would thus depart from the basic premises on which the fiduciary standard is based. Any lessening of the current standard or a complicated, meandering of its application should be avoided. Retail investors should be able to understand and count on a standard whereby anyone providing them with personalized investment advice will put the interests of those investors first. At a time when investor confidence needs restoration, any dilution of such a fundamental standard for the retail investor would be an unfortunate step in the wrong direction and an abrogation of longstanding policy."

The current CSA consultation distances its best interest standard from important fiduciary standards and risks endorsing lesser/weaker declarations of the best interest standard itself. In the consultation it references IIROC stance with respect to the fiduciary intent of a best interest standard. IIROC's best interest standard is one that is to a certain extent reliant on disclosure or transaction remuneration and I would refer again to text from the above noted CFA Institute letter to the SEC:

> "Disclosure alone is seldom a substitute for assessing the actions performed in the light of prudence, loyalty and care, regardless of the disclosure. In other words, while it is helpful to alert clients to potential conflicts of interest, it alone does not meet the bigger duty to the client that is contained in a true fiduciary duty standard of care"

Just what is a best interest standard? Other sources

The CSA Consultation states that "With respect to the experience in the U.K. and Australia, two other common law jurisdictions, we understand that the statutory "best interest" standard in those jurisdictions does not, by itself, establish a fiduciary duty. It refers to the Law Commission Report of 2015 on Fiduciary Duties of Investment Intermediaries.

The aim of the report was "to evaluate how far the law encourages pension funds and others to make "long-term investment decisions" and addressed a review of fiduciary law with respect to intermediaries further up the investment chain.

In addressing this issue the Law Report looked at the components of a fiduciary standard, especially with respect to best interest matters. It did not state that a best interest standard did not establish a fiduciary duty. In the section addressing global regulatory change I do reference the UK governments decision not to specifically use the term fiduciary for the reasons so noted.

It stated that the courts have emphasised that the core of fiduciary duty is the obligation of loyalty. Mere incompetence, it stated was not enough to breach this core fiduciary duty. It stated that a fiduciary owes other duties, such as a duty not to be negligent but this is not per se a fiduciary duty.

It also stated that when fiduciary duties "work well they operate alongside regulatory rules and market structures which align the interests of the intermediary with those of the saver."

It stated that "although fiduciary duties are often equated with the duty to act in the interest of another" that was only half the story, "that fiduciaries will owe both fiduciary duties and non-fiduciary duties" though only "those duties that are peculiar to fiduciaries are properly termed fiduciary duties".

It referred to legal precedent to state that a duty to exercise skill and reasonable care is not itself a fiduciary duty, However with respect to best interest standards specifically it did hone in on this issue in a number of instances:

> Quoting P Finn, Fiduciary Obligations 1977: "Several academics have emphasised the importance of **an undertaking to act on behalf of another** as the touchstone of a fiduciary relationship. It has been said that a fiduciary "is, simply, someone who undertakes to act for or on behalf of another in some particular matter or matters""**.**
>
> "In his seminal work Fiduciary Obligations, Paul Finn said that: For a person to be a fiduciary he must first and foremost **have bound himself in some way to protect and/or to advance the interests of another**"
>
> Quoting from P Finn, Fiduciary Obligations (1977) para 15: "What must be shown … is that **the actual circumstances of a relationship are such that one party is entitled to expect that the other will act in his interests in and for the purposes of the relationship**. Ascendancy, influence, vulnerability, trust, confidence or dependence doubtless will be of importance in making this out, but they will be important only to the extent that they evidence a relationship suggesting that entitlement."
>
> Referring to Arklow Investments V Maclean "The Privy Council has noted that: The [fiduciary] concept **encaptures a situation where one person is in a relationship with another which gives rise to a legitimate expectation, which equity will recognise, that the fiduciary will not utilise his or her position in such a way which is adverse to the interests of the principal**."
>
> "The key test is whether there is **a legitimate expectation that one party will act in another's interest**. However, discretion, power to act and vulnerability are indicators of such an expectation"

The report then goes on to place "best interests" as a core component at the core of the definition of a fiduciary:

> As we noted above, **the distinguishing duty of a fiduciary is the duty of loyalty**. As Lord Justice Millett noted in Bristol and West Building Society v Mothew:
>
>> The principal is entitled to the single-minded loyalty of his fiduciary. This **core liability has several facets**. A fiduciary must act in good faith; he must not make a profit out of his trust; **he must not place himself in a position where his duty and his interest may conflict**; he may not act for his own benefit or the benefit of a third person without the informed consent of his principal. This is not intended to be an exhaustive list, but it is sufficient to indicate the nature of fiduciary obligations. They are the defining characteristics of the fiduciary.

The principle defined by the UK government in place of that of the semantically challenged fiduciary is similar in content and spirit to the above, as is the best interest rule itself under the FCA's COBS 2.1.1.

The Law Society did however state that a duty of care is not a fiduciary duty and the CSA when it states that its best interest standard, which it defines as a standard of care and not a fiduciary duty, is not a fiduciary duty may well be alluding to this point. This is however different from the current codification of the Federal Fiduciary standard in the US which includes both a duty of loyalty and a duty of care.

A well referenced report into Fiduciary Duties, When Do Fiduciary Duties Arise? By James Edelman, 2010, also makes reference to the key role of a best interest duty of loyalty:

> The focus is instead upon explaining why those duties which are usually characterized as fiduciary will arise:
>
> (a) a fiduciary must not to put himself in a position of conflict without informed consent,
>
> (b) a fiduciary must not to make a profit from his position without informed consent;
>
> (c) a fiduciary must act in the best interests of the beneficiary; and
>
> (d) a fiduciary must act in good faith. Some or all of these duties have been described as "the irreducible core of the fiduciary obligation".
>
> In Bristol & West Building Society v Mothew, in a passage which has been cited with approval on many occasions, Millett L.J. described the four fiduciary duties above **as duties of loyalty which are "special to fiduciaries" and explained that such duties arise when "someone…has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence."**

US legislative intent with respect to Dodd Frank clearly states that a best interest standard is a fiduciary standard. The SEC in its Study on Investment Advisers and Broker Dealers also makes this point clear:

> The duty of loyalty requires an adviser to serve the best interests of its clients, which includes an obligation not to subordinate the clients' interests to its own. An adviser's duty of care requires it to "make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information."

Comments on Section 8, Part 3 – Re Benefits of a best interest standard - Section 8

With respect to the identified/possible benefits.

Governing principle.

A regulatory best interest standard would constitute a governing principle that would:

- *govern the interpretation of more specific regulatory requirements (e.g., those obligations related to KYC, KYP, conflicts of interest and suitability) as a result of ambiguity, new developments or other changes in the investment environment, and*
- *act as a guide for registrants and securities regulators to address situations arising in the client-registrant relationship that fall outside specific rules.*

As discussed, the proposed best interest standard has been cut off at the knees by the CSA with its statement that the standard itself is not a fiduciary duty and by the fact that it is framed as a standard of care as opposed to a duty of loyalty. Other jurisdictions, the US aside, have noted its fiduciary intent but stopped short of labelling it as such for clearly stated reasons that do not suggest the standard is bereft of fiduciary qualities.

It is a standard of care in an industry populated by services regulated on the basis that they are transactional relationships with limited liability for investment advice. The proposed titles, the focus on products and the implication that advice is still incidental to the transaction in the targeted reforms misrepresents the true nature of most non advisory investment advice relationships.

I am uncertain as to what exactly the impact this diminutive standard will have on advice in Canada. The Proposed Targeted Reforms already set the boundaries to which the standard will apply, so it does not in and of itself make for any changes here.

As a governing principle it summarises the intent of the rules themselves and focuses the advisors and the firms to have the best interests of the client when providing "advice" and recommending transactions. But there are too many loopholes in the proposed rules to enforce its primary objective which I assume to be the selection of the less expensive investment option: firms can decide to go down the proprietary route to protect not just their higher cost products but also the cash flows to their advisory businesses. Additionally the proposed targeted reforms that accompany the best interest standard do not reflect modern service based processes and are arguably overly prescriptive.

The primary objective of a best interest standard is to focus the advisor/firm on the processes that support service delivery, so that liabilities that would otherwise occur between service representation and actual processes are minimised. Additionally, a best interest standard would force an industry to modernise and innovate and to enhance service standards and outcome for investors.

The industry remains product and transaction focused. I see no reason to call the standard itself a best interest standard.

Closes the expectations gap

A regulatory best interest standard, over and above the proposed targeted reforms, would help close the expectations gap between the standard of care that clients believe they are receiving from registrants and the standard of care that registrants are subject to under securities legislation. ***Clients would have the confidence that their relationship with a registrant is governed by a standard of care that prioritizes their interests and that this will govern the interpretation of specific rules as well as situations not presently covered by the rules****. A statutory best interest standard would also align with the standard of conduct that representatives who seek to follow high standards of integrity themselves feel they already provide to their clients. In this sense, it would close this gap as well.*

I have issues with this statement. While I applaud the intent to raise standards of care, if the investor is to be able to repose their trust in these standards of care the duty should be one with an implied fiduciary standard. We are asking investors to place even more trust in an industry which is still plagued by conflicts of interest. The proposed targeted reforms make no mention of the integrity of investment processes and appear to be guided by an intent to upgrade the current regulatory model. I see the standard itself focused more on product outcomes than process outcomes and for this reason would suggest that any attempt to get the investor to place yet more trust in their advisor is misguided.

More objective, client-centered standard of care.

A regulatory best interest standard would be a more objective, client-centered standard of care than the current standard of care (i.e., dealing fairly, honestly and in good faith). At the heart of the regulatory best interest standard is a clear expectation that when registrants are faced with competing interests, their clients' interests are paramount. This would provide a more concrete, intuitive and actionable standard of care for registrants than the current standard of care.

The standard of care is with respect to the transaction given that the standard retains the term "shall deal" instead of "advise". The fact that the consultation has stated that the best interest standard is not a fiduciary duty, assumes that transaction remuneration will remain, this retention of the term to deal in the standard considerably weakens the objectivity of the standard itself.

Appropriate tone from the top.

The regulatory best interest standard would codify what we currently expect as a sound "tone from the top" at registrants, but now given the strength of a regulatory requirement. This would better enable management of firms to assert that the development of a strong compliance culture within the firm is the right thing to do and is a necessary risk management principle. This standard would strengthen the role of CCOs who, with their firms' knowledge, could implement the best practices to be adopted rather than accept minimum standards set out in prescriptive rules.

The standard is clearly not a true best interest standard. It is nevertheless an attempt to get firms and advisors to work more effectively within the current regulatory framework. Unfortunately this framework is one arranged around product distribution and transaction remuneration, a frame dripping with conflicts of interest. I nevertheless appreciate the intent to get advisors to make more client focused recommendations but at the same time express considerable concern over the failure to recognise that the provision of personalised investment advice should accorded with a true best interest standard.

A principle-based approach allows greater flexibility for registrants.

Framing the regulatory best interest standard as a principle would allow the concept of the client's best interest to be the guiding principle that serves as guide to regulators' expectations and would ***allow registrants to take a flexible, tailored and contextual approach when dealing with (i) the varied conduct situations that can arise in respect of their clients, and (ii) the rapid pace of change within Canada's capital markets generally.*** *In addition, the requirement for registrants to act in the best interest of clients and the focus on client outcomes are important elements of the proposed regulatory best interest standard that would support a principle-based approach, rather than a more prescriptive, process-based approach.*

Where is the point at which the standard is aimed?

It is unclear what the standard itself is: if it is not a duty to act in someone's best interests, as per the fiduciary duty of loyalty, but a standard of care in a construct that remains focused on the transaction point; if it deliberately separates standards under a discretionary service from those that are not, especially in the light of common law precedent with respect to liabilities in an arm's length commercial relationship, then what is the standard of care?

Just how much trust can an investor place in their advisor's processes or is it indeed trust in the most appropriate product selection?

Where is the point at which the standard is aimed?

If the standard is aimed at the processes over which the advisor has discretion, of which there are many, then it is an obligation to act in an area of complete discretion. If it is aimed at the transaction, for which the investor is deemed to be responsible under current regulation, and, for which there is now a POS document the regulators have deemed sufficient to inform, then the point of trust is a very small point indeed. In reality the POS documentation is insufficient for investors to make an informed decision, because of the weight of process around the transaction, but sufficient to inform them of the basics of an investment. It cannot provide a platform for an informed decision – see my comments in Appendix A.

Investors responsible for investing to fund their retirement.

The savings landscape has changed -- amounts invested by investors often constitute a major portion of their wealth and responsibility for funding the costs of living during old age is shifting more to investors. There are various causes for this change, including the shift away from defined benefit retirement plans in Canada. A regulatory best interest standard would acknowledge the critical *importance of advice in savings, including retirement, and the enormous financial stakes involved for Canadian investors.*

This is an argument for truly impartial investment advice that puts the client's interest first and an industry that does not revolve around transaction remuneration. The US has specifically introduced a Uniform Fiduciary Standard for retirement accounts and has not shied away from naming the duty as a fiduciary one.

Mitigates client-registrant information gap and validates clients' significant trust in registrants.

The adoption of a regulatory best interest standard may help to further mitigate concerns with the lower financial literacy of many investors by ensuring that the registrant has the clients' interests top of mind, rather than requiring clients (who may not be equipped to do so) to attempt to determine whether a particular course of action is in their best interests or not. This would place an appropriate obligation on the party to the relationship who is most often the most knowledgeable and financially literate, namely the adviser or dealer and their representatives. This aligns with what we know about clients' actual ability and/or confidence to manage their own financial affairs. It would also clarify that the registrant would be expected to objectively help formulate the client's best interests, providing a service that is necessary and appropriate for most clients. Since clients already believe that registrants must act in their best interest and place significant trust in registrants, this should not result in investors becoming less engaged in the relationship with their registrant but rather having the confidence to engage in a dialogue with a professional who is required to be unquestionably in the "client's corner".

Again, I have serious concerns about a statement that suggests the advisor has a clear duty of loyalty when the consultation expressly states that there is no such duty. The proposed targeted reforms likewise revolve around the transaction at a time when we need to make sure that the gap between service representations and the ability of service processes to meet those expectations are narrowed. A true best interest standard would push the liability for this gap onto the firm and the advisor. See my point in "where is the point at which the standard is aimed?".

Immediate impact.

The key investor protection concerns identified are so substantial that solutions could not await an iterative process of regulatory amendments if the concerns are not mitigated by such amendments or other initiatives, such as CRM2 and Point of Sale. The regulatory best interest standard would be an overarching principle that would allow swifter regulatory action in the interests of investors where required and where registrants do not live up to the spirit of the proposed targeted reforms. While the CRM2 and the Point of Sale initiatives are important enhancements to our regime, their fundamental focus on disclosure is unlikely to sufficiently address the concerns we have identified in Part 5.

I agree that the focus of disclosure in the CRM and POS is insufficient to address the issues identified. I agree that a best interest standard would change the landscape. I have reservations over its present framing in particular the clear dividing line between discretionary and non discretionary accounts. Giving discretionary accounts a fiduciary standard while advisory accounts a watered down best interest standard narrowed to a fine point, that is arguably one of best product (itself watered down if conflicts of interest remain), is framing the liability for the integrity of the construction, planning and management process as one for which the investor has a large degree of responsibility.

One of the reasons why a best interest standard was needed, was to acknowledge a duty of care that only a court could previously award. Given that the regulation of the advisory relationship remained that of an arm's length commercial relationship common law would only grant a fiduciary relationship under extreme circumstances. The issue was a) that the relationship had changed, b) acknowledging the relationship had changed meant that the relationship was now primarily one that should be categorised by a fiduciary standard and c) given that these relationships were increasingly uniformly fiduciary in character that they be accorded a statutory best interest standard to i) recognise the higher standard of care required in the relationship and ii) to give guidance to the courts with respect to the intent of regulation and definition of the relationship.

Under the current proposed best interest standards and the reaffirmation of the product focus of the relationship, noted in the Proposed Targeted Reforms, we are back to square one, but arguably worse off. Regulators have looked at the issue, have decided it is still largely an arm's length transaction relationship, arguably with better definition over episodic duties, to better manage the liability to the industry in the provision of that relationship. Investors seeking restitution and attempting to prove the relationship had liabilities that were fiduciary in nature risk having less chance of success. The blurry lines have been repainted; the decision to grant discretionary managers a fiduciary duty no more than a ceremonial act.

I would strongly suggest that the current standard be renamed a best product standard and not a best interest standard.

Assists in professionalization of advisers, dealers and representatives.

The best interest standard would assist in the progress toward the professionalization of the advisory role in Canada similar to other important services that require practitioners to comply with professional standards of conduct. Similarly, it would support and align with the evolution in organizational culture that regulators, and many registrants, have been encouraging for some time.

Clearly there is a strong movement to establish a professional financial advice culture in Canada and this is part of the problem. Recognising professional standards in the eyes of investors without enforcing professional standards, without creating a standard that would force advisors to deliver on those standards creates liabilities that are borne by investors. These fiduciary liabilities are largely process driven and represent the gap between service representation and the capabilities of service provision. The industry is concerned about the liabilities that fiduciary standards would impose on its businesses. The fact is that alignment of service promises with process capabilities will manage these fiduciary liabilities. A fiduciary liability is effectively extinguished with the proper structure and processes and the monitoring of those processes.

How do we get people to conform to professional and regulatory standards? We do this by imposing liabilities for non performance, for placing the responsibility for process, for negligence (intentional deviation from good practice and process) and for careless omission at their door. Given the complexities of the investment process and the considerable discretion over those processes, the most effective and appropriate sanction is a fiduciary liability. The standard needs to be uniformly applied, not selective according to client status, otherwise we are giving permission to deviate from the necessary standards of care that are required to deliver the necessary process outcomes.

The current proposed best interest standard as discussed appears to be focused on the best product only, and leaves the investor exposed to considerable liability. I would not trust the proposed standard.

Aligns with conduct expectations of key international and domestic standard setters.

International bodies such as the International Organization of Securities Commissions (IOSCO), the Group of Twenty (G20) and the Organisation for Economic Co-operation and Development (OECD) are clear that, in the wake of the financial crisis, financial intermediaries, such as advisers and dealers, should act in their clients' best interest. International and domestic standard setters have also identified the over-arching obligation to act in the client's best interest, or to place the client's interest first, as a key component of the conduct expectation for their members.

As noted in the section dealing with global regulatory change, Canada's regulators lack not only legislative support but legislative intent behind the fiduciary nature of best interest standards. Canada lags global regulatory standards and has done so for a while[5].

Fosters confidence and trust in capital markets and strengthens investor protection.

The introduction of a regulatory best interest standard would increase confidence and trust by investors in Canadian capital markets and would strengthen the protection for such investors. This may have the effect of encouraging investors (i) that are not currently invested in securities products to begin investing in securities products and (ii) that are currently invested in securities products to invest more of their overall financial assets in securities products.

I have serious concerns about asking investors to repose higher levels of trust in the current retail financial services market place and especially so under what appears to be a weakened best interest standard.

Comments on Section 8, Part 4 - Reasons the BCSC Is Not Consulting on a Regulatory Best Interest Standard

Our objectives are to deliver better regulatory responses, empower investors with better information and improve investor financial outcomes.

In other words to retain the historical regulatory view of the transactional, and hence arms length commercial nature, of the advisory relationship, to retain the current emphasis on investor responsibility for the decision and to rely on product and relationship disclosure to make sure that investors have the information they need to make informed decisions about transactions and their advisory relationship. To keep Canada's retail financial services industry in the dark ages if at all possible.

The BCSC ignores global regulatory change, the vast libraries of research on the topic of the effectiveness of disclosure, of the well recorded and noted change in the advisory relationship, of the complexities and responsibilities of the investment process, of the developments in technology that can deliver process driven solutions, of the representations of professionalism and the development of a professional culture and standards that are focussed on advice based service process, on the need for and importance of innovation in the financial services market place and of the inability of the investor to make complex informed decisions, again for which there is vast amounts of well documented research.

The BCSC is proposing an alternative approach that in our view will significantly strengthen the standards of conduct, lead to better investor outcomes and advance the best interests of investors.

The proposed changes rely on disclosure of conflicts of interest. Disclosure is unlikely to change conduct. Research on disclosure strongly suggests that it is ineffective without bold health warnings that can also adversely effect trust in the client advisor relationship. Advisors are often given moral license by the disclosure to take advantage of the position of conflict.

The proposed changes remain focused on the product and the transaction and ignore the importance of process in the construction planning and management of assets to meet investor's financial needs.

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[5] Andrew Teasdale, POINT OF SALE DISCLOSURE AND REGULATORY FAILURE IN CANADIAN RETAIL FINANCIAL SERVICES
http://www.moneymanagedproperly.com/technical%20docs/Point%20of%20Sale%20and%20Regulatory%20Failure%20September%202010.pdf

Implementing specific requirements that deal directly with the identified issues in the client-registrant relationship will strengthen investor protection and confidence of investors in our capital markets.

The issues identified are due to conflicts of interest (transaction remuneration) in the relationship, a failure to provide effective sanction for poor advice, a failure to acknowledge the actual relationship and hence to regulate the processes of that relationship and a failure to hold firms and advisors to account for the liabilities of their representations. The world view of the BCSC is 30 to 40 years behind the times.

> "*It has been pointed out that investor protection should not be achieved at too high a cost to the participants in the market; and that a degree of risk is inherent in the securities market. These concerns can be subsumed under the general principle that one should not overregulate*[6]"

The adoption of a broad, sweeping and vague best interest standard will create uncertainty for registrants and may be unworkable in the current regulatory and business environment.

A best interest standard that was intended to acknowledge the fiduciary standards of non discretionary investment advice mandates would be broad, would be sweeping, but would not be vague. It would hold the industry accountable for the integrity of their investment processes, processes over which they exercise complete discretion. It would as of this moment be difficult to implement, but as with other jurisdictions time would be given for the industry to make the necessary changes. The industry possesses the technology, many of the processes and quite certainly the expertise to make these changes. Those who wish to continue to be transaction/trade generation led would be free to continue to operate but no longer under the guise of providing advice but that of transactions and incidental transaction advice under a conflict of interest.

Introducing an over-arching duty called a best interest standard while continuing to permit certain fundamental conflicts to exist between registrants and their clients is not in the public interest. Doing so may exacerbate one of the issues we identified; the expectations gap between clients and registrants and may raise clients' expectations about investor protection that may not be realized under a best interest standard.

I am in agreement but this is within the BCSC's power to change. .

The CSA should establish clear requirements for registrants to follow and regulators and courts to enforce. The proposed targeted reforms, followed through with coordinated and focused compliance and enforcement efforts, and full realization of the CRM2 and Point of Sale initiatives, will achieve the best outcomes for investors and advance the best interests of investors. The concerns of BCSC staff are set out more fully in the next section.

With respect to clear guidelines for a court to enforce I will restate comments from this document:

One of the reasons why a best interest standard was considered necessary was to acknowledge a duty of loyalty and care that only a court could acknowledge. Given that the regulation of the advisory relationship was still considered an arm's length commercial relationship, common law would only grant a fiduciary relationship under extreme circumstances. The issue was a) that the relationship had changed, b) acknowledging the relationship had changed meant that the relationship was now primarily one that should be categorised by a fiduciary standard and c) given that these relationships were increasingly uniformly fiduciary in character that they be accorded a statutory best interest standard to recognise the higher standard of care required in the relationship and to give guidance to the courts with respect to the intent of regulation and definition of the relationship.

[6] Report of the Standing Committee of the Ontario Legislature on Government Agencies August 1988

Under the Proposed Targeted Reforms the product/transaction focus of the relationship has been reaffirmed. The courts will note that regulators have looked at the issue, have decided it is still largely an arm's length transaction relationship, arguably with better definition over episodic duties, to better manage the liability to the industry in the provision of that relationship. Investors seeking restitution and attempting to prove the relationship had liabilities that were fiduciary in nature risk having much less chance of success. The blurry lines have been repainted. Worse the duties to advisory clients have been sectioned off from a true fiduciary standard by the accordance of such, in the review process, to discretionary relationships only.

These are clear guidelines in which consumers who have been subjected to poor advice processes, when the representations of such were different, will be forced to accept whatever restitution firms decide to give them. This is the regulation of the investor and the enforcement of their supposed relationship liabilities.

Comments on Section 8, Part 5 - Reasons certain CSA jurisdictions have concerns with the potential regulatory best interest standard

The proposed best interest standard may exacerbate the expectations gap between clients and registrants because of the existing restricted registration categories and proprietary business models permitted in Canada.

These CSA jurisdictions have come up with a number supposed barriers to the implementation of a best interest standard but not one suggestion to try and resolve them.

The issue is that at present there is no notion of the management of the liability represented by the expectations gap. The solution proposed by these jurisdictions is to marginally enhance the standards of care and accountability for certain omissions in the suitability process (cash reserve and debt considerations) but it does not address the expectations gap per se. This liability is associated with responsibility for the processes that underpin personalised investment advice for the management of assets to meet financial needs over time. This is the fundamental basis of the relationship and the promise to deliver such is the reason why trust is reposed in the relationship.

Clients may expect that all registrants have an unqualified duty to act in their best interests, not understanding that some conflicts would still be permitted.

The argument here is that because the best interest standard may not apply to all registrants, because they do not offer a sufficient range across the asset universe to be able to effectively populate the risk/return universe at a sensible cost, that those who do should not be held accountable.

I am confused that "these" regulators, while stating that disclosure over who would and who would not be held accountable to a best interest standard is not viable, are on the other hand relying on disclosure of relationships and products, that are proven to be ineffective, to define the client's responsibility. They are hiding behind the client's inability to avoid reform while proclaiming the client's ability to accept liability when numerous research and surveys report that this is not the case.

The solution is simple. Get rid of these narrow product specialists. Reinsert the product into mainstream advisor toolkits, make sure that advisors have the required specialist knowledge to be able to recommend them. This is not outside the ability of individuals who have passed the CFP, the CIM, the CFA exams, and other educational standards. There is no reason in this day and age to have segregation of advice along product lines. Likewise, let MFDA advisors use low cost exchange traded funds.

More importantly limit access to areas of the market place that require more advanced expertise (complex products, hedge funds, structured notes, options, direct stocks) to individuals who the necessary experience and qualifications and adherence to professional ethical standards. Those who want to sell, let them be called sales people, let the relationship disclosure state they are not there to provide personalised investment advice, that if they want this they need to access the service of someone registered to do so.

Solutions are staring our regulators in the face!

The proposed standard will not prohibit certain fundamental conflicts between registrants and their clients. Registrants will continue to be able to:

• sell a limited range or type of investment products (these registrants have the clear limitation that there may be nothing in the limited range of products they offer that is actually in the investor's "best interest" to buy);

• be owned by, or affiliated with, businesses that create the investment products they sell; and

• be compensated by investment product manufacturers rather than the clients they are meant to serve.

Get rid of transaction remuneration. This is within the powers of all members of the CSA. Look to the UK and other regulators with respect to delineation of those who can only offer restricted investment advice.

*While trust in a representative is of course important and desirable, the proposed best interest standard **may cause investors to completely absolve themselves of any responsibility for their investment decisions**, on the mistaken belief that registrants will be held to a higher standard of care that will prohibit conflicts that are permitted today. Research shows that engaged and informed investors lead to better investment decisions*.

This statement makes a number of assumptions about investors and advisors and the nature of fiduciary liability within investment advice relationships that are incorrect.

- It assumes that the issues in the industry are due in large part to investors reneging on investment choices.
- It ignores the fact that regulation and distribution overly focuses on the transaction and not the integrity and definition of the processes that support personalised investment recommendations.
- It ignores the fact that under transaction remuneration models, attention to the integrity and structure of these processes are not rewarded or held accountable for omissions due to the limited nature of regulation of the transaction and the limited parameters of the KYC/NAAAF and the ability to influence the options selected.
- It ignores the fact that whatever decision an investor makes is tied to the processes and standards, culture and ethics and conflicts of the advisor. An investor who wishes to take an aggressive allocation to risky assets might be given a balanced but heavy exposure to global equity markets and limited allocation to lower risk assets if they purchased from solutions dictated by say an institution's investment team, but a leveraged portfolio full of dodgy unlisted micro tech stocks from another advisor. The range of outputs and the integrity of the outputs are large and, at their extreme, bear no relationship to professional standards, yet they fit the boundaries of the KYC, and if you are deemed knowledgeable of risk taking, then God help you. The current system allows too wide a range of extremes resulting in outputs that would be hard to reproduce in a well structured, disciplined and responsible service process.

Well defined investment processes that fully address the 3 main components of the investment planning, construction and management process would limit the ability an investor to renege.

These components are briefly explained below:

- Risk profiling, fact finding and education (both of risk and the way the advisor/firm manages risk and personalizes the portfolio to meet the client's financial needs). Risk profiling would address a number of factors: attitudes to risks such as volatility, performance risks (passive v active, globally diversified v domestic), how conservative they are the extent to which they would like more security and certainty than say the advisor would recommend for their profile.

- The portfolio construction, planning and management systems/procedures/decision rules: this would hold the firm's allocation models, and benchmark security selection for those models, rules as to how these models would adjust allocations for changing risk and yield/liability profiles, as well as the inputs for risk and return etc. This component would also include the modeling of risk and return and assess the client's ability to take risk.

- Due diligence with regard to security and product research and selection:

When addressing a fiduciary liability in a non discretionary setting the onus is on the advisor to prove:

- That they undertook the necessary due diligence to understand the client and their needs;

- That their processes for structuring and planning were sensible and reasonable and the relationship, given the firm's discipline, between the recommendations and the client's needs and preferences were clearly defined and the solutions were capable of managing and mitigating the major risks, with allowance for risk preferences, as per representations made as to the capabilities of the service itself.

- That the main points of their process, the portfolio and the strategy and the recommendations were explained and that there was sufficient documentation in writing for the client to assess.

- That the investor was allowed the opportunity to discuss and question and confirm (especially their own financial circumstances and objectives and or assessment of risk).

- That over time communication between advisor and client continued to reaffirm the objectives of the portfolio and how its allocation and risks related to the preferences and financial needs of the investor.

If an investor wants an extreme strategy it is up to the advisor to determine whether they have the processes and procedures to accommodate that strategy.

A best interest standard would force firms and advisors to clearly define their processes and make them fit for purpose. The output of such processes would be clearer, better organised, well communicated and documented. The liability of the promised representation would be managed and this essentially is the fiduciary liability, the reason why the client reposed trust in the advisor.

In a well defined, well communicated, well structured service process that is focused on the client's best interests, clients would be more aware, not less engaged, would have greater interaction and not less.

Failure to implement a best interest standard and a focus on structured service processes will leave the liability unattended. This is a regulatory liability and one could say a fiduciary one. The implied fiduciary liability that exists in today's service representations needs to be managed and standards that would enforce the management of this risk need to be applied. Yes, the industry may struggle to implement as is as of today, and so regulators need to give time and advance warning that regulation is focused on the management of the liability that some may express as an expectations gap but that is clearly a fiduciary liability.

In the absence of more fundamental changes to restricted registration categories and conflicted business models, the Jurisdictions with Concerns about a BIS think making it our priority to implement the proposed targeted reforms discussed in this Consultation Paper and vigorously enforcing the current conduct standard to "deal fairly, honestly and in good faith" will improve investor protection and investor confidence.

Regulators are abnegating their responsibility to address the issues noted. This is no reason not to act. This has been on the regulatory table since at least 2004. Change the registrations; unify the advisory model; separate sales from advice.

The proposed targeted reforms are geared to the realities of our current registrant categories and conflicted business models.

Why are our regulators continuing accept conflicted business models? The argument that no change should be considered because the system is impaired is illogical.

The proposed best interest standard will create legal uncertainty. It does not create a clear standard for registrants to follow or for regulators to enforce. Imposing a best interest standard that permits the existing restricted business models and conflicted compensation structures will create legal uncertainty. The proposed standard is expressly not a fiduciary duty, so courts may no longer rely on existing jurisprudence in that area.

Agreed! A true best interest standard and the removal of transaction remuneration would resolve the issue. These arguments make no mention of this, so one must assume that they are not in favour of a standard that would not create legal uncertainty.

The Jurisdictions with Concerns about a BIS are uncertain how regulators or the courts will interpret a standard that on the one hand expressly requires conduct in the client's best interest and the avoidance of material conflicts, but in other cases permits conduct that may not be in the client's best interest as long as there is disclosure.

I totally agree. But there is a solution to this, albeit one that the CSA does not appear to wish to take.

There are also tensions between the proposed standard and more specific regulatory requirements, which may create uncertainty for registrants. In some cases, specific requirements contemplate conduct that seems inconsistent with the proposed standard. For example, currently firms that sell only proprietary products can meet their suitability requirement provided they ensure any recommendation they make to purchase a security from their product list is suitable for the client.

I agree. Retaining a commission based structure within a system that allows proprietary products to be sold while conforming to a so called best interest standard would be inappropriate. While there is clearly work that needs to be done in this area this should not preclude a move to a true best interest framework free of transaction remuneration.

When Australia introduced its statutory best interest standard, it included a "safe harbour" if registrants followed certain prescribed steps. One of the elements of the safe harbour was that registrants take "any other steps that, at the time the advice is provided, would reasonably be regarded as being in the best interests of the client, given the client's relevant circumstances". In 2014, a new government proposed a bill that included removal of this language, following its commitments to reduce compliance costs for the financial services industry and for consumers who seek advice. The government was concerned that the catch-all provision created significant legal uncertainty and rendered the safe harbour unworkable for registrants because it was too open-ended. Because it does not establish a clear standard for registrants to follow or for regulators or courts to enforce, it is uncertain whether the proposed standard will drive better behaviour by registrants and at what cost any changes in behaviour will come.

I have read the document and rule in question. It is clear to me that the safe harbour provision is there to let registrants know that the suitability consideration should address all pertinent issues. The rule remains and has not been repealed, to my knowledge. The regulators are grasping at straws in this respect.

The CRM2 and Point of Sale Initiatives are intended to improve communication in the client-registrant relationship around costs and investment performance. Their effectiveness should be measured before we consider a best interest standard.

The CRM and CRM2 are disclosure initiatives whose aim is to upgrade disclosure surrounding the transaction based regulatory frame. As noted in this document, the upgrades to the suitability frame make it indistinguishable from those advice based services operating under fiduciary standards. The CRM could quite easily be assumed within a proper best interest standard framework and in truth has helped lay the ground work for the transition. This is not a robust argument as to why service process standards in the industry should not be recognised and regulated in accordance with their obligations.

Other jurisdictions that have implemented a best interest standard have done so in conjunction with targeted reforms prohibiting certain conflicted compensation models. The proposed standard is unlikely to be effective without more fundamental changes to the Canadian securities industry, including reforms to compensation structures.

The UK RDR was promoted and planned years in advance of the actual change. As stated the CSA should proceed with plans to remove transaction remuneration form the retail financial services industry and to unify the retail advice platform.

The proposed standard may impact interpretation of existing fiduciary standards for certain registrants, i.e. portfolio managers and investment fund managers..

If these jurisdictions are indeed concerned about the impact of weaker standards then perhaps they should address the impact of weaker standards on the investors they presently wish to refuse the protection of higher standards.

Question 36

36) Please indicate whether a regulatory best interest standard would be required or beneficial, over and above the proposed targeted reforms, to address the identified regulatory concerns.

A true best interest standard is necessary a) to establish a regulatory rule that acknowledges the fiduciary type responsibilities involved in the management of non discretionary accounts, b) to require that firms and advisors take responsibility for making sure that their representations of service match the integrity and purpose of their processes and c) otherwise to scale back their representations of service to that of a sales based as opposed to an advice based relationship.

Question 37

37) Please indicate whether you agree or disagree with any of the points raised in support of, or against, the introduction of a regulatory best interest standard and explain why.

Please see my points and comments noted throughout my submission!

Question 38

38) Please indicate whether there are any other key arguments in support of, or against, the introduction of a regulatory best interest standard that have not been identified above.

As noted in this submission in specific sections and in my comments to the statements and arguments of regulators with respect to best interest standards.

Comments on Section 9 – IMPACT ON INVESTORS, REGISTRANTS AND CAPITAL MARKETS

Question 39

39) What impact would the introduction of the proposed targeted reforms and/or a regulatory best interest standard have on compliance costs for registrants?

I believe that the proposed best interest standards are unclear and that the proposed targeted reforms are overly prescriptive. I believe that the focus on the transaction and all the innumerable transaction points may create compliance overload. It would be better to focus on the development of structured service processes and regulate the way these processes determine suitability and transaction rationales. I believe there are serious issues with attempting to stretch the regulation of the transaction on a transaction by transaction basis to be able to cover the wider service representations of the today and this is showing up in the Proposed Targeted Reforms. Unfortunately it takes an in depth knowledge on how to simplify complex systems to be able to understand exactly the folly of the direction of current regulation.

Question 40

40) What impact would the introduction of the proposed targeted reforms and/or a regulatory best interest standard have on outcomes for investors?

The best interest standard is really an obligation to offer the best product on the shelf. This may have some benefit to investors but the majority of the issues impacting advice and the standards of advice remain in play. There may be some benefit from the proposed targeted reforms in that it elevates the standard of care somewhat with respect to basic financial analysis, but there are concerns over this as noted in my comments. Overall the reforms are likely to achieve little while adding additional complexity to the present system.

Question 41

41) What challenges and opportunities could registrants face in operationalizing: (i) the proposed targeted reforms? (ii) a regulatory best interest standard?

Challenges are too numerous to mention. Again my concerns are noted in detail in each specific section. The opportunities are limited.

Question 42

42) How might the proposals impact existing business models? If significant impact is predicted, will other (new or pre-existing) business models gain more prominence?

I feel the CSA jurisdictions, especially those who are against introducing a best interest standard of any shape or form, are ignorant of the dynamics of the current business model and the necessary changes that need to happen to allow innovation and more competitive business models to flourish. Regulators could at the very least have allowed for a new registration category for advisors operating in the non advisory segment, who wish to eschew transaction returns, to offer personalised investment advice under fiduciary standards.

Question 42

43) Do the proposals go far enough in enhancing the obligations of dealers, advisers and their representatives toward their clients?

Comments on Section 5 – KEY INVESTOR PROTECTION CONCERNS IN CONNECTION WITH THE CLIENT-REGISTRANT RELATIONSHIP

With respect to the identified "key investor protection concerns" my brief comments are noted:

Clients are not getting the value or returns they could reasonably expect from investing:

At least part of the reason for this is the wording of the existing suitability requirement. Failure of registrants to consider all relevant factors, including product costs and investment strategies (such as the use of leverage or choosing active over passive management of assets) in their suitability analysis may prevent clients from meeting the goals of their investment activity.

The suggestion here is that regulators have not been prescriptive enough, that it is their fault that advisors/product sellers have not considered all the necessary ingredients of product selling. Also, for example, the new regulations provide no guidance on leverage beyond that already provided so I fail to see how the brief cameo in the new rules will change anything. I comment on this in my response to section 7 questions. This is too much an "oh silly me, now where did I leave the milk" response to the serious issues facing the industry.

Clients are not getting appropriate final solutions because of a) conflicts of interest, b) the ability of advisors to represent a higher standard of care than they actually need to deliver, c) registrants are under qualified, under supervised, d) the lack of focus on structures and disciplines that would better manage risk and return. In short a lack of focus on the best interests of the client.

Expectations Gap:

Most investors incorrectly assume that their registrants must always provide advice that is in their best interest*. As a result,* ***clients have misplaced reliance or trust on their registrants,*** *resulting in* ***opportunities for some registrants to take advantage of their clients and creating an expectations gap between clients and registrants.***

Most investors place too much reliance on their registrants*, which exacerbates the* ***agency problem*** *inherent in* ***the client-registrant relationship*** *and can result in sub-optimal investments.*

Clients need to understand the nature of the relationship, and what level of trust and reliance they should afford their registrant*. The problem of misplaced reliance is exacerbated when registrants (1) use titles or designations that exaggerate their proficiency or the services they actually provide and (2) sell a limited or proprietary shelf of products*.

The CSA assume that the issue is one of misplaced trust and not also one of misplaced representation of service, expertise and reason to trust. The reason therefore why many investors are receiving poor outcomes is because their trust takes away their discretion from the decision. It implies that this discretion is not otherwise transferred to the agent and is otherwise misplaced, absent from the point at which they ought to take responsibility for the decision.

Advisors and institutions are allowed to advertise their expertise, their professionalism, even that they act in the client's best interests. Indeed IIROC proclaim that their registrants have a duty to act in their client's best interests, but not so the CSA. There is no sanction here against these advisors and institutions in their solicitation of such trust.

There are many reasons why investors rationally trust their advisors. Investment is a complex area. Advisors represent themselves as professionals who can help them manage their assets to meet their needs. Regulation promotes trust in the system and their advisors. There are a great many reasons why brokers are no longer mere agents in the process: their actions, representations and services with respect to the provision of advice have long since moved outside of the episodic incidental relationship that used to characterise the agent/investor relationship. Every country bar Canada seems to recognise this.

Importantly there is no emboldened health warning on any relationship disclosure as to the extent the client can rely on the advisor. The CRM disclosure for advisory accounts is as follows:

> An "advisory account" is an account where the client is responsible for investment decisions but is able to rely on advice given by a registered representative. The registered representative is responsible for the advice given. In providing this advice, the registered representative must meet an appropriate standard of care, provide suitable investment recommendations and provide unbiased investment advice[7].

The above statement is insufficient a disclosure as to the true nature of the relationship. It is ambiguous and fails to define the legal liability for investors with respect to trusting their advisor. Yet, there is no proposal in the submission to clearly and forcefully communicate the actual relationship.

It is worth noting some of the research into this area: Dimitris Georgarakos and Roman Inderst, "Financial Advice and Stock Market Participation[8]" (Goethe University, 2014)".

> "Using data from a large European survey, we provide novel evidence that the use households make of advice is affected both by their own financial capability and by the trust they put in professional advice. **For households with high financial capability or households who do not trust financial advice, it is their perception of legal rights as consumers of financial services that induces stock market participation. Instead, households with lower financial capability need to trust financial advice in order to invest in stocks**.
>
> Our empirical analysis suggests that it is a key determinant of households' willingness to invest in risky assets. Our model and empirical results suggest, however, that **advice matters most for households with low own financial capability, and only when they trust advice**. **But even then households must, at the same time, have sufficient faith in legal institutions that govern financial markets**. Our results may have some bearing on the current discussion on how to restore confidence in financial markets. Our findings suggest that to foster stockholding among households with low own financial capability, trust in advice is a key prerequisite.

Conflicts of Interest:

The application in practice of the current conflicts of interest rules is, in many instances, less effective than intended. Not only is the concern that disclosure may be ineffective in mitigating conflicts of interest, disclosure may have a counter-intuitive effect of increasing reliance on advice where the client is told such advice is, or potentially is, conflicted. Part of the challenge for regulators is identifying when disclosure of conflicts is effective, and when it may exacerbate the conflict situation or is ineffective.

The CSA has identified one key problem but is not, apparently, going to do anything about it. My comments on this issue is well evidenced in this document.

[7] IIROC, Client Relationship Model – Implementation 2012
http://www.iiroc.ca/Documents/2012/c168cd67-0f80-468e-b38b-c6ef773ecc41_en.pdf
[8] http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1641302

Information Asymmetry:

The current regulatory framework is, in many instances, less effective than intended in mitigating the consequences of the information and financial literacy asymmetry between registrants and their retail clients. With the limited financial literacy of most investors, the increasing complexity of securities products and the limited effectiveness of initiatives to improve financial literacy, coupled with the challenge that most investors have in avoiding biases and applying their financial knowledge in their decision making, more onus for prioritizing the client's interest and ensuring that clients understand the information and advice they receive should shift onto registrants.

Essentially, rather than making advisors responsible for delivering outcomes of integrity that acknowledge the relationship and the discretion and trust reposed within it, they are seeking regulation that will require advisors to prioritize client's interests within the context of the client/registrant relationship.

What the CSA is intending to do is unachievable and quite frankly ignorant of the frame in which they expect investor to make investment decisions. I explain the issues in the Appendix A.

Danielle Winchester in "Three Essays on the Impact of Financial Advice" makes a number of references to research on this issue:

> "Consumers cannot adequately evaluate the quality of the advice prior to, or even after, its purchase since most consumers do not have either the technical knowledge or experience to do so (Guenzi & George, 2010; Mitra, Reiss, & Capella, 1999)."
>
> "Because of information asymmetry, the potential for opportunism exists because consumers must rely on the service provider‟s financial expertise and proclaimed advice quality (Dulleck & Kerschbamer, 2006; Pesendorfer & Wolinsky, 2003)."

Clients are not getting outcomes that the regulatory system is designed to give them:

There are a number of potential causes of this concern, including opaqueness in the suitability assessment, existing requirements that require more clarity to assist in effective enforcement, barriers to obtaining redress for a registrant breach, and lack of effective compliance and enforcement in certain cases.

There is no mention in this section of best interest standards. This a key section, perhaps the most important section in the consultation. There is no mention of concerns raised by many investor advocates including key players in this area, FAIR Canada and the IAP. The issues according to the CSA are lack of clarity in rules, issues with the KYC, conflicts of interest which need to be prioritised, excessive trust by investors who have misread the relationship and informational asymmetry that in the opinion of the regulators can be addressed by making sure investors understand the information passed their way.

Possible bias against consumers re role in impaired investment outcomes?

I express some concern that the CSA Consultation has not adequately addressed the issue facing investors and are biased in their assessment of the role of consumers in impaired retail financial service outcomes.

Note the comment "***clients have misplaced reliance or trust on their registrants"*** in Section 5 regarding Key Investor Protection Concerns and *"**coupled with the challenge that most investors have in avoiding biases and applying their financial knowledge in their decision making**"* with respect *to* asymmetry of knowledge in the same section. In "Reasons Certain Jurisdictions have concerns" with the proposed best interest standard the following comment was made "*the proposed* *best interest standard **may cause investors to completely absolve themselves of any responsibility for their investment decisions**,"*

I raise this point because the Brondesbury report appeared to be lay much of the blame on impaired outcomes in the retail sector on investors. I highlight a number of references from the report that establishes the grounds for my concerns:

> P 10 – "…we must recognize that advisors must be compensated and financial institutions must be profitable. There are legal and regulatory requirements that make this so."
>
> P45 – "Investor behaviour biases lead to sub-optimal returns and these biases can be confused with compensation impacts."
>
> P 50 – "Behavioral biases of investors are not easy to overcome and they are a key factor in sub-optimal returns on investment. This poses a real limitation of the conclusions we can draw from the research literature, when we look solely at clients of commission-based advisors….If there is no comparison between different forms of compensation, one can easily be misled into believing that sub-optimal behaviour is the result of the advisor's recommendations and not, at least in part, the behavior and attitudes of the investor"
>
> P 51 "As we posited earlier in this chapter, the complexity of investor choices is the root of the problem. Experimental research shows that investors are often uncomfortable with the investment process, and instead of understanding the concepts, they seek shortcuts, heuristics, and opportunities to delegate that relieve them of the burden of understanding the complexity…."
>
> P53 "…disclosure and rational discussion may not be enough to overcome behavioral biases. This is especially the case since many investors have no interest in this type of discussion. With 40% of Canadians failing a general investment knowledge test and many demonstrating unrealistic expectations for investment returns (CSA Investor Index, 2012), it is clear that many investors don't wish to spend a significant amount of time on financial matters. Without a real comparison of investment decisions for investors of comparable sophistication using advisors with different compensation, we suspect that much of what we see as impact of compensation is just investors failing to make rational decisions."
>
> P 44 – "Time is a precious commodity to most advisors. There is only so much time an advisor can afford to spend to overcome the behavioral biases of investors, regardless of how they are compensated."
>
> P53 – "There are two issues related to behavioral biases that must be mentioned here. The first is the question of who is responsible for overcoming the behavioral biases of individual investors. While helping clients to do so may be something that a top-notch advisor will choose to do, we are not aware of any rule or principle that points to de-biasing as an advisor or a firm responsibility, regardless of compensation scheme unless a failure to do so impacts 'investment suitability' in some way."
>
> P57- "the answer to whether advisors are obligated to de-bias clients (other than when a failure to do so leads to suitability issues) can only be a matter of policy. On a practical level, however, we can say that an obligation to de-bias clients would be time-consuming and costly."
>
> P68 – "In terms of placing clients into higher risk products than their risk profile suggests is warranted, we speculated in an earlier chapter that this may be an advisor strategy to help deal with a mismatch between risk profile and investment objectives. In a 2014 InvestorPulse Survey commissioned by BlackRock Investments, they found that investors have consistently

unrealistic beliefs about the income their retirement savings will generate, typically underestimating what they will need by 50% or more. The report comments that inconsistencies between risk profile and attainment of objectives are likely to be at odds over the long-term."

P30 – "The question that is unanswered is why advisors recommend higher risk products. In Canada, higher commissions for riskier investments may account for some of the preference. More broadly, there may be a desire to maximize return for clients……We speculate that advisors recommend riskier investments in the hope of getting better returns for their clients. They are motivated by a belief that clients will ultimately base advisor retention decisions on the amount of money they make. This is consistent with investor behaviour for exiting mutual funds, but we have no direct proof that it applies to dropping advisors. Our firm has heard comments to this effect in interviews with advisors, but this issue was not central to those advisor studies . Since we did not systematically collect the information, this does not constitute empirically supported findings. "

P 70 "As a close to this discussion, we note that none of the regulation or impact studies look at the responsibility of the individual investor for their own well-being. The philosophical underpinning of the regulation is that investors need help because this is too complex to figure out on their own. While we don't dispute that assertion, we contend that a discussion of individual responsibility is merited. To use an analogy, seatbelts are mandated to help save lives in the event of an auto accident, but it is the driver's responsibility to handle their vehicle in a manner that makes an accident less likely. Perhaps there is a parallel in financial services regulation."

P 69 – "In academic research, much of the disadvantage engendered by biased advice is that the return on a recommended investment is greatly diminished by commission costs. When commissions are removed from the equation then return to the investor should be higher. As we pointed out earlier, however, the return to the investor in a fee-based regime can only be reckoned after all fees have been charged against the investment return. The research on regulatory impact suggests that while product cost is lower and advisors recommend more low cost products, the cost of advice and other fees (e.g., administration, platform) is likely to rise"

Comments on Section 7 - Proposed targeted reforms

The proposed targeted reforms relate to the current "*client-registrant relationship*", which in the case of advisory services is governed by a suitability standard where "*the investor is responsible for the investment decision but is able to rely on advice given by a registered representative. The registered representative is responsible for the advice given. In providing this advice, the registered representative must meet an appropriate standard of care, provide suitable investment recommendations and provide unbiased investment advice.*"

The proposed targeted reforms include the "*regulation of conflicts of interest, the KYC and KYP requirements, the suitability obligation, the use by registrants of business titles and proficiency. These potential reforms are intended to work together to improve the client-registrant relationship*."

This puts the foundation of the consultation as one which is looking to enhance the existing CRM project. This puts the main thrust of the proposed regulatory change as one which looks to continue to enhance the regulation of the transaction in keeping with the underlying industry distribution model.

Section 7 - Conflicts of interest

Part 13 of NI 31-103 would be amended to require that firms and representatives must respond to each identified material conflict of interest in a manner that prioritizes the interests of the client ahead of the interests of the firm and/or representative.

Any disclosure given to a client about a conflict of interest must be prominent, specific and clear. The disclosure must be sufficient to be meaningful to the client such that the client fully understands the conflict, including the implications and consequences of the conflict for the client.

Firms and representatives must have a reasonable basis for concluding that a client fully understands the implications and consequences of the conflict that is disclosed. Please refer to Appendix A for a description of potential guidance.

Question1

Is this general approach to regulating how registrants should respond to conflicts optimal? If not, what alternative approach would you recommend?

It is noted in the links to regulatory compliance reports, provided in the consultation, that efforts to manage conflicts of interest appear to be making headway in all but the most important area, that of compensation related conflicts.

> However, when it came to compensation-related conflicts, most firms sampled lacked a meaningful process to identify, deal with, monitor and supervise compensation-related conflicts. For example, most firms did not have mechanisms in place to identify advisors who recommend products that yield higher fees and bonuses, when there are other suitable but less expensive alternatives available.

Removing transaction and product based remuneration from registrants who are providing financial advice to investors would be my preferred response. A process that truly minimises conflicts of interests is going to minimise transaction payments and focus on simpler structural outputs: this is the objective of a true best interests standard where embedded commissions have been excluded. I can see years and years and years of issues with a system that attempts to deal with commission based conflicts of interest in the way intended.

Investors should not be forced to have to work out the impact of conflicts of interest on the optimality of the wealth management solution provided. They should be faced with the true costs of the service to allow them to better decide service options and the value of those options.

Disclosure has noticeable drawbacks according to a recent study titled, "Consumer Decision-Making in Retail Investment Services: A Behavioural Economics Perspective[9]" (European Commission, 2010) suggested that

> "our experimental results **raise doubts that disclosure can always be relied upon to help consumers understand that the advice that they are receiving may not necessarily reflect a choice that is solely in their own best interests...**First, we find that the impact of disclosing conflicts of interest is context-dependent. **Online subjects hardly responded at all to disclosure of advisor remuneration**....Only those subjects who took more time over their decisions reacted appropriately **and even then only when the disclosure was flagged in a bold red font,** for the simplest of decisions.
>
> In contrast, laboratory subjects, with more time and fewer distractions, exhibited a strong reaction to the disclosure of biased incentives, showing evident mistrust of advice.
>
> Second, **we find that full and transparent disclosure and/or a health warning may be necessary for people to properly understand the implications of the information being disclosed to them**. Online subjects, who were only told that their advisor was paid a commission, did not react to this disclosure unless it was accompanied by a health warning. **Laboratory subjects who were told the exact details of their advisor's remuneration structure responded to disclosure without such a warning**. Thus, the effectiveness of conflict of interest disclosure as a policy lever crucially depends on the precise form and content of that disclosure. **People do not appear to naturally recognise conflicts of interest and respond appropriately unless the implications are clearly spelled out to them in some fashion**.
>
> **Third, we find that disclosing conflicts of interest sometimes simply elicits a kneejerk reaction that can be harmful as well as helpful**. Subjects in the laboratory exhibited contrarian behaviour in their investment choices when biased incentives were disclosed, investing significantly less in the recommended alternative."

Question 2

Is the requirement to respond to conflicts "in a manner that prioritizes the interest of the client ahead of the interests of the firm and/or representative" clear enough to provide a meaningful code of conduct? If not, how could the requirement be clarified?

Again, transaction based remuneration bias the investment advice process away from a portfolio's structural integrity towards higher transaction remuneration impairing the integrity of the wealth management solution. High product costs are one of the root causes of investment risk and can invalidate the supposed risk/return benefits of many investment products. Consumers have a difficult time making investment decisions in the first place without having to parse through and calculate the structural impacts of transaction remuneration as well any negative ifnleucnes this compensation may have wrought on the structure and integrity of the wealth management solution.

As per the same study "

> We find that consumers struggle with even comparatively simple investment decisions in an experimental context. .
>
> Furthermore, we find strong evidence of biases in un-advised consumer investment decisions: extreme aversion against uncertainty; aversion against complex (structured)

[9] http://ec.europa.eu/consumers/archive/strategy/docs/final_report_en.pdf

products; and confusion in the presence of complex (superfluous) information. In circumstances where a more risky or complex investment is the optimal choice, the share of funds invested optimally falls by 15 to 27 percentage points.

In Experiment 1, only 56% of funds were invested optimally. Just 25% of investment decisions were made completely optimally (i.e. all funds invested in the better of two available products) and only 1.4% of subjects made all five investment choices optimally

In this particular study of those investors faced with a series of 5 simple investment, only 1.4% succeeded in making the correct choice in all 5 decisions. Add in the ineffectiveness of disclosure and the further complexity of the transaction remuneration and clearly we have evidence that investors are not going to be able to make informed decisions either about products or relationships. This is why a best interest standard is necessary.

Question 3

Will this requirement present any particular challenges for specific registration categories or business models?

Yes: I would expect the ability to properly prioritise transaction based conflicts of interest while retaining the integrity of the wealth management structure to be an intensely complex exercise with no clear decision rules capable of providing viable optimisation and ordering of interests.

Other research

62 Daylian M. Cain, George Loewenstein and Don A. Moore, "The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest," The Journal of Legal Studies 34, 1 (January 2005): 1-25.

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=480121

> Conflicts of interest can lead experts to give biased and corrupt advice. Although disclosure is often proposed as a potential solution to these problems, we show that it can have perverse effects. First, people generally do not discount advice from biased advisors as much as they should, even when advisors' conflicts of interest are honestly disclosed. Second, disclosure can increase the bias in advice because it leads advisors to feel morally licensed and strategically encouraged to exaggerate their advice even further. This means that while disclosure may [insufficiently] warn an audience to discount an expert-opinion, disclosure might also lead the expert to alter the opinion offered and alter it in such a way as to overcompensate for any discounting that might occur. As a result, disclosure may fail to solve the problems created by conflicts of interest and it may sometimes even make matters worse.

Section 7 - Know Your Client

Section 13.2 of NI 31-103 would be amended by adding requirements that registrants must:

- *ensure that the KYC process results in a thorough understanding of the client;*

- *gather more client-centered information in respect of each of the three key elements of the KYC obligation, including:*

  o investment needs and objectives: time horizon for their investments, how liquid they need their investments to be, and applicable investment constraints;

  o financial circumstances: the amount and nature of all assets and debts, employment status, basic tax position, and spousal and dependents' status and needs; and risk profile: the client's risk profile for investment purposes, based on concepts including risk attitude, risk capacity and loss aversion (terms to be defined for client);

- *ensure that KYC forms and a record of the risk profile, both at initial account opening and upon material changes, are dated and signed by both the client and the representative and a copy is provided to the client; and*

- *take reasonable steps to update their client's KYC information (and related form) at least once every 12 months, and more frequently in response to material changes in circumstances affecting the client or the client's portfolio. Please refer to Appendix B for a description of potential guidance*

Question 4

4) Do all registrants currently have the proficiency to understand their client's basic tax position? Would requiring collection of this information raise any issues or challenges for registrants or clients?

All registrants should be able to understand a client's basic tax position. This should be a fundamental professional requirement. Whether it is necessary to perform tax calculations for all levels of service is another matter. Simplified service options providing one off advice for small investments should not require this information.

Question 5

5) Should the CSA also codify the specific form of the document, or new account application form, that is used to collect the prescribed KYC content?

Part 1 No with respect to general standards.

The present industry minimum standard represents no more than a parameter to parameter CYA tick sheet for transaction liability management. A best standard example could of course be provided for guidance and I would suggest liaising with professional standards for this. Proscribing a minimum standard would impact innovation and service development and would obviate the intent of even the limited "best interest" standard. Service standards/options should dictate the information requirement. It is noted that

For example, proper assessment of a client's time horizon and hence liquidity needs would involve a detailed net cash flow projection of inflows to the portfolio (probable savings, expected capital inflows, prospective (risk adjusted) portfolio income) and outflows (preferred and planned income and capital expenditures, planned retirement dates) to be used to assess optimal portfolio structure and portfolio withdrawals and other investment planning criteria. The collection of client data is only the first step in the process of data collation and preparation.

Assessing portfolio construction parameters such as liquidity needs and time horizon are no more than guesstimates and result in sub optimal solutions if we define them only as short term/medium term or long term. Some short term horizon demands could be easily met from clients' savings/portfolio income or from a specifically allocated security within a portfolio.

I would personally do away with the current standard format which encourages simplistic assessment of investment objectives, time horizon and risk profiles. I would also recommend that firms develop, if they have not already done so, a separate risk profiling sheet covering the various aspects of risk profiling and in particular risks that impact portfolio structuring or selection. As noted in the IAP Risk Profiling report, risk profiling itself is a more detailed and involved process.

Part 2 Yes with respect to simplified advice channels

...where investors are seeking quick simple cheap and effective investment advice re savings/investment advice for small sums and are unwilling or unable to contract for more expensive services. A simplistic KYC format could be available for say clients under a notional amount of say $30,000.

Part 3

I think it important to recognise that current standards of data collection emanate from historic attempts to regulate transactions at the stock broker/sales level and not to define parameters for the giving of personalised investment advice. The CSA need to seriously consider the service process differences between a sales process and a true advice process and the different demands of such processes.

If the objective of regulation is to keep the advisory component of the retail financial services industry at a basic product/security level dictated by a simple set of client information parameters then this should be made clear and communicated to investors to allow them to select the advice level most suited to their financial needs and knowledge/expertise limitations. A true best interest standard would focus not only on client data but the format of that data for effective processing of construction planning and management of assets to meet financial needs.

Current minimum standards as discussed are no more than CYA forms designed to limit transactional liability. We can trace the evolution of the KYC documents some way back in the US because regulators have provided historical KYC rules online and we know that such rules have only developed fairly recently in Canada due to legal judgements on the issues:

> "**a duty to "know your client" and avoid unsuitable investment advice has not always existed.** In 1972 in R.H. Deacon & Co. Ltd. v. Varga, 32 the Ontario Court of Appeal rejected the idea that there was an obligation to "know your client" and ensure suitability... The court held that, absent reliance by the client, an investment dealer and IA were "the same as any other agent acting for a principal" and had the duties limited to following instructions and avoiding conflicts of interest[10]"

Note the following "Proposed Amendments to Article III, Sections 2 and 21 (c) of the Rules of Fair Practice Re: Customer Account Information; Last Voting Date: April 5, 1990[11]" from the FINRA website:

> When recommending to a customer the purchase, sale, or exchange of any security, Article III, Section 2 currently requires that a member have reasonable grounds for believing that the recommendation is suitable for the customer *on the basis **of any facts disclosed by the customer** as to his other security holdings, financial situation, and needs*.
>
> The NASD Board of Governors believes that these procedures should be strengthened to require additional information on each account and that sufficient information be obtained to

[10] The Fasken Martineau 2005 report "Liability and Damages in Unsuitable Investment Advice Cases

[11] http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=1313

> permit the member firm to make more informed determinations about accounts and investment recommendations.
>
> The Board therefore proposes to amend Section 21(c) to require a member to make reasonable efforts to obtain, prior to the settlement of the initial transaction in a non institutional customer account, the tax identification or Social Security number of the customer and the occupation and name and address of the employer of each customer for each account, in addition to the above-listed information currently required to be obtained. ...prior to the execution of a transaction recommended to a non institutional customer, a member must make reasonable efforts to obtain information concerning that customer's financial status, tax status, investment objectives, and such other information used or considered to be reasonable and necessary by the member or registered representative in making recommendations to the customer.

The KYC is not a long standing formal standard of good practise but a catch up to the development of regulation of the transaction. The "suitability standard" and its trappings are found wanting primarily because the nature of financial advice services has changed and moved on from the transaction. We are currently stretching the intent of the regulation of the transaction industry to attempt to cover that of the provision of personalised financial/investment advice and the framework and responsibilities of the framework have been found wanting.

More detailed information without a process capable of dealing with that information will create liabilities for those providing advice. Many in the CSA believe that the introduction of a best interest standard will create liabilities for those providing financial advice, but the real liability already exists. This is the implied and often express promise to provide services that can best construct plan and manage assets and affairs to meet an investors financial needs while managing risk and return in a way that complement their own personal investment preferences.

The liability is allowing firms to pass on the liability to investors.

Question 6

6) Should the KYC form also be signed by the representative's supervisor?

In a transaction return environment, if a supervisor is him or herself engaged in managing and expanding his or her client base the objectives of supervision are going to be impaired. This is one of the issues in a sales based service process without dedicated monitoring and quality control of a centralised service process – there is no division of labour.

The issue is not of course one of signing off, but making sure that the information is optimal to satisfy a) professional standards and b) to meet the demands of the contracted service.

In today's commission driven distribution system almost everyone in the distribution chain is conflicted. We know from the many IIROC and MFDA disciplinary proceedings that supervision fails on a regular basis with respect to issues much more evident than the minutae of data collection.

One key method in which information demands can be effectively monitored is as follows:

Define, in some detail, the service process and the inputs required for that service process. Without these key inputs you cannot select or monitor or manage a portfolio. This is irrespective of whether you operate a discretionary or non discretionary operation: the inputs and the outputs are the same.

Confirm the details of the client's financial situation with the client by providing them with a copy of their financial details and asking them to provide information on any other item if this is omitted.

Provide in writing the suitability rationale for the advice, whether this be asset allocation, buying or selling, or selection of withdrawal levels etc and refer back to the client risk profile with and client financial details to support this.

Confirming KYC data collection is a process that requires a) validation with the investment/advice process (this can be monitored via software reporting and if the process is automated lack of critical data would be picked up), b) validation with the client and c) cross referencing with the recommendation. This is a basic advice framework.

Instead of having the KYC ticked off, make sure that the overall process is being properly managed. Automation of the process and hence data input and collection will simplify and aid monitoring.

Other issues

And information on regular financial commitments to be able to assess financial needs.

Section 7 Know Your Product – Representative

Part 13 of NI 31-103 would be amended by explicitly setting out that representatives must have sufficient knowledge of a product, together with the KYC information about the client, to support a suitability analysis.

This would include requirements for representatives to:

(1) understand and consider the structure, product strategy, features, costs and risks of each security on their firm's product list,

(2) understand and consider how a product being recommended compares to other products on the firm's product list, and

(3) understand and consider the impact on the performance of the product of all fees, costs and charges connected to:

- *the product,*
- *the client's account, and*
- *the product and account investment strategy. Please refer to Appendix C for a description of potential guidance.*

Question 7

7) Is this general approach to regulating how representatives should meet their KYP obligation optimal? If not, what alternative approach would you recommend?

Products in many transaction distribution models serve as hybrid portfolio construction processes.

At a fundamental level it is the interaction of a client's asset liability and risk profiles with the advisor's/firm's investment process (including assumptions)/disciplines that determines the asset allocation, the withdrawal and liquidity management, the periodic rebalancing parameters and hence the appropriate securities/products to populate the portfolio.

The more sophisticated the asset liability and risk profiling process the more closely the risk/liquidity/return/correlation profile of the asset population matches that required by the client.

The know your product directives only refer to one part of the above process: this is the part by which the product's components, role, costs, liquidity and risk/return profile are assessed with respect to their structure and costs and features and then compared to other products amid an assessment of the impact of costs etc on performance.

No consideration is given to the interaction of the product with the ability to efficiently populate the asset allocation, that is its structural risk/return and liquidity/asset allocation impact. In truth the simpler, the more liquid, the more direct the security/product the better.

Many complex products impair portfolio structure and their ability to manage withdrawals and liquidity risks:

Take a structured note that takes the place of a bond and serves as a hybrid lower risk asset class with equity type characteristics. It may have features that prevent it from distributing, this means that the overall portfolio is deficient in yield so that other assets will have to be sold to re-establish the yield profile relevant to the client's liability profile. This may result in a transfer of higher risk equities to lower risk higher yielding assets, or some such similar adjustment. The transfer of what may originally have housed a more liquid/yielding bond to a less liquid non yielding asset also impairs the liquidity of the portfolio. A process that correctly adjusts for yield, risk, liquidity and long term risk/return optimisation considerations would find that structured products result in awkward readjustments of allocation that end up impairing the efficiency and structure of the portfolio. These complex products also tend to be higher cost and costs are one of the major factors impacting risk and return on portfolios. Additionally the structure of many complex products adjust the probability distribution of the portfolio's return introducing additional uncertainty and imbalances in prospective outcomes. Many products are extremely confusing even to those who are most able to understand them. **I note below comments from two different research papers on this particular subject**.

The guidance noted in Appendix C of the consultation does state that registrants should have "also an understanding of the impact of the proposed amount of the investment, the proposed investment strategy involving the security, and the role of the security in the client's broader portfolio". Unfortunately the impact of many a product can often only be ascertained by fairly complex modelling of the interaction of its liquidity, cost and risk/return characteristics with the clients ALM/risk profile and other assets within the portfolio.

The proposed rule does not have an explicit know your client's portfolio with respect to liquidity, risk/return, asset allocation and costs. There is no specific know your investment process. I also note that no performance benchmarks are provided for investors in the point of sale documentation or in the CRM required performance reporting. So there is little here for investors to be able verify the effectives of their products or their portfolio relative to the instructions the proposed rule looks to send to advisors.

If you have a construction/planning and management process that allows you to model your portfolios you can then also easily model the impact of products and their costs. Otherwise, just considering a product, mentally for a while for the factors noted, is going to be an extremely difficult model to regulate.

It would be far easier to dispense with transaction returns that end up favouring complex high cost products in favour of fee based remuneration that would reward sevice structures that focus on building fundamental asset allocation structures that can be populated with the most direct, liquid, cost efficient for the allocation desired. Note that this does not preclude true active funds from being recommended if the investment and portfolio discipline looks to manage risk and return via allocation to contrary investment disciplines.

The present proposed know your product enhancement are going to be of limited use in establishing a best advice standard let alone a best interest standard as long as commissions remain integral to product selection and portfolio construction.

I would recommend that a know your investment process requirement be established that would determine how a firm/advisor goes about structuring portfolio solutions to meet different yield and liability profiles and adjustments for risk profiles. This process would set the asset allocation universe for client portfolios which would set the basis for product selection with a focus on the most efficient product/security for that particular portfolio role/asset allocation. Once a process is established we have greater clarity and meaning over products and securities. The process can then be explained to the client and used to support suitability. Moreover a well defined process for asset and security allocation feeds directly into the KYC requirements. The benefits of such a process focus should be obvious for many compliance issues.

Research on closet indexing

From the report "Indexing and Active Fund Management: International Evidence" Jan 2015 (Cremers, Ferreira, Matos, Starks"[12]:

> "We find that actively managed funds are more active and charge lower fees when they face more competitive pressure from low-cost explicitly indexed funds...we provide evidence that the average alpha generated by active management is higher in countries where low-cost passive alternatives are more popular, while the average alpha is lower in markets where closet indexing is more prevalent. Overall, our evidence suggests that enhanced competitive pressure from index funds and ETFs creates more incentives for skilled managers to pass on alpha to fund investors whereas closet indexing has the opposite effect."
>
> "the availability of explicit indexing is associated with improved levels of competition in a fund industry, while closet indexing is indicative of the reverse."
>
> "We find that truly active funds significantly outperform closet indexers. Further, we find that the truly active funds are able to outperform their benchmarks on average by 1.04% per year (0.12% if equal-weighting)"
>
> "Markets with more competition from explicitly indexed funds display active funds that pursue more differentiated product strategies (i.e., funds exhibit higher active shares) to deliver alpha to investors and charge lower fees for active management. In contrast, in countries in which investors have limited options of paying lower fees for beta exposure through passive management, many active fund managers are effectively closet indexers who charge higher fees and underperform. A quasi-natural experiment using the exogenous variation in the availability of indexed funds generated by the country adoption of defined-contribution pension systems supports a causal interpretation of the results."

Canada, on a country of sales basis, has the highest closet index component of all the major countries noted in the research and the highest total costs of all regions assessed at 2.78% per annum. A commission free environment would lead to less closet indexers, greater use of low cost indexed funds and may well reinvigorate those who specialise in true active management.

Research on complex products: structured notes

The following are excerpts from "The Dynamics of Overpricing in Structured Products", Thomas Ruf, UNSW Australia Business School, School of Banking and Finance, September 22, 2011:

> "….research has begun to focus on the negative aspects of SPs arguing that issuers market and sell complex products with low expected returns (Henderson and Pearson, 2010) to retail investors by exploiting their behavioral biases and lack of financial literacy (Bernard et al., 2009)."
>
> "Henderson and Pearson (2010) call SPs the 'dark side of financial innovation' because investors would be better off in the money market than buying SPARQs, the particular SP they analyze. Bernard et al. (2009) argue that issuers emphasize outcomes with high payouts and low probabilities in their marketing materials leading retail investors to overweigh those states in their expected return calculation."

[12] http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1830207

"Bethel and Ferrell (2007) discuss legal and policy implications of the explicit targeting of unsophisticated investors with offers of complex financial securities. In the model of Carlin (2009) issuers faced with increasing competition increase the complexity of their products to make comparisons for investors more costly and maintain overpricing."

"Previous literature has consistently reported overpricing in structured products in general, for the U.S. (Bernard et al., 2009), for Germany (Wilkens et al., 2003) and for Switzerland (Gr□unbichler and Wohlwend, 2005), and for warrants in particular (Horst and Veld, 2008; Abad and Nieto, 2010) when compared to products on derivatives exchanges."

"The extent of overpricing can be sufficiently large to ensure that expected returns lie below the risk-free rate (Henderson and Pearson, 2010) and thus there is no reason for rational investors to buy some of these products. Other studies point out how issuers take advantage of investors' susceptability to certain mental errors like over-optimism (Bernard et al., 2009), how they optimally increase complexity to maintain overpricing (Carlin, 2009) and increase search costs (Dorn, 2010)."

The following is taken from a paper, "Over pricing and Hidden Costs of Structured Products for Retail Investors: Evidence from the Danish Market for Principal Protected Notes"

"Our data set consists of detailed information on almost 400 Danish issues of PPNs during the period from 1998 to 2009. Comparing actual offer prices with theoretical fair values we find that on average PPNs are overpriced by about 6%. While overpricing of structured retail products is well-documented in the literature, our paper is the first to compare the level of overpricing with the product costs disclosed by sellers at issuance. ***We find that on average only about half of the overpricing can be explained by disclosed product costs***. The finding of a significant hidden cost component in structured retail products is new to the literature."

"That PPNs are overpriced relative to their fair value is not surprising since all the different agents participating in the design, construction, marketing, and sale of these products must be compensated for their efforts."

"…costs should be almost negligible after the time of issuance as no current portfolio management services are needed in connection with typical PPNs. However, an explanation for the result can perhaps be found in the fact that PPN arrangers/issuers often point to mutual funds when critics question the costs of PPNs. Mutual fund fees and costs normally amount to around 1{2% per year, which is of course nicely comparable with our estimated average total cost of 6% for PPNs with an average time to maturity of 4 years, i.e. approximately 1.5% per year. So in the absence of better explanations ***for PPN costs one might conjecture that PPN arrangers simply set costs and fees of PPNs at a level that can be justified by comparisons with a well-known retail investment alternative, namely mutual funds."***

"PPNs with a capped option element bear higher costs and are thus more overpriced than non-capped products. Since a cap limits the upside potential for investors and thus depresses the option value, another way of stating this result is that in general PPN investors are not properly compensated { e.g. by a higher participation rate { when arrangers/issuers decide to cap a PPN. ***As suggested to us by a practitioner, one explanation for this finding may be that some PPNs are designed and priced first without taking the cap into account***. The cap is then added sort of "in the last minute" as a "safety valve", i.e. to limit the issuer's risk from mis-estimated hedging costs"

Section 7 - Know Your Product – Firm

Part 13 of NI 31-103 would be amended by explicitly requiring that firms:

- *ensure, through policies and procedures, training tools, guides or other methods, that their representatives have the information and ability to comply with their KYP obligation; and*

- *identify whether they have a proprietary or mixed/non-proprietary product list.*

  o A "proprietary product list" would be defined as a product list that includes only proprietary products.

  o A "mixed/non-proprietary product list" would be defined as a product list that includes both proprietary and non-proprietary products, or only non-proprietary products, that the firm is registered to advise on or trade in.

*Mixed/non-proprietary firms would be required to select the products they offer in accordance with policies and procedures that include **a fair and unbiased market investigation of a reasonable universe of products** that the firm is registered to advise on or trade in; **a product comparison to determine whether the products the firm offers are appropriately representative of the reasonable universe of products** most likely to meet the investment needs and objectives of its clients, **and an optimization process** where the firm makes any necessary changes to the range of products it offers to achieve a range of products that is appropriately representative of the products most likely to meet the investment needs and objectives of its clients, based on the securities products that the firm is registered to advise on or trade in.*

Question 8

8) The intended outcome of the requirement for mixed/non-proprietary firms to engage in a market investigation and product comparison is to ensure the range of products offered by firms that present themselves as offering more than proprietary products is representative of a broad range of products suitable for their client base. Do you agree or disagree with this intended outcome? Please provide an explanation.

First of all I would point out that the proposed rule change included in its frame the term "***reasonable universe of products** most likely to meet the investment needs and objectives of its clients"* yet the question amended this to "*representative of a broad range of products suitable for their client base".* Arguably, suitable offers a wider frame of opportunity than "most likely to meet" given that the current suitability standard frames the term suitable as a process that allows a product to be sold as long as it matches the profile defined by the KYC parameters. If we are talking suitability in this context we are indeed allowing a wide range of products impaired by cost and other features and this muddies the water somewhat, so clarification first off on the terminology is required.

At a fundamental level, in order to be able to define the universe of products within a process focussed on delivering personalised advice, firms need to define the asset allocation universe for their service options and to do this with respect to investment advice they need to identify and define the relevant portfolio construction planning and management processes. This would help define "***the reasonable universe of products** most likely to meet the investment needs and objectives of its clients..".* it would also mean excluding a whole range of complex structured products and high cost closet indexers as well as active funds who are unable to differentiate themselves sufficiently from indexed allocations. Additionally it would help define the term "most likely to mean" as it would already provide guidance with respect to liquidity, yield, volatility, credit and other risks, and of course, the lowest cost option for taking up the allocation.

There are nevertheless conflict of interest issues that are not addressed by the consultation and proposed rule changes: the resulting optimal product list from such a process may well exclude large areas of products a firms is able to advise on or trade in. Given that the distributors (brokers, dealers etc) generate their revenue from products this is a conflict of interest especially if the advisor wishes to steer towards more efficient advice based platforms. Should distributors actually be defining the product list? What responsibility would the distributors be taking in the intermediary chain by selecting products that do not effectively prioritise the client's interests, that impair the portfolio construct, that lead to second or third best outcomes.

As we tighten the CRM regulatory frame we have to be mindful of the fact that at the complaint level it is usually the advisor who is blamed yet we know that it is the distributor who sets the reward structures.

Ridding securities/products of their embedded transactional remuneration would better allow firms to clearly assess those assets/products that would best populate their clients' investment universe. Better still adding a fiduciary standard would force firms to make sure that product securities lists are truly efficient and fit for purpose.

Under the current standard of regulation we still have an unassailable conflict of interest between distributor and advisor.

With respect to terminology:

Unfortunately the term products ""most likely to meet" the investment needs and objectives of its clients" could indeed be a very vague one if portfolio structural integrity and efficiency are not primary considerations, or even a capability within a firm's processes. Without the development of reference points for product and security selection derived from an investment planning construction and management process the door is wide open to the selection of a whole range of products that could meet the investment needs and objectives of clients, but jus not very well. The research on conflicts of interest is clear on this and I note some of this research below.

I would recommend that the CSA provide clearer definition as to what it means by the term "most likely to meet" as well a give indication as to its views on the higher level process that define the asset allocation universe.

If a low cost index fund had a 100% ability to meet the client's need to invest in the Canadian stock market what is the additional hurdle cost or performance metric for closet cost/active funds to qualify?

To what extent are we allowing product selection to impair investment outcomes for investors?

Again failure to remove embedded compensation from products and transaction complicates the product selection decision and creates conflicts between processes that would suggest alternative outcomes?

Product universe and novice advisors

We also have not discussed product/securities clearance for novice advisors. Should new registrants be allowed to recommend direct securities, complex structured products, and should they even be free to recommend their own asset allocations? Should they not be referred to following structured portfolio guidance from the firm and mentored by a specifically designated unit designed to inculcate good practises and adherence to KYC and KYP etc.

The CSA review of key processes has barely scratched the surface of issues that are relevant to high standards of care in the provision of personalised investment advice. As much of the research in this area suggests the ability to influence better outcomes in a frame where transaction based conflicts are allowed, and where the standard of care (not a true best interest standard) and hence the sanctions available agaist breaches or care are restricted, is likely extremely limited.

So the answer no: I disagree with the intended outcomes as stated;

> *The intended outcome of the requirement for mixed/non-proprietary firms to engage in a market investigation and product comparison is to ensure the range of products offered by firms that present themselves as offering more than proprietary products is representative of a broad range of products suitable for their client base.*

It fails to adequately define how the proposed change will impact the range and quality of products selected and fails to clearly denote the hurdles and screening processes expected to support the outcome. Reframing it within the term suitable, a term that already frames the existing universe of outcomes also provides little clarity over the intended delineation of outcomes. Lack of any reference to conflicts of interest throughout the distribution chain, investment advice processes required to help define the universe and lack of attention to critical quality control issues are notable.

Question 9

9) Do you think that requiring mixed/nonproprietary firms to select the products they offer in the manner described will contribute to this outcome? If not, why not?

My comments to 8 apply similarly here.

Question 10

10) Are there other policy approaches that might better achieve this outcome?

To name but a few:

Removing conflicted remuneration (including product/transaction sales targets and other indirect inducements) and applying a best interest standard that would allow firms to focus on processes defining the universe and therefore to more clearly define securities and products relative to client needs, service options and efficient investment outcomes.

Making sure that novice advisors a) follow set allocation models for a range of risk preferences and yield/asset liability requirements, b) are restricted to a simple set of cost effective investment products and strategies (i.e. no leverage), c) are given close supervision with respect to following KYC/KYP and know your process procedures.

Institute a know your process regulatory requirement to allow the development of process focussed service models.

Question 11

11) Will this requirement raise challenges for firms in general or for specific registration categories or business models? If so, please describe the challenges.

Yes and no! If KYC, conflict of interest and suitability requirements are more fully enforced and attempt to enforce a higher standard of care and hence products that actually are compensation and cost restricted, then yes. But the natural trajectory is still a best interest one, still one where the representation of advice, professionalism and the standards of advice will continue to rise in importance. The conflict between product distribution and advice will tighten. If these new rules and procedures end up just being for show, then there will be little change for the industry but a great opportunity to raise standards and the sanctions for failing to achieve represented standards will be missed.

Question 13

12) Will this requirement cause any unintended consequences? For example, could this requirement result in firms offering fewer products? Could it result in firms offering more products?

Factors that impact the provision demand and availability of advice include trust (positively in the case of greater trust), conflicts of interest (negatively in the case of effective disclosure), higher standards and professionalism (positively with respect to trust) and the number of advisors entering or leaving the industry (other factors held constant) as well as costs (negatively with higher costs and positively with lower costs). If reforms improve disclosure of conflicts of interest and warnings over the limitations of advice then this could well reduce demand for products and services, likewise if higher standards result in advisors and firms not wishing to operate under those higher standards then this could also reduce the availability of advice.

Hopefully these reforms will result in those products that are either higher cost or currently inappropriately sold to fall in numbers and those that are lower cost and under sold but are more suitable in terms of more closely matching the asset allocation universe of a fit for purpose portfolio constriction, planning and management process, to rise in numbers. If there is no change in the distribution and proposition of products then the current will have likely failed. The increased disclosure of the cost of transaction advice in Canada may well give pause to those investors who might feel they are not being offered value and who may decide to seek alternative avenues for investment advice.

The argument of choice favoured by many financial services firms in Canada is that regulatory change in the form of best interest standards and the removal of transaction based conflicts of interest will drastically reduce the access to advice by smaller investors. Anyone who cares to look at the research in this area would find that the advice gap has existed for some time and is more a product of the current frame than any change in regulation. Declines seen in the advisor population in places like the UK has more to do with reducing access to inappropriate advice and that the move towards best interest standards has actually engendered a genuine movement, in those countries where change has occurred, to address these issues. I discuss this issue further in section XXXX

Question 14

13) Could these requirements create incentives for firms to stop offering non-proprietary products so that they can fit the definition of proprietary firm?

Question 15

14) Should proprietary firms be required to engage in a market investigation and product comparison process or to offer non-proprietary products?

No not necessarily as long as the fact they are restricted to providing only proprietary products are fully disclosed.

Question 16

15) Do you think that categorizing product lists as either proprietary and mixed/non-proprietary is an optimal distinction amongst firm types? Should there be other characteristics that differentiate firms that should be identified or taken into account in the requirements relating to product list development?

It depends on the disclosure surrounding the difference.

Research

The paper “**Financial Advisors: A Case of Babysitters**?[13]”, Hackethal et al 2011, provides some interesting insights with respect to the sale of financial products.

[13] http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1360440

Current theoretical work but also policy debate on financial regulation seem to be based on the idea that financial advisors know what is good for individual customers but have an incentive to misrepresent this and to take advantage of their customers, who are typically uninformed and cannot figure out the poor quality of advice. Regulation is then needed to make sure that this conflict of interests is dealt with.

First, sales incentives can lead financial advisors to systematically recommend unsuitable products to their clients that entail suboptimal outcomes on the client side. Second, due to agency costs from multitasking and monitoring, a firm employing sales agents (such as BFAs) would be expected to choose lower standards than an entrepreneur (IFA). **Our findings below are quite consistent with these predictions and provide two further insights: (i) advisors may affect portfolio outcomes not only by recommending unsuitable products but also by encouraging excessive trading; and (ii) the notion that advisors have an edge over their clients need not refer solely to unsophisticated clients, but also to experienced but inattentive ones who fail to monitor advisors and the outcome of their activities effectively.**

Strikingly, however, the sample average of the Sharpe ratio on advised accounts is also lower than that on self-run brokerage accounts, suggesting that advisees 'paid' on average a higher cost (in terms of returns) to attain lower risk than what was available to self-managed accounts. **In fact, many banks not only narrow down the menu of financial products offered to investors, but also provide extra incentives for their agents to advise clients to purchase funds or structured products produced by the bank itself or by one of its subsidiaries**.

The paper "The Market for Financial Advice: An Audit Study" by Mullainathan, Noeth and Schoar (2012)[14] shows the impact of product bias on investor outcomes:

Overall, advisers had a significant bias towards active management. In nearly 50% of the visits, the adviser encouraged investing in an actively managed fund; by contrast, in only 7.5% of the advice sessions (21 visits), advisers encouraged investing in an index fund. When advisers mentioned fees, they did so in a way that downplayed them without lying. For example, they often used arguments like, "This fund has 2% fee but that is not much above industry average." **These results suggest that the market for financial advice does not serve to de-bias clients but in fact exaggerates biases that are in the adviser's financial interest while leaning against those that do not generate fees**....Overall our findings suggest that the market for advice works very imperfectly. **The advice by and large fails to debias clients and if anything may exaggerate existing biases or, in some cases, even makes the clients worse off."**

The essay "The Good, the Bad, and the Misguided: How Managers Inadvertently Encourage Deviant Behaviors", in the Fedbruary 2006 edition of the Academy of Management Perspectives is also of relevance[15]:

"Research has uncovered numerous examples of the connection between commissions and/or gratuities and workplace deviance. Studies of individuals in sales positions in a variety of industries (e.g., automobiles, real estate, insurance, and financial services), whose income was 80 to 100 percent based on commission, found evidence of workplace deviance, including undercharging for services, lying about meeting quotas, and padding expense

[14] http://www.nber.org/papers/w17929

[15] http://ww2.valdosta.edu/~mschnake/LitzkyEddlestonKidder2006.pdf

accounts. It is the link between sales or customer satisfaction and financial rewards that provides a context for commissioned- and gratuity based employees to rationalize deviant behaviours. Work place deviance may occur when managers engage in, or tolerate deviant behavior, and/or when managers create an organizational climate that allows employees to put undue pressure on newcomers to conform to group norms.

Misconduct in Financial Services: Differences across Organizations[16] (Brown, Minor, working paper 2015 HBS)

" Using data from the insurance regulator in Texas, we find support for the model's hypotheses. Namely, exclusive experts working for large branded firms are more likely to be the subject of a complaint, relative to independent experts, and experts with more experience are the subject of more complaints per year. Disparities across types of organizations and experience levels are not readily explained by differences in market share.

Our research relates to the current discussion of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the conflict of interest rules proposed by the U.S. Department of Labor.

Brokers often work for large branded companies, whereas registered investment advisors are often independent. We find that experts working in large branded firms are already more likely to extract surplus through misconduct. Thus, holding these brokers to a lower standard may exacerbate consumer harm.

The study "Financial Advice and Individual Investors' Portfolios"[17], Bleuthgen 2008 lends some support to the use of model portfolios within the sales based distribution process:

"When opening a security account, each customer has to indicate which 11 of the following six generic investment strategies corresponds most to her risk attitude: safe, low risk, conservative, balanced, growth, speculative. For each of the six investment strategies the bank creates one generic model portfolio (i.e. a recommendation of how to distribute assets across major asset classes).

While the bank derives more revenues from advised clients, advised clients' portfolios also resemble more closely the optimal portfolios prescribed by financial theory.

The bank designs and updates almost monthly six model portfolios - one for each generic investment strategy.

Errors for advised investors are always lower than errors for self-directed investors except for the class of the least risk-averse investors. Thus, advisors shepherd clients into portfolios that follow the bank's asset allocation rules better. **Even if these rules are not ideal, our results are consistent with the hypothesis that advisors add discipline to the investment process and aid clients in maintaining a stable asset allocation**.

Annual sales and purchase turnover is indeed higher for advised clients, suggesting that advisors induce clients to churn their portfolios..... Additionally, wealthier, older, and more risk-tolerant investors incur significantly higher transaction costs than less wealthy, younger, and more risk-averse investors

[16] http://www.hbs.edu/faculty/Publication%20Files/16-022_3af0a13c-b764-416d-884b-b24e2f4519e2.pdf

[17] http://papers.ssrn.com/sol3/papers.cfm?abstract_id=968197

In this study we investigated the role of financial advisors who are employed by a bank and whose salary is largely fixed.

Section 7 – Suitability

Section 13.3 of NI 31-103 would be replaced with the following.

***A registrant must ensure that, before it makes a recommendation to (or recommendation not to), or accepts an instruction from a client to, buy, sell, hold or exchange a security**, or makes a purchase, sale, hold or exchange of a security for a client's managed account, such purchase, sale, hold or exchange (or decision not to purchase, sell, hold or exchange in the case of a recommendation not to take any of these actions) satisfies the following three elements, as applicable:*

- ***Basic financial suitability**: by identifying whether there are any other basic financial strategies, such as paying down high interest debt or directing cash into a savings account, that are more likely to achieve the client's investment needs and objectives than a transaction in securities;*

- ***Investment strategy suitability**: by identifying a basic asset allocation strategy for the client (and evaluating any other proposed investment strategy) **that is most likely to achieve the client's investment needs and objectives**. This would include identifying a target rate of return the client will need to achieve his or her investment needs and objectives, assessing the target rate against the client's risk profile and resolving any mismatches. If the risk required to achieve the investment needs and objectives is higher than the client's risk capacity, the registrant must revisit the investment needs and objectives with the client; and*

- ***Product selection suitability**: by ensuring that the purchase, sale, hold or exchange of the security (or the decision not to purchase, sell, hold or exchange) is both:*

    - *suitable for the client, and*

    - ***most likely to achieve the client's investment needs and objectives, given the client's financial circumstances and risk profile, based on a review of the structure, features, product strategy, costs and risks of the products on the firm's product list**.*

***This determination must take into account the impact on the performance of the product of any compensation paid to the registrant** by the client or a third party in relation to the product and the impact of the investment strategy of the product.*

***Registrants must perform a suitability analysis of the portfolio of securities in the client's account at the firm**:*

- *when accepting an instruction from the client to buy, sell, hold or exchange securities or using (or ceasing to use) an investment strategy involving a security;*

- *when recommending that the client buy, sell, hold or exchange securities or using (or ceasing to use) an investment strategy involving a security; and*

- *within a reasonable time after any of the following events occur while the client retains an account with the firm, and in any case, at least once every 12 months, or more frequently if the investment strategy (if any) proposed by the representative requires more frequent monitoring:*

    - *securities received into the client's account by deposit or transfer;*

    - *change in representative or firm for the account;*

o material changes in the client's KYC information that the registrant knew or reasonably should have known;

o occurrence of a significant market event affecting capital markets to which the client is exposed; and

o material change in the risk profile of an issuer whose securities are held in the client's account, whether determined by external credit ratings or other internal or external risk assessment mechanisms.

Where an unsuitable investment is identified within an account, the registrant must take appropriate measures to ensure the client receives advice considering the client's investment needs and objectives, risk profile, and other particular circumstances (for example, an appropriate measure or course of action may include contacting the client in a timely manner to recommend changes). Where a client does not want to dispose of the unsuitable investment, it may be appropriate to recommend changes to other investments within the account in order to ensure the suitability of the overall portfolio.

Comments on the rule

Prima facie along with a higher standard of care with respect to the collection of client personal, financial and asset information we now have an explicitly higher standard of care with respect to the impact of investment decisions on the overall financial position of the investor.

Higher standards of care with a greater focus on the process help representation of service meet the actual standard of service. Liabilities to both investors and industry narrow as service standards rise to service standard representations. Behind the CSA intent to raise the focus of the suitability standard on basic financial suitability and basic strategy suitability represents such an intent.

Nevertheless I do have issues with respect to the rule which the questions provided do not provide sufficient opportunity to address.

Advised versus unsolicited

I believe the CSA should give serious consideration to treating advised sales processes (predominantly populated by personal recommendations to investors) and unsolicited transactions separately.

Additionally it needs to treat one off recommendations outside of a management contract separately. Asset management service contracts need to cover both discretionary and non discretionary services.

Investment advice services, whether they are made on an individual transaction basis or part of a non discretionary portfolio management service, given their reliance on the advisor's recommendations should be conducted under a fiduciary type best interest standard. The requirements for an individual personal recommendation where no wider mandate exists and those for the management of a portfolio on a non discretionary basis are clearly different.

Historical antecedents impacting the regulatory frame

The historical KYC/suitability process for assessing transactions is largely constrained by boundaries associated with the traditional broker/client relationship. The limited parametric boundaries of the KYC/NAAF suggest that the suitability analysis envisaged was primarily one to screen client initiated trades, or trades where advice was no more than incidental to the transaction. A higher suitability standard would have imposed an obligation where there was none to give and no implied or explicit representation of a higher service.

As we know, what were once primarily transaction relationships with limited advice, have become more or less advice based relationships with a great many clients operating under de facto portfolio management agreements.

Unfortunately the historical culture and processes that once dominated the financial services landscape, the limited suitability frame and the predilection for “transaction focused interaction” continue to bleed into the more advanced representations of service that populate the market for advice. Part of the cultural issues with inappropriate advice and difficulties in regulation and enforcement are likely due to these antecedents.

Clearly we have a conflict between the standards required of services where recommendations are effectively advisor initiated and the standards required of services that were once more heavily populated by client initiated transactions and informal trade ideas. Failure to address this issue will continue to leave investors exposed to the vestiges of a culture that is not suitable for the provision of advice to the vast majority of retail clients.

If the retention of a wheeler dealer cultural option is important to Canadians then it should be sectioned off under a separate service option with the necessary clear emboldened health warnings.

A simple parameter to parameter KYC process to verify unsolicited trade orders, or transactions initiated upon no more than incidental advice would continue to seem appropriate for those clients who unreservedly use brokers for order execution and who do not rely on them for advice, but is clearly not appropriate for the vast majority of Canadians who look to these “professionals” to provide advice in their best interests. Professional advisors should not encourage wanton trading, extreme and unsuitable strategies.

Overly prescriptive rules and simplified processes for smaller investors with less complex financial needs

The new suitability rules appear overly prescriptive with respect to discussion of basic financial suitability and basic financial strategies, especially with respect to target rate of return specifics.

Many of these points could be covered in more detailed guidance. While the CSA does provide more detailed guidance on KYC/KYP and suitability issues they tend to be more compliance procedure related than honing in on specific suitability practises. The UK FCA tend to be more detailed, and helpful, on what is good and bad practise in this respect (e.g. 1, 2, 3, 4, 5). The CSAs Mystery Shopping project should have been an opportunity to explore the standards of advice in the industry and I am surprised that more detailed findings from their reviews have not found their way into this consultation: overviews of compliance reviews have been provided but these lack the necessary detail to inform the development of the current rules.

It may be that the decision to add the basic financial suitability requirement to the rule is in fact due to issues unearthed in suitability sweeps both at the CSA and SROs. I would expect in a regime that has been overly focused on transactions, and bound by limited parameter to parameter suitability standards for some time, that failure to address fundamental suitability issues, such as cash needs and overall investment planning considerations, may well be an issue. If that is the case then the CSA must make it clear that they are expecting advisors to look at the overall financial position of the investor when giving investment advice and that issues such as money to meet emergency expenditure needs, liquidity management and consideration of financial debts and other prospective liabilities is now a part of the suitability standard.

The basic financial suitability requirement noted in the current rules look to be guidance more appropriate for smaller investors with less complex financial needs who are looking to build up capital or save for a specific objective. In this respect the analysis and product coverage would be simpler. The UK FCA addresses this part of the advice giving spectrum. The product shelf for this regulated activity would be considerably smaller.

However, for investors with larger sums and more complex needs the new rules would limit the analysis that would be required to meet professional standards of suitability. These investors, whether they end up using discretionary or non discretionary management services, are looking to advisors/ers to structure a portfolio of assets to meet their financial needs over time; their future net liabilities will be both of an income and a capital nature and may be both in the form of obligations owed or discretionary expenditure or both. The overall investment plan, portfolio construction and ongoing management would need to ensure that the structure of assets is able to meet these needs on an ongoing basis. If an advisor lacks expertise for part or all of the process he or she would need to refer the client to a financial professional who can. Services marketed to the public would need to reflect the advisors/ers firms capabilities.

There are obviously issues here that are in conflict with processes focused on transaction remuneration. Advisors who are more transaction focused will more likely have under developed investment planning service processes, or would be unwilling to spend time on work that may have no remunerative value.

A best interest fiduciary type standard under a model which precludes transaction remuneration and incentives would facilitate the development of processes focused on suitability as opposed to the transaction. This is critical: a best interest standard would place the responsibility for the gap between service representation and actual structural processes firmly on the firm/advisor. It is not that a best interest standard would unfairly add to the liabilities and costs of providing advice at all. Firms should be able to decide what level of service and expected service outcomes they wish but they need the service processes to structure, plan, manage and ultimately deliver on their service promises.

Letting registrants know that their suitability analysis should consider the need for short term cash holdings, the relative attractiveness of repaying debt (debt is a negative return asset class).and the interaction of their portfolio with their overall financial position is something that should be an accepted part of the expected standard of care but enforcing it under the current distribution model may be problematic.

The attempt to expand the remit of the suitability analysis is not in conflict with the representations of service made in marketing communications and advisor client discussions but may well be in conflict with the overall distribution imperative.

Basic investment strategy suitability:

In a stand alone recommendation, a strategy is how the recommendation is structured or intended to achieve its objective. Essentially a suitability analysis would explain why the recommendation has been made, why it is suitable with respect to various risks, asset allocation and client financial needs.

This is such a natural element of the investment process that I am surprised that it needs to be specifically noted in a rule. Strategies range from the simple to the complex

One of the two main reasons noted in the guidance is with respect to those with a narrow product focus: they would have to be able to define exactly why their specific recommendation is suitable to meet the objective. Hopefully this is meant to deter those with narrow product lines applying their wares to the wider financial needs of investors and to narrow their focus down to areas where their niche has rationale. A best interest standard would raise the standard of care with respect to such advice. This is one of the many drawbacks to the segregation of Canadian financial services between for example insurance, mutual funds and full service brokers.

The other reason is with respect to financial leverage: leverage is an extremely high risk strategy and it's use within the industry subject to some considerable abuse, as the OBSI has itself found it in a number of failures to pay.

Strategies such as leverage

I would hesitate to frame leverage as a basic strategy. An advisor recommending a leveraged strategy should really have an extremely sound reason for recommending it. The risks of leverage in a high cost product/securities market place are much higher than the risk presented in most marketing communications on the subject. Additionally, the use of leverage in a portfolio requires much higher levels of active monitoring and careful attention to risk management. Applying a best interest standard to recommendations including leverage is necessary to help limit the use of leverage, to restrict it to a) investors with the ability to take a substantial loss without impacting their financial security, b) who have expressed a clear independent intent to either borrow or to request high risk investments, and c) whose willingness and ability to accept high risk strategies are well documented.

A best interest standard would require that modelling of leverage risks take into consideration a) actual product and transaction charges, b) actual interest rates charged on the debt, c) the risks of such strategies over different market conditions (i.e. from peak market and economic cycles and rising interest rates) with respect to the underlying securities/asset allocation.

With respect to high risk strategies the onus on proving that this was actually in the best interest of the client should be on the advisor/firm. A best interest standard places the emphasis on the client's ability and willingness to bear risk and professional standards and good judgement.

With respect to wider investment planning issues

With respect to mandates to manage the client's portfolio, whether this be on an advisory or discretionary basis, the strategy of the recommendations should be covered the Investment Policy Statements or other comprehensive reporting and regular reviews discussing strategy and continuing suitability. The way in which the portfolio is structured/personalised to provide yield, liquidity, growth etc, the way it is structured to manage risks and returns over time including its diversification and specific investment styles, as well as the rules that will govern how the portfolio is managed over time, are all strategic.

Limiting the boundaries of strategy through the use of the term "basic" is problematic. The boundaries of the strategy should be defined by the service representation and the ability to deliver by the many service and investment processes though which strategies are structured and managed.

The proposed rule, as with the basic financial suitability requirement appears to be more in tune with delivering basic/simplified investment options for smaller investors with less complex financial needs.

Target rate of returns

Having to identify a target rate of return for each basic strategy is again not fully explained.

Every portfolio will have an expected return based on the various assumptions used in its construction and any other assumptions used to assess withdrawal strategy risks relative to the vissicitudes of return. If the portfolio has a corresponding liability or liability profile then set against this rate of return and the profile of this return, the capital with either run out, increase in value or decline but not fully run out within the lifetime of the asset liability relationship. If an investor's financial demands on a portfolio are such that they risk consuming their entire capital within their life expectancies then either savings need to increase or withdrawals need to fall, based on the assumptions used.

Therefore it is not the required rate of return alone that is important but the relationship between the required rate of return and expected returns on assets. Hopefully the expected rate of returns on assets has incorporated aspects of the uncertainty of return and the risks to return. Moreover, the suitability of a strategy can turn alone on the costs of a strategy, irrespective of the allocation of the strategy. This means that you can game the return expectations such that the required rates of return are achievable. Regulators will therefore need to monitor risk and return assumptions used in the model of assets and liabilities over time.

That said i am in favour of requiring that advisors' service processes consider the modelling of the ability of a client's assets to meet financial needs over time where this fits in the with represented service. I do not see the need to require it irrespective, especially for stand alone investments where the investor is also likely to be saving over time.

Communication of suitability

Written communication of recommendations would be important in establishing the level of care taken with respect to the decisions, the extent to which the advisor had attempted to understand the issues and the role of objective processes. It would provide investors with information to help them in their decisions and a reference point in the event of complaint that would assess to what extent the advisor had determined the suitability of the recommendations.

Suitability letters have been standard requirements under Australian and UK regulation for some time and would help establish the "strategy" and the suitability process.

Product selection suitability

Product selection suitability*: by ensuring that the purchase, sale, hold or exchange of the security (or the decision not to purchase, sell, hold or exchange) is both:*

> *o suitable for the client, and*
>
> *o* ***most likely to achieve the client's investment needs and objectives, given the client's financial circumstances and risk profile, based on a review of the structure, features, product strategy, costs and risks of the products on the firm's product list****.*

Depending on the sophistication of the process, an investment planning process would take various inputs - risk preferences, financial needs, a firm's core investment disciplines and optimal asset/security portfolios and decision rules and assumptions which adjust the firm's view of the universe for client risk and liability profiles – and out of this process would come a personalised asset allocation and security/product selection.

The point is that product or security selection in a disciplined process is determined by suitability. The structure of a portfolio is determined by all the factors noted in the above rule. So the so called suitability inputs determine structure, and products and securities are used to populate that structure. Since a firm should be looking to populate its asset allocation universe with the most efficient and cost effective/competitive vehicles, products and securities should naturally be a product of an effective process. If you start at the product selection and then test for risk profiles, structure, featurs, product strategy, costs and risks you will end up with an excessive number of permutations.

This is a key reason why regulating transaction based processes where advisors do take numerous trips to the product shelf is a regulatory and compliance nightmare. All the decision rules defining how products are selected for yield, risk, liability and risk preferences should be centralised in a disciplined process. The transformation of a transaction based system to a service based sophisticated process focussed on the core functions of construction planning and management is not being addressed in this consultation.

Analysis of portfolio suitability

Registrants must perform a suitability analysis of the portfolio of securities in the client's account at the firm*:*

• *when accepting an instruction from the client* ***to buy, sell, hold or exchange securities*** *or using (or ceasing to use) an investment strategy involving a security;*

• *when recommending that the client* ***buy, sell, hold or exchange securities*** *or using (or ceasing to use) an investment strategy involving a security; and*

• *within a reasonable time* ***after any of the following events*** *occur while the client retains an account with the firm, and in any case,* ***at least once every 12 months, or more frequently if the investment strategy (if any) proposed by the representative requires more frequent monitoring:***

o ***securities received*** *into the client's account by deposit or transfer;*

o ***change in representative*** *or firm for the account;*

o ***material changes in the client's KYC information*** *that the registrant knew or reasonably should have known;*

o ***occurrence of a significant market*** *event affecting capital markets to which the client is exposed; and*

o ***material change in the risk profile of an issuer*** *whose securities are held in the client's account, whether determined by external credit ratings or other internal or external risk assessment mechanisms.*

Here we have the implication that a recommendation is made first and then verified with respect to suitability processes.

This is again a throwback to the traditional brokerage model whereby the broker throws transaction ideas to the client and or the client throws transaction ideas to the broker, and to cover the liability a quick parametric analysis is conducted. Does it fit, more or less?

The industry needs to transition from a service process which is led by the transaction idea to a process which is led by structured construction, planning and management investment "suitability" processes. There is no formal industry wide study with respect to how advisors/ers/firms are actually conducting their processes.

Structured suitability processes

If you have a centralised investment construction, planning and management process, actionable deviations in preferred allocations to securities and products would be initiated and identified by the system: every time a market moves by a certain % (rebalancing), a client spends more than he should (liquidity deficit), or requests capital when a capital request has not been planned (liquidity need), or when an allocation moves out of line by more than the parameters of the allocation model allows, a recommended structure and hence actionable transactions would be provided.

Irrespective of the level of automation and sophistication it should be the suitability frame, adjusting to new information, which decides whether a security should be sold, or an allocation should be increased.

So, new securities come into the portfolio...

and create a new allocation structure, changes in yield, liquidity, market cap, diversification etc. A disciplined process/system would allow you to analyse and transition in a series of steps:

The most important decisions would be deviations in liquidity and high relative to lower risk asset allocations (especially for clients taking regular withdrawals); the imperatives would be with respect to differences in allocation across the various assets (overweight corporate bonds relative to short term government debt (effectively maturity, liquidity, credit mismatches etc) or overweight the US relative to international and then say overweight large caps versus small and as far as the system has allocation parameters.

You may not be able to make all the changes immediately, but you would identify the most important liabilities.

Regulating the process is easier many time easier than regulating each transaction

The recommendations to the client are also easier to support and explain. It is also more compliant in that the decision rules and structures that are applied to all clients and that allow you to deal with clients of varying risk profiles and liability needs can be assessed and used as a basis for monitoring, if needed, what is happening across portfolios. It should be very difficult for registrants to deviate from a structured investment process and if they do, it should be easily flagged.

A change in representative...

Should either make no difference if they are using the same processes, which should be the case if they are in the same firm. If the new representative has a different process the advisor should go through their suitability process (construction, planning and management) as if it were a new client and review all the allocations and planning requirements as defined in their relationship/service agreement.

Material changes in KYC

You change the inputs to the system, existing assets, liability and risk profiles (which encompass investment objectives and time horizons) and you should be able to come up quickly with new asset allocations and investment planning modelling implications. In fact, if you had a centralised process and you inputed the new details your systems would clearly show the deviations.

Occurence of a significant market event

A portfolio should be structured to deal with risk: you have to look through the events that will hit you when deriving your modelling and decision rules. A market event would impact allocations and may present opportunities for reallocation, but the core of the portfolio, especially where clients have significant withdrawals to fund expenditure, are unlikely to change materially.

A significant market event where an advisor lacks a structured process to assess an appropriate portfolio allocation to manage these risks may well find their portfolios exposed.

Investors need to know if the advisors they use have systems and disciplines that can manage these risk events (clearly this does not mean avoid) or whether the advisor will have hundreds of unstructured portfolios at the time of a significant event.

The fact that the CSA have a rule that is effectively transaction/trade idea led suggests that the suitability processes on average are rudimentary and parametric. This is a liability.

Major risks of market events hit portfolios that are over exposed to higher risk assets relative to the client's liability and risk profile, but they also impact those advisors who have been using return expectations that may well apply across long term historical averages but not to market and economic peaks.

Material change in the risk profile of the issuer:

A change in the risk profile of the issuer, assuming it is still a hold , will be picked up by a disciplined, centralised system. Within a portfolio transactions are rarely looked at on a transaction by transaction basis, but within the portfolio whole. A change in the risk profile of a mutual fund may actually only move the overall profile of the portfolio a percentage or 2. The allocations may still be within acceptable boundaries. Change for the sake of change should be avoided as this incurs costs.

Representation of service: a disciplined process or a series of trades

Clients need to know if they are being serviced by a disciplined process or an ad hoc transaction led process.

If we represent a certain level of service, expertise and outcome then the liability is the extent to which the investment process falls short of being able to deliver suitable investment outcomes. Suitable in this context is an allocation and security selection that is derived from a structured investment process and discipline (simple or otherwise) and that accurately reflects the risk profile and liability profile of the client.

We have in the current rules an implication that the trade idea comes first and then it is assessed against suitability parameters. This is ill disciplined, disorganised, labour intensive to validate and cross reference against suitability processes and a nightmare to regulate enforce and comply with. This is a system with innumerable liabilities. Centralised construction planning and management processes, which are client profile focused, are designed to manage these liabilities, to ensure that investment discipline and process are applied appropriately to client financial needs and risk preferences.

We need to encourage the introduction of best interest processes in the retail financial services industry in Canada. There is going to be a difference in service outcomes for those clients run off a trade generation system and those run off a centralised service process with clear decision rules as to how portfolios are structured relative to risk and liability profiles with respect to their own disciplines.

If investors are led to believe that advisors act in their best interests then they will assume they possess the necessary tools and systems to manage those risks. In fact some may well be able to meet this expectation, but not all and I assume the regulators are unsure as to what level of risk currently exists in the industry with respect to investment process. The fact that they are telling advisors overtly in a rule, a rule which should clearly imply that such should be the case, that they need to address these issues means that standards are insufficient at present to meet client expectations. The fact that we are still defining regulation from a trade idea perspective – generate trade idea then run it through suitability – strongly suggests that protections to investors in the event of unsuitable advice are insufficient. We are left effectively to common law and OBSI to help define just what the relationship is and just what the responsibilities are. Common law will note that the rules do not imply a fiduciary standard, that the standards are basic and trade related and make no reference to the need to manage the liability between representations made by advisors and the actual capabilities of their processes. Investors will be forced to mitigate, foresee and act in advance when in reality they will not possess the knowledge or the wherewithal to do so.

An aside to the past.

The rules that we have here are transactional. By writing the rules as such it implies that the suitability advice is episodic, incidental to the transaction (with reference to the portfolio) but not a continuous duty to monitor the portfolio that would be afforded by a structured and disciplined processs. The definition is important as Arthur Laby discusses in his essay "Fiduciary Obligations of Broker-Dealers and Investment Advisers[18]" :

> If an adviser has agreed to provide continuous supervisory services, the scope of the adviser's fiduciary duty entails a continuous, ongoing duty to supervise the client's account, regardless of whether any trading occurs. This feature of the adviser's duty, even in a non-discretionary account, contrasts sharply with the duty of a broker administering a non-discretionary account, where no duty to monitor is required. The two accounts in this example

[18] http://digitalcommons.law.villanova.edu/cgi/viewcontent.cgi?article=1050&context=vlr

are similar in nature-**both the broker and the adviser hold themselves out as providing non-discretionary investment advice-yet the adviser's duty entails ongoing diligence while the broker's duty is episodic.**

This distinction between episodic duties under the Exchange Act and ongoing duties under the Advisers Act for similarly structured accounts tallies with other provisions of the statutes. Under **Exchange Act Section 10(b) and Rule 10b-5, conduct must be "in connection with" the purchase or sale of securities**. There must be a purchase or sale of securities **before liability arises**. This is not the case under the **Advisers Act..**; **an actual purchase or sale** is not needed..... The distinction between episodic and ongoing duties also is consistent with the way leading treatises, Congress, and the courts historically have conceptualized the scope of the advisory relationship and the resulting duties.

I believe that the service represented by the industry is one that requires a fiduciary standard to hold advisors accountable to their service processes. My concern is that the rules as written imply that the duty is still advice with respect to the transaction as opposed the transaction being incidental to the advice. The transaction in the fiduciary standard comes after the process, in the "suitability standard" it comes before the suitability assessment. If you have hundreds of investors and you lack a process and each transaction is a trade idea before it is first and foremost a product of suitability, then the liabilities the investors are exposed are quite significant and unaccounted for within current regulation. Either we step up with respect to standards and enforce the standards implied by the representative service or clearly state that the service is limited, focused on the transaction, the liabilities outside the simple suitability standard are the clients and if they want a best interest solution they need to go elsewhere.

Question 16

16) Do you agree with the requirement to consider other basic financial strategies?

See my comments above. Briefly: yes with respect to strategies no with respect to basic. It is unclear what the boundaries are with respect to service expectations. The requirement to consider liquidity and debt and other financial needs at the short end of the portfolio are implied responsibilities of investment planning and are part of the implied service representations made by those advisors offering non discretionary wealth management. I would not frame leverage as a basic strategy and have made points with respect to leverage in my comments noted above.

Question 17

17) Will there be challenges in complying with the requirement to ensure ***that a purchase, sale, hold or exchange of a product is the "most likely" to achieve the client's investment needs and objectives****?*

It depends on the process. If the advisor's process is trade generation led followed by a suitability assessment then this may well be difficult to achieve in terms of ensuring that the overall suitability of the portfolio is at a standard that is capable of managing risk and return in the context of the client's liability and risk profiles.

Recommendations that have come out of a suitability process bounded by investment disciplines and decision rules with respect to liability and risk profiles, then the transaction will already be suitable. There is no mention of the investment process here. The investment processes determining suitability help manage the risks of the service proposition. The gap between representations of service and expectations of service are very much dependent on the integrity of the portfolio construction, planning and management processes of the organisation. The gap is either a contractual misrepresentation, negligence and/or a breach of fiduciary standards, depending on how you view the liability itself and the implied discretion. If the process is trade led the discretion is limited but the liability gap between the service representation and the ability to meet that service representation is a large one (fraudulent misrepresentation/negligence).

If the process is underpinned by processes defining suitability (construction, planning and management etc) then the discretion is substantial, the gap between service representation and ability to meet that service controlled and hence the fiduciary duty serves to manage the liabilities of service representation.

Requiring that all hold decisions be subject to a suitability analysis is an absurd one where service is underpinned by structured suitability processes where security and product selection inputs are part of the process monitoring. For those where transactions are trade idea generated, then yes, I could see the need for this. This is yet another reason why services foundered on trade generation (transactional) are not fit for purpose for investors looking for proper wealth management solutions. They are an unquantified liability given the service representations associated with them.

Question 18

18) Should there be more specific requirements around what makes an investment "suitable"?

No! Regulatory guidance such as the type provided by the FCA may be more than adequate. What is more important is to monitor the processes used by firms and advisors to deliver wealth management. The more structured the process the clearer the decision rules and the data inputs. Greater attention should be on the organisation's advice processes governing construiction planning and management of assets to meet financial needs relative to risk profiles and an organisation's investment disciplines. Higher educational standards and adherence to recognised professional standard should help set higher suitability standards.

Different service representations will have different process requirements and hence suitability inputs will vary. What is important here is that the service representation is matched by internal suitability processes and that the representation of service and capabilities to investor are appropriate.

Question19

19) Will the requirement to perform a suitability assessment when accepting an instruction to hold a security raise any challenges for registrants?

See my response to question 17 and my more detailed responses to the rule.

Question 20

20) Will the requirement to perform a suitability analysis at least once every 12 months raise challenges for specific registrant categories or business models? For example, a client may only have a transactional relationship with a firm. In such cases, what would be a reasonable approach to determining whether a firm should perform ongoing suitability assessments?

Please see my comments with respect to advised versus unsolicited. In brief client accounts which are clearly transactional and client led, and not just accounts where they are being swayed by the culture of the advisor to appear so, should be differentiated with bold disclosure of the risks and extremely limited responsibilities of the broker/salesperson.

Question 21

21) Should clients receive a copy of the representative's analysis regarding the client's target rate of return and his or her investment needs and objectives?

Please see my comments re target rates of return. Certainly clients should receive a copy along with an explanation of the risks to the analysis – what if returns are lower than expected. I would also recommend, as per my comments in communication of suitability above, that suitability decisions for stand alone recommendations are put in writing, as should individual policy statements for non discretionary management clients.

Question 22

22) Will the requirement to perform a suitability review for a recommendation not to purchase, sell, hold or exchange a security be problematic for registrants?

Please see my comments re question 17 and my detailed comments on the rule which discuss these issues.

Section 7 - Relationship Disclosure

Section 14.2 of NI 31-103 would be amended by including the following explicit requirements.

Nature of Relationship Disclosure

Firms would be required to disclose the actual nature of the client-registrant relationship in easy-to-understand terms.

Proprietary Product List Disclosure

Firms must disclose whether they offer proprietary products only or a mixed/non-proprietary list of products. Firms that offer a mixed/nonproprietary list of products must disclose the proportion of proprietary products they offer. Where the product list of the firm meets the definition of a "proprietary product list", the firm must clearly disclose to its clients, prominently and in plain language at the time of account opening (or before any product or service is provided), that:

- *their product list is restricted to proprietary products and they will only recommend proprietary products; and*

- *as a result, the suitability analysis conducted by the firm and its representatives does not consider:*

o the larger market of non-proprietary products; and o whether such non-proprietary products are better, worse or equal in meeting the client's investments needs and objectives.

This obligation does not apply when firms deal with institutional clients.

Restricted Registration Category Disclosure Firms that are mutual fund dealers, exempt market dealers, scholarship plan dealers or restricted dealers/advisers must clearly disclose to their clients, prominently and in plain language at the time of account opening (or before any product or service is provided), that they only offer, as a result of their registration category, a limited range of products and, as a result, the suitability analysis conducted by the firm and its representatives does not consider:

- *a full range of securities products; and*

- *whether such other types of products are better, worse or equal in meeting the client's investments needs and objectives..*

Comments on relationship disclosure

Existing securities legislation in British Columbia, Saskatchewan, Ontario, Québec, Nova Scotia, Prince Edward Island, Nunavut, Yukon, and the Northwest Territories would be amended to introduce a statutory fiduciary duty for registrants when they manage the investment portfolio of a client through discretionary authority granted by the client.

The consultation, as part of the Proposed Targeted Reforms, have recommended that services that provide advice under a discretionary authority should be accorded a statutory fiduciary duty yet fail to explain why they feel one service representation should be afforded a higher standard than the other. Is this a case of prioritisation of interests working in reverse to the client? That is the interests of the retail financial services industry relative to the liabilities and standards of care inherent in the provision of non discretionary investment advice. Why should investors receiving advice under non discretionary mandates, which surely must rely on the same processes, be accorded less protection and/or lower standards of care?

To have a fiduciary duty for the provision of investment advice means that you are responsible for making sure that the representations of service are matched by the processes that construct, plan and manage. A simple representation of services requires less sophisticated processes, but the liabilities of both should be covered by the processes themselves. A more sophisticated service is looking to provide a higher level of service possibly across a wider spectrum of needs and strategies and vice versa for the simpler.

According a fiduciary status to the relationship therefore gives cause to the advisor to consider that liability, to determine the extent of that liability (re service representation) and to manage that liability via appropriate service process that deal with the key inputs to the analysis of suitability.

Logically, unless you clarify otherwise in your relationship agreements, the processes for portfolio management should be the same, irrespective, for both discretionary and non discretionary accounts.

The assumption must therefore be that non discretionary accounts are not afforded the same standard of care and that the disciplines and structures and resulting liabilities are somehow different. In fact, the assumption is, that part of the liability associated with the failure of service representation to meet the implied standards is passed on to the client.

In sections detailing the importance of statutory/regulatory standards I addressed investors inability to be to understand the nuances of relationship disclosure, especially with respect to the relationship in common law that the courts would interpret in the absence of a properly qualified best interest standard. In my response to Section 7 – Conflicts of interest I also included research on the ability of investors to properly understand disclosure. The proposed rules on disclosure do not address the fact that there are liabilities associated with the type of relationship that investors select that are not covered by investor protection initiatives. I believe that if this reality were disclosed it would cause investors to lose trust in the industry and its regulation.

Somehow under current rules, the client with a non discretionary relationship is considered responsible for mitigating negligence or errors of omission, or worse. If this is the case, this liability needs to be disclosed, because these are risks associated with the relationship decision.

There are a number of risks with respect to investing. The obvious ones are the risks that asset prices via their effect on markets and economies in general and other specific risks that impact individual securities to greater or lesser extent. Systematic risks (market wide) and their impact can be modelled by structure and modelling of risks to return while non systematic risks (individual security risks) can be managed via either diversification or more detailed due diligence (a la Buffet).

But risks cannot be totally avoided and outside of careful structuring of portfolios so that they are sensitive to risk preferences and liability profiles, being careful with respect to costs and other issues, fiduciaries are not going to be liable for market broad market based risks. Similarly they are not going to be liable for the risks of individual securities having issues providing there is a proper and sensible strategy to manage these risks.

Fiduciaries are not liable for managing risks that their structures, disciplines and processes are not designed to avoid or mitigate as long as their representation of the risks they can manage and mitigate are clear and reasonable. As long as they have diligently completed their data collection and risk profiling, have well structured processes for constructing planning and managing portfolios and have completed the necessary due diligence and monitoring of securities and products, and have effective processes for communication and registering client assent, their fiduciary liabilities have been managed.

If a fiduciary has been negligent, has failed to collect information, has not maintained his processes, or has sidestepped them, then of course the liability that should have been managed is still in situ.

So why does the CSA feel that non discretionary portfolios should not be subject to the same standard? It is a difficult question. Many firms in the market place are owned by larger institutions that have the expertise to deliver the necessary processes and systems. The many educational designations now available to professionals all point out the importance of structure and process and the technology is available for those who do not possess the expertise and resources to develop their own systems to acquire the foundations for delivering well structured processes capable of mitigating fiduciary liabilities in this area.

There are a few possible reasons.

The first is that they believe the actual relationship in situ is essentially that of the old broker client relationship. Advice is only incidental to the transaction, the framework for assessing suitability is limited to making sure a trade idea or client suggestion is "suitable" within a narrow meaning of the word. The advisor has no formal structured process for managing assets, does not provide or represent that they provide portfolio management and hence the only function they perform, that of providing and reacting to trade ideas and providing advice with respect to those trades, is limited. The liability is only limited to the act at hand. This is more or less an arms length commercial relationship and one in which the courts are known to be averse to according a fiduciary responsibility.

This is more or less as Arthur Laby stated in "Fiduciary Obligations of Broker-Dealers and Investment Advisers[19]"

> "..under agency principles, one's fiduciary duties are tied to the scope of one's responsibilities. Because the scope of a broker's responsibilities is often unclear, the attendant duties are similarly ambiguous....Thus, in determining the nature of a broker's fiduciary duty, one must analyze the broker's power over the assets or affairs of the customer. This principle often is stated in the language of trust: a broker's fiduciary duty is limited to matters relevant to the affairs entrusted to him or her."

And also:

> "...in the case of non-discretionary accounts, a broker's activity generally is limited to conduct surrounding a particular transaction, whereas the scope of an adviser's activity extends beyond a particular trade. The different scope of activity yields different duties"

The trouble with the above is that regulation of the transaction has widened its remit to overall financial needs, to requiring greater amounts of information about the client, to requiring suitability assessments of the entire portfolio whenever a trade is considered plus other occasions. It is bordering on a continuous obligation to monitor. Additionally we have representations in the market place a) that advisors are professionals capable of accepting a client's trust and managing their affairs and b) of a level of services and obligation that exceeds that of that of the traditional broker relationship.

The other may be that the CSA believes that the transfer of discretion is the only act which triggers a fiduciary relationship. Again from Laby's "Fiduciary Obligations of Broker-Dealers and Investment advisors":

> "Whether an account is discretionary provides a clean dividing line to assess whether trust has been reposed. A customer who cedes discretion must trust the broker unreservedly because the broker is authorized to make investment decisions without checking with the

[19] http://digitalcommons.law.villanova.edu/cgi/viewcontent.cgi?article=1050&context=vlr

> customer in advance.... for why discretion often proves determinative is that the fiduciary obligation serves as a necessary substitute for the customer's monitoring of the account"

But as stated the nature of the services has changed over the last few decades and this is not reflected in CSA assessment of the relationship. I refer to Arthur Laby:

> "If an adviser has agreed to provide continuous supervisory services, the scope of the adviser's fiduciary duty entails a continuous, ongoing duty to supervise the client's account, regardless of whether any trading occurs. This feature of the adviser's duty, even in a non-discretionary account, contrasts sharply with the duty of a broker administering a non-discretionary account, where no duty to monitor is required. The two accounts in this example are similar in nature - both the broker and the adviser hold themselves out as providing non-discretionary investment advice - yet the adviser's duty entails ongoing diligence while the broker's duty is episodic"

And also:

> "For non-discretionary accounts, however, brokers' duties tend to be intermittent, while advisers' duties tend to be ongoing-extending to dormant periods of inactivity in the customer's account. During these periods, a typical stockbroker owes no duty to the customer while an adviser acts more like a protective guardian and has a positive duty to act should market conditions or the client's circumstances call for a change"

As noted in the new rules and reflected in the changes to IIROC's rules following the introduction of the CRM, the advisers duties have evolved far from that of the relationship the CSA appears to be basing its assessment of liability. Laby echoes these changers in representation of service and responsibility:

> "Arms length broker-dealer registered representatives began to label themselves as financial advisors, financial consultants, financial representatives, and investment specialists. These titles imply that the individual is not acting at arm's length. They are meant to induce a customer to repose trust in the professional as a neutral source of research and recommendations. Because advice is such an important part of a broker's activity, and because dispensing advice calls for the imposition of fiduciary duties, brokers that give advice should be subject to fiduciary obligations"

From the perspective of an investment professional, the dividing line is the discretion that a professional has over the data collection, the risk profiling, the often complex processes that construct, plan and manage. The transaction is incidental to the advice and the decision to accept the transaction is based on the client's trust reposed in the advisors processes that construct, plan and manage. There is a clear passage of discretion and clear repose of trust.

To deny the investor the right of treating an advisor as someone with who can be held accountable to a fiduciary standard the CSA is placing the interests of the industry over and above those of the investor. If we cannot prioritise the client at the start of the relationship then how can we possibly correctly prioritise their rights within it.

If a fiduciary duty, a best interest standard with fiduciary responsibilities is not accorded to investors who have de facto non discretionary portfolio management agreements then advisors should clearly state that this is the case in the relationship disclosure document.

The core issue therefore at the heart of the consultation is who is responsible for the liability between the service representations made in the contract between the advisor/firm and the client. If there is a shortfall between the service representation and the expectations associated with it, who is responsible for it? A best interest fiduciary type standard would force industry representation of service to be matched by the appropriate process and service standards. As it is the best interest standard as represented in the consultation is only a duty of care as defined in the Proposed Targeted Reforms.

In the absence of a best interest standard firms should fully disclose the legal nature of the relationship with the investor and the risks and liabilities associated with advisor errors and omissions.

If the relationship is not considered a best interest relationship with fiduciary type duties, but an arm's length commercial relationship with a limited standard of care, then the client should be suitably warned.

The client should be instructed that if they want a relationship where the advisor is obligated to act in their best interests that they will need to select a discretionary account.

Without a best interest standard to enforce representations of service and expertise investors will be exposed to varying liabilities many of which are neither actionable nor recoverable.

Question 23

23) Do you agree with the proposed disclosure required for firms registered in restricted categories of registration? Why or why not?

There are a number of issues here that lie outside the focus of the current review and should be addressed separately.

Question 24

24) Do you agree with the proposed disclosure required for firms that offer only proprietary products? Why or why not?

Yes, and again there are issues here that lie outside the immediate focus of the consultation.

Question 25

25) Is the proposed disclosure for restricted registration categories workable for all categories identified?

There are a number of issues here that lie outside the focus of the current review and should be addressed separately.

Question 26

26) Should there be similar disclosure for investment dealers or portfolio managers?

There are a number of issues here that lie outside the focus of the current review and should be addressed separately.

Question 27

27) Would additional guidance about how to make disclosure about the relationship easier to understand for clients be helpful?

Full and proper disclosure of the actual relationship in the context of the extent to which the investor is able to rely on the advice of the investor needs to be transparent. Current disclosure of the relationship avoids this issue. Given the risks of relying on an assumption that an advisor will act in his client's best interests, a clear and unequivocal health warning needs to be prominent on the client relationship disclosure. In the absence of a true best interest standard relationship disclosure is going to be ambiguous at best and misleading in all other instances with respect non discretionary retail financial services advice.

Section 7 – Proficiency

Division 2 of Part 3 of NI 31-103 would be amended to add the following explicit requirements:

• *increased proficiency for representatives, including **standards that explicitly incorporate the knowledge elements required for compliance with the proposed targeted reforms, including that all representatives must generally understand the basic structure, features, product strategy, costs and risks of all types of securities, such as equities, fixed income, mutual funds, other investment funds, exempt products, and scholarship plan securities**;*

• *in particular, increased proficiency regarding **how product costs and investment strategies** (e.g. active vs passive) can impact investment outcomes for clients; and*

• *that representatives are subject to a continuing education requirement, including on key securities regulatory obligations such as suitability, the KYC and KYP obligations and conflicts of interest, as well as an ethics training component*

Comments on proficiency

The educational focus on products as opposed to investment process is in keeping with a series of reforms that seeks to limit advisor responsibility for advice and hence the innovation of the retail financial services industry towards service based investment process. Emphasis remains on transactions while the rest of the world focuses on standards, competition, innovation and higher professional standards as well as attempts to resolve the pressing issue of small investor access to proper advice.

The knowledge requirements stated here are minimal. They lack thought on how we can help develop professional standards and an ethical culture. Products tend to be short cuts for process. An Awareness of portfolio constriction and the need for simple low cost direct allocation components would cause many advisors to doubt the validity of a great many of today's products. I see little in the consultation that would suggest that the CSA is indeed seeking to prioritise the rights and needs of investors in retail financial services.

Question 28

28) To what extent should the CSA explicitly heighten the proficiency requirements set out under Canadian securities legislation?

This is a consultation on its own and it outside of my scope of my submission. I would suggest a review of global standards in this respect.

Question 29

29) Should any heightening of the proficiency requirements for representatives be accompanied by a heightening of the proficiency requirements for CCOs and UDPs?

Quite definitely for both. But again outside the my scope for the present submission.

Section 7 - Titles

A new requirement would be added to NI 31-103 that explicitly requires that all client-facing business titles for representatives be prescribed, as follows:

Alternative 1:

> • *for a representative (i) where his or her sponsoring firm is registered as a portfolio manager or investment dealer and has a mixed/non-proprietary product list, and (ii) that manages a client's discretionary account: **securities advisor – portfolio management***

- *for a representative (i) where his or her sponsoring firm is registered as a portfolio manager or investment dealer and has a mixed/non-proprietary product list, and (ii) that advises a client with a non-discretionary account:* ***securities advisor***

- *for a representative of any other firm that is not an investment dealer or portfolio manager but that has a mixed/non-proprietary product list:* ***restricted securities advisor***

- *for a representative of any firm that has a proprietary product list:* ***securities salesperson****.*

Alternative 2:

- *for representatives of firms registered as portfolio managers and of firms registered as investment dealers that are IIROC members and manage clients with discretionary accounts:* ***advisor***

- *for representatives of any other firm:* ***salesperson***

Alternative 3:

- *representatives could only use their individual category of registration (e.g., dealing representative and/or advising representative)*

Comments on titles

Advisors who do not wish to be held to best interest standards, whose only focus is product sales and transaction remuneration should not be able to call themselves an advisor. They are strictly salespeople and the relationship disclosure should be clear about this.

A failure to move to a true best interest standard would nevertheless leave many advisors who are currently operating in that capacity, or moving towards that capacity, exposed. The Proposed Target Reforms fail to acknowledge the difference between non discretionary management of assets and financial needs and that of the traditional broker/client relationship.

The objective of the proposed target reforms appears to be that of keeping Canada's retail financial services system in the dark ages.

I would recommend that if the CSA does not wish to impose a fiduciary standard on the industry in general, that in the interests of those professionals who wish to offer their clients best interest standards, who wish to be free of transaction remuneration conflicts and who wish to operate under the title of advisor, that a separate registration category be opened up to allow the development of a conflict free independent financial advice in Canada.

Question 30

30) Will more strictly regulating titles raise any issues or challenges for registrants or clients?

Yes as noted above.

Question 31

31) Do you prefer any of the proposed alternatives or do you have another suggestion, other than the status quo, to address the concern with client confusion around representatives' roles and responsibilities?

Anyone wanting to be called an advisor/er should be held to a fiduciary standard. Anyone who does not should be called a sales person.

Question 32

32) Should there be additional guidance regarding the use of titles by representatives who are "dually licensed" (or equivalent)

Note my answer to Q31.

Section 7 – Designations

NI 31-103 would be amended to include specific provisions about the designations (i.e., credentials that are used to indicate that the individual has specialized knowledge or expertise in an area gained through education and/or experience) that each category and specific types of representatives may use when dealing with clients. Please refer to Appendix G for a description of potential guidance

33) Should we regulate the use of specific designations or create a requirement for firms to review and validate the designations used by their representatives?

The preeminent issue is whether or not someone who provides personalised investment advice should be held accountable to a fiduciary/best interests standard. The issue with titles and designations is that they denote expertise, responsibility and accountability and therefore engender trust and reliance. Any title or designation that does not accord with thge regulatory standard accorded to that individual, or that gives an impression contrary to the regulated standard should not be displayed.

Section 7 Role of UDP and CCO

Question 34

No comments.

Section 7 – Statutory Fiduciary Duty when Client Grants Discretionary Authority

Question 35

I have responded to this issue in my comments on relationship disclosure. I see no logical reason why advice provided on a discretionary basis should not also be held accountable to a fiduciary standard when given on a non discretionary basis.

Comments on questions 44 onwards

Qs 43,44, 45, 46 – relates to institutional relationships. No comment here.

Sales practices

Questions 48 to 53 – all inducements to recommend one product or security over another should be removed from those who provider personalised advice to investors. Inducements distort the market for advice as noted in numerous academic research.

KYC – Appendix C

Q 45

Having information that would allow you calculate marginal tax rates is important for modelling and for asset location decisions. I note the CSA is suggesting a required rate of return is being considered for investments: if you do not know the tax rates likely to be applied to returns then how can you calculated the required rate of return?

How the information is used depends on the level of service and the expertise available. Advisors should make sure that clients are suitably advised with respect to tax matters and many tax issues would likely be outside the ambit of many advisors.

For simplified advice services dealing with smaller investors looking to accumulate small sums, advice need not consider matters outside those of a general tax nature.

Q55 - no comment.

Q56 - Should additional guidance be provided in respect of risk profiles?

Risk profiling is a core component of the suitability analysis for all professional advisors. The IAP Risk Profiling Report completed by Plan Plus made a number of substantive recommendations which I see no need at this moment to add to.

Q57 - Are there circumstances where it may be appropriate for a representative to collect less detailed KYC information? If so, should there be additional guidance about whether more or less detailed KYC information may need to be collected, depending on the context? – No comment.

KYP – Appendix D

Q 58) Should we explicitly allow firms that do not have a product list to create a product review procedure instead of a shelf or would it be preferable to require such firms to create a product list?

Firms/advisors should have a review procedure irrespective. Product lists or rather securities and products firms use to populate "model" portfolios should be in situ.

Q59) Would additional guidance with respect to conducting a "fair and unbiased market investigation" be helpful or appreciated? If so, please provide any substantive suggestions you have in this regard.

Outside the scope of the review.

Q 60) Would labels other than "proprietary product list" and "mixed/non-proprietary product list" be more effective? If so, please provide suggestions.

No comment.

Question 61) Is the expectation that firms complete a market investigation, product comparison or product list optimization in a manner that is "most likely to meet the investment needs and objectives of its clients based on its client profiles" reasonable? If not, please explain your concern.

There are two issues here are there not? The objective of the distributor which may be to satisfy the universe of all its advisors and the advisor/firm who may only wish to use product/securities that fit within its disciplines and processes for structuring portfolios.

The advisor may have a requirement for a general market fund which is intended to capture the market return, in which case they should be looking for a low cost indexed fund. If they do not like the market and want to access a contrary allocation they would need to look at the universe of active funds with a general exposure to the market.

They advisor/firm may also have smaller cap components, in which case they may select a small cap fund or a small cap index fund depending on whether they are looking for index or contrary index characteristics.

In terms of a best interest standard with respect to security/product advice they should be looking at returns after transaction and management expenses so hurdle rates for active funds with high costs would be quite high in order to justify inclusion.

The existence of transaction returns and inducements to advisors muddies the water. With transaction returns advisors are selecting funds based on how much they need to be paid and are unlikely to spend time completing due diligence on funds with little or no such remuneration. While remuneration is still a factor in service costs for fee based practices, advisors can become more focused in their security/product selection, increasing the efficiency of portfolios, as well as becoming more competitive in terms of service pricing.

Question 62) What, if any, unintended consequences could result from setting an expectation in the context of the suitability obligation that registrants must identify products both that are suitable and that are the most likely to achieve the investment needs and objectives of the client? If unintended consequences exist, do the benefits of this proposal outweigh such consequences?

Essentially the process here is that suitability first defines the allocation space (i.e. Equities, Canadian equities, small cap) and then looks to the fund that best fits that allocation space with the highest expected post cost return. If advisors are willing to sacrifice remuneration for the best investment it will work, if not, then expect avoidance of the rule.

Questions 63) Should we provide further guidance on the suitability requirement in connection with ongoing decisions to hold a position?

Please see my comments re this in the main section of suitability.

64) Should we provide further guidance on the frequency of the suitability analysis in connection with those registrant business models that may be based on one-time transactions? For example, when should a person or entity in such a relationship no longer be a client of the registrant for purposes of this ongoing obligation to conduct suitability reviews of the client's account?

Yes, especially with the need to develop simplified advice processes, although I would term the existing Canadian rules as reflecting a simplified suitability process.

Appendix H

Question 65) Should the Standard of Care apply to unregistered firms (e.g., international advisers and international dealers) that are not required to be registered by reason of a statutory or discretionary exemption from registration, unless the Standard of Care is expressly waived by the regulator?

It depends

Question 66) Do you believe that the Standard of Care is inconsistent with any current element of securities legislation? If so, please explain.

Yes: inconsistent with transaction remuneration.

Question 67) Do you agree that the Standard of Care should not apply to the underwriting activity and corporate finance advisory services described above? If not, please explain

No comment.

Conclusion and Recommendations

The proposed best interest standard should be renamed a best product standard. It is not a fiduciary standard. To leave it as is would misrepresent the nature of the services provided by “advisors” and would increase the unattended fiduciary liability in the system.

The recommendation to accord discretionary accounts with a fiduciary standard is an empty gesture and unfair to those in receipt of non discretionary advice and by virtue of the statement it is making I would recommend that such differentiation of service standards, where none should in fact exist, should not proceed.

The provision of personalised investment advice should be accorded a fiduciary standard, irrespective of the nature and sophistication of the service.

I therefore recommend that the only option available to the CSA is to proceed with preparations for implementing a true best interest standard which would force the industry to deliver service standards that match their service representations and manage the fiduciary liability risk that any gap between service representation and process capability represents.

I recommend that with respect to the provision of personalised investment advice that we remove the dividing lines between products and reinsert these products into the mainstream. There is no reason for product silos and the impaired advice that comes out of these silos.

I recommend that that we develop a two tier system of service representation, both of which would be accorded a true best interest standard.

The first tier would be represented by the simplified advice structures that more or less accord with current minimum industry standards with upgraded KYC and other enhancements. These would be populated by new advisors, advisors with basic minimum educational qualification. These service structures would not be allowed to offer direct equities, new issues, options, leverage, complex structured products, hedge funds, exempt securities etc but would focus on simple low cost outcomes derived from well structured centralised processes. This would help ensure that the demands of the smaller investor market remains addressed. Processes for these service structures can be developed that will ensure that outcomes cover basic financial suitability and basic investment strategies. This tier of advisor would essentially be client relationship manager and would not make any asset allocation or security selection decisions per se outside of those deemed necessary for personalised fine tuning.

A second tier that would offer more sophisticated financial advice and non discretionary investment planning/financial planning/portfolio management options, populated by advisors with more experience, higher professional qualifications and adherence to professional ethical standards. Their system will be more sophisticated etc.

Regulation would focus on processes not transactions. The Proposed Targeted Reforms as they stand are likely unworkable with respect to the monitoring of each individual transaction and a process driven framework would focus on the rules and processes from which transactions are derived. Determining deviation from process is a much easier regulatory and compliance objective. The details lie within my submission.

I recommend that all product and transaction remuneration and inducements be removed from those providing personalised investment advice and that a charging structure for tier 1 simplified advice be considered. Many of the recommendations made in the UK’s Financial Advice Market Review are worth considering in this respect.

The CSA Consultation ignores the reality of the market for financial advice, ignores the representation of service, fails to understand the personalised advice process and leaves the fiduciary liability that lies within the market place unattended. Again the details lie within my submission.

The future of financial advice lies with more efficient processes. Investor protection issues will not be solved by fiddling around with the millions of transactions but by enforcing a higher duty with respect to the much smaller set of decisions rules impacting process. The details lie in my submission.

Yours sincerely,

Andrew Teasdale, CFA

CC: British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon Territory
Superintendent of Securities, Nunavut

Appendix A - What is the Regulatory Model?

Defining the transaction based model, its regulation and the contract between investor and advisor is critical to effective regulation and “fair dealing”.

A belief that the investor is responsible for their investment decisions, and that they are responsible for educating themselves to make informed investment choices, may be, under certain conditions, a rational solution to the problem of distributing products in the market place. Nevertheless, much of the research on disclosure suggests investors are not sufficiently educated to make complex investment decisions and disclosure has little material impact on the decision, and therefore, arguably, that the certain conditions are much more limited than current regulation perceives.

In a regulated business model where investors are responsible for the investment decision, I would recommend that the true nature of the regulated service be communicated to the investor, at outset, so that investors can choose whether to retain discretion over all, part or none of the investment decision process and the extent to which they wish, or are able, to better educate themselves to make their own discretionary decisions.

Parameter to Parameter suitability

Regulation of the transaction in Canada would appear to be based on a simple parameter to parameter process. These parameters are those outlined in the KYC (time horizon, investment objective, risk profile, investment experience and net worth).

The parameters are used to drive product and security selection and are suited for investor initiated transactions: many might argue that the informational content of the KYC parameters are insufficient for an advisor to take responsibility for (or rather have discretion over) the construction, planning and management of a portfolio.

Under the parameter to parameter model, the investor is responsible for a) providing the parameters (that is for providing the suitability framework) that guide the advisor’s security recommendations, in particular the risk aversion and investment objectives, b) for understanding the investment and associated disclosures and c) for making the decision to transact.

The advisor is responsible for a) recording the parameters, b) confirming that these are the client’s parameters including the client’s experience, expertise and investment knowledge, for these may constrain the transaction set, c) for providing a transaction recommendation that matches the parameters, and d) for providing sufficient information about the transaction to allow the investor to confirm that the recommendation’s parameters matches the parameters of the KYC. The minimum information content of the process (minimum standards) and the strict division of responsibilities is key to the operational viability of this industry segment.

The investor is ultimately responsible for making sure that they understand how a recommendation meets their financial needs and risk preferences by understanding their own needs, the product and how the product or transaction fits into their needs. That they have also initiated the request effectively seals the deal.

The KYC would also appear to only focus on funds that require a transaction, and not overall finances from which investable funds can be derived. This is important, because the KYC and the transaction based service, and its regulation, is not structured to deal with wider financial advice and the responsibility that a transaction recommendation has in a wider context. Under the transaction based service, the investor is assumed to have already made these types of decisions. It is therefore important that the investor is aware of the boundaries of the “regulated service.”

However, while a parameter to parameter model might under certain conditions satisfy a transaction request for a specific sum of capital, applying the set of parameters to wider spectrums, such as a portfolio, stretches the rationale of the model. Within a portfolio, there are a number of components ranging from low risk to higher risk, short term to longer term, low yield to higher yield, all of which to greater or lesser extent will form part of the portfolio spectrum: each of these components relate to a differing yield, time horizon and effective risk and investment objective. Expecting an advisor to delineate these components from a KYC is difficult: a process that did this would have a significant element of discretion, unless it used a process provided by the consumer or the parameters of the advisor's process were matched to the parameters of the investor's process; but such processes would imply varying degrees of sophistication which cannot be effectively detailed in the KYC. In these instances it is not really clear where discretion starts and ends in more complex scenarios: this is essentially the heart of issues concerning investor responsibility and advisor representation of services offered. It is therefore important, if responsibility is to be accepted by the consumer, for the consumer to be aware that they are responsible for bringing to the table a fairly sophisticated process to make these decisions.

Point of sale disclosure

The current point of sales disclosure is therefore designed to interact with the basic KYC parameters: risk to risk, investment objective to investment objective, time horizon to time horizon etc. It is a quick check on the compatibility of the transaction with the KYC parameters.

Since the POS is being delivered within a sale's process, with the investor responsible for the decision, education and due diligence, and the parameters defining the decision, the process can remain focussed on turning over the transaction. The investor needs to be aware of this.

A quick decision would imply that the investor is making an informed asset allocation decision of significance and is able to quickly internalise issues of significance: they already know the parameters they are looking for and only need to make sure that these match their requirements; investors aware of their responsibility and looking for asset allocation vehicles would be more likely to make these types of decisions.

Providing for Point of Sale disclosure to be given to investors after a transaction is implemented means that there is no confirmed opportunity to match the parameters of the KYC to the product at the point of sale. Therefore, the investor cannot yet be proven to have taken responsibility for the investment decision. While acceptance of the decision once in receipt of the POS would imply such, the intervening period assumes a level of advisor discretion and responsibility over the decision that is not permissible under regulation of the transaction. This clearly places the interests of the product advisor above those of the investor without informing the investor of the significance of the event.

Client's best interests

Under current regulation, advisors are not obligated to act in their client's best interests: that is to provide a solution which after disclosing and discounting service and transaction costs, provides an optimal balance of risk and return relative to a set of clearly defined parameters.

A model that is not obligated to provide a best interest outcome assumes that an investor is a) aware of the constraints of the service in terms of products and securities recommended and other service options available, and b) that they are initiating the transaction with full awareness of the cost/benefit trade off, and c) they could choose to transact direct and avoid the product advice, assuming of course that all products can be transacted direct.

Because they are assumed to be aware of the constraints of the transaction service option, this must mean that they have made a choice between a) having their money managed for them under the discretion of the advisor and b) managing their money themselves using the product advisor as a sounding board for product recommendations, assuming that they have processed the cost/benefit outcome.

The above assumes that an investor is aware of the parameter to parameter framework and its limitations. It also assumes that the investor has a suitability process sufficient to understand and incorporate the product into the financial universe from which they have derived the KYC parameters. If they do not have an adequate internal suitability process, they would need to seek the type of advice that would institute another's suitability process, which is a defining aspect of a fiduciary type responsibility.

It also assumes that the primary reason for the transaction request is for the advisor's product expertise and access to product distribution, which the consumer does not possess. It is important to note that many international regulators place consumer choice and a competitive market outcome (lower costs and higher standards) as a key objective of point of sale regulation.

This current transaction model is a simple one: its aim is to link the product and transaction industry with the investor without imbuing the process with responsibilities and costs that may impugn its viability. Consumers need to be made aware of the choices they have and the trade offs they are taking when they accept a particular service option.

A simple framework of significance

The Canadian model is a simple framework of significance: significance in the sense that the parameters of the client and the parameters of the product are deemed to hold all the necessary information needed to provide a transaction recommendation. Yet, there is no direct reference to the information needed to process the parameter inputs, to assimilate the transaction within the whole, or when to seek to advice that would provide such. It is assumed that this information is already known.

International regulators appear to believe that consumers have less knowledge regarding the suitability framework, are less able to operate a simple parameter interface, depend more on advisors for the suitability process and require explanation of the rationale for suitability as well as greater explanation of the product profile and the limits and parameters of the service.

The current framework assumes a lot and it has significance. The investor needs to know what they are assumed to be responsible for in this framework, and when an advisor has crossed the line demarcating advisor and investor responsibilities.

The model

If investors are to be held responsible for investment decisions under the current regulatory model, then the model would need to satisfy a number of assumptions.

1. The investor initiates the transaction, and knows they are initiating the transaction.

2. Investors independently determine the parameters to be delivered to the KYC and are not influenced by the product advisor. The KYC parameters and sums to be invested are summary outputs of an analysis of the investor's personal financial situation.

3. Investors have their own internal suitability processes which determine when and how much to invest, and how much to allocate.

4. Where leverage is part of the transaction process, the amount recorded in the margin/leverage agreement would need to be independently initiated by the investor.

5. Investors are aware of the processing and information requirements to satisfy 2 and 3 and 4, and would know when to solicit a fiduciary advice based service if they cannot meet these requirements.

6. Investors are engaging with the product advisor because of the product advisor's product knowledge and expertise with respect to aligning security selection with the KYC suitability parameters.

7. Investors are graded according to their expertise and knowledge and the product universe is expanded or constrained according to this expertise.

8. Investors are assumed to have access to a wider range of information on investments, investment styles, portfolio theories and other material to enable them to make informed transaction decisions and adequate financial and portfolio analysis, and they are aware of this.

9. On an ongoing basis, product advisors only make transaction recommendations based on the continuing suitability of the investments. The investor relates these suitability recommendations with their own processes to decide, independent of the advisor, whether to buy or sell.

10. With respect to Point of Sale disclosure, investors are aware that this disclosure provides basic information that is to be used to check compatibility with their KYC parameters, and that they still need to perform their own due diligence.

As noted, the model is simple and clearly demarcates responsibility. Also, as discussed, it is not clear how this model is intended to relate to suitability within a portfolio context and more complex products. It is critical that the investor be made aware of the assumptions of the regulated model to allow them to make an informed decision about the service they need and, if they accept the transaction model, the transactions recommended.